Republic of Finland
Rating Report

AA+ STABLE OUTLOOK

Credit strengths	Credit challenges
• Wealthy and modern economy	• Moderate growth potential
• High government debt affordability	• Rising fiscal pressures
• Outstanding institutional quality	• Financial stability vulnerabilities

Rating rationale:

Wealthy and modern economy: Finland's ratings are supported by its wealthy and modern economy, which benefits from elevated human capital and a strong infrastructure in future economic areas such as digitalisation and the environmental transition. The economy is proving resilient to the current external shocks related to the Covid-19 pandemic and the Russia-Ukraine war.

High government debt affordability: Finland's fiscal resilience is anchored to the government's ample net financial asset position, a favourable debt structure and prudent liquidity management, underpinning debt affordability in the context of rising financing costs.

Outstanding institutional quality: Finland ranks among the top countries globally in terms of governance indicators and has a strong track record of implementing structural reforms enhancing external competitiveness, strengthening the sustainability of the welfare system and addressing labour market rigidities.

Rating challenges include: i) the country's moderate growth potential, constrained by weak productivity dynamics, labour market rigidities and a declining working-age population; ii) rising fiscal pressures from Finland's ageing population, which weigh on the medium-term trajectory of public finances; and iii) financial stability risks, including those arising from the size of the Finnish banking sector relative to that of the domestic economy.

Finland's sovereign rating drivers

Risk pillars		Quantitative		Reserve currency	Qualitative*	Final rating
		Weight	Indicative rating	Notches	Notches	
Domestic Economic Risk		35%	aaa	EUR [+1]	-1/3	AA+
Public Finance Risk		20%	aa		0	
External Economic Risk		10%	bb+		-1/3	
Financial Stability Risk		10%	aaa		0	
ESG Risk	Environmental factors	5%	aa		+1/3	
	Social factors	7.5%	b+		0	
	Governance factors	12.5%	aaa		0	
Indicative outcome		**aa+**			**0**	
Additional considerations					**0**	

Note: *The qualitative scorecard adjustments, capped at one notch per rating pillar, are weighted equally with an aggregate adjustment rounded to the nearest integer. The reserve currency adjustment applies to currencies in the IMF's SDR basket. For details, please see Scope's 'Sovereign Ratings' methodology. Source: Scope Ratings.

Outlook and rating triggers

The Stable Outlook reflects Scope's view that risks to the ratings are balanced.

Positive rating-change drivers

- Material improvement in growth outlook
- Improved fiscal outlook, resulting in sustained debt reduction

Negative rating-change drivers

- Significant deterioration in growth outlook over the medium term
- Weaker fiscal outlook, resulting in a material increase in public debt
- Crystallisation of financial stresses on the government balance sheet
- Escalation of geopolitical risks, threatening macroeconomic stability

Ratings and Outlook

Foreign currency

Long-term issuer rating	AA+/Stable
Senior unsecured debt	AA+/Stable
Short-term issuer rating	S-1+/Stable

Local currency

Long-term issuer rating	AA+/Stable
Senior unsecured debt	AA+/Stable
Short-term issuer rating	S-1+/Stable

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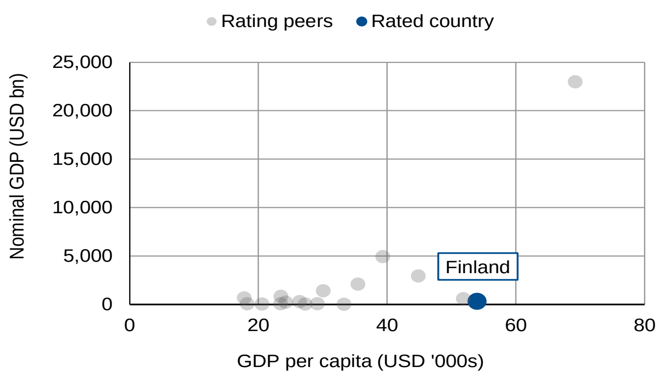
Domestic Economic Risks

