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 16-06-2023 “Sovereign Ratings” “Rating Criteria and Definitions”

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Rating Action

Neuss, 16 June 2023

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 economy has so far withstood the recent succession of crises relatively well, but we expect real GDP to post a modest decline this year, mainly based on contracting domestic demand weighed down by cross currents related to the energy crisis and high inflation, as well as deteriorating financing conditions and high uncertainty; economic growth will likely strengthen from next year, as easing inflation will be less of a drag on real incomes and export growth will benefit from the recovering global economy
2. While cyclical headwinds should abate, structural bottlenecks could restrain economic expansion over the medium term if left unaddressed; a shrinking workforce, shortages in skilled labor and lagging productivity growth are set to curb Finland’s underlying growth; further risks to medium-term growth emanate from possible imbalances in productivity and wage growth, as well as high and rising household debt; a high degree of non-cost competitiveness, building on strengths such as substantial innovative capacities and a highly digitalized and sustainability-oriented economy
3. Exceptionally strong institutional framework, with Finland being a global standard-setter in terms of good governance; extensive advantages stemming from the sovereign’s EU and EMU membership, further strengthened by its recent NATO membership; we believe that structural challenges on the macroeconomic and fiscal side will be addressed by the incoming government following general elections in April, as we ultimately view Finnish policymaking as highly responsive and forward-looking, inter alia as illustrated by recent reforms geared towards the labor market, the social security system, and a greener economy
4. After a further improvement in public finances last year, driven by a winding down of pandemic-related measures and buoyant tax receipts, we expect the headline deficit to widen this year and decrease only moderately in 2024; in the medium term, spending pressure will presumably remain high, mainly due to measures related to the energy crisis, initiatives to ensure external security, including ramped-up defense spending, higher R&D outlays, and the green transformation

5. All else being equal, we expect persistent deficits alongside sluggish economic growth and gradually rising debt servicing costs to translate into a further rising public debt ratio over the medium term; that said, we assume that authorities will put high emphasis on fiscal consolidation in the upcoming legislative term; fiscal risk associated with ageing costs and contingent liabilities remain high, but are tempered by high debt affordability, prudent debt management, a favorable debt profile, and sizable government assets
6. External risks, essentially pertaining to external liabilities of the financial sector, remain limited, as reflected by Finland's slightly negative net international investment position (NIIP) which has hovered within in a narrow range in recent years; the current account balance deteriorated significantly in 2022, due to higher energy prices and the primary income balance, but we expect the deficit to narrow in line with our assumption of positive net external trade and normalizing energy markets in 2023/24

Reasons for the Rating Decision and Latest Developments[1]

Macroeconomic Performance

The sovereign's creditworthiness is underpinned by its overall sound macroeconomic profile, with very high per capita income levels and a relatively high degree of diversification. Finland's economy has so far traversed the successive crises relatively well, although the country was heavily dependent on Russian trade, including fossil fuels, when the war broke out. Whilst the economic impact from the energy crisis had been moderate as compared to European peers, cyclical and structural headwinds have led to a weaker outlook by now. The authorities' decisive policy response has swiftly made the country independent from Russian energy supplies, reducing energy security vulnerabilities, but we think it will take some time for Finnish businesses to reorient their trade. A relatively robust labor market and high employment rate have helped stabilize the economy. While Finland's cost competitiveness needs to be monitored in terms of the alignment of productivity and wage growth, we continue to view its non-cost competitiveness as a credit strength. Doing business in Finland is facilitated by a welcoming environment, and the sovereign is among the global leaders in digitization and innovation. Structural challenges persist, including labor and skills shortages, as well as Finland's shrinking workforce, which will act as a drag on potential growth.

After a relatively moderate pandemic-related economic slump in 2020 (-2.4%), Finland's economic output expanded for the second consecutive year, reaching 2.1% in 2022, following real GDP growth of 3.0% a year before. While GDP growth thus exceeded the five-year average (2018-2022: 1.0%), it remained well below that of the euro area (EA) as a whole, which grew by 3.5% in 2022.

Last year's economic growth was driven by private consumption and gross fixed capital formation, each of which contributed 1.1 p.p. to real GDP growth, respectively, reflecting the release of pent-up demand for services in the aftermath of the Covid-19 pandemic along with strengthening construction and R&D investment. Owing to government efforts to cushion the blow from the energy crisis, public consumption also contributed 0.7 p.p. to the expansion in

[1] This rating update takes into account information available until 9 June 2023.

real economic activity. On the other hand, net external trade weighed on output growth (-2.3 p.p.), as imports increased by a substantial 7.5%, compared to 1.7% growth in exports.

