PRESS RELEASE

SEPTEMBER 24, 2021

DBRS Morningstar Confirms Republic of Finland at AA (high), Stable Trend

SOVEREIGNS

DBRS Ratings GmbH (DBRS Morningstar) confirmed the Republic of Finland's Long-Term Foreign and Local Currency – Issuer Ratings at AA (high). At the same time, DBRS Morningstar confirmed the Republic of Finland's Short-Term Foreign and Local Currency – Issuer Ratings at R-1 (high). The trends on all ratings remain Stable.

KEY RATING CONSIDERATIONS

The Stable trend reflects DBRS Morningstar's view that Finland's public finance and economic fundamentals remain strong, despite the substantial deterioration induced by the Coronavirus Disease (COVID-19). The Finnish economy, which has proven more resilient than originally anticipated, is expected to experience a strong recovery in 2021 and 2022 on the back of the economic reopening, strong household position, and improving external sector. The main downside risks are associated with a substantial pandemic setback. Provided that the pandemic shock is temporary, the long-lasting effects on the Finnish economy appear to be small thanks to policy support. DBRS Morningstar expects Finland's fiscal deficit to narrow over time as the economy recovers and the temporary support is withdrawn. The public debt ratio is expected to continue to increase albeit at a slower pace in coming years, but to remain manageable.

Finland's AA (high) ratings are underpinned by the strong public-sector balance sheet, which reinforces its ability to fund future liabilities, and the Finnish government's commitment to sound economic policies. Finland's wealthy economy, with significant human capital and high value-added sectors, also supports the ratings. On the other hand, an ageing population will constrain potential growth and burden public finances over the medium term. As an open and small country, Finland economic prospects are exposed to swings in external demand and global financial conditions. Furthermore, DBRS Morningstar notes that the high level of household debt, which could amplify economic downturns, remains a concern.

RATING DRIVERS

One or any combination of the following factors could trigger an upgrade: (1) progress in curbing healthcare and long-term care spending growth pressures, (2) improvement in Finland's medium-term economic performance, and (3) sustained improvement in fiscal performance and a reduction in the public debt ratio.

One or any combination of the following factors could trigger a downgrade: (1) long-lasting economic effects of the pandemic on potential economic growth, compounding the challenges from an ageing population, or (2) a deviation from prudent fiscal policies that prevents stabilisation of the public debt ratio in the longer term.

RATING RATIONALE

The Economy Showed Resilience During the Pandemic, But Ageing Population Weigh on Growth Prospects

Finland's high GDP per capita of USD 48,984 in 2020 is an important credit strength and reflects its skilled labour force, its expertise in high-tech sectors, including its leading role in digital and clean-energy technologies; and relatively strong research and development (R&D) investment intensity. Pre-pandemic, Finland's GDP growth averaged 2.1% per annum from 2016 to 2019 underpinned by a recovery in exports and investments after a prolonged period of weak economic performance. So far, the Finnish economy has proven more resilient to the pandemic shock than most of its European peers and compared with previous expectations. Finland's GDP contracted by 2.9% in 2020, well below the GDP drop of 6.0% in the EU-27. The combination of Finland's economic structure, which is less reliant on contact-intensive sectors, lower pandemic incidence and less stringent restrictions, and a strong response of the public sector underpinned the country's outperformance in 2020.

Finland's real GDP exceeded its pre-pandemic levels after growing by 2.1% on a quarterly basis in Q2 2021. The recovery has been widespread, although the travel, food and accommodation service sectors are still well below pre-pandemic levels. In tandem, the labour market has been strengthening. The trend employment rate for those aged 15 to 64 stood at 72.8% in August 2021, slightly higher than its pre-pandemic highs, although the trend unemployment rate at 7.6% remains relatively high. The easing of restrictions and the continued progress in the vaccine rollout, a projected shrinking household savings rate, the stimulus from fiscal policy and the European Union (EU) funds, and an improving situation in Finland's export markets are expected to create the conditions for a strong recovery for the next two years. The latest projections from the Ministry of Finance (MOF) point in this direction, with GDP growth accelerating to 2.6% in 2021 and to 2.8% in 2022, mostly driven by strong private consumption recovery. Noteworthy, the stronger than anticipated second quarter growth suggests that GDP growth for 2021 as a whole could be stronger than currently forecast. Looking ahead, the pandemic remains the key downside risk to the outlook, including the efficacy of vaccines. The emergence of supply-side bottlenecks, labour shortages, and cost-inflation pressures could hold back economic momentum. On the other hand, a faster drawdown of savings accumulated during the pandemic could provide additional impetus to domestic demand.