- **Growth outlook:** The Finnish economy has rebounded strongly from Covid-19, with real GDP growth of 3.0% last year, after a relatively mild contraction of 2.2% in 2020. The economy has remained on a solid footing during the first half of 2022, with higher-than-expected growth in the first and second quarters resulting in carry-over annual GDP growth of 2.6% so far. We expect the economic outlook to weaken from the second part of this year with growth of 2.3% in 2022 and just 0.2% in 2023, reflecting the worsening of the energy crisis and the global economic slowdown. Growth should then rebound to about 1.4% in 2024. Over the medium term, we expect economic growth to converge towards a modest potential of 1.2%, constrained by a declining working-age population and mild productivity gains.
- **Inflation and monetary policy:** Inflationary pressures have been elevated in the past months, exacerbated by the ramifications of the Russia-Ukraine war on energy and food prices. The harmonised inflation rate stood at 7.9% YoY in August, though below the 9.1% rate in the euro area, also thanks to a more marginal role of natural gas in Finland's energy mix. We expect price pressures to remain elevated in the coming months, as we deem unlikely a rapid solution to the energy crisis and because price pressures are becoming more broad-based, as reflected in elevated core inflation of 4.5%. We expect an annual inflation rate for this year above 6.5%, followed by 3.5% in 2023. The ECB is reacting swiftly with rate hikes for 125 bps so far this year, on top of the halt of net asset purchases under its QE programmes.
- **Labour markets:** The labour market has shown solid trends in recent months. In August, employment counted 100,000 more workers than before Covid-19, resulting in a record high employment rate (trend adjusted) of 73.6%, against 70% pre-shock. The number of unemployed was back at 2019 levels, close to 190,000, meaning participation has increased. Finnish workers are highly qualified: more than 43% have a university degree, outperforming the euro-area average, while low-skilled employees are about half the euro-area average. We expect the unemployment rate to remain close to the current levels of 6.8% in 2022-24, given that further reductions are unlikely given the weakening economic outlook and persistent labour market rigidities, resulting in a structural unemployment rate close to 7%, above that of peers.

Overview of Scope's qualitative assessments for Finland's *Domestic Economic Risks*

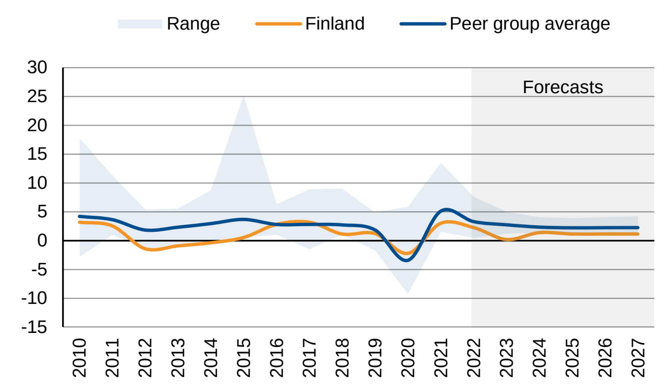
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Growth potential of the economy	Weak	-1/3	Resilient economy, relatively modest growth potential
	Monetary policy framework	Neutral	0	ECB is a credible and effective central bank; effective policy framework and transmission over the cycle
	Macro-economic stability and sustainability	Neutral	0	Competitive economy, favourable business environment and highly skilled labour force; limited economic diversification

