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## Research Update:

# Finland 'AA+/A-1+' Ratings Affirmed; Outlook Stable

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## Research Update:

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## Overview

- Finland's economic growth has peaked and we expect it will start decelerating.
- Public sector consolidation is progressing, but longer-term sustainability of public finances is contingent on reforms to boost labor supply and enhance productivity.
- We are affirming our 'AA+/A-1+' ratings on Finland with a stable outlook.

## Rating Action

On March 15, 2019, S&P Global Ratings affirmed its 'AA+/A-1+' long- and short-term foreign and local currency sovereign credit ratings on Finland. The outlook remains stable.

We also affirmed our 'AA+' long-term foreign and local currency issue ratings on Finnvera PLC's senior unsecured euro medium-term note program, which the government of Finland guarantees.

## Outlook

The stable outlook reflects our expectation that continued economic growth will aid Finland's gradual fiscal consolidation and that Nordea Bank's re-location of its headquarters to Finland will not present supervision-related challenges or weaken the country's current external position.

We could raise the long-term rating if the Finnish economy's external metrics structurally improved, evidenced, for example, by strong and sustained current account surpluses. Greater reform momentum to address challenges posed by a decreasing and aging workforce, resulting in longer-term sustainability of public finances, would be positive for the ratings.

We could consider a negative rating action if structural reforms don't succeed, leading to weaker growth or a substantial deterioration in Finland's fiscal performance, in turn leading to sharply increasing debt.

## Rationale

Our ratings on Finland are supported by the sovereign's wealthy economy. Finland has a track record of stable, transparent, and effective governance and political institutions, which, for instance, led to the conclusion of the "competitiveness pact" between Finnish trade unions, employers, and the government in 2016. Such recent reforms have boosted trade and employment. Nevertheless, we think the economy reached its cyclical peak midway through 2018. In our view, further reforms will be required to help the economy contend with structural challenges, including those related to demographic pressure. The ratings are further supported by the government's low net debt and the benefits of eurozone membership, including high credibility of the European Central Bank's (ECB's) monetary policy and access to deep capital markets.

The ratings remain constrained, however, by Finland's relatively large external debt, which stems from its extensive pan-Nordic financial system and the resulting significant external financing needs.

### **Institutional and economic profile: Cyclical growth peak has passed as investment boom fades and structural challenges begin to weigh on long-term growth**

- Economic growth will cool in 2019 as cyclical growth-drivers lose speed and external demand softens.
- We believe medium-term demographic challenges to long-term growth will require a policy response.
- Reform momentum seems to have weakened, as demonstrated by delays in social and health care reforms, which triggered a government resignation just five weeks ahead of the 2019 elections.

Finland's strong and cyclical growth upturn allowed Finnish real GDP to reach its pre-financial crisis level in the second quarter of 2018. At the same time, we believe that Finland's economic cycle peaked. Leading components, in particular investments and exports, have cooled since then. Official national accounts data from Statistics Finland shows that output expanded by 2.2% in 2018 compared with our forecast of 2.9%. The cool down in particular exemplifies Finland's sensitivity to external investment cycles. The concentration of Finnish exports on capital goods suggests that cooling external demand will rapidly translate into a drop in output for Finnish industries and the economy.

That said, Finland's solid export performance over the past three years is not merely a reflection of strong demand from trading partners. It is also based on the positive effects of the 2016 competitiveness pact, which helped boost Finland's price competitiveness by extending annual working hours, shifting parts of social security contributions from employers to employees, and

reducing public-sector holiday bonuses. The solid upswing has above all resulted in a strengthening of the labor market, with rising real wages, improved consumer sentiment, and higher employment (currently at 72%, a stated target set by the incumbent government).

As Finland's economic cycle enters a mature phase, we believe that growth will come less from investments and exports and rely to a larger extent on domestic consumption, which has to date been muted because the government's consolidation efforts have curbed public consumption. We foresee a slowdown in exports in 2019-2021 on the back of slowing external demand and declining cost competitiveness, in part also connected to the strong euro exchange rate. Importantly, we observe signals that construction, in particular new production in real estate, is declining and we expect this to present a drag on headline growth over the coming two years. Moreover, we note that key investment projects in the public sector have been stalled pending environmental permits, which suggests that public investments will stay muted in the short term. Therefore, as investments cool, we expect that growth will increasingly depend on domestic demand, since the strengthening labor market looks set to revive private consumption and sustain growth levels through 2022. Although research and development (R&D) funding increased in the central government's 2019 budget, at 0.83% of GDP, we note that the trend of low investment in R&D continues, which impedes prospects for diversification of industry.