Last year's overall performance masked a technical recession in the second half of 2022. Given high inflation, rising interest rates and weak external demand, real GDP contracted in the third (-0.4% q-o-q) and fourth quarters (-0.6%) of 2022, respectively. This notwithstanding, the sovereign continues to enjoy very high levels of wealth, acting as a vital pillar to its macroeconomic profile and, in turn, its credit rating. GDP per capita increased to USD 58,651 in 2022 (IMF data, PPP terms), representing the world's 16th largest reading and standing above the median of our AA-rated universe (USD 56,426).

We note that the response of the Finnish authorities prevented a more severe economic impact in a geopolitical context and in terms of the energy crisis. Before the Russian invasion of Ukraine, Finland imported more than two-thirds of its natural gas and almost two-thirds of its oil and petroleum products from Russia. Thanks to swift and decisive political action, Finland diversified to other countries and quickly became independent of Russian energy sources. An important part of the process of replacing Russian energy was a U.S. LNG terminal, which went into operation in mid-January and has a capacity large enough to supply the Baltic States as well as Poland with gas.

Looking ahead, high uncertainty along with high - albeit receding - inflation, and tightened financing conditions will likely drag down domestic demand in the near term. Furthermore, we expect global trade to gradually gain momentum from the end of this year, and it will take some time for external demand to fully recover from the medium-term drag from the substitution of Russian trading partners. For 2023 as a whole, we project real GDP to shrink by 0.2% and to exhibit an increase by 1.4% in 2024.

We emphasize that uncertainty around these forecasts remains high, in particular against the backdrop of risks related to the war in Ukraine. We view modest economic prospects for the near-term as corroborated by the growth outcome in this year's first quarter, as real GDP rebounded moderately, increasing by only 0.2% q-o-q, mainly driven by public consumption (+3.1% q-o-q) and net exports coming on the back of import compression (-2.7% q-o-q). Private consumption virtually stagnated, ticking up by 0.1%.

In our view, consumer spending will continue to be constrained by elevated inflation and rising interest rates. Consumer confidence seems to have bottomed out last September, but continues to be downbeat. Adjusted for price changes, household disposable income has contracted for three consecutive quarters on a y-o-y basis, falling by 2.0% in Q4-22 (Statistics Finland). While Finnish HICP inflation rates have remained below euro area levels since Russia's invasion of Ukraine, decelerating to 5.2% y-o-y in May 2023 (May-22: 7.1%), nominal wage growth is unlikely to keep pace this year before real wages likely become more supportive next year amid declining price pressures. Meanwhile, core inflation appears to have plateaued more recently. After hovering around 5.0%, core inflation rose by 4.3% y-o-y, the lowest level since August 2022.

As a case in point, a collective agreement for technology industry workers was signed in February, entailing salary increases by 3.5% in 2023 and 2.0% in 2024. Moreover, employees will receive a lump sum payment of EUR 400 in the first contract year. While we consider the risks of a wage-price spiral to be contained at this stage, we will continue to monitor developments closely. By the same token, government measures should alleviate the impact of inflation and rising interest rates on households' purchasing power.

As a result, households' purchasing power will remain under pressure in the near term. Having accumulated relatively small excess savings during the coronavirus crisis and displaying a low savings rate more generally, households have few financial reserves to fall back on. According to Statistics Finland data, households recorded a declining savings rate in the second, third and fourth quarters of 2022.

We believe that the relatively resilient labor market will buttress private consumption. In April 2023, Finland's monthly unemployment rate was at 6.9% (Eurostat, sa, nca), close to its pre-pandemic and the euro area level. Labor participation climbed to 80.3% in Q4-22 (79.4% in Q4-21), standing well above the euro area's 74.6%. In addition, Finland achieved good results on the European Commission's (EC) Social Scoreboard, in particular in the fields 'equal opportunities' and 'social protection and inclusion'.

Employment continued to perform well, growing by an average of 2.9% y-o-y in the first three quarters of 2022, but moderating to an annual rate of 1.5% in Q1-23 (EA: 1.6%). At the same time, the employment rate has continued on its upward trajectory since the pandemic-induced slump in 2020. Posting at 74.2% in April (15-64y, Statistics Finland), the employment rate is very close to the government's target of 75%.