Nominal GDP and GDP per capita, USD



Source: IMF World Economic Outlook (WEO), Scope Ratings

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

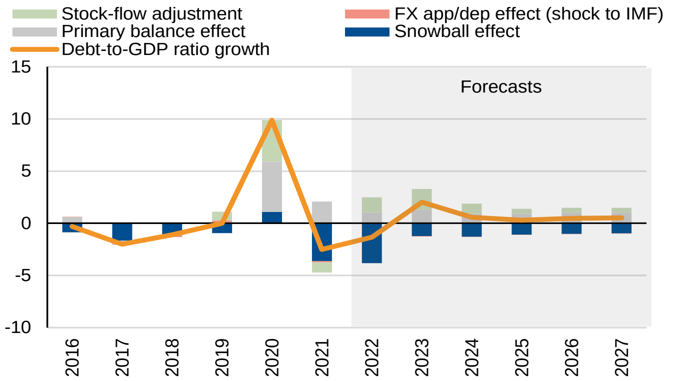
Public Finance Risks

- **Fiscal outlook:** Finland's public finances are recovering rapidly from Covid-19. Last year the fiscal deficit narrowed to 2.7% of GDP from 5.5% in 2020 and should further decline to about 1.6% of GDP this year, despite the fiscal costs of the Russia-Ukraine war, including additional defence spending and support measures for dealing with high energy prices. The government has also introduced a EUR 10bn lending facility for energy companies. Considering the weak economic outlook, the costs of the conflict and the ongoing reorganisation of healthcare services, the deficit should increase to 2.0% of GDP in 2023 and then decline to 1.7% of GDP in 2024, thanks to lower security spending and the economic recovery. Looking ahead, we expect the deficit to widen to 2.0% of GDP by 2027, based on persistent fiscal imbalances driven by Finland's ageing population and gradually higher debt servicing costs.
- **Debt trajectory:** In the summer a change in government debt statistics was implemented with the inclusion of interest subsidy loans to housing providers, which increased the debt-to-GDP ratio by 6 pp at the level of 2021, to 72.3%. Robust nominal GDP growth and a contained deficit should result in a moderate decline in the debt-to-GDP ratio this year to about 71%, although this will also depend on the actual take-up of the loan scheme to the energy sector. In the next years we expect the debt ratio on a moderately increasing trajectory towards 75% of GDP by 2027, given persistent fiscal deficits and a moderate growth outlook. Contingent liabilities pose risks, given sizeable government guarantees of about 25% of GDP, while long-term sustainability is challenged by rising ageing-related costs, with the net present value of the increase in healthcare and pension spending until 2050 estimated by the IMF at 35% of GDP.
- **Debt profile and market access:** The Finnish government is the wealthiest in the euro area, with a net financial asset position of EUR 163bn in Q2 2022, or 62% of GDP, stemming from its public pension scheme. We expect annual funding needs above 10% of GDP over 2022-27 with possible peaks at 15% of GDP in 2022-23, depending on the actual use of the loan support scheme for the energy sector. The debt profile is robust, with an average debt maturity of 7.7 years and 96% of debt in euros, the remainder consisting of (hedged) USD programmes to broaden the investor base. Market conditions remain favourable, although financing costs have markedly increased, as is the case across euro area sovereigns, with the yield on the 10-year government bond above 2.5% at the time of writing, from about 0% at the beginning of the year.

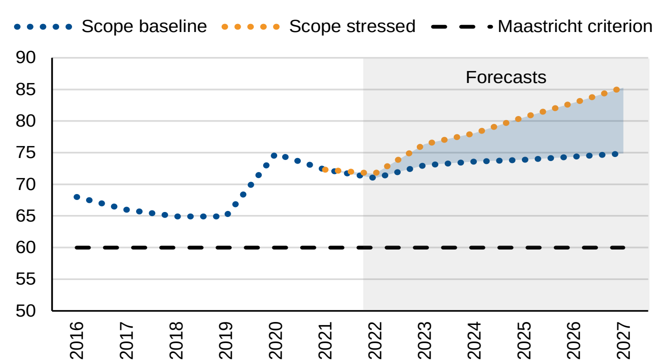
Overview of Scope's qualitative assessments for Finland's *Public Finance Risks*

CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa	Fiscal policy framework	Neutral	0	Robust recovery in the fiscal position after the pandemic; rising spending pressures over the medium term
	Debt sustainability	Neutral	0	Debt set to remain on a moderately upward trajectory in the medium term
	Debt profile and market access	Neutral	0	Excellent government market access, favourable debt profile

Contributions to changes in debt levels, pps of GDP



Debt-to-GDP forecasts, % of GDP



In this report we do not show IMF forecasts for comparison, as they do not incorporate the recent methodological change in Finland's statistics on government debt.