As some of the temporary tailwinds lose strength, Finland's growth is expected to converge with its potential growth rate, weighed down by unfavourable demographics and relatively weak productivity growth. The working-age population (aged 15 to 64), which had already started to dwindle in 2010, is projected to shrink in coming decades. In this context, DBRS Morningstar will continue to assess the effectiveness of different policy initiatives aimed at increasing potential growth and improving economic competitiveness. The government has implemented or is studying measures to reduce the social security disincentives to work, reduce the mismatches in the labour market that hinder employment and investment, and speed up work-based immigration processes. The government is increasing public funding to support R&D, which is high in Finland but lagging behind its Nordic peers, as well as providing tax incentives for business investment.

Strong Fiscal Track-Record But Pandemic And Population Age-Related Expenditures Weigh on Public Finances

DBRS Morningstar considers Finland's track record and commitment to prudent fiscal policy, supported by a strong fiscal framework, to be key credit strengths. Before the pandemic hit, Finland managed to lower its fiscal deficit to 0.9% of GDP in 2019 from 3.0% of GDP in 2014 by controlling expenditures and benefitting from employment growth generated through measures in the Competitiveness Pact. The pandemic-induced recession, which triggered Finland's strong automatic stabilisers, and the introduction of supplementary discretionary policies substantially widened the country's fiscal deficit-to-GDP ratio to 5.4% in 2020. To cushion the impact from the shock of the pandemic, the government implemented targeted grants to support businesses, extended unemployment and social benefits, reduced private-sector pension contributions, and enhanced the healthcare response. The impact of the coronavirus-related measures on the fiscal deficit is estimated at 2.9% of GDP in 2020 and 1.7% of GDP in 2021. The government has authorised some below-the-line measures including guarantees, loans, and capital injections for over 5.0% of GDP.

The MOF's latest projections, more positive in light of the more favourable macroeconomic environment, foresee a gradual improvement in Finland's fiscal position as the economy recovers and the coronavirus-related measures are phased out. The MOF projects the fiscal deficit to remain high at 4.3% of GDP in 2021, weighed on by coronavirus-measures, before shrinking to 2.6% of GDP in 2022. The stronger activity could lead to somewhat better fiscal outturns. The 2022 Draft Budget, which envisages a significant drop in COVID-19 related spending and a strong rebound in revenues amid a strong recovery, includes measures aimed at supporting the green transition, digitalisation, boosting investment and labour availability. The draft budget proposes the allocation of EUR 1.2 billion of the EUR 2.1 billion in grants Finland is expected to receive under the EU's Recovery and Resilience Facility between 2021 and 2026. The deficit is not expected to return to its pre-coronavirus levels until at least 2025 as the aftermaths from the pandemic are expected to compound Finland's demographic-driven spending pressures.

The main challenge for the public accounts in the medium to long term is the increasing fiscal pressure from an ageing and shrinking working-age population. In relation to this, after more than a decade in the making, the Finnish parliament approved the plan to transfer the responsibility for organising health, social, and emergency services to newly created 'wellbeing services counties' from the municipalities by the start of 2023. The reform is expected to create transitional costs for several years and to potentially generate savings around the turn of the decade and onward, which will hinge on the potential economies of scale and the incentives for an efficient provision of these services. DBRS Morningstar will continue to monitor its implementation to assess the effectiveness of the reform in curbing age-related spending in the medium to long-term.