Having said this, Finland's labor market faces structural challenges such as labor and skills shortages. After moderating in the second half of 2022, the number of job vacancies jumped to historically high levels in Q1-23, almost double the 10-year average (Statistics Finland). Finding skilled workers appears to be a broad-based problem, with shortages not only being prevalent in ICT and technology, but also in education, healthcare and social care.

In this context, we highlight the relatively low percentage of people aged 25-34 with tertiary education. The corresponding share of 40.7% (2022, 2019: 42.0%) is lower than in the euro area overall and in the other Nordic economies. To be sure, we think employers will tend to hoard labor regardless of easing economic activity, given shortages in skilled labor, which should translate into a rather modest increase in Finland's unemployment rate in the near term.

The limited supply of skilled labor could also weigh on investment. According to the EIB Investment Survey 2022, 85% of Finnish firms cite skills shortages as a barrier to investment, alongside energy costs (63%). We expect fixed investment to decline this year before recovering moderately in 2024, largely driven by deteriorating funding conditions, elevated energy and raw material costs, and high uncertainty, which are likely to cause businesses to push back investment decisions.

Construction is one of the hardest-hit sectors in this context, with presumably declining residential property investment in particular dragging on gross fixed capital formation. In April, construction confidence dropped to its lowest level since the onset of the war in Ukraine, and even below the trough seen during the pandemic. Similarly, building permits fell in Q4-22 to one of the lowest levels seen in the last 30 years in Q4-22, after five consecutive quarters of y-o-y declines.

Likewise, Finland's industrial sector faces headwinds, inter alia easing domestic and external demand, implying negative repercussions for material and equipment investment. New orders have entered negative territory in Q3-22, and capacity utilization continued to decrease, standing well below its long-term average in Q2-23 (76.3% vs. 80.9%). At the same time, we assume fixed investment to be supported by public investment through initiatives and reforms under the Recovery and Resilience Plan (RRP), which aims to build the infrastructure needed to successfully implement the digital and green transitions and ensure energy security, although the allocated funds in percent of GDP compare as moderate vis-à-vis fellow EU members.

We expect net external trade to make a positive contribution to GDP growth this year and next, mainly driven by declining imports as a corollary of weak domestic demand. Exports are set to suffer from the decelerating global economy and prospectively sluggish economic growth of Finland's key trading partners, likely to gain traction in 2024. As a case in point, the real GDP of Germany (2023e: 0.2%, 2024e: 1.4%) and the Netherlands (2023e: 1.5%, 2024e: 1.1%) declined in the first quarter of 2023. In addition, trade with Russia will continue to fall after bilateral exports and imports decreased by roughly 41% and 27% respectively in 2021-22 (Statistics Finland).

Medium- to longer-term perspectives remain clouded by structural challenges pertaining to Finland's ageing population and shrinking workforce, which will weigh on potential growth if left unaddressed. Finland's old-age dependency ratio was the second-highest in the EU-27, having risen to 37.4 in 2022. Concurrently, the working age population accounted for 56.1% of the total population (20-64y, Eurostat data), representing the second-lowest reading among EU-27 member states.

Moreover, real labor productivity has evolved relatively unfavorably from a European perspective, edging down by 0.4% in 2021-22 and significantly by 2.4% since 2017 (EA: +1.2% and +0.7% respectively, Eurostat). Still, wage growth has been broadly in line, implying no adverse impact on cost competitiveness so far. Accordingly, Finland's real unit labor costs fell by 0.6% last year and have ticked up by 0.7% since 2017 (EA: -1.3%/0.0%, AMECO data).

However, as headline inflation starts to ease and with a delayed rise in wages, Finland could potentially experience a deterioration in its cost competitiveness position. Additionally, finding new trading partners to replace Russia could prove difficult and thus negatively affect medium-term growth. We will vigilantly monitor price competitiveness, as Finland's global export market share in volume terms fell by 3.1% in 2022, following a 4.6% decline in the previous year (Eurostat).

Tying in with medium-term risks, we note that household indebtedness measured against disposable income is high and rising. Although having lost some momentum over the last two years, household debt increased to 118.6% as of Q4-22 (Q4-21: 118.3%, ECB data), corresponding to one of the highest readings in the euro area. Concurrently, the share of variable rate loans is high and interest rate caps do not exist in most cases. Hence, high debt in tandem with tighter financial conditions could entail negative reverberations for household spending going forward. In this context, we assess the government's proactivity as positive, having adopted a package geared towards limiting household indebtedness in January 2023, with effect from July 2023 (see below).