Source: Statistics Finland, Scope Ratings forecasts

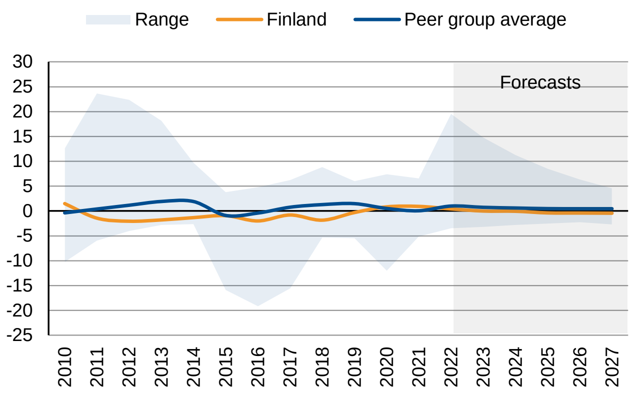
External Economic Risks

- **Current account:** Finland has traditionally run small current account deficits, averaging 1.2% of GDP over 2015-2019, with surpluses in the goods and primary income balance insufficient to offset deficits in the services and secondary income accounts. In 2020 and 2021, the current account was however in surplus, at 0.8% of GDP on average, driven by larger surpluses in the goods balance, but especially in primary income, as financial institutions halted dividend distributions. In the first half of this year, the current account turned to deficit, which widened to over EUR 6bn in Q2, driven by a significant deficit in the primary income account, the slowdown in external demand and higher energy and commodity prices. We expect the current account balance to continue to post moderate deficits in the coming years, as energy prices normalise but weaker trade relations with Russia – the fifth largest export market for Finland last year – continue to affect the export outlook. Overall, Finland's export markets are well diversified by geography. Key export sectors reflect the country's core industries, with larger shares in the forest, machinery and metal manufacturing, and chemical industries.
- **External position:** Finland's external debt is high relative to the size of the economy, reflecting the large size of its banking sector. It stood at 229.5% of GDP as of Q2 2022, broadly unchanged from 2019-21 levels, which is high compared to the other Nordic countries and euro-area peers. Financial institutions account for about half of total external debt, while the general government and central bank sectors together account for about a quarter. The level of short-term external debt is elevated, at 108.0% of GDP as of Q2 2022, which signals vulnerability to external shocks. This is however mitigated by a moderate net creditor position of the Finnish economy since the beginning of the year.
- **Resilience to shocks:** Together with other euro-area member states, Finland benefits from the euro's status as an international reserve currency, significantly mitigating risk from currency sell-off and sudden stops of capital flows.

Overview of Scope's qualitative assessments for Finland's *External Economic Risks*

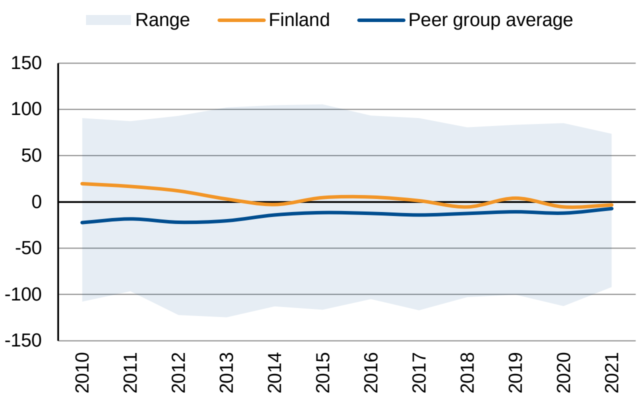
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb+	Current account resilience	Neutral	0	Moderate export sectoral diversification and competitiveness
	External debt structure	Weak	-1/3	Elevated external debt, reflecting liabilities of Finnish financial institutions; a large share is short-term external debt
	Resilience to short-term shocks	Neutral	0	Euro-area membership mitigates exposure to international markets

