

Research Update:

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

September 4, 2020

Overview

- We expect Finland's economy will suffer a COVID-induced contraction of 4.5% in 2020, followed by muted recovery as structural challenges weigh on economic growth.
- We expect the government will continue to tap into its fiscal space to assist the economy in 2021, but embark on gradual consolidation that stabilizes debt to GDP by 2023.
- We are affirming our 'AA+/A-1+' long- and short-term ratings on Finland.
- The outlook is stable.

Rating Action

On Sept. 4, 2020, S&P Global Ratings affirmed its 'AA+/A-1+' long- and short-term foreign and local currency sovereign credit ratings on Finland. The outlook is 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 the deterioration of Finland's public finances will moderate over the period to 2023 as COVID-19 fiscal stimulus measures are withdrawn and the government embarks on a program of fiscal consolidation alongside modest economic recovery.

Downside scenario

We could consider a negative rating action in the next two years if Finland's economic recovery is much weaker than expected, leading to a continued deterioration in Finland's fiscal performance.

Upside scenario

We could raise the long-term ratings if Finland's external performance structurally improves, in combination with successful policy implementation that significantly strengthens economic

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growth potential and secures stronger public finances.

Rationale

Due to the domestic and external fallout from the COVID-19 pandemic, we anticipate Finland's real GDP will contract by 4.5% in 2020. We expect the country's recovery and medium-term growth prospects will be tested by structural constraints that include lackluster productivity growth amid a shrinking employment pool. We also expect government reform activity will pick up speed in order to counter inefficiencies in the labor market. The government will look to mitigate skills mismatches while initiating investments in infrastructure and research and development (R&D) to counter these challenges and sustain growth potential. In the meantime, the strength of the economic recovery will largely depend on private consumption and a gradual resurgence of demand from Finland's key EU trading partners, which we expect will be supported by measures from the EU. Finnish exports are concentrated in the capital goods sector and dependent on key trading partners' business sentiment and investment cycles.

While Finland's fiscal position will weaken in 2020-2021, we anticipate the government will embark on consolidation efforts that stabilize Finland's net general government debt at below 40% of GDP by 2023. Because we still consider this comparatively low, it provides Finland with some fiscal space. Finland's high level of economic prosperity; its stable institutions; and the benefits of eurozone membership, including the high credibility of the European Central Bank's (ECB's) monetary policy and access to deep capital markets, further support the ratings. In particular, Finland's debt-servicing costs stand at historical lows because government bond yields benefit from ECB purchasing programs.

Institutional and economic profile: The strength of Finland's recovery post-COVID will depend on policy measures to address structural challenges related to productivity and the labor market.

- We expect the Finnish economy will contract by 4.5% in 2020, but recover most of the lost ground by 2022, given effective support schemes are set to preserve productive capacity.
- Private consumption and expansionary fiscal policy will drive growth in 2021, with exports slow to catchup.
- A revival of structural reform momentum will be required to strengthen growth potential in the rebuild post COVID-19.

Data from Statistics Finland suggests that the Finnish economy weathered the lockdown in second-quarter of 2020 comparatively well, recording a loss of output of 4.5%, significantly below the eurozone equivalent. We believe this reflects built-up order books in the Finnish industry, which have sustained production. In addition, we note the high degree of essential goods in the consumption baskets of Finnish households. Consumption in general has been supported by the comprehensiveness of existing social welfare schemes, bolstered by extraordinary policy support.

Even though we expect the economy will contract by a comparatively modest 4.5% in 2020, we believe recovery could face structural headwinds because dampened employment levels, a loss of cost competitiveness, and labor market inefficiencies present a drag on potential. Prior to COVID-19, the Finnish growth cycle dynamics were on a weakening trend. Output had been contracting since the last quarter of 2019, when structural challenges had started to impact activity levels. We believe these underlying dynamics could resurface and limit the strength of the

recovery, absent success in structural reforms. We expect the economy will rebound by 2.3% in 2021, primarily due to a return of private consumption as households channel parts of their excess savings from 2020 into the economy. For 2022-2023, we expect growth will average 1.4%.