On the other hand, non-cost competitiveness remains credit positive, as evidenced by Finland's 8th rank in the IMD World Competitiveness Yearbook 2022, up three places from 2021. The improvement was mainly due to better outcomes in government and business efficiency (ranking 10th and 5th, respectively), underscoring Finland's business-friendly environment. Other vital strengths relate to its innovation ecosystem. Finland was ranked 9th out of 132 economies in the UN's Global Innovation Index 2022, with the innovation pillars 'infrastructure', 'knowledge and technology outputs' and 'business sophistication' standing out in particular.

Spending on research and development is already among the highest in the EU, coming in at 3.0% of GDP in 2021. Notwithstanding, policymakers legislated the Act on Research and Development Funding, which came into force in January this year and formally establishes that R&D expenditure will be gradually raised to 4% of GDP by 2030. In our view, this should enhance productivity, bolster competitiveness and ultimately prove beneficial with a view to Finland's underlying growth.

What is more, Finland can build upon an excellent foundation to advance digitization in the coming years, having been leading in the EC's Digital Economy and Society Index 2022. The highest scores were achieved in human capital and integration of digital technology, while also performing above EU average in the remaining categories.

Institutional Structure

We continue to view the Republic of Finland as one of the world's leading economies in terms of good governance. While the sovereign's excellent institutional quality represents a key factor explaining its very high creditworthiness, it also reflects the authorities' very prudent and responsive policymaking. Moreover, as a small and open economy, we assess Finland's EU/EMU membership as credit supportive, entailing major benefits such as access to broad and deep capital markets as well as trade facilitation. We also observe that Finland's HICP inflation, wages and MFI interest rates were broadly aligned with the euro area. Since the Russian invasion in Ukraine raised profound security concerns, in particular given the geographic proximity to the Russian Federation, Finland joined NATO on 4 April 2023, which we assess as positive for its creditworthiness. Commitment to achieving carbon neutrality by 2035 remains strong, as suggested by the regular updating of plans and strategies, ensuring that climate targets are not jeopardized and further underscoring the sovereign's forward-looking approach to policymaking.

The exceptionally high quality of Finland's institutional framework is underpinned by the World Bank's Worldwide Governance Indicators (WGIs), which we deem most relevant for our assessment of the sovereign's institutional set-up. According to the WGIs, Finland is consistently ranked among the world's best across all dimensions, outperforming the euro area average and median of our AA-rated sovereigns by far.

Looking at the most recent vintage, referring to 2021 as the reporting year, Finland again achieved excellent results. For the seventh consecutive year, Finland retained its position as the leader out of 209 economies in terms of 'rule of law', mirroring the extremely high perceived quality of the judiciary. Likewise, the perceived extent to which public power is exercised for private gain ('control of corruption') is very low, as illustrated by a remarkable second position (out of 209 economies).

Regarding the perception of freedom of expression, freedom of association and free media, as well as the extent to which citizens participate in the selection of the government ('voice and accountability'), Finland also scored extremely high, ranking second out of 208 countries. Although it lost its top-three position in 'government effectiveness', slipping by one place to fourth out of 209, Finland achieved the second-best result among the EU-27 states.

Finland's very strong institutional framework continues to be improved, and we assess the sovereign's responsiveness and forward-looking policymaking as positive. Thus, the Finnish government has implemented a National Anti-Corruption Strategy and its Action Plan 2021-2023. Furthermore, a law on whistleblower protection entered into force this January, providing for stricter reporting obligations and offering greater protection for whistleblowers. Moreover, parliament approved a partial reform of the Anti-Money Laundering Act in March 2023, providing the Financial Supervisory Authority with more effective tools to monitor the compliance with sanctions.

Looking at political events, the center-right National Coalition Party won the general election (April 2023) with 20.8% of the vote (+3.8 p.p.), ahead of the Finns Party, which took 20.1% of the vote. The Social Democrats, the party of the incumbent PM Marin, increased their share in the public vote to 19.9%, but came in only third. It is noteworthy that – contrary to the general trend observed in most of the other EU member states – Finland's political landscape has become less fragmented, with large parties gaining at the expense of smaller parties such as the Greens, whose voting share fell to 7.0% (2019: 11.5%). In our view, a less fragmented political landscape tends to be conducive to more cohesive policy formulation and implementation. The two largest parties together account for 94 out of 200 seats.