Current account balance, % of GDP



Source: IMF WEO, Scope Ratings

Net international investment position (NIIP), % of GDP



Source: IMF, Scope Ratings

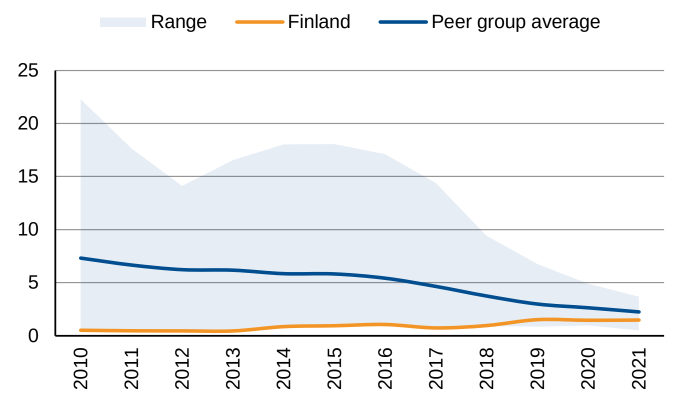
Financial Stability Risks

- **Banking sector:** The Finnish banking sector is large and highly concentrated, with total assets over three times the size of the domestic economy. The sector is solid and resilient to shocks, as reflected in capitalisation, profitability and asset quality metrics outperforming European averages. The CET1 ratio stood at 17.3% as of Q2 2022, above the EU average of 15.2% (in Q1). The return on equity in general also outperforms peers, although it dropped to 4.2% in Q1 2022 from 9.4% in Q4 2021, given higher uncertainty in the operating environment caused by the Russia-Ukraine war. The sector's asset quality outperforms the euro-area average, as reflected in a lower non-performing loan ratio of 1.1% in Q1 2022. Banks' liquidity position is strong as well, with the liquidity coverage ratio at 170.0%. A loan-to-deposit ratio significantly above the EU average indicates Finnish banks' greater reliance on wholesale funding.
- **Private debt:** Finland's private sector debt stood at 179.5% of GDP in Q1 2022, back to 2014 levels. This is above the euro-area average of 168.9%, but significantly below levels in Denmark, Norway and Sweden. Non-financial corporations' debt was 112.7% of GDP as of Q1 2022, while household debt stood at 66.8% of GDP. Debt service ratios in both segments compare favourably vis-à-vis the other Nordic economies. Household indebtedness relative to disposable income, mostly related to housing loans, has been on an increasing trend in recent decades and reached 133.8% by Q1 2022.
- **Financial imbalances:** Housing prices have remained fairly stable in Finland compared to the other Nordic countries. However, there was a marked acceleration last year following the pandemic shock, especially in the Greater Helsinki area. In response, the Financial Supervisory Authority (FSA) has decided to maintain the maximum loan-to-collateral ratio for new residential mortgage loans other than first-home loans at 85%. To further limit potential stability risks posed by the high levels of household indebtedness, the FSA has also issued the recommendation of a stressed debt-service-to-income limit of 60% for the granting of future housing loans as of January 2023. Overall, the direct exposure of the Finnish financial sector to Russia is limited, although heightened risks could materialise via indirect exposures to the Nordic and Baltic regions, cyberattacks and the repricing of risk in financial asset valuations.

