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 16-07-2021 "Sovereign Ratings" "Rating Criteria and Definitions"

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Rating Action

Neuss, 16 July 2021

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. Finland's prosperous and well-diversified economy has been able to navigate fairly successfully through the corona crisis so far, with growth significantly less impaired in comparison to European peers; we expect to see healthy growth in 2021/22, buttressed by recovering household spending and flourishing goods exports, while investment activity should accelerate on the back of waning economic uncertainty
2. Enduring structural challenges remain a matter of concern, as a rapidly aging working-age population coupled with sluggish labor productivity growth linked to the demise of the key electronics industry and tepid R&D investment, as well as growing skill shortages and incipient challenges related to labor market matching, drag on the economy's underlying growth; vital reforms have been initiated but will take time to take root
3. Sovereign continues to boast one of the most sound institutional frameworks worldwide, displaying exceptionally and persistently high quality along all governance dimensions; extensive benefits from EU/EMU membership; while the health and social services reform had been delayed for years, policymakers have finally approved the laws, strengthening our belief in Finland's high responsiveness to structural challenges
4. Despite substantial, pandemic-related increase, debt-to-GDP still well below the euro area average; while debt ratio should continue to creep up, we view risks to fiscal sustainability - which are further reinforced by rising aging costs and high continent liabilities – as contained in the medium term, given very strong and increasing debt affordability, sizable government assets, as well as prudent debt management and credible policy-making
5. We believe external risks to be modest and mainly related to the large share of deposit takers in external debt; small current account surplus after a run of moderate deficits, and a positive net international investment position (NIIP)

Reasons for the Rating Decision and Latest Developments[1]

Macroeconomic Performance

Our credit assessment of Finland is backed by a strong macroeconomic performance profile which continues to reflect very high per capita incomes and moderate, albeit relatively stable trend growth. The Finnish economy seems to have weathered the crisis fairly well, and trend growth looks set to take a relatively mild hit in the wake of the corona crisis. Infection rates have been comparatively low by international standards, thus prompting less stringent restrictive measures, with its economy benefiting from its economic structure, a high affinity for remote work, and a relatively low population density. Finland's economy appears to have regained some lost ground in terms of cost competitiveness, while non-cost competitiveness remains high. Non-financial corporations (NFCs) command over notable risk buffers, but household debt has to be followed closely as it has continued to increase during the crisis. Potential growth remains dragged down by laggard productivity growth and the rapidly aging workforce, translating into rather subdued economic prospects for the medium- to longer term.

The Covid-19 pandemic pushed the Finnish economy into its deepest recession since the global financial crisis (GFC) when real GDP contracted by 8.1% (2009). Before the corona crisis hit, Finland posted reasonably solid growth rates in a euro area (EA) comparison, averaging at 1.8% p.a. in 2015-2019 (EA: 1.9%), though markedly trailing its Nordic peers Denmark and Sweden (2.7% and 2.6% respectively). Last year, total output dropped by 2.9%, which nevertheless appears moderate as opposed to its fellow EU member states, as economic fallout was ultimately less severe in only a few European economies; the euro area's economy plunged by 6.5% (EU: -6.1%).

As a consequence, Finland's per capita income did not weaken to the same degree as in other European economies. Indeed, the decline by 1.8% was one of the lowest in the EU. Drawing on latest IMF estimates, GDP per capita totaled USD 49,853 (PPP terms, current prices, outstripping that of AA-rated peers such as France (USD 46,062) and the UK (USD 44,117), and lying above the 'AA' median. That said, we observe a considerable gap towards other AA peers Austria and Belgium, and also with Nordic peers Denmark (USD 58,933) and Sweden (USD 54,146).

We think that Finland's comparatively moderate economic damage can be traced back to the relatively low infection rates observed in the subsequent waves. The cumulative 14-day infection rate peaked during Finland's third wave at only 173.4 in week 11 in 2021, while hitting a transitory high of a mere 111.9 back in Q4 – both substantially below the levels seen in all other EU member states. Low infection rates, in turn, necessitated significantly less stringent containment measures, as illustrated by the Stringency Index compiled by Blavatnik School of Government.

