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Research Update:

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

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Overview

- Finland's growth cycle is set to cool from its 2018 peak as investment slows and structural factors weigh on longer-term growth potential.
- Public sector consolidation is progressing, but structural reforms to ensure labor supply and enhance productivity will be required to boost growth and secure longer-term sustainability of public finances.
- We are affirming our 'AA+/A-1+' sovereign credit ratings on Finland.
- The outlook remains stable.

Rating Action

On Sept. 14, 2018, 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 issuance, which 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 decision to move its headquarters to Finland will not weaken the country's current external positions.

We could raise the ratings if the Finnish economy's external metrics structurally improve, evidenced, for example, by strong and sustained current account surpluses. If the government successfully navigates the growth challenges posed by a decreasing and aging workforce, and notably revives growth potential so as to secure the long-term sustainability of public finances, it would build additional upside momentum to the ratings.

We could consider a downgrade 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 levels.

Rationale

Our ratings on Finland are supported by the sovereign's wealthy economy, which in 2018 will likely post its strongest growth since 2010. This uptick owes partly to Finland's track record of stable, transparent, and effective governance and political institutions, which, for instance, led to the conclusion of the so-called competitiveness pact between Finnish trade unions, employers, and the government.

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

Institutional and economic profile: Structural challenges weigh on long-term growth

- After peaking in 2018, we expect economic growth to slow significantly as investments and exports temper on subdued external demand.
- We believe further structural reforms will be needed to help the economy contend with the medium-term structural challenges of a shrinking employment pool and aging population.
- Long-awaited social and health care reforms could stop short of completion as disagreements persist and political positions increasingly deadlock in the run-up to the 2019 elections.

We expect Finland's economic cycle to peak in 2018, with output expanding by 2.9% for the full year. This marks the second consecutive year with growth rates of around 3% and in which activity has been buoyed by strong exports stemming from robust growth in the EU and the consequent significant investments in machinery and construction.

Finland's strong export performance of late is not merely a reflection of strong demand from trading partners, though. It is also based on the positive effects of the competitiveness pact enacted in 2016, which helped boost Finland's price competitiveness by extending annual working hours, through shifts in social security contributions from employers to employees, and cuts in public-sector holiday bonuses. The solid upswing has resulted in a strengthening labor market, demonstrating rising real wages, improved consumer sentiment, and higher employment levels (currently at 72%, a stated target set by the incumbent government).

As Finland's economic cycle enters a mature phase, we believe that the drivers of growth will shift away 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 muted public consumption. Although data through the second quarter of 2018 suggest that investment in machinery has stalled, we expect the strengthening labor market to revive private consumption and sustain domestic demand through 2021. However, we note that the trend of low investment in research and development continues, which impedes prospects for diversification of the industry structure.

We foresee a slowdown in exports in 2019-2020 on the back of slowing external demand and declining cost competitiveness, in part also connected to the strong euro exchange rate. Moreover, the concentration of Finnish exports on capital goods, sensitive to external investment cycles, suggests a quick transition from cooling external demand to economic output.

While the rapidly expanding economy has reduced unemployment, the 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. 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.

In our view, the structural challenges from an aging population and a declining employment pool will wear on the economy's growth potential over the longer term. To contend with these developments, alleviate skill mismatches, and incentivize labor force inclusion, further reforms to the labor market will be needed. 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, we do not expect any traction on major reforms to surface until after the 2019 elections. Currently, we foresee that any short-term reform efforts will focus on the completion of a longstanding major reform initiative to the social and health care sector, the "SOTE" reform. We believe there is a risk that this reform could fall short of being completed within the designated timeframe (by the end of 2018), which would likely keep the SOTE at the top of the coming government's reform agenda and could hence stall other key reform efforts.

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 move of its headquarters to Finland will increase both its external assets and liabilities.
- Current accounts will likely continue to show small and shrinking surpluses as increasing domestic demand drives imports.