Overview of Scope's qualitative assessments for Finland's *Financial Stability Risks*

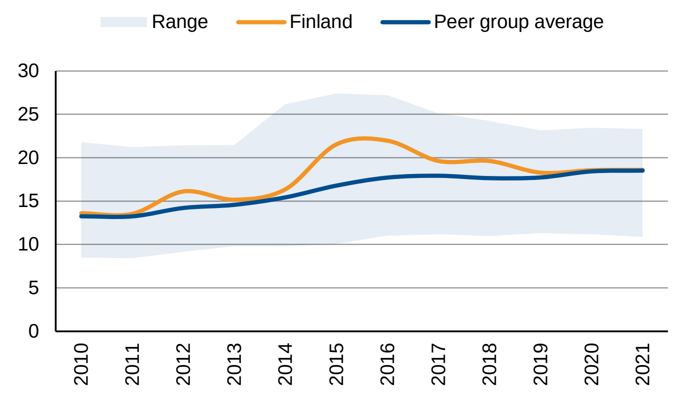
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	Profitable and adequately capitalised banking sector
	Banking sector oversight	Neutral	0	Effective oversight by the Bank of Finland and the ECB as part of Banking Union
	Financial imbalances	Neutral	0	High private sector debt levels, large size of the banking sector vis-à-vis the real economy

Non-performing loans, % of total loans



Source: IMF, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

ESG Risks

- **Environment:** Finland has one of the most ambitious emission reduction targets globally, namely, to become carbon neutral by 2035. In July 2022 the new Climate Change Act entered into force, setting emission reduction targets for 2030, 2040 and 2050, at 60%, 80% and at least 90% respectively compared to 1990 levels. This transition will require significant policy efforts and economic transformation. The 2021 Annual Climate Report highlighted the need of additional measures to cut emissions by 11 million tonnes of CO2-equivalents (Mt CO2-eq) of a total gap of 27 Mt CO2-eq to attain carbon neutrality. At the same time, Finland benefits from several factors facilitating these efforts. These include ample natural resources, such as the land sector use as an emissions sink and renewable energies, which already account for more than 40% of the county's total energy consumption, one of the highest shares in the EU. Finland has low vulnerability to natural disaster risks as captured by the World Risk Index.

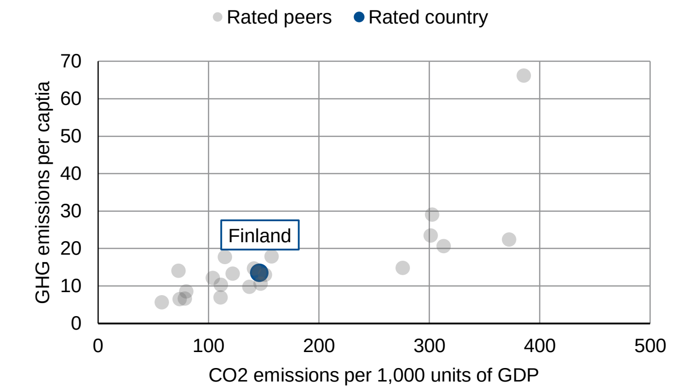
- **Social:** Finland benefits from an advanced social safety net and a high-quality education system, reflected in the lowest levels of income and gender inequality among European countries, as well as a share of people at risk of poverty and social exclusion well below the EU average (14% vs 22%). Social risks relate to the country's adverse demographic trends. Finland has the second highest old-age dependency ratio in the euro area, at 36.8% in 2021, up from 22.9% in 2000. According to the 2021 Ageing Report, the ratio will increase to about 47% by 2030, with serious implications in terms of higher social spending and lower growth potential.

- **Governance:** Finland benefits from the outstanding quality of its institutions, ranking at or above the 99th percentile in five out of six World Bank Governance Indicators. The ruling five-party coalition led by Social Democrat Prime Minister Sanna Marin has retained a good record on implementing reforms, including the landmark healthcare system reform and policy efforts to increase employment and public investment. The government has faced stability challenges related to the decision to raise government spending ceilings. Elections will be held next year. Finland is exposed to rising geopolitical risks after the escalation of the Russia-Ukraine war, given its 1,300km long border with Russia. In our view, Finland's significant international ties to European and other Western allies, recently reinforced by country's application to the NATO miliary alliance, strongly limits security risks for Finland.