Sharp rises in coronavirus cases may have been avoided due to characteristics of the Finnish economy, such as its population density, which in fact is the lowest in the EU (2019: 18.2 per km2). Furthermore, tourism is of minor importance, accounting for 2.7% of Finland's gross value added (GVA) in 2018, one of the lowest readings among OECD members. More generally, 'trade, transport, accommodation and food services, which have been heavily hit by the pandemic, accounted for only 15.4% of total gross value added in Q4-19 (EA: 18.9%, Eurostat data). We also note that Fins tend to be more inclined to teleworking than workers in other EU states, judging

[1] This rating update takes into account information available until 14 July 2021.

by pre-pandemic survey data (Eurostat, 2019). As of March 2021, 58.6% of Finland's workforce worked remotely, and more than 70% of Finnish workers were satisfied with working from home (2nd highest in EU), according to a Eurofound survey.

That being said, the brunt of collapsing total output was borne by private consumption, as in other European economies. The government's support measures averted more severe damage, stabilizing labor market conditions (see below) and disposable income, but economic uncertainty in tandem with confinement measures pushed up precautionary and forced household savings, causing the households' savings rate to jolt to its highest level since the early 1990s (4.9%, 2019: 0.8%). Household spending slumped by 4.7%, almost twice as high as during the GFC, thereby shaving off 2.5 p.p. of real GDP growth.

The Finnish manufacturing sector proved remarkably resilient, as indicated by monthly data on industrial production throughout 2020. However, uncertain and weak economic prospects stifled business investment as investment decisions were pushed back into the future or abandoned altogether, mainly felt in machinery and equipment investment, which fell by 3.0% in 2020. Still, overall gross fixed capital formation only decreased by 0.7% on the year, due to the lower decline in construction investment (buildings and structures, -0.4%) which was supported by public investment.

Amidst disruptions in global value chains, extreme economic uncertainty, and receding investments in Finnish export markets, external trade surprised on the upside, as the impact was not as severe as we had expected by the middle of last year. Exports in goods staged a strong rebound in the second half of 2020, expanding by 4.3% and 9.1% q-o-q, with the Q4 outturn being boosted by large cruise ship orders. Goods exports had recouped their losses by the end of the year (on a quarterly basis), whilst services exports suffered (2020: -15.9%), causing overall exports to decline by 6.7%, while imports fell by 6.4%, resulting in a slightly negative growth contribution of net external trade.

With a view to this year and the next, we expect a brisk recovery, which is likely to be led by a strong bounce back in household spending, robust export growth, and gradually accelerating investment activity. The year was off to a modest start, as real GDP growth only stagnated in the first quarter against the preceding one. Whilst the decline in private consumption (-0.6% q-o-q) was to be expected due to tightened restrictive measures, investment was mildly supportive of output growth (+0.2%). Exports plunged (-6.2%), but base effects due to the aforementioned ship exports likely played a key role here.

We hold Q1 as a minor setback and see the stage set for a strong recovery going forward as confinement measures are gradually removed, in lockstep with significant headway on the Finnish vaccination front. In March and April this year, a state of emergency was temporarily reinstated in the wake of a third infection wave. The most restrictive measures were lifted by June, and the remaining restrictions are to be wound down by August, according to the government's targeted schedule.

As elaborated above, infection cases may be deemed relatively low. The 14-day cumulative infection rate stood at only 38.5 in week 27. The government has forged ahead with its plan to prioritize first-dose inoculations. Almost 77% of its population have thus received a first dose as of week 27, the fifth-highest share in the EU, whereas only 30.4% of the population has been fully vaccinated.

Ultimately, we view progress in Finland's vaccination campaign as instrumental for the recovery to take a firm hold. We project real GDP to rise by 2.8% in 2021, before economic growth accelerates to 3.0% in 2022, but have to emphasize that any forecast remains subject to unusually high uncertainty, essentially in view of new strains of the virus, such as the Delta variant which accounts for a worryingly rising share in virus cases in Europe.

Exports should be fostered by increasing external demand from key export markets such as Germany, the Netherlands, and Sweden, in which we also expect to see reinvigorated growth. Moreover, we think that goods exports will benefit from solid global manufacturing. Indeed, export expectations in the industrial sector have recovered, reaching their highest level since Q4-18. Overall, we expect a rather modest positive contribution of net external trade in 2021/22, since imports should be propelled by rising export activity and recovering domestic demand.

