

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 strong public finances and economic fundamentals mitigate the risks posed by Russia's invasion of Ukraine. The Finnish economy recovered swiftly from the pandemic shock with no significant long-term economic scarring effects. GDP growth continued to be strong during the first half of 2022; however, the energy crisis sparked by Russia's invasion of Ukraine is expected to slow down growth as we move towards next year. The main risks to the economic outlook are linked to the evolution of the energy crisis in Europe, the inflationary dynamics, and the degree of tightening of financial conditions. Finland's traditionally high commercial linkages with Russia have continued to shrink this year and the effects from Russia's gas and electricity cut-off are manageable. During 2021 and part of 2022, Finland's strong economic rebound and the phasing out of the pandemic support measures have helped public finances to rebalance. On the other hand, the weaker economic backdrop and the measures to cope with the fallout from the invasion will increasingly weigh on public finances. Given the spending pressures from an ageing population amid relatively modest growth prospects, reversing the projected gradual increase in the public debt ratio will most likely require additional fiscal consolidation measures in the future.

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 economy, Finland's economic prospects are exposed to swings in external demand and to 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) an 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) a material and persistent worsening in Finland's economic performance, (2) a deterioration in Finland's fiscal performance leading to a sustained increase in its public debt ratio, and (3) a substantial crystallisation of contingent liabilities.

RATING RATIONALE

After a Rapid Recovery From the Pandemic, the Energy Crisis Poses Economic Risks

Finland's high GDP per capita, at USD 54,008 in 2021, is an important credit strength and reflects a skilled labour force, high-value-added sectors, and a relatively strong research and development 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. The pandemic halted this positive trend and resulted in a contraction in output of 2.2% in 2020, however, relatively mild from an international perspective thanks to Finland's relatively smaller contact-intensive sectors, better pandemic outcomes, and sizeable policy support. With the reopening of the economy, Finnish real GDP grew by 3.0% in 2021, driven principally by the revival in domestic demand, staging one of the quickest recoveries in Europe and recovering its pre-pandemic activity levels already in Q2 2021. The labour market proved resilient too, benefiting from government support. As of August 2022, the trend employment rate for those aged 15 to 64 stood at 73.6%, exceeding the 72.6% reached in February 2020 and well above the average level of 67.2% during 2015. The trend unemployment rate still remains slightly above pre-pandemic levels at 7.2%.

Economic activity continued to be strong during the first half of 2022, with GDP growth at 1.0% QoQ in Q2; however, the energy crisis sparked by Russia's invasion of Ukraine is intensifying the recessionary risks in the near term. The effects of the energy crisis, which is fuelling inflation and causing a tightening of financial conditions, are expected to intensify ahead of the winter. Finland's consumer price inflation reached 7.6% YoY in August 2022. The erosion of households' purchasing power, higher interest costs, and elevated energy bills will erode domestic demand at the same time that European growth slows down significantly. Subject to elevated uncertainty, the Ministry of Finance projects GDP growth to slow down to 1.7% in 2022 and to 0.5% in 2023 before picking up to 1.4% in 2024. The main risks to the outlook relate to the severity and duration of the economic fallout of Russia's invasion, which could exacerbate the energy/raw material price pressures and cause energy supply shortages, as well as the possibility of faster and more pronounced monetary policy tightening if inflation proves more persistent than anticipated.

Over the medium to long term, countering the effects of unfavourable demographics and relatively weak productivity growth will remain key to Finland's economic prospects. In this sense, DBRS Morningstar will continue to monitor the effectiveness of the government reforms and investments in raising employment, investment, and productivity in coming years.