Coalition talks are currently underway. National Coalition party chair Orpo recently indicated that progress has been made between the four negotiating parties (National Coalition Party, Finns Party, Swedish People's Party of Finland and Christian Democrats), and that the government program could be finalized by mid-summer. By and large, we expect policy continuity, with a stronger focus on fiscal consolidation.

Turning to greening the economy, Finland ranked second in the 2022 EC's Eco-Innovation Index. Similarly, Finland boasted the second-highest share of renewable energy sources at 43.1% in 2021, standing well above the average EU-27 reading (21.8%). There is room for improvement in terms of greenhouse gas emissions, in particular against the backdrop of its ambitious climate targets. Amounting to 8.8 tons per capita in 2021, Finnish greenhouse gas emissions are higher than the EU-27 average (7.9 tons) as well as those of its Nordic peers (Denmark: 7.7 tons, Sweden: 4.7 tons).

Finland, in our view, continues to be a frontrunner when it comes to sustainability and advancing its green transition. As a case in point, Finland ranks first in the UN Sustainable Development Report 2022. In addition, Finland displays the highest share of firms that have already taken action on climate change and plan to do so over the next three years in the EIB's most recent Investment Survey. With the adoption of the new Climate Act last year, Finland will be the first country to become fully carbon neutral by 2035. In order to achieve its goal of becoming a fossil-free economy, the government introduced the new medium-term climate change policy plan 2022, which identifies opportunities to further reduce emissions and provides an update of the energy and climate strategy in 2022.

Fiscal Sustainability

We generally view public finances as a supportive element to the sovereign's creditworthiness, with government authorities demonstrating a track record of sound debt management, repeated outperformance of fiscal targets and credible commitment to fiscal discipline. A comparatively low estimated VAT gap suggests high tax compliance, also supported by the relatively advanced stage of the digitalization of Finland's tax administration. Following its recent moderation amid strongly increasing tax revenue and withdrawal of Covid-19-related support, we expect the general government deficit to increase this year and maintain a similar level in 2024 on the back of higher spending related to the *energy crisis, significant stepping-up of defense expenditure and increased funding of wellbeing services counties. While awaiting the incoming government's fiscal plan, which will be presented later this year, the debt-to-GDP ratio looks set to trend upwards over the medium term against the backdrop of modest growth and rising interest expenditure. Fiscal prudence, a still high, albeit deteriorating, degree of debt affordability and considerable government assets mitigate fiscal risks arising from contingent liabilities and ageing costs.*

Following the acute phase of the pandemic, Finland's fiscal balance improved continuously. The winding down of government support to cushion the effects of the Covid-19 crisis led to a significant narrowing in the headline deficit last year. At -0.9% of GDP (2021: -2.8% of GDP), the deficit was back in line with its average reading of -0.8% of GDP per year in 2017-19, remaining well below the level of the euro area as a whole in 2022 (-3.5% of GDP).

Bolstered by considerable increases in tax receipts and net social contributions, total general government revenue grew by 5.5% in 2022 (2021: 8.2%). At the same time, total general government expenditure rose much more slowly (+1.9%), thanks to comparatively moderate growth in the compensation of employees (+2.8%), as well as intermediate consumption (+5.9%) and a significant reduction in outlays related to subsidies (-24.8%).

In response to the soaring energy costs, the government adopted several measures to support the purchasing power of households. Among these were the VAT reduction on electricity and passenger transport from January to April 2023, increased child benefits, and a tax deduction for people with high electricity bills. According to the Stability Program 2023 (SP23), the support measures to alleviate rising energy prices are estimated to amount to EUR 430.2mn (or 0.2% of our estimated 2023 GDP) in the current year.

The envisaged spending to soften the blow to the private sector from higher energy costs was part of the authorities' response to the challenging economic and geopolitical circumstances in the context of Russia's military aggression against Ukraine, which will likely deteriorate fiscal metrics this year and next, along with higher spending in the context of the overhaul of the healthcare, social welfare and rescue services, and adjustments to inflation. The so-called Security Policy Escape Clause in reaction to the war in Ukraine also includes significantly ramped-up spending on security infrastructure and higher expenditure to foster energy self-sufficiency.