The biggest growth impetus should thus come from private consumption amid the winding down of Covid-19-related restrictions on economic activity, and we expect households to gradually draw down on their tremendous stock of savings accumulated over the crisis, in tandem with diminishing economic uncertainty. Household spending is likely to perk up further in 2022, as restrictive measures will be prospectively removed by then. Households surveyed appear increasingly upbeat, with consumer sentiment at its highest levels since the beginning of 2018. We see purchasing power generally aided by still favorable financing conditions, as well as solid wage and employment growth.

The Finnish labor market has proven rather resilient during the Covid-19 pandemic, largely due to the government's support measures, the extended and modified furlough scheme in particular. The number of workers on full-time furlough peaked in Apr-20 (~ 163,700) and dwindled to roughly 41,000 this May (Statistics Finland). Annual unemployment edged up from 6.7% to 7.8% in 2019-20 (LFS-adjusted), but remained well below the levels observed in 2013-18, and on par with the euro area average.

Looking forward, we expect unemployment to recede gradually, driven by economic recovery and the government's labor market measures (see below). On a monthly basis (LFS-adj.), unemployment is trending downwards after having peaked at 8.8% in August 2020, now standing at 7.8% in May. Concurrently, employment should evolve favorably, and we see the narrowing decline in employment, from -1.5% y-o-y in Q4-20 to -0.8% in Q1, as a harbinger of the recovering labor market. By the same token, vacancies have caught up over the last quarters, at almost 60,000 already posting at pre-pandemic levels again.

Brightening economic prospects and waning uncertainty, together with tailwinds from export growth and public investment, should help investment activity to gain traction going forward. In addition, low funding costs remain in place, and corporate profitability has held up well so far, also thanks to official aid measures. The profit share of NFCs stood at 29.3% in Q1-21 as compared to a pre-pandemic level of 29.9% in Q4-19. Business confidence in the industrial sector has returned and order books are well-filled, judging by May's survey data, both hinting at continued growth in machinery and equipment investment. In the same vein, capacity utilization almost matched its long-term average in Q2-21. In addition, Q3 and Q4 (2020) building permit data suggests that housing investment should also lend some support to investment growth.

Meanwhile, we think that Finland's medium- to longer-term outlook remains dampened by longstanding structural challenges. According to latest estimates by the European Commission (EC), Finnish potential growth will rise to 1.4% in 2021 and 2022 respectively. While this would put the

Nordic state on par with the euro area average in 2022, it would fall significantly short of the 2.2% and 2.1% projected for Denmark and Sweden.

As recently affirmed by the EC's Aging Report 2021, Finland already displays one of the highest old-age dependency ratios in the EU (2019: 38.9%, 20-64y), and is projected to rise by another 7.9 p.p. by 2030. Hence, labor input will likely continue to provide little stimulus to underlying growth, being curbed by a rapidly declining working-age population, with net migration (2030: 0.2% of population) unlikely to alter this picture significantly.

What is more, labor productivity growth is relatively low, having averaged at only 0.4% between 2011 and 2020 (per hour worked) as compared with 0.9% in the euro area as a whole. As a result, Finland's labor productivity now accounts for 108.3% of the EU total (2011: 114.6%) vs. 109.9% in the euro area. To be sure, the country can be regarded as leading in terms of education and innovation, the latter repeatedly underscored by e.g. the EU innovation scoreboard. Still, shortages of skilled labor appear to be emerging, and Finland has fallen behind relative to its European peers when it comes to its tertiary educational attainment, with the respective share (25-34y) having increased by only 4.4 p.p. in 2011-20 (EA: 8.2 p.p.). Also, investment in R&D has been virtually stagnant over recent years, standing at 2.8% of GDP in 2019 (2015: 2.9%). We believe both factors rather hamper the economy's underlying growth.

By contrast, cost competitiveness of the Finnish economy appears to have strengthened over recent years, suggesting that reforms have been partly successful in restoring the economy's competitiveness. Labor productivity was thus more aligned with the development of real compensation per employee. As a corollary, real unit labor costs have evolved more favorably than in Finland's European key trading partners and the euro area overall. Drawing on AMECO data, real ULC dropped by 5.0% in 2015-20, whilst increasing by 2.6% in the euro area overall. Likewise, Finland's global export market share has been on the rise over recent years, following a multi-year decline up to 2015, and continued to increase slightly to 0.44% in 2020.