Finland Benefits From a Strong Fiscal Track Record, but 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. After a marked deterioration of the fiscal deficit-to-GDP ratio to 5.5% in 2020 triggered by the pandemic, the ratio improved to 2.7% in 2021 driven by the rapid economic recovery and the phasing-out of coronavirus support. Rapid revenue growth, spurred by activity and employment growth, and the end of the vast majority of coronavirus support measures are helping public finances to continue to rebalance in 2022. On the other hand, a slowdown in economic and employment growth and the implementation of measures to support households and firms absorb higher energy prices are expected to increasingly weigh on the fiscal deficit ratio. The Ministry of Finance now projects the fiscal deficit ratio to decline to 1.4% in 2022 before deteriorating to 2.2% in 2023 and 2024. The main risks in the near term are linked to a weaker evolution of the economy, the need for further measures to deal with the unforeseen effects from the energy crisis, higher healthcare spending due to the backlog created by the pandemic, and higher public wages.

The main challenge for Finland's public sector 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 potential economies of scale and

incentives for an efficient provision of these services. DBRS Morningstar will continue to monitor Finland's implementation of this reform, in order to assess its effectiveness in curbing age-related spending in the medium to long term.

The Public Debt Ratio Increased Because of The Pandemic, but a Healthy Public-Sector Balance Sheet Mitigates Risks

Before the pandemic, Finland's public debt as a percentage of GDP increased significantly to 64.9% in 2019 from 34.7% in 2008. Still, Finland's strong public finances provided sufficient room to cushion the coronavirus-related shock, albeit at the expense of lifting the ratio to 74.8% in 2020. The public debt ratio dropped to 72.3% in 2021, helped by strong nominal growth and a shrinking fiscal deficit. Notably, Finland's general government debt statistics from 2000 have been revised this summer to include the interest subsidy loans provided by the Housing Finance and Development Centre of Finland, which represented around 6.1% of GDP in Q4 2021, as part of the general government consolidated EDP debt, instead of being accounted in the state guarantees. The Ministry of Finance projects the public debt ratio to continue declining to 71.2% in 2022, before gradually increasing to 72.7% in 2023 and 74.1% in 2024.

The stock of explicit guarantees of the state, at around 20.0% of GDP in 2021, after excluding the interest subsidy loans, pose additional risks to the public debt ratio. Finland's stock of explicit guarantees has been increasing steadily in recent years and is among the highest in the EU in terms of GDP. Furthermore, the Finnish government recently proposed the introduction of a EUR 10 billion loan and guarantee scheme to ease liquidity needs of electricity producers in Finland. Nevertheless, 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 66.4% of GDP in Q1 2022, 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 7.7 years and minimal exchange-rate risk after swaps. While funding costs have been increasing rapidly this year, DBRS Morningstar notes Finland's lengthy debt profile means higher funding costs will permeate only gradually.

Financial System is Sound and Risks to Financial Stability are Contained

The Finnish banking system weathered the impact of the pandemic thanks to its strong initial position that was enhanced by the response at the national and euro system level. According to European Banking Authority data, the Finnish banks' CET1 capital ratio of 17.5% and leverage ratio of 5.5% remained healthy and higher than the EU averages as of Q1 2022. Profitability has recovered thanks to lower provisioning during 2021, and asset quality has remained strong with the nonperforming loans ratio at 1.1% in Q1 2022. While Finnish banks' direct exposure to Russia is limited, representing less than 0.1% of total assets according to the Finnish Financial Supervisory Authority, a weaker operating environment and tighter financing conditions could lead to a deterioration in asset quality. Also, the invasion has increased cyber-security risks. DBRS Morningstar considers that Finnish banks' strong capitalisation provides sufficient buffers to absorb potential losses and continues to provide credit to the economy under most scenarios.

The main vulnerabilities of the financial system are linked to the level of household indebtedness and the structure of the banking system. Household indebtedness, at 134.4% of adjusted disposable income in Q2 2022, has increased steadily over time and remains a source of concern, although it is still below its Nordics peers. 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. Furthermore, Finland's fully amortising mortgages, stricter credit policies, and lower tax deductibility have helped to contain further build ups of risk in recent years. 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. Therefore, retaining the strong confidence among investors that Finnish banks enjoy will remain important under a more challenging environment.