The government has commissioned several studies and expert groups to tailor a strategy to support economic growth post COVID-19. These include policy proposals to strengthen employment levels, a key goal in the government program, but also action plans to strengthen public sector investments, including spending on R&D, digitalization, and improving the transportation infrastructure. In addition, we expect authorities will make use of eligible resources under the upcoming EU Recovery Fund. Alongside a focus on the stability of public finances, we expect the government will begin looking toward implementing structural reform in its upcoming budget bill in October.

Confidence in Finland's overall reform ability took a hit in March 2019, when the parliament failed to pass legislation necessary to implement a longstanding major reform initiative in the social and health care sector--the "SOTE" reform. Despite the reform delays, we observe a strong political consensus about the need to push the SOTE reform forward to ensure the sustainability of public finances which, aside from the impact of COVID-19, are under structural pressure from an aging population. Therefore, we believe that the social and health care reform will remain on top of the policy agenda for the government in 2020 as it moves its fiscal focus from short-term emergency support to medium-term policy targets.

Flexibility and performance profile: Low net general government debt provides room to absorb fiscal fallout from COVID

- The solid starting point of Finland's public finances allow it to absorb the temporary, pandemic-induced widening of the budget deficit.
- The large banking sector underpins high external financing requirements.
- As in other eurozone economies, Finland's fiscal stimulus will be backstopped by an expected increase in net asset purchases by the ECB this year.

The Finnish authorities introduced significant support measures to preserve the economy's productive capacity and ensure household solvency through the COVID-19-induced demand slump. These quickly-deployed measures centered on enhancing income and sustaining employment. Together with associated spending items already present in the 2020 budget, they add up to an estimated cost of about 3.5% of GDP. We forecast government revenue will reduce by about 4% of GDP in 2020, resulting in a government deficit of 8% of GDP. Looking beyond 2020, we expect economic recovery will require fiscal support and forecast a general government deficit at 4.5% in 2021, before government consolidation efforts tighten the deficit to 3% of GDP in 2022-2023.

Finland's contingent liabilities, predominantly guarantees, are large and amount to almost 25% of GDP. Of the guarantees, 60% relate to deliveries of Finnish cruise ships. Central government guarantee authorizations have also increased in 2020 as part of the government's COVID-19 support schemes to businesses. In addition to the fiscal deficit, we expect that guarantees amounting to some 2% of GDP, largely related to the small and midsize enterprise sector, will appear on the government's balance sheet over 2020-2021. This assumption takes into account the large and increasing guarantee commitments, and the financial distress affecting several industries.

As a consequence, we forecast Finland's net general government debt to GDP will approach 30%

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of GDP at year-end 2020, and continue increasing before stabilizing below 40% in 2023. In calculating this metric, we deduct from gross debt 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, approximately 30% of GDP in liquid assets held by the public sector's earnings-related pension funds. In 2023, we forecast that gross general government debt will stabilize below 75% of GDP.

While its debt stock is rising, Finland's debt servicing cost stands at historical lows. Finland benefits from the eurozone's extensive debt markets, and the impact of quantitative easing on Finnish government bond yields. However, the ultimate fallout for Finland's public finances and the public debt path after the COVID-19 shock will depend on the effectiveness of the government's and the EU's economic policy to support a broad-based recovery.

We expect Finland's current account will approach balance in 2020 as dampened demand reduces imports, and exports face a similar decline. Furthermore, we expect deficit on the services balance will shrink due to lower spending by Finns on overseas vacations, with the income balance similarly tightening because of lower income outflows from restrictions on banking sector dividends. For 2021, we expect the current account will record modest deficits because although increasing domestic consumption will generate imports and drive the initial economic rebound, exports will be slow to catch up.

Finland's external ratios continue to be dominated by financial institutions. Although the relocation of Nordea Bank to Finland has affected Finland's international investment position, with both assets and liabilities increasing significantly, these moved in tandem, leaving the net position largely unaffected. However, Nordea Bank's move has substantially increased the size of the banking sector to about 335% of Finland's GDP, compared with 250% previously. Although Nordea is under the ECB's remit, the redomicile of the major Nordic bank has prompted the Finnish Financial Supervisory Authority to upscale local supervision and regulatory activities to highlight the importance of continued close regional cooperation and preparedness for crises.

The financial sector's large cross-border exposures, including funding risk related to foreign-financed wholesale funding, continue to present the key risk. In particular, the economy's external short-term debt will remain well above 100% of current account receipts (CARs), and narrow net external debt will stay high at about 225% of CARs on average over 2020-2023. That said, if we consider Finland's net international investment position, the country looks much stronger, with external assets largely equal to external liabilities.