Overview of Scope's qualitative assessments for Finland's *ESG Risks*

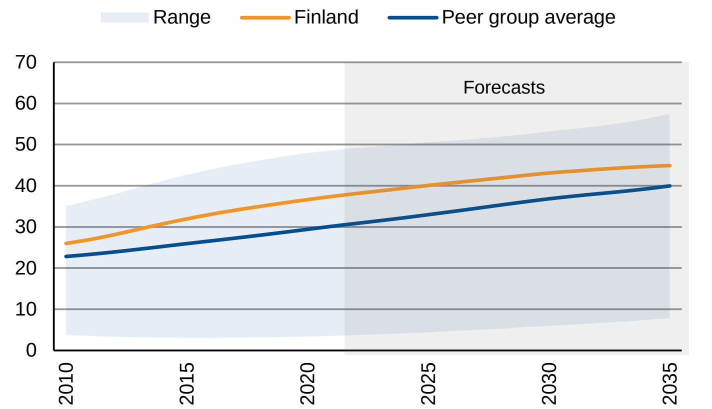
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa	Environmental factors	Strong	+1/3	Good record in environmental sustainability and governance; ambitious policy efforts to achieve carbon neutrality by 2035
	Social factors	Neutral	0	Unfavourable demographics, but strong income and social equality, high-quality education system
	Governance factors	Neutral	0	Very high quality of institutions and stable policy environment, geopolitical risk exposure

CO_2 emissions per GDP and GHG emissions per capita, $mtCO_2e$



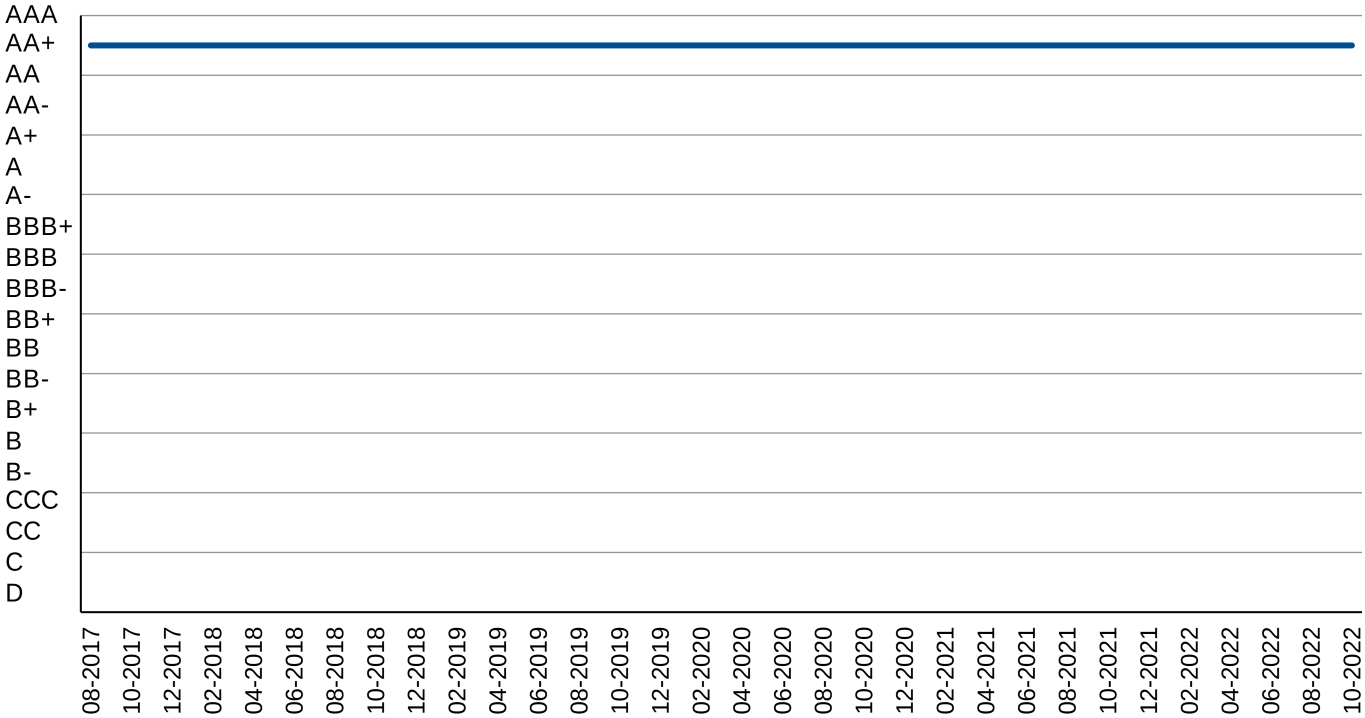
Source: European Commission, Scope Ratings