While the rapidly expanding economy has reduced unemployment, tightening labor market conditions are actually producing labor shortages, in particular within construction, and accentuating the skill mismatches and structural nature of the remaining unemployed. Importantly, problems remain with productivity and the labor market. Specifically, we observe that hours worked have been increasing annually by about 4.5% over the past two years, below the growth of output, suggesting that productivity has been weak. Absent stronger reform momentum to boost Finland's labor force, we expect growth will converge toward Finland's potential rate of around 1.5% by 2020.

Confidence in the government's reform ability took a hit in March 2019 when the failure to pass legislation necessary to implement a longstanding major reform initiative in the social and health care sector, the "SOTE" reform, prompted a government resignation, just five weeks before the April general elections. Even though the content of the SOTE reform has been politically contested, we observe a strong political consensus about the need to push it forward. Therefore, we believe that the social and health care reform will stand as a top priority of the incoming government, which could delay other key reform efforts.

Stronger reform momentum will be required to handle the structural challenges from an aging population and a declining employment pool. If not addressed, these will weigh on the economy's growth potential over the longer term. A reform of the social security system has recently been brought for consideration, and in our opinion, its implementation could be a positive step in this direction. However, given the recurring setbacks on the SOTE, concrete

action on further major reforms aside from the SOTE could be difficult in the near term.

**Flexibility and performance profile: Large external refinancing needs reflect Finland's large and developing financial sector**

- Finland's fiscal position continues its gradual consolidation, and the government's debt as a share of GDP continues to fall.
- The country's external position remains heavily dominated by the financial sector, and Nordea Bank's relocation to Finland has increased the government's external assets and liabilities.
- Current accounts will likely continue to show small but shrinking deficits as domestic demand drives imports.

We expect Finland's public finances to continue on a gradual consolidation path through 2022. We do not expect the 2019 elections to materially alter this trend, given the widespread consensus in favor of fiscal prudence within the established political parties. For 2018, we estimate that strong economic activity boosted tax revenues, while improving labor market conditions helped to contain social expenditures, resulting in a small general government deficit of 0.5% of GDP.

In the longer term, there remains a sustainability gap in the country's public finances of around €8 billion (3% of 2022 GDP), which the government intends to close through reforms to the social and health care sectors, among others. As a result of gradually closing fiscal deficits, general government gross debt continues to decline as a share of GDP. According to our forecasts, Finland's gross general government debt now stands below 60% of GDP. In terms of holdings of government securities, over 70% of outstanding Finnish government debt continues to be held by nonresidents.

For the purposes of our analysis, we focus on net rather than gross general government debt. To that end, we deduct not only the Finnish Treasury's cash holdings and its minority ownership of publicly listed companies through the state-owned asset manager Solidium, but also, and more importantly, we deduct approximately 30% of GDP in liquid assets held by the public sector's earnings-related pension fund. As a result, Finland's net general government debt ratio is among the lowest in the eurozone (for more, see [www.spratratings.com/sri](http://www.spratratings.com/sri)).

Benefitting from strong exports, Finland's current account position has strengthened in recent years, with pent-up demand for investment goods in the EU and a continued recovery in the paper and pulp industry underpinning the positive dynamics. For 2018, we observe a return to a more sizable deficit at 1.6% of GDP, up from an average of 0.7% of GDP in the three preceding years. The widening current account in 2018 reflects a deterioration of the primary income balance but also rising goods imports and continuous deficits on the services balance. Generally, we forecast that Finland's current account will remain in small, and shrinking, deficits through 2022, as domestic demand will

sustain imports and lowered external demand will put a lid on exports. Foreign direct investment inflows will likely remain highly volatile, owing to the impact of large acquisitions, such as foreign investors' past purchases of Finnish companies in the shipbuilding or technology sector.

Finland's external ratios continue to be dominated by financial institutions. In particular, relocation of Nordea to Finland has affected Finland's international investment position, with both assets and liabilities increasing significantly, but largely in tandem, leaving the net position largely unaffected. In addition, the Nordea move has substantially increased the size of the banking sector to about 375% of Finland's GDP, compared with 250% previously. This has prompted the Finnish Financial Supervisory Authority to upscale local supervision and regulatory activities while also highlighting the importance of continued close regional cooperation and preparedness for crises.

Broadly, we do not expect the Nordea move will change the overall picture of Finland's external balances. External short-term debt by remaining maturity will remain well above 100% of current account receipts (CARs) and narrow net external debt will stay around a high 175% of CARs on average over 2019-2022. At the same time, we note that Finland's external position, as indicated by the country's overall net external creditor position, is much stronger than its narrow net external debt position. In spite of this, we consider external imbalances a rating constraint for Finland.

Overall, Finland's banking system remains profitable and well capitalized, and it is dominated by pan-Nordic banks and a domestic cooperative banking group (see "Banking Industry Country Risk Assessment: Finland," published Feb. 2, 2018, on RatingsDirect). In our view, the banking system poses only a limited contingent liability to the sovereign. Moreover, to address potential negative spillovers into Finland from other Nordic and Baltic financial systems, the so-called Nordic-Baltic Stability Group's (NBSG) remit was enhanced in January 2018. The NBSG comprises ministries, central banks, regulators, supervisors, and resolution authorities from the Nordic-Baltic region.