While we consider Finland's banking system profitable and well capitalized, we believe Finnish banks could come under pressure if the economic rebound underwhelms (see "Seven Finnish Banks Outlooks Revised To Negative On Deepening COVID-19 Downside Risks," published on May 19, 2020). Specifically, more-pronounced economic distress or weaker and delayed recovery could weaken the operating conditions for the Finnish banking sector, reduce the banks' business prospects, and weaken their asset quality over the next two years. In this regard, the historically high indebtedness of Finnish households could potentially be a mounting credit risk for the banking sector. We observe that, despite significantly decreased housing market activity since April 2020, COVID-19 has so far had not had a major impact on the real estate market. In our base case, we forecast moderate credit losses from households, despite increasing unemployment and, and more muted credit demand before returning to precrisis levels in 2021-2022.

Key Statistics

Table 1

Finland Selected Indicators

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Economic indicators (%)										
Nominal GDP (bil. LC)	207	211	218	226	234	241	232	240	247	255
Nominal GDP (bil. \$)	275	235	241	255	276	269	259	276	279	283
GDP per capita (000s \$)	50.4	42.9	43.9	46.4	50.1	48.8	46.9	50.0	50.4	51.0
Real GDP growth	(0.4)	0.5	2.8	3.3	1.5	1.1	(4.5)	2.3	1.5	1.3
Real GDP per capita growth	(0.8)	0.2	2.5	3.0	1.3	1.1	(4.6)	2.1	1.3	1.1
Real investment growth	(1.8)	0.5	9.0	4.8	3.9	(1.0)	(5)	2.5	1.0	1.2
Investment/GDP	22.1	21.7	23.3	23.9	25.3	24.0	24.0	23.9	23.7	23.5
Savings/GDP	20.8	20.8	21.2	23.1	23.6	23.5	23.6	21.9	22.3	22.8
Exports/GDP	36.5	35.4	34.8	37.6	38.5	40.1	38.1	38.3	38.9	39.9
Real exports growth	(2.0)	0.4	3.9	8.6	1.7	7.5	(9.5)	3.0	3.5	3.5
Unemployment rate	8.7	9.4	8.8	8.6	7.4	6.7	7.7	7.7	7.5	7.5
External indicators (%)										
Current account balance/GDP	(1.3)	(0.9)	(2.0)	(0.8)	(1.6)	(0.5)	(0.4)	(1.9)	(1.4)	(0.7)
Current account balance/CARs	(2.9)	(2.2)	(4.7)	(1.7)	(3.5)	(0.9)	(0.8)	(4.1)	(3.0)	(1.4)
CARs/GDP	45.5	43.4	42.8	45.7	46.6	48.5	46.8	46.7	47.8	48.7
Trade balance/GDP	0.7	0.9	0.0	0.7	0.1	1.1	0.2	(0.4)	(0.2)	0.3
Net FDI/GDP	6.1	7.8	(6.3)	1.4	(4.9)	1.8	1.2	1.2	1.2	1.2
Net portfolio equity inflow/GDP	0.0	0.8	1.8	(0.7)	1.3	(3.0)	(1.0)	(1.0)	(1.0)	(1.0)
Gross external financing needs/CARs plus usable reserves	436.7	478.3	393.5	338.0	287.8	352.8	378.4	370.1	361.0	353.0
Narrow net external debt/CARs	197.1	210.6	223.6	246.9	218.8	217.2	237.3	226.1	220.5	213.9
Narrow net external debt/CAPs	191.5	206.2	213.5	242.9	211.4	215.2	235.4	217.2	214.2	210.9
Net external liabilities/CARs	6.8	(9.8)	(10.4)	0.6	14.8	(2.2)	(3.8)	0.5	3.4	4.7
Net external liabilities/CAPs	6.6	(9.6)	(9.9)	0.5	14.3	(2.2)	(3.7)	0.5	3.3	4.6
Short-term external debt by remaining maturity/CARs	373.1	426.3	327.0	266.7	207.9	279.7	313.2	298.7	288.0	278.9
Usable reserves/CAPs (months)	1.1	1.2	1.1	1.1	0.9	0.9	1.1	1.0	1.0	0.9