Old age dependency ratio, %



Source: United Nations, Scope Ratings

Appendix I. Rating history



NB. Positive/Negative Outlooks are treated with a +/-0.33-notch adjustment. Credit Watch positive/negative with a +/-0.67-notch adjustment.

Appendix II. Rating peers

Rating peers are related to sovereigns with an indicative rating in the same rating category or in adjacent categories per Scope's Core Variable Scorecard, including a methodological reserve-currency adjustment.

Peer group*
Austria
Denmark
Finland
Germany
Ireland
Israel
Luxembourg
Netherlands
Norway
Sweden
Switzerland

*Publicly rated sovereigns only; the full sample may be larger.

Appendix III. Statistical table for selected CVS indicators

This table presents a selection of the indicators (24 out of 30 – with the governance indicator reflecting a composite of six indicators) used in Scope's quantitative model, the Core Variable Scorecard, in line with Scope's Sovereign Rating Methodology. The metrics and sources for the data presented here ensure comparability across global peers and may therefore differ from national and other selective international statistics.

Core variable	Source	2017	2018	2019	2020	2021
GDP per capita, USD '000s	IMF	46,437	50,033	48,667	49,159	54,008
Nominal GDP, USD bn	IMF	255.6	275.8	268.5	271.6	298.9
Real growth, %	IMF	3.2	1.1	1.2	-2.3	3.3
CPI inflation, %	IMF	0.8	1.2	1.1	0.4	2.1
Unemployment rate, %	World Bank	8.6	7.4	6.7	7.8	7.5
Public debt, % of GDP*	IMF	61.2	59.8	59.6	69.0	66.7
Interest payment, % of revenue	IMF	0.5	0.3	0.3	0.2	0.0
Primary balance, % of GDP	IMF	-0.4	-0.7	-0.8	-5.3	-2.7
Current account balance, % of GDP	IMF	-0.8	-1.8	-0.3	0.8	0.9
Total reserves, months of imports	IMF	1.1	1.0	1.1	1.4	1.5
NIIP, % of GDP	IMF	1.3	-5.5	4.1	-5.4	-3.3
NPL ratio, % of total loans	IMF	0.7	1.0	1.5	1.5	1.5
Tier 1 ratio, % of RWA	IMF	18.9	19.2	17.7	17.7	-
Credit to private sector, % of GDP	World Bank	93.4	94.2	95.4	100.2	-
CO_2 per EUR 1,000 of GDP, mtCO_2e	EC	176.2	178.9	164.4	155.7	-
Income share of the bottom 50%, %	WID	21.6	21.7	21.7	21.5	21.5
Labour-force participation rate, %	World Bank	76.6	77.8	78.2	-	-
Old-age dependency ratio, %	UN	34.1	35.0	35.8	36.6	37.4
Composite governance indicators**	World Bank	1.8	1.8	1.7	1.8	-

* NB: does not incorporate the recent methodological change in Finland's statistics on government debt.

** Average of the six World Bank Worldwide Governance Indicators.

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps)	26.8

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