In our opinion, the sovereign's economy continues to be characterized by strong non-cost competitiveness, as highlighted by the World Economic Forum's (WEF) assessments. Its latest Global Competitiveness Report (2019) placed Finland at rank 11 out of 141 economies. While awaiting an update in this respect, the WEF evaluated which countries are better prepared for an economic transformation in the aftermath of the corona crisis, e.g. by creating a vibrant business environment, or preparing its labor force for future labor market demands; Finland is attested the best performance on economic transformation readiness overall (1st out of 37 economies).

On a more cautious note, we remain wary of debt trends in the Finnish private sector. NFCs were not only able to retain their profitability during the corona crisis, but indebtedness of NFCs increased by a mere 3.9 p.p. to a moderate 85.0% of GDP in the year up to Q4-20, broadly in line with its 2010-2019 average (86.4% of GDP). At the same time, we are somewhat more concerned with a view to the unabated rise in household indebtedness, mainly driven by mortgage lending and low funding costs. Household debt totaled 118.2% of disposable income in Q4-20, up from 114.9% a year before, and among the highest levels in Europe (ECB data). We note that Finnish authorities are aware of these developments, essentially against the backdrop of increasing residential property prices (see below).

Institutional Structure

The sovereign's credit ratings continue to be supported by the extremely high quality of its institutional framework, which is standard-setting from a global perspective, and mirrors Finland's outstandingly high governance standards and track record of sound and predictable policy-making. Institutional conditions are supported by membership in the European Union and European Monetary Union, as well as by high-quality institutions in the fiscal (National Audit Office), financial (FIN-FSA), and monetary (ECB) realms. As regards the latter, we observe that Finnish HICP inflation and MFI interest rates have been broadly aligned with the euro area over the last decade. Thanks to a broad consensus on overarching policy goals, the landmark health and social services reform (SOTE) has thus been finally adopted.

The Republic of Finland's extraordinarily and persistently high institutional quality continues to be reflected by the Worldwide Governance Indicators (WGI) assembled by the World Bank. The sovereign is not only among the leading countries worldwide in this respect, but can look back on a remarkable track record of being consistently ranked among the top ten out of 209 economies worldwide over the last two decades, and this in all the WGIs we assess. Accordingly, Finland obviously surpasses not only the euro area average, but also the respective 'AA' and 'AAA' median readings in our rating universe.

We have observed no significant changes since our last review. An outstanding rank 1 out of 209 economies on the WGI rule of law continues to attest a very high quality of property rights and contract enforcement as well as a high level of perceived judicial independence. We note that Finland was ranked first in seven out of the last ten assessments. Additionally, the sovereign continuously seeks to enhance the independence and effectiveness of its judiciary, as mirrored by the implementation of the National Courts Administration in 2020 and the restructuring of the prosecution service back in 2019. The EC notes in its Rule of Law Report that it sees challenges related to digitalizing the justice system, but we are quite confident that decision-makers will swiftly ramp up capacities, as Finland ranks first in the 2020 Digital Economy and Society Index (rank 4 on digital public services).

The sovereign improved from a relative rank 4 to rank 3/209 in terms of the WGI voice and accountability which measures freedom of expression and association, as well as free media, while being assessed to be one of the least corrupt states in the world, reflected by an excellent rank 3 on control of corruption. The government plans to establish a transparency register which is geared towards ameliorating transparency with regard to lobbying actions; a parliamentary working group put forward a proposal this May. We also gather that policy-makers intend to tighten post-employment restrictions for civil servants, having tabled a bill amending the Civil Service Act.

Moreover, perceived quality of policy formulation and implantation remains very high, as indicated by rank 4 on the WGI government effectiveness, with Denmark being the only EU country faring better in this regard. Against this backdrop, we believe that sound and credible policy-making and a high degree of responsiveness to meeting structural challenges remain decisive credit strengths. As in other European countries, a more fragmented political environment has not made policy-making easier, e.g. reflected by two no-confidence motions tabled in 2021 alone. Nevertheless, we see the government's ability to effectively formulate and implement reforms as given, recently highlighted by the adoption of the SOTE.

Whilst significant delays in the implementation of the SOTE reform had given some rise to questions concerning the sovereign's capacities to reform, we have seen material progress since our last review. After the government had submitted its long-awaited bill on the introduction of 21 wellbeing services counties, and the reform of the organization of health and social services to parliament last December, these were passed on 23 June. The respective laws are envisaged to come into force gradually, with the Act on the Wellbeing Services Counties and other laws, such as the Act on the Order of Social and Health Care being effective as of 1 July 2021. The last laws will enter into force at the beginning of 2023.