We assess house price developments in Finland as contained compared with those of its Nordic peers and, in turn, the risks are modest. However, household debt has increased markedly as a result of the expansion in the house loan stock, with the ratio of debt to disposable income rising to about 130% as of year-end 2018, from 100% in 2006. That said, the increase in household debt uptake has remained lower than the growth in nominal GDP. The risk could be amplified, however, as the majority of Finnish mortgage loans are at floating rates, and a rise in interest rates might therefore pose risks of a slowdown in consumption and wider implications for the real economy. Furthermore, we observe a continued elevated growth rate in consumer lending, together with housing corporation debt, adding an additional element of risk to household debt positions.

We acknowledge that indebtedness is unequally distributed between households. The highly indebted households are typically in the highest income brackets

and slightly more than half of Finnish households hold no debt. Despite the economic headwinds in recent years, Finnish banks' credit losses have remained low, indicating the resilience of the corporate and household sectors.

We expect Finnish inflation will remain moderate compared with that of most European peers. More generally, Finland benefits from the eurozone's deep and liquid debt markets, the credibility of the ECB's monetary policy, and the positive effects of the ECB's quantitative easing on Finnish government bond yields. Still, membership in a monetary union reduces Finland's monetary flexibility, and we believe that monetary accommodation alone is unlikely to lead to sustained real economic growth.

## Key Statistics

Table 1

Finland Selected Indicators										
(Mil. €)	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
<b>Economic indicators (%)</b>										
Nominal GDP (bil. €)	203	205	210	216	224	233	241	248	256	264
Nominal GDP (bil. \$)	270	273	233	239	253	275	281	305	320	330
GDP per capita (000s \$)	49.8	50.1	42.6	43.6	46.0	49.9	50.9	55.2	57.7	59.3
Real GDP growth	(0.8)	(0.6)	0.5	2.8	2.7	2.2	1.8	1.5	1.3	1.3
Real GDP per capita growth	(1.2)	(1.1)	0.1	2.5	2.4	2.0	1.6	1.3	1.1	1.1
Real investment growth	(4.9)	(2.6)	0.7	8.6	4.3	3.2	2.8	2.4	2.0	2.0
Investment/GDP	21.4	20.9	20.9	22.1	22.4	24.1	24.1	24.3	24.6	24.8
Savings/GDP	19.5	19.4	20.2	21.4	21.8	22.5	23.5	23.9	24.2	24.6
Exports/GDP	38.8	37.2	36.4	35.9	38.5	39.0	39.5	39.9	40.4	41.0
Real exports growth	1.1	(2.7)	0.8	3.5	7.7	1.5	2.5	2.2	2.2	2.3
Unemployment rate	8.2	8.7	9.4	8.8	8.6	7.4	7.3	7.1	7.0	7.0
<b>External indicators (%)</b>										
Current account balance/GDP	(1.9)	(1.5)	(0.7)	(0.7)	(0.7)	(1.6)	(0.6)	(0.5)	(0.4)	(0.2)
Current account balance/CARs	(4.2)	(3.4)	(1.6)	(1.7)	(1.5)	(3.5)	(1.3)	(0.9)	(0.8)	(0.4)
CARs/GDP	46.4	45.7	44.3	44.7	45.9	46.1	47.9	47.9	48.5	49.1
Trade balance/GDP	1.3	0.9	0.9	0.2	0.8	0.5	0.3	0.2	0.1	0
Net FDI/GDP	0.8	6.3	7.8	(5.7)	0.8	(3.3)	1.2	1.2	1.2	1.2
Net portfolio equity inflow/GDP	(2.1)	0.2	0.9	(3.6)	(6.4)	(2.5)	(1.0)	(1.0)	(1)	(1)
Gross external financing needs/CARs plus usable reserves	474.0	436.9	472.9	383.2	339.0	290.8	302.9	288.2	274.1	266.6
Narrow net external debt/CARs	207.1	197.4	211.8	212.5	245.5	229.3	218.7	196.2	185.5	171.5
Narrow net external debt/CAPs	198.8	191.0	208.4	209.0	242.0	221.5	216.0	194.3	184.0	170.8
Net external liabilities/CARs	(7.4)	6.8	(2.9)	(17.5)	(4.8)	1.8	2.8	(2.9)	(2.0)	(7.6)