We expect Finland's public finances to continue on a gradual consolidation path through 2020. We do not expect the 2019 elections to materially alter the current trend of public finances, given the widespread consensus in favor of fiscal prudence within the established political parties. For 2018, we project that the strong economic activity will boost revenues, while improving labor market conditions will help contain social expenditures, resulting in a small general government deficit of 0.7% of GDP.

In the longer term, there remains a sustainability gap in the country's public finances of around €8 billion (3% of 2021 GDP), which the government intends to close through the reforms to, among others, the social and health care sectors. We consider that the SOTE reform, when finally passed, has the potential to generate annual savings of approximately €3 billion (1.3% of 2017 GDP).

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 debt ratio could fall further to below 60% in 2018. 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.spratings.com/sri).

Benefitting from strong exports, Finland's current account moved into a surplus of 0.7% of GDP in 2017. Pent-up demand for investment goods in the EU and a continued recovery in the paper and pulp industry underpinned this turnaround. Generally, we forecast that Finland's current account will remain in small, but shrinking, surplus through 2021, as domestic demand will lead to a pick-up in imports. 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, particularly Nordea Bank. Nordea Bank Finland PLC's January transformation from a subsidiary of the Nordea Group into a branch of Nordea Bank AB affected Finland's net external liability position. On this occasion, we understand Nordea transferred large parts of its "external" assets (such as its trading and liquidity book) and, to a lesser extent, its liabilities, to its Swedish parent. However, as Nordea completes the move of its headquarters to Finland in October 2018, we foresee this transfer being reversed, in addition to further changes, as Nordea Bank's foreign branch operations settle on Finland's external balance sheet. Once the Nordea move is complete, we estimate that the banking sector assets could increase to about 400% of Finland's GDP compared with 250% prior to the Nordea move.

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 200% of CARs on average over 2018-2021.

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 128% as of year-end 2017, 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 the 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, and that the credit cycle seems to be picking up again.

In line with the broader eurozone trend, inflation has started to recover in Finland since 2017. 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 European Central Bank's (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 by itself is unlikely to lead to sustained real economic growth.