In an attempt to lift the Finnish economy's underlying growth and stabilize public finances, authorities produced an ambitious labor market agenda, according to which they aim to ratchet up the employment rate to 75% by 2025 - instead of the pre-pandemic target of 2023 - and to raise the number of employees by 80,000 by the end of the decade. To this end, the government decided in 2021 on various measures, including the transfer of employment and business services to municipalities, work-based immigration, and reforms supporting lifelong learning. Judging by an initial assessment by the Ministry of Finance (MOF), these measures may add roughly 11,000 new employees, adding to the 31,000-33,000 additional employees which may result from decisions already taken in 2020 (e.g. package for people aged over 55y).

In our view, the sovereign's responsiveness is also underscored by reforms which address climate risks. At the beginning of this month, the government submitted a bill for a new climate law, setting out policy plans to reach its ambitious objective of becoming climate neutral by 2035. While Finland has come a long way in cutting its greenhouse gas (GHG) emissions since the 1990s, policy-makers have pledged a GHG emission reduction target of 60% by 2030 (compared to 1990 level). Over the last decade, Finland cut its GHG emissions significantly, by 4.3 tons p.c. to 10.1 in 2019, but still posts above the EU average of 8.4 tons p.c. At the same time, we see that the Nordic nation has to be deemed as a European front-runner regarding renewable energy, with its overall share of energy from renewable sources standing at 43.1% (2nd highest in EU, 2019). Also, Finland has continuously been among the leading countries in the EC's eco-innovation index since its inception, ranking second among the EU member states in 2021.

Fiscal Sustainability

The government's response to the outbreak of the Coid-19 pandemic resulted in a marked deterioration in the sovereign's fiscal metrics and a concurrent reversal in its debt trend. While we expect a relatively swift moderation in Finland's headline deficit, its public debt ratio is likely to increase further, albeit slowly and very gradually. The most significant fiscal risks in the medium to longer term remain age-related outlays - mainly pension and long-term care costs - and substantial contingent liabilities which have risen since the onset of the crisis. Having said this, we believe that public finances remain sustainable, at least over the medium term, given highly affordable debt, sound debt management which enabled locking in lower rates for longer, and sizable government assets complemented by forward-looking fiscal policy-making.

The Finnish government exhibits a track record of fiscal prudence, as inter alia suggested by rather moderate headline deficits over the last decade. Thus, Finland's headline deficit had remained at or below the Maastricht threshold of 3% of GDP, even in times of the global financial crisis and the euro debt crisis. More recently, we have witnessed rather modest deficits, averaging at only 0.8% of GDP in 2017-19. More generally, this gives us confidence that the government

will return to the proposed fiscal path once the dust has settled, as foreshadowed by the authorities in their fiscal plan for 2022-25.

As the corona crisis hit, authorities had to seize indispensable measures to limit the economic fallout by safeguarding corporate liquidity and limiting job losses, and to protect the health of the population. Due to substantially ramped-up expenditure and plunging economic activity, the deficit on the general government level shot up to 5.4% of GDP in 2020. According to Ministry of Finance data, the budgetary impact of Covid-19- measures came in at roughly 3.0% of GDP. Support for Finnish businesses accounted for the largest share in this regard (~1.0% of GDP), including grants and general cost support, as well as aid for sole entrepreneurs. Costs for health and social services measures and other pandemic-related expenditure accounted for 0.9% of GDP, and the extension of unemployment and social benefits added a further 0.3% of GDP. On the revenue side, private sector pension contributions were lowered (0.5% of GDP). We note that tax revenue held up relatively well in 2020, as taxes on income and wealth declined by 1.7%, whilst the VAT intake dropped by only 0.9%.

Going into 2021, we expect that revenues will show reinvigorated growth. Based on the premise that economic activity will gain traction throughout the year, income taxes and taxes on production and imports should grow significantly – driven by rising household spending, higher earnings facilitated by employment growth, and increasing corporate tax payments. Furthermore, social contributions are likely to go up, also due to the expiration of the reduction in private sector pension contributions. Indeed, income taxes rose by 2.5% y-o-y in this year's first quarter, while taxes on production and imports inched up by 1.2% (SWDA, Statistics Finland data).