Public Debt Increases, But Healthy Public-Sector Balance Sheet and Very Favourable Financing Costs and Debt Profile Mitigate Risks

Finland's strong public finances have provided sufficient room to cushion the coronavirus-related shock. As a consequence, the public debt-to-GDP ratio considerably increased to 69.5% in 2020 from 59.5% in 2019, reversing the reduction that took place during 2016–19. The MOF projects the debt ratio to continue edging slowly higher towards 75.0% by 2025. The International Monetary Fund (IMF) envisages a less-pronounced increase in the debt ratio to 71.2% by 2026. A relatively high and rising stock of explicit guarantees—around 25.0% of GDP in 2021 for the central government—or its implicit liabilities associated with a relatively large banking sector pose additional risks to the public debt ratio.

Despite higher public debt levels, Finland's strong public balance sheet and good debt affordability reinforce the government's ability to fund its liabilities. The general government net financial assets ratio stood at 64.5% of GDP in 2020, although around two-thirds of the assets are ring-fenced for pension payments and not available for budgetary purposes. Finland's central government debt has an average maturity of 7.3 years and minimal exchange-rate risks after swaps. Finland's financing costs remain very favourable, with the 10-year government bond yield generally staying in the negative territory since mid-2019.

Financial System is Sound and Risks to Financial Stability are Contained

The Finnish banking system remained strong, despite the more challenging operating environment caused by the pandemic. According to European Banking Authority data, Finnish banks' CET 1 capital ratio of 18.1% and leverage ratio of 5.8% at Q1 2021 remain healthy and higher than the EU averages. Despite the pandemic-led substantial increase in loan loss provisions and lingering pressure from the ultra-low interest rate environment, Finnish banks' profitability levels were still positive and better than the EU average in 2020. While the ultimate impact of the pandemic on the hardest hit sectors remains unclear, early indicators suggest a moderate impact. Asset quality remains strong, with a very low nonperforming loans ratio at 1.43% at Q1 2021. The strong capital buffers should allow the Finnish banking system to absorb a potential deterioration in asset quality over time, especially for the most affected sectors when support is eventually withdrawn, and continue to provide credit to the economy under most scenarios. On the other hand, the Finnish banking system's relative size, concentration, interconnectedness, and reliance on wholesale funding are structural features that could amplify shocks to the economy, especially if combined with investor confidence deterioration.

DBRS Morningstar notes that Finland's high level of household debt, at 140.0% of disposable income in Q1 2021, is still below its Nordic peers, but the continuously increasing level remains a source of concern. On a more positive note, Finland's fully amortising mortgages, stricter credit policies, and lower tax deductibility have helped to contain further build-ups of risks in recent years. DBRS Morningstar considers the risks to financial stability to be contained. The banks remain highly exposed to the property market; however, there is no discernible evidence of significant imbalances in the residential or commercial property market.

Finland Has Recovered Cost-Competitiveness and Shows No Evidence of External Imbalances

Before the pandemic, Finland had largely restored cost-competitiveness thanks to the Competitiveness Pact and to wage moderation between 2016 and 2018. The current account recorded an average deficit of 1.4% of GDP during 2011–19, with no signs of imbalances building up in DBRS Morningstar's view, given its small and stable pattern. This period was preceded by ample current-account surpluses before the structural decline in demand for Nokia's handset business and paper products. Against the pandemic backdrop, the current account shifted to a surplus of 0.8% in GDP in 2020, driven by a reduction in the primary-income deficit and a stronger trade balance surplus that offset a wider service deficit. Going forward, Finland's information and communications technology exports and capital and intermediate goods exports could benefit from a strong recovery in its most important export markets (northern Europe, the United States, and China) and a global investment increase. Finland's net international investment position amounted to 8.8% of GDP at Q1 2021. While Finland's gross external debt-to-GDP ratio remains high at 249.6% of GDP, a sizable portion of these liabilities corresponds to long-term debt and intercompany lending, which tends to be more stable than other sources of financing.