Key Statistics

Table 1

Finland Selected Indicators

(Mil. €)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. €)	200	203	205	210	216	224	234	243	251	259
Nominal GDP (bil. $)	257	270	273	233	239	253	281	305	314	323
GDP per capita ($000s)	47.5	49.8	50.1	42.5	43.6	45.9	51.0	55.1	56.5	58.0
Real GDP growth	(1.4)	(0.8)	(0.6)	0.1	2.5	2.8	2.9	2.2	1.5	1.3
Real GDP per capita growth	(1.9)	(1.2)	(1.1)	(0.2)	2.2	2.5	2.7	1.8	1.1	0.9
Real investment growth	(1.9)	(4.9)	(2.6)	0.7	8.5	4.0	4.7	3.2	2.2	2.0
Investment/GDP	22.5	21.4	20.9	20.8	22.0	22.3	23.1	23.4	23.7	24.0
Savings/GDP	20.2	19.5	19.4	19.9	21.6	23.0	23.8	23.9	24.1	24.2
Exports/GDP	39.5	38.8	37.2	36.5	36.0	38.5	39.2	39.8	40.2	40.7
Real exports growth	1.2	1.1	(2.7)	0.9	4.0	7.5	4.2	3.5	2.2	2.1
Unemployment rate	7.7	8.2	8.7	9.4	8.8	8.6	8.3	8.0	8.0	8.0
EXTERNAL INDICATORS (%)										
Current account balance/GDP	(2.3)	(1.9)	(1.5)	(0.9)	(0.3)	0.7	0.7	0.5	0.4	0.2
Current account balance/CARs	(4.8)	(4.2)	(3.4)	(1.9)	(0.8)	1.5	1.4	1.1	0.8	0.5
CARs/GDP	47.6	46.4	45.7	44.5	44.8	46.8	47.6	47.5	48.1	48.4
Trade balance/GDP	1.2	1.3	0.9	0.8	0.4	1.0	1.1	1.1	1.1	1.0
Net FDI/GDP	(1.3)	0.8	6.3	7.8	(5.8)	(0.2)	1.2	1.2	1.2	1.2
Net portfolio equity inflow/GDP	(3.2)	(2.1)	0.2	0.9	1.8	(5.1)	(0.5)	(0.5)	(0.5)	(0.5)
Gross external financing needs/CARs plus usable reserves	349.3	472.8	435.2	471.8	382.8	334.6	278.6	261.9	296.8	291.8
Narrow net external debt/CARs	189.5	203.7	196.3	212.8	220.1	248.4	206.7	180.2	176.1	175.2
Narrow net external debt/CAPs	180.9	195.5	189.8	208.8	218.4	252.2	209.7	182.2	177.5	176.1
Net external liabilities/CARs	1.7	(10.3)	6.0	1.4	(5.7)	(11.7)	(11.3)	(14.5)	(9.1)	(4.3)
Net external liabilities/CAPs	1.6	(9.9)	5.8	1.4	(5.7)	(11.9)	(11.4)	(14.6)	(9.2)	(4.4)
Short-term external debt by remaining maturity/CARs	274.1	410.5	371.1	418.6	317.7	265.7	201.9	183.3	220.2	214.3
Usable reserves/CAPs (months)	1.0	1.0	1.0	1.2	1.1	1.1	1.0	0.9	0.9	0.9
Usable reserves (mil. $)	11,082	11,268	10,669	10,018	10,468	10,517	11,220	11,525	11,839	12,162
FISCAL INDICATORS (%, General government)										
Balance/GDP	(2.2)	(2.6)	(3.2)	(2.8)	(1.8)	(0.6)	(0.7)	(0.6)	(0.4)	(0.2)
Change in net debt/GDP	2.6	2.4	2.0	2.3	1.3	(1.8)	0.7	0.6	0.4	0.2
Primary balance/GDP	(0.7)	(1.3)	(1.9)	(1.5)	(0.6)	0.5	0.3	0.5	0.8	1.1
Revenues/GDP	54.0	54.9	54.9	54.4	54.2	53.1	54.0	54.0	54.0	54.0
Expenditures/GDP	56.2	57.5	58.1	57.1	55.9	53.7	54.7	54.6	54.4	54.2
Interest/revenues	2.7	2.4	2.4	2.3	2.1	1.9	1.9	2.1	2.3	2.4
Debt/GDP	52.4	54.7	58.4	61.8	61.4	59.6	58.7	57.2	56.0	54.6

Table 1

Finland Selected Indicators (cont.)										
(Mil. €)	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
Debt/revenues	97.0	99.7	106.3	113.7	113.2	112.2	108.7	106.0	103.6	101.1
Net debt/GDP	17.9	20.0	21.8	23.7	24.3	21.6	21.4	21.2	20.9	20.5
Liquid assets/GDP	34.5	34.7	36.5	38.2	37.1	38.0	37.3	36.1	35.0	34.1
MONETARY INDICATORS (%)										
CPI growth	3.2	2.2	1.2	(0.2)	0.4	0.8	1.2	1.3	1.6	1.7
GDP deflator growth	3.0	2.6	1.7	1.9	0.6	0.8	1.6	1.6	1.7	1.8
Exchange rate, year-end (€/$)	0.76	0.73	0.82	0.92	0.95	0.83	0.82	0.79	0.80	0.80
Banks' claims on resident non-gov't sector growth	6.6	6.5	2.9	0.9	1.2	2.8	4.3	3.6	3.2	3.1
Banks' claims on resident non-gov't sector/GDP	92.2	96.5	98.3	97.2	95.4	94.8	94.6	94.4	94.4	94.4
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	8.1	(3.7)	0.5	(2.8)	(2.3)	(6.0)	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	
Key rating factors	
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: Guarantee Criteria, Oct. 21, 2016
- 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, Sept. 5, 2018
- Sovereign Ratings List, Sept. 5, 2018
- Sovereign Risk Indicators, July 5, 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
- Global Sovereign Rating Trends: First-Quarter 2018, April 11, 2018
- Sovereign Debt 2018: Global Borrowing To Remain Steady At US$7.4 Trillion, Feb. 22, 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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