On the other hand, this year's epidemiological situation requires continued significant Covid-19 outlays, inter alia for Finland's vaccination and testing program, pandemic-related research, and other support measures geared towards disadvantaged groups and the corporate sector, including cargo and passenger shipping businesses. Discretionary measures to mitigate adverse pandemic effects and stimulate the economy could add up to a negative budgetary impact of roughly 1.7% of estimated GDP. This also includes the additional spending of approx. EUR 590mn from the third supplementary budget for 2021 which aims to cover e.g. the extension of labor market support for self-employed workers and ramped-up unemployment benefits.

Total additional expenditure, according to the third supplementary budget, amounts to roughly EUR 2.2bn, thereby pushing central government net borrowing to roughly EUR 14.4bn or 5.8% of GDP. Apart from pandemic-related expenditure, this also includes a sizeable transfer of 0.3% of GDP to the State Guarantee Fund to capitalize Finnvera, and investment financing which is to be brought forward. We note that public investment is envisaged to remain high in the medium term, at over 4% of GDP according to the SP21.

Taken together, we expect Finland's headline deficit to decrease, but to remain elevated at 4.2% of GDP this year. In 2022, public finances should improve further, with the deficit narrowing to 2.3% of GDP, thanks to accelerating economic growth and the prospective easing of the epidemiological situation in tandem with a broad vaccination coverage. Still, uncertainty around those estimates remains unusually high, as the pandemic may require renewed confinement measures.

General government debt is thus bound to edge up further. To be sure, the sovereign entered the corona crisis from a favorable starting position, as its public debt ratio stood at only 59.5%

of GDP in 2019. However, collapsing economic growth and the significant widening in the headline deficit caused government debt to surge by 9.7 p.p. to 69.2% of GDP last year (Eurostat spring notification, prior to GDP revision from 14 July). Whilst this marks a historical high, Finland's debt ratio posts well below the euro area average (98.0% of GDP), as well as the 'AA' median in our rating universe (83.9% of GDP). In our baseline scenario, it will climb further, though slowly and very gradually, to 71.0% of GDP in 2021 and 71.2% of GDP next year.

We note that the Finnish government has signaled that it intends to stabilize the public debt ratio by the middle of the decade. Authorities plan to rein in the rise in debt-to-GDP mainly via three key measures, namely increasing employment, strengthening the framework conditions for economic growth, and the SOTE reform. A key role is played by the government's objective to raise the employment rate to 75% by 2025 (see above).

While we view the consolidation plans as reasonable and generally feasible, these are subject to considerable risks. Thus, costs incurred by the transition to the new health and social services system (SOTE) may exceed the initial plan envelope, while the burden relief provided by the employment measures may turn out lower, as recently indicated by estimates gauged by Finland's National Audit Office. In addition, cost pressure is not likely to wane against the backdrop of structural transformation processes pertaining to a greener and digitalized economy, although the EU's Recovery and Resilience Facility will lend viable support to this end (EUR 2.1bn in grants, 0.9% of GDP).

Moreover, we closely follow compliance with the spending limits rule which had been suspended in 2020. With the fiscal plan for 2022-25, decision-makers announced that the previous expenditure framework is to be expanded, raising the spending limits by EUR 900mn and EUR 500mn in 2022 and 2023 respectively. That said, we do not think that Finland's fiscal discipline is at risk of becoming jeopardized.

Notable upward pressure on Finland's debt ratio will result from defense spending, as the government's aircraft project will likely add costs totaling EUR 10bn or 4.2% of GDP by 2030 (MOF data). Arguably more importantly, the demographic challenges elaborated above will entail significant fiscal sustainably risks in the medium to long term. From a fiscal angle, outlays for pensions and care tend to increase with a higher population share of elderly people, while the declining working-age population diminishes the tax base to finance the rising costs. Drawing on latest estimates from the EC's Aging Report 2021, Finland already finds itself among the EU member states with the highest age-related costs, standing at 26.5% of GDP in 2019. The Aging Working Group reckons that these will increase by 1.4 p.p. by 2030, mainly driven by pensions and long-term care spending (+0.7 p.p. respectively).

Another risk factor, which may potentially derail the government's fiscal plans, is the substantial stock of contingent liabilities which has been increasing sharply over recent years. Prior to the outbreak, public guarantees stood at a high 25.1% of GDP in 2019, up from 20.9% of GDP in 2015. The maximum amount of public guarantees announced in response to Covid-19 totals 6.3% of GDP, whereas the take-up has been somewhat more moderate (1.4% of GDP), lifting the total stock of guarantees 26.1% of GDP in 2020 (SP21 data).