Strong Institutional Framework and Policy Stability

Finland's political and institutional framework is among the strongest in the world, consistently ranked among the top performers in the World Bank's governance indicators. Despite the political fragmentation, a tradition of coalition governments with strong majorities leads to stable and consensus-based policy making. Prime Minister Sanna Marin of the Social Democratic Party heads a five-party centre-left coalition government that holds a majority in parliament. In response to the deterioration generated by the coronavirus, the government outlined its objective to stabilise the government debt-to-GDP ratio by the end of the decade, with an emphasis on economic growth, employment, public administration efficiency, and healthcare and social services reform. The current government programme includes the objective of reaching carbon neutrality by 2035 and becoming carbon negative soon after.

ESG CONSIDERATIONS
A description of how DBRS Morningstar considers ESG factors within the DBRS Morningstar analytical framework can be found in the DBRS Morningstar Criteria: Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings at https://www.dbrsmorningstar.com/research/373262.

For more information on the Rating Committee decision, please see the Scorecard Indicators and Building Block Assessments. https://www.dbrsmorningstar.com/research/384844.

EURO AREA RISK CATEGORY: LOW

Notes:
For more information regarding rating methodologies and Coronavirus Disease (COVID-19), please see the following DBRS Morningstar press release: https://www.dbrsmorningstar.com/research/357883

All figures are in euros (EUR) unless otherwise noted. Public finance statistics reported on a general government basis unless specified.

The principal methodology is the Global Methodology for Rating Sovereign Governments https://www.dbrsmorningstar.com/research/381451/global-methodology-for-rating-sovereign-governments (July 9, 2021). Other applicable methodologies include the DBRS Morningstar Criteria: Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings, https://

www.dbrsmorningstar.com/research/373262/dbrs-morningstar-criteria-approach-to-environmental-social-and-governance-risk-factors-in-credit-ratings (February 3, 2021).

The sources of information used for this rating include Ministry of Finance (Summer Economic Survey, June 2021; Government Negotiations on the Budget 2022, September 2021; Recovery and Resilience Plan, August 2021), Central Government Debt Management Office, Statistics Finland (Tilastokeskus), Bank of Finland, European Commission, European Banking Authority, Finnish Financial Supervisory Authority, European Centre for Disease Prevention and Control, Ministry of Social Affairs and Health (Health and Social Services Reform), The Social Progress Imperative (2020 Social Progress Index), European Central Bank, Statistical Office of the European Communities, Bank of International Settlements, Organisation for Economic Co-operation and Development, IMF, World Bank, UNDP, and Haver Analytics. DBRS Morningstar considers the information available to it for the purposes of providing this rating to be of satisfactory quality.

With respect to FCA and ESMA regulations in the United Kingdom and European Union, respectively, this is an unsolicited credit rating. This credit rating was not initiated at the request of the issuer.

With Rated Entity or Related Third Party Participation: YES
With Access to Internal Documents: NO
With Access to Management: NO

DBRS Morningstar does not audit the information it receives in connection with the rating process, and it does not and cannot independently verify that information in every instance.

Generally, the conditions that lead to the assignment of a Negative or Positive trend are resolved within a 12-month period. DBRS Morningstar's outlooks and ratings are under regular surveillance.

For further information on DBRS Morningstar historical default rates published by the European Securities and Markets Authority (ESMA) in a central repository, see: http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. DBRS Morningstar understands further information on DBRS Morningstar historical default rates may be published by the Financial Conduct Authority (FCA) on its webpage: https://www.fca.org.uk/firms/credit-rating-agencies.

The sensitivity analysis of the relevant key rating assumptions can be found at: https://www.dbrsmorningstar.com/research/384842.

This rating is endorsed by DBRS Ratings Limited for use in the United Kingdom.

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For more information on this credit or on this industry, visit www.dbrsmorningstar.com.

Ratings

Finland, Republic of

Date Issued	Debt Rated	Action	Rating	Trend	Attributes
24-Sep-21	Long-Term Foreign Currency - Issuer Rating	Confirmed	AA (high)	Stb	EU U
24-Sep-21	Long-Term Local Currency - Issuer Rating	Confirmed	AA (high)	Stb	EU U
24-Sep-21	Short-Term Foreign Currency Debt - Issuer Rating	Confirmed	R-1 (high)	Stb	EU U
24-Sep-21	Short-Term Local Currency Debt - Issuer Rating	Confirmed	R-1 (high)	Stb	EU U

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