In addition, R&D expenditure is envisaged to be increased to 4% of GDP by 2030, while the transition towards becoming a carbon-neutral economy by 2035 demands continuous investment. Against the backdrop of the purchasing power measures, enhanced defense and social spending, as well as adjusted R&D and climate-related policies, we expect the headline deficit to increase to about 2.6% in 2023 and remain little changed the year after (2024e: 2.4%). Partially temporary measures on the revenue side, such as the adopted windfall tax on the profits of electricity businesses for 2023, should mitigate the budgetary effect of the spending measures to some degree. Overall, uncertainty surrounding the projections remains high, not least owing to the unpredictability of the war in Ukraine.

General government debt measured against GDP edged up to 73.0% in 2022 from 72.6% in 2021. In this context, it is worth recalling Statistics Finland's methodological changes to the calculation of general government debt last year, which alongside revised national account data had led to a marked upward revision of the debt-to-GDP ratio of several percentage points. Given our assumptions of moderate growth, higher headline deficits and likely rising interest expenditure, the public debt ratio should drift upwards in 2023 and 2024. We project the debt-to-GDP ratio to rise to 73.8% in the current year and to increase further to 75.7% next year.

Acknowledging a degree of uncertainty over the medium-term fiscal path in the context of the imminent change of government in Finland, we expect fiscal prudence to range high on the agenda, given - from our perception - a track record of consensus-seeking policy making and cross-party commitment to fiscal sustainability. We gather that the National Coalition party declared budgetary discipline a main policy objective in its electoral program.

We take note of the Ministry of Finance’s expenditure and structural survey, which was conducted in light of its outlook from December 2022, and which highlighted the need to improve general government finances by at least EUR 9bn over the next two parliamentary terms. The measures discussed in the survey, e.g. improving the efficiency of funding related to education, partly abolishing and reforming social security benefits or reducing index-linked expenditure might serve as goalposts with regard to fiscal policymaking of the incoming government.

Contingent liability risks remain in place, with respective liabilities standing at a sizeable 25.7% of GDP in 2022 (central government, SP23), of which 4.3 p.p. were linked to the financial sector. We note that Finnvera accounted for the largest share of central government securities and guarantees, with more than half of Finnvera’s guarantee exposure related to the cruise shipping sector, which was hit hard by the coronavirus crisis. Perspectives for cruise shipping have brightened, although some risks persist, and additional loss provisions could occur if the anticipated further recovery of the sector fails to materialize.

Finland’s banking sector weathered the recent succession of crises relatively well and continues to give a sound impression when looking at relevant metrics capturing capitalization and asset quality. According to EBA data, the NPL ratio further improved, falling to 0.9% in Q4-22 as compared to 1.8% in the EU, while capitalization buffers stood well above the EU average, as underscored by a CET1-ratio of 17.3% as of Q4-22 (EU: 15.5%). In terms of return on assets as a measure of profitability, Finland’s banking sector was well-aligned with the EU average, posting at 0.6% in last year’s final quarter (EU: 0.5%).

This notwithstanding, we will monitor developments against the backdrop of ongoing monetary policy tightening and high household indebtedness. In this context, rising interest rates tend to directly translate into a higher debt servicing burden for households, as the majority of loans to households is subject to variable interest rates. Moreover, at 143.2% (Q3-22, ECB data), the loan-to-deposit ratio compares as high. A series of measures aimed to contain risks around lending to private households is set to enter into force from July 2023. Changes to macroprudential policies encompass, inter alia, the introduction of a limit on the maximum maturity of home loans and housing company loans as well as the barring of business practices, where loans are granted to people with poor creditworthiness.

The Finnish banking sector remains one of the largest in the EU, with total assets of 362.1% of GDP as of Q3-22. Recalling that the five largest banks account for more than 80% of total banking sector assets, concentration risks and regional interconnectedness generally present some vulnerabilities. Apart from this, the significance of wholesale funding renders the sector somewhat more prone to financial market risks. That said, a recent episode of some market turbulences amid struggling US and Swiss financial institutions did not lead to any major spillovers.

We have to reiterate that public finances will face considerable pressure due to the ageing population and shrinking labor supply, prospectively weighing on fiscal sustainability. We continue to view fiscal risks as mitigated by significant government assets, sound debt management and still high, albeit prospectively less favorable, debt affordability. Combined total assets of the State Pension Fund of Finland (VER) and the public pension fund Keva came to 31.6% of GDP as of end 2022. Finland's debt portfolio exhibits an average weighted maturity of 7.5 years in March 2023 (ECB data), having risen somewhat over the pandemic phase.