**Table 1**

<b>Finland Selected Indicators (cont.)</b>										
<b>(Mil. €)</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>	<b>2019</b>	<b>2020</b>	<b>2021</b>	<b>2022</b>
Net external liabilities/CAPs	(7.1)	6.6	(2.9)	(17.2)	(4.7)	1.7	2.7	(2.9)	(2.0)	(7.6)
Short-term external debt by remaining maturity/CARs	411.8	373.0	420.1	317.4	268.2	211.3	224.8	208.4	192.8	184.9
Usable reserves/CAPs (months)	1.0	1.0	1.2	1.1	1.1	1.0	0.9	0.9	0.8	0.8
Usable reserves (mil. \$)	11,268	10,669	10,018	10,468	10,517	10,310	10,720	11,025	11,345	11,675
<b>Fiscal indicators (general government; %)</b>										
Balance/GDP	(2.6)	(3.2)	(2.8)	(1.7)	(0.7)	(0.5)	(0.3)	(0.2)	(0.1)	(0.1)
Change in net debt/GDP	2.4	2.0	2.3	1.3	(1.8)	0.5	0.3	0.2	0.1	0.1
Primary balance/GDP	(1.3)	(1.9)	(1.5)	(0.6)	0.4	0.5	0.8	1.0	1.2	1.2
Revenue/GDP	54.9	54.9	54.3	54.2	53.3	54.0	54.0	54.0	54.0	54.0
Expenditures/GDP	57.5	58.1	57.0	55.9	54.0	54.5	54.3	54.2	54.1	54.1
Interest/revenues	2.4	2.4	2.3	2.1	2.0	1.9	2.1	2.3	2.4	2.3
Debt/GDP	54.7	58.4	61.8	61.4	59.6	58.7	57.3	55.8	54.4	53.0
Debt/revenues	99.7	106.3	113.8	113.2	111.9	108.8	106.1	103.3	100.7	98.1
Net debt/GDP	20.0	21.8	23.6	24.3	21.6	21.3	20.9	20.5	20.0	19.5
Liquid assets/GDP	34.7	36.5	38.1	37.1	37.9	37.5	36.4	35.4	34.4	33.5
<b>Monetary indicators (%)</b>										
CPI growth	2.2	1.2	(0.2)	0.4	0.8	1.2	1.3	1.6	1.7	1.7
GDP deflator growth	2.6	1.7	1.7	0.1	0.9	1.9	1.4	1.7	1.7	1.7
Exchange rate, year-end (€/€)	0.73	0.82	0.92	0.95	0.83	0.87	0.83	0.80	0.80	0.80
Banks' claims on resident non-gov't sector growth	6.5	2.9	0.9	1.3	2.7	4.6	4.6	4.6	4.6	4.6
Banks' claims on resident non-gov't sector/GDP	96.5	98.3	97.0	95.5	94.7	95.1	96.4	97.7	99.2	100.7
Foreign currency share of claims by banks on residents	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Real effective exchange rate growth	(3.7)	0.4	(2.7)	(1.7)	(6.1)	(0.6)	N/A	N/A	N/A	N/A

Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository corporations other than the central bank, whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private- sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. N/A--Not applicable. The data and ratios above result from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

## Ratings Score Snapshot



**Table 2**

Finland Ratings Score Snapshot	
<b>Key rating factors</b>	
Institutional assessment	2
Economic assessment	1
External assessment	4
Fiscal assessment: flexibility and performance	1
Fiscal assessment: debt burden	1
Monetary assessment	2

S&P Global Ratings' analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). S&P Global Ratings' "Sovereign Rating Methodology," published on Dec. 18, 2017, details how we derive and combine the scores and then derive the sovereign foreign currency rating. In accordance with S&P Global Ratings' sovereign ratings methodology, a change in score does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the scores. In determining the final rating the committee can make use of the flexibility afforded by §15 and §§126-128 of the rating methodology.

## Related Criteria

- Criteria | Governments | Sovereigns: Sovereign Rating Methodology, Dec. 18, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

## Related Research

- Sovereign Ratings History, March 5, 2019
- Sovereign Ratings List, March 5, 2019
- Sovereign Debt 2019: Eurozone Commercial Borrowing To Increase 1.6% In 2019, Feb. 22, 2019
- Banking Industry Country Risk Assessment Update: February 2019, Feb. 22, 2019
- Eurozone Sovereign Rating Trends 2019, Jan. 14, 2019
- Sovereign Risk Indicators, Dec. 13, 2018. An interactive version is also available at <http://www.spratings.com/sri>
- Default, Transition, and Recovery: 2017 Annual Sovereign Default Study And Rating Transitions, May 8, 2018
- Banking Industry Country Risk Assessment: Finland, Feb. 2, 2018

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision. After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

## Ratings List

### Ratings Affirmed

#### Finland

Sovereign Credit Rating	AA+/Stable/A-1+
Transfer & Convertibility Assessment	AAA
Senior Unsecured	AA+
Short-Term Debt	A-1+

#### Finnvera PLC

Senior Unsecured	AA+
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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at

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