In our view, these risks are attenuated by the sovereign's very strong and increasing debt affordability. The sovereign displays one of the lowest interest expenditure-to-revenue ratios in the EU, which stood at 1.32% in 2020 - down from 1.56% a year before, and from 2.02% in 2016. Long-term government bond yields remain at historically low levels, trending slightly upwards

since the turn of the year, posting at -0.072% at the beginning of July (2-Jul-21, weekly quote). Finland's Bund spread continues to be low and stable, moving in a narrow band between 9 and 47 bp since the beginning of 2018.

While we expect the interest rate environment to remain supportive in the medium term - also due to the ECB's very accommodative monetary policy, including the purchase programs PEPP and PSPP - we continue to view Finland's debt management as very sound and forward-looking. The sovereign displays a well-laddered redemption profile. Finland's average weighted maturity increased from 6.2y in May 2020 to roughly 7.5y in May this year. We think that refinancing risks are further mitigated by the holding structure of the sovereign's debt, with the foreign official sector (32%) and the Finnish central bank (22%) holding more than half of it as of end-2020. What is more, the sovereign commands over a sizable amount of liquid financial assets, judging by national accounts data, largely made up by equity and investment fund shares (Q4-20: 104.5% of GDP).

We do not deem residential property price growth as a reason for concern. Still, we continue to follow developments closely, as household debt has shown strong persistent increases over the last decade. Annual growth of house prices picked up in 2020, but stood at a still relatively low 3.3% in the fourth quarter of 2020 (Eurostat data). In the same vein, we have witnessed somewhat more dynamic mortgage lending growth since mid-2019. Yet, at 4.0% y-o-y (May-21), lending for house purchase appears far from excessive, also as compared to peers. Affordability indicators such as the price-to-income ratio do not hint at mounting imbalances.

In any case, the Finnish banking sector, with total assets of 357% of GDP (Q4-20) one of the largest in the EU since the relocation of Nordea, remains in good shape. The CET 1 ratio increased from 16.9% in Q1-20 to 18.2% in this year's first quarter, while the NPL ratio remained low and stable at 1.4% - both metrics outperforming the respective EU averages and pointing to buffers to cushion surfacing risks.

Foreign Exposure

A broadly balanced current account and positive net international investment position do not indicate imminent external risks. However, the Finnish overall NIIP masks pockets of vulnerability associated with a highly negative investment position on account of MFIs, in connection with their tendency to rely on wholesale funding.

Last year, Finland's current account shifted into positive territory after a run of moderate deficits (2015-19 average: -1.2% of GDP). The improvement from -0.3% of GDP in 2019 to a surplus of 0.8% of GDP in 2020 came mainly on the back of a widened primary income surplus (0.5% to 1.7% of GDP), as dividend earnings of non-residents declined significantly, and the increase in the goods balance to 1.4% of GDP (2019: 1.0%), which was partly due to cruise ship orders in Q4.

While the current account was in deficit on a quarterly basis in Q1-21, the moving four-quarter sum resulted in a current account surplus, posting at 1.3% of GDP. That said, we expect the current account surplus to narrow in 2021 alongside the economic normalization and as Finland brings the pandemic under control, and to post modest surpluses going forward, in line with the recent gains in export market shares.

The NIIP jumped to 9.3% of GDP in Q1-21, up from 2.2% of GDP in the previous year's first quarter and after finishing the year at 0.9% of GDP in Q4-20, with its increase largely driven by rising stocks of portfolio and other investments. We note that Finland's NIIP mainly balances a positive net FDI position on the one hand, and a negative net portfolio investment position on the other.

Q1's positive NIIP continues to mask stark differences in a sectoral decomposition. In this regard, the MFIs other than the central bank remain of particular importance, persistently boasting a large and negative NIIP. In the first quarter of this year, the MFIs NIIP widened to -71.0% of GDP, from -53.0% of GDP a year before (Statistics Finland data). Risks are aggravated by the MFI's reliance on wholesale funding in this respect. The loan-to-deposit ratio in the Finnish banking sector stood at 148% in Q1-21, one of the highest readings in the EU.