Last year, annual interest payments rose for the first time since 2012, increasing by 12.1%, whilst remaining at a relatively low level in terms of total revenue (2022: 1.0%) and in terms of GDP (2022: 0.5%), respectively. Standing at roughly 3.1% at the end of May 2023 (weekly data), the yield on 10-year government bonds climbed to its highest level since 2011. In a similar vein, the Bund spread increased notably over the last 16 months, drifting up from 26bp at the end of January 2022 to 61bp at the end of this May.

In light of the ECB's more aggressive than initially expected monetary policy tightening cycle, the interest rate environment is set to deteriorate further. Following the last 25bp hike of its key policy rates in May 2023, we expect the ECB to raise rates by a further 50bp by the end of the year, presumably via two 25bp hikes. As regards the PEPP and the APP, the ECB decided to reinvest maturing principals from securities under the former until at least the end of 2024, whereas reinvestments under the latter will be discontinued altogether from July 2023 following a phase of being reduced.

Foreign Exposure

In our view, external risks remain contained. Finland's NIIP is unlikely to raise sustainability concerns over the medium term, and we expect it to remain relatively stable in the near term. Adversely affected by the energy crisis, Finland displayed its largest current account deficit on Eurostat records, but we anticipate that it will narrow over the medium term as energy prices decline and external demand recovers. However, Finland's external position could be impacted by second-round effects worsening its cost competitiveness and persisting trade effects originating from the geopolitical crisis.

Finland's current account balance shifted into negative territory last year, after current account surpluses of 0.5% of GDP and 0.6% of GDP in 2020 and 2021, respectively. Posting at -3.9% of GDP, the deficit dipped well below the average reading recorded in 2010-19 (-1.1% of GDP). Following the lifting of pandemic restrictions, demand for services abroad grew faster than services exports, leading to a significant widening of the services balance deficit (-2.3% of GDP, 2021: -0.8%). The goods balance turned from a surplus of 0.9% of GDP into a deficit of 0.5% of GDP in 2021-22, mainly on account of the energy balance. At the same time, the primary income balance deteriorated by 1.7 p.p. to -0.1% of GDP as the suspension of dividend payments by financial institutions was abolished.

As elaborated above, we expect energy prices to ease and net exports to make a positive contribution to economic growth as a result of declining import growth. Further out, we assume that increasing growth momentum in Finland's main trading partners will lead to stronger export growth. Together with a moderately positive primary income balance, this should lead to a narrowing of the current account deficit going forward, and we expect modest deficits to prevail in the medium term.

Given the projected trajectory of the current account balance, we consider external risks as limited, with the NIIP presumably moving by and large sideways in the medium term. Due to lower FDI and a widening deficit in financial derivatives and employee stock options, the Finnish NIIP deteriorated slightly from 1.0% of GDP in 2021 to -2.7% of GDP last year and has moved in a narrow range between -6.5% of GDP and +6.5% of GDP since 2015.

Moreover, it should be noted that the share of external debt at the general government level in general government gross debt has been dwindling in recent years, reaching roughly 46% in last year's fourth quarter, down from 50% in Q4-21 and 69% five years ago (Eurostat), although to a considerable degree due to the denominator effect, i.e. a higher level of general government debt. Apart from that, we highlight the risks associated with the financial sector's high level of external debt. As of Q4-22, deposit-taking corporations accounted for 54.0% of total external debt (QEDS data).

Rating Outlook and Sensitivity

Our rating outlook on the long-term credit ratings of the Republic of Finland is stable, reflecting our expectation of improving macroeconomic performance as adverse repercussions from the energy crisis fade, as well as the extraordinarily high quality of the sovereign's institutional conditions and its track record of fiscal prudence, which balance fiscal risks.

We could raise the outlook or rating if Finland's economy recovers faster than expected from the cyclical drag of the energy crisis and the negative spillovers from the Russian war against Ukraine, and/or if reforms to tackle structural impediments to economic growth progress, which would also prove conducive to Finnish underlying growth, including initiatives related to demographic developments. Upward pressure could also result from a reversal in the sovereign's debt trend and a significant decline in contingent liabilities.

On the other hand, a negative rating action could be triggered if the rise in the sovereign's public debt ratio becomes more entrenched, e.g. in the absence of fiscal consolidation measures and/or if medium-term growth fails to pick up. The latter could be part of a scenario in which structural reforms are not sufficiently implemented, adverse consequences from the geopolitical context lead to medium- to longer-term scarring effects on the Finnish economy, and/or geopolitical developments escalate further. Materializing contingent liability risks could also result in a downgrade of the rating or outlook.