Finland's Restored Cost-Competitiveness Will Help Absorb the Higher Energy Cost on the External Account

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. While the current account turned to positive territory during 2020–21, the Russian invasion of Ukraine has intensified the headwinds on the external front mainly through lower bilateral trade, a weaker external backdrop, and more expensive energy imports. Russia traditionally has been an important trading partner for Finland; however, trade links between the countries have materially diminished since 2013 and even more in recent months as a consequence of the sanctions and voluntary decoupling. Finland’s exports of goods and services to Russia shrank to 2.2% of total in Q2 2022 compared to 4.0% in Q4 2021, while imports of goods and services from Russia declined to 3.9% of total from 10.0%, over the same period. Finland has been able to rely more heavily on Norway and Sweden to at least partially replace its energy dependence from Russia following the energy and gas cut off. Finland’s net international investment position was 1.3% of GDP at Q2 2022, however, the country’s elevated gross external debt-to-GDP ratio at 229.7% of GDP in Q2 2022 remains a source of concern, given the cross-border exposures of the financial sector, including wholesale funding.

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 policymaking. Prime Minister Sanna Marin of the Social Democratic Party heads a five-party centre-left coalition government that holds a majority in parliament. The next parliamentary elections are scheduled for 2 April 2023. DBRS Morningstar expects, regardless of its composition, the next administration to implement measures to help the economy deal with the energy crisis and to remain committed to prudent fiscal policy-making in the medium term. Russia’s invasion of Ukraine resulted in a historic change in Finland’s defence policy, ending its historical neutrality and leading to its application for NATO membership. Finland will hold an invitee status until the accession protocols have been ratified by the NATO members and the Finnish parliament.

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

There were no Environmental, Social, and Governance factors that had a significant or relevant effect on the credit analysis.

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/396929/dbrs-morningstar-criteria-approach-to-environmental-social-and-governance-risk-factors-in-credit-ratings> (17 May 2022).

For more information on the Rating Committee decision, please see the Scorecard Indicators and Building Block Assessments. <https://www.dbrsmorningstar.com/research/403026>.

EURO AREA RISK CATEGORY: LOW

Notes:
All figures are in euros 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/401817/global-methodology-for-rating-sovereign-governments> (August 29, 2022). Other applicable methodologies

include the DBRS Morningstar Criteria: Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings, <https://www.dbrsmorningstar.com/research/396929/dbrs-morningstar-criteria-approach-to-environmental-social-and-governance-risk-factors-in-credit-ratings> (May 17, 2022).

The sources of information used for this rating include the Ministry of Finance (Autumn Economic Survey, September 2022; Press Release - Supplementary budget proposal to secure the effective functioning of the electricity market, September 5, 2022), Bank of Finland (Bulletin 2, July 2022; Bulletin 1, May 2022), Central Government Debt Management Office, Statistics Finland (Exceptional Revision in the Financial Accounts Statistics, June 2022), European Commission, European Banking Authority, Finnish Financial Supervisory Authority (Press Release — Press Conference March 15, 2022), Ministry of Social Affairs and Health (Health and Social Services Reform), Ministry of the Environment (Press Release - March 3, 2022), The Social Progress Imperative (2021 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, 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.

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

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The sensitivity analysis of the relevant key rating assumptions can be found at: <https://www.dbrsmorningstar.com/research/403025>.

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

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Ratings

Finland, Republic of

Date Issued	Debt Rated	Action	Rating	Trend	Attributes
23-Sep-22	Long-Term Foreign Currency - Issuer Rating	Confirmed	AA (high)	Stb	 
23-Sep-22	Long-Term Local Currency - Issuer Rating	Confirmed	AA (high)	Stb	 
23-Sep-22	Short-Term Foreign Currency Debt - Issuer Rating	Confirmed	R-1 (high)	Stb	 
23-Sep-22	Short-Term Local Currency Debt - Issuer Rating	Confirmed	R-1 (high)	Stb	 

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