Rating Outlook and Sensitivity

Our rating outlook on Finland's long-term credit ratings is stable, as we believe that its economy will recover strongly this year and next, while authorities remain committed to fiscal sustainability which should result in a stabilizing debt ratio over the medium term. Still-prevalent economic and fiscal risks pertaining to the Covid-19 pandemic are largely mitigated by the factors discussed in the rating rationale, in particular the high-quality institutional framework and sound policy-making. Still, we have to point out that any assessment and interpretation of economic and fiscal developments and prospects remains more challenging than under normal circumstances.

We could consider a negative rating action if medium-term growth comes in significantly weaker than we expect, as the pandemic has not yet been fully overcome, and new variants may deter economic recovery, leading to output losses and rising unemployment. Moreover, a renewed outbreak may require another round of substantial fiscal measures, further derailing public finances. In this vein, downward pressure on the rating could also arise if the upward trend in the public debt ratio becomes more entrenched. This could also be the case if the government's sustainability plan fails to rein in rising public debt, if demographics lead to unsustainable public finances, or if substantial contingent liabilities crystallize in general government accounts.

By contrast, a positive rating action could be prompted by medium-term growth exceeding our current baseline scenario, which might be the case if e.g. Finnish households became significantly more inclined to spend their accumulated savings, recent cost competitiveness gains were to be sustained, or a determined pursuance of structural reforms were to bear fruit. By the same token, successful structural reforms may lead to a reversal in the sovereign's debt trend, thus engendering strengthened fiscal metrics.

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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

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

Environ-mental Quality	Ecological Risks	Ressource Management	Education	Health	**Demo-graphics**
Labor	Equality	Technology & Infrastructure	Safety & Security	**Judicial System**	**Quality of Public Services**
Integrity of Public Officials	Quality and Efficacy of Regulations	**Civil Liber-ties/ Political Participation**	Market Access	**Business Environment**	Data Transparency

Environment	**Social**	**Governance**	**Highly significant**	**Significant**	**Less significant**	**Hardly significant**

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]	2015	2016	2017	2018	2019	2020	2021e
Macroeconomic Performance							
Real GDP growth	0.5	2.8	3.2	1.1	1.3	-2.9	2.8
GDP per capita (PPP, USD)	42,570	44,995	47,622	49,316	50,791	49,853	51,867
Credit to the private sector/GDP	95.5	95.7	94.7	95.8	97.1	102.3	n/a
Unemployment rate	9.4	8.8	8.6	7.4	6.7	7.8	n/a
Real unit labor costs (index 2015=100)	100.0	98.5	94.6	95.1	95.4	95.0	n/a
Ease of doing business (score)	80.1	80.1	80.0	80.0	80.2	n/a	n/a
Life expectancy at birth (years)	81.6	81.5	81.7	81.8	82.1	82.2	n/a
Institutional Structure							
WGI Rule of Law (score)	2.1	2.0	2.0	2.0	2.0	n/a	n/a
WGI Control of Corruption (score)	2.3	2.2	2.2	2.2	2.2	n/a	n/a
WGI Voice and Accountability (score)	1.5	1.5	1.6	1.6	1.6	n/a	n/a
WGI Government Effectiveness (score)	1.8	1.8	1.9	2.0	1.9	n/a	n/a
HICP inflation rate, y-o-y change	-0.2	0.4	0.8	1.2	1.1	0.4	1.6
GHG emissions (tons of CO2 equivalent p.c.)	10.4	10.9	10.4	10.7	10.1	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	-2.4	-1.7	-0.7	-0.9	-0.9	-5.4	-4.2
General government gross debt/GDP	63.6	63.2	61.2	59.7	59.5	69.2	71.0
Interest/revenue	2.1	2.0	1.9	1.7	1.6	1.3	n/a
Debt/revenue	117.7	117.1	115.5	113.7	113.8	135.0	n/a
Weighted average maturity of debt (years)	5.9	6.1	6.2	6.3	6.4	6.4	n/a
Foreign exposure							
Current account balance/GDP	-0.9	-2.0	-0.8	-1.8	-0.3	0.8	n/a
International reserves/imports	0.2	0.2	0.1	0.1	0.2	0.2	n/a
NIIP/GDP	4.8	5.5	1.2	-5.6	4.0	0.8	n/a
External debt/GDP	210.6	194.7	181.0	218.1	224.0	224.0	n/a

Sources: IMF, World Bank, Eurostat, AMECO, ECB, Statistics Finland, 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

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, 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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