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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

Creditreform Rating has signed the ESG in credit risk and ratings statement formulated within the framework of the UN Principles for Responsible Investment (UN PRI). The rating agency is thus committed to taking environmental and social factors as well as aspects of corporate governance into account in a targeted manner when assessing creditworthiness.

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.

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 assessment of an economy's competitive stance by e.g. the World Bank, the World Economic Forum, the European Commission, and IMD Business School and the World Intellectual Property Organization (UN) add further input to our rating or adjustments thereof, we judge the ESG factor 'Business Environment' as significant.

While Covid-19 may exert 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 on public finances. To be sure, we will follow ESG dynamics closely in this regard.

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**

Economic Data

[in %, otherwise noted]	2017	2018	2019	2020	2021	2022e	2023e
Macroeconomic Performance							
Real GDP growth	3.2	1.1	1.2	-2.4	3.0	2.1	-0.2
GDP per capita (PPP, USD)	47,622	49,234	50,687	50,072	53,833	58,651	60,897
Credit to the private sector/GDP	94.7	95.9	97.3	102.0	101,0	97.3	n/a
Unemployment rate	8.7	7.5	6.8	7.7	7.7	6.8	n/a
Real unit labor costs (index 2015=100)	94.6	95.2	95.6	94.9	95.9	95.3	95.1
World Competitiveness Ranking (rank)	15	16	15	13	11	8	n/a
Life expectancy at birth (years)	81.7	81.8	82.1	82.0	81.9	n/a	n/a
Institutional Structure							
WGI Rule of Law (score)	2.1	2.1	2.0	2.1	2.1	n/a	n/a
WGI Control of Corruption (score)	2.2	2.2	2.2	2.2	2.3	n/a	n/a
WGI Voice and Accountability (score)	1.6	1.6	1.6	1.6	1.6	n/a	n/a
WGI Government Effectiveness (score)	2.0	2.0	2.0	1.9	2.0	n/a	n/a
HICP inflation rate, y-o-y change	0.8	1.2	1.1	0.4	2.1	7.2	5.2
GHG emissions (tons of CO2 equivalent p.c.)	10.4	10.6	10.0	8.8	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	-0.7	-0.9	-0.9	-5.6	-2.8	-0.9	-2.6
General government gross debt/GDP	66.0	64.8	64.9	74.7	72.6	73.0	73.8
Interest/revenue	1.9	1.8	1.6	1.4	1.0	1.0	n/a
Debt/revenue	124.7	123.4	123.8	144.8	136.9	138.9	n/a
Total residual maturity of debt securities (years)	6.2	6.3	6.4	6.4	7.2	7.5	n/a
Foreign exposure							
Current account balance/GDP	-0.8	-1.8	-0.3	0.6	0.5	-3.9	n/a
International reserves/imports	14.9	13.1	15.5	19.8	19.5	16.6	n/a
NIIP/GDP	1.2	-5.6	4.0	-4.0	1.0	-2.7	n/a
External debt/GDP	181.0	218.3	224.4	222.7	208.7	213.5	n/a

Sources: IMF, World Bank, Eurostat, AMECO, ECB, IMD Business School, 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
Monitoring	15.07.2022	AA+/ stable
Monitoring	16.06.2023	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 Ministry of Finance (MoF) and the Treasury participated in the credit rating process as the authorities provided additional data and information and commented on a draft version of the report. Thus, this report represents an updated version, which was augmented in response to the factual remarks during their review. However, the rating outcome as well as the related outlook remained unchanged.

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, 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 the event 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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Future events are uncertain, and forecasts are necessarily based on assessments and assumptions. Hence, this rating is no statement of fact but an opinion. Nor should these ratings be construed as recommendations for investors, buyers or sellers. They should only be used by market participants (entrepreneurs, bankers, investors etc.) as one factor among others when arriving at investment decisions. Ratings are not meant to be used as substitutes for one's own research, inquiries and assessments. Thus, no express or implied warranty as to the accuracy, timeliness or completeness for any purpose of any such rating, opinion or information is given by Creditreform Rating AG in any form or manner whatsoever. Furthermore, Creditreform Rating AG cannot be held liable for the consequences of decisions made on the basis of any of their ratings.

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