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	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Usable reserves (mil. \$)	10,669	10,018	10,468	10,517	10,310	11,418	11,372	11,096	10,677	10,393
Fiscal indicators (general government; %)										
Balance/GDP	(3.0)	(2.4)	(1.7)	(0.7)	(0.9)	(1.1)	(8)	(4.5)	(3.0)	(3.0)
Change in net debt/GDP	2.0	2.8	1.3	(1.8)	(0.4)	(0.8)	9.0	5.5	3.0	3.0
Primary balance/GDP	(1.8)	(1.3)	(0.6)	0.3	0.1	(0.3)	(7.1)	(3.5)	(1.8)	(1.7)
Revenue/GDP	54.3	54.1	53.9	53.1	52.5	52.1	49.5	54.0	54.0	54.0
Expenditures/GDP	57.3	56.5	55.7	53.7	53.4	53.2	57.5	58.5	57.0	57.0
Interest/revenues	2.3	2.1	2.0	1.9	1.7	1.6	1.8	1.9	2.2	2.4
Debt/GDP	58.0	62.0	61.5	59.6	58.0	57.6	68.7	71.9	72.9	73.8
Debt/revenues	106.9	114.6	114.1	112.3	110.4	110.7	138.8	133.2	135.0	136.7
Net debt/GDP	21.7	24.1	24.7	22.0	20.8	19.4	29.2	33.6	35.6	37.6
Liquid assets/GDP	36.3	37.8	36.8	37.6	37.2	38.2	39.6	38.3	37.3	36.3
Monetary indicators (%)										
CPI growth	1.2	(0.2)	0.4	0.8	1.2	1.1	0.3	1.2	1.4	1.4
GDP deflator growth	1.6	1.6	0.1	0.6	1.9	1.8	0.8	1.4	1.5	1.8
Exchange rate, year-end (LC/\$)	0.82	0.92	0.95	0.83	0.87	0.89	0.87	0.88	0.89	0.91
Banks' claims on resident non-gov't sector growth	2.9	0.9	1.3	2.7	4.6	4.5	1.5	4.5	4.5	4.5
Banks' claims on resident non-gov't sector/GDP	97.6	96.4	94.9	93.9	95.0	96.4	101.6	102.4	103.9	105.3
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	0.1	(3.2)	(4.1)	(7.6)	5.1	(3.9)	N/A	N/A	N/A	N/A

Sources: Eurostat, Statistics Finland (Economic Indicators), Statistics Finland, Eurostat (External Indicators), Statistics Finland, the Bank of Finland (Fiscal Indicators), and the Bank of Finland, International Monetary Fund (Monetary Indicators).

Adjustments: Government debt adjusted by excluding guarantees on debt issued by EFSF.

Definitions: 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 claims on nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. N/A--Not applicable. LC--Local currency. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. 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

Ratings Score Snapshot

Key rating factors	Score	Explanation
Institutional assessment	2	Generally strong track record of policies that deliver sustainable public finances and balanced economic growth. Unbiased enforcement of contracts and respect for rule of law with generally effective checks and balances between institutions. Finland is one of the most cohesive civil societies, as evidenced by high social inclusion, degree of social order, and capacity of political institutions to respond to societal priorities. However, coordination requirements at the level of the Economic and Monetary Union may hinder timely policy responsiveness.
Economic assessment	1	Based on GDP per capita (US\$) and growth trends as per Selected Indicators in Table 1.
External assessment	4	Based on narrow net external debt/CARs as per Selected Indicators in Table 1. The sovereign has external short-term debt by remaining maturity that generally exceeds 100% of CARs, as per Selected Indicators in Table 1. The Sovereign's net international investment position is more favorable than the narrow net external debt position by over 100% of CARs, as per Selected Indicators in Table 1.
Fiscal assessment: flexibility and performance	2	Based on the change in net general government debt (% of GDP) as per Selected Indicators in Table 1. The sovereign has large liquid assets relative to GDP as per Selected Indicators in Table 1.
Fiscal assessment: debt burden	2	Based on net general government debt (% of GDP) and general government interest expenditure (% of general government revenues) as per Selected Indicators in Table 1. Nonresidents hold over 60% of government commercial debt.
Monetary assessment	2	In the context of our monetary assessment, we consider the euro to be a reserve currency. The European Central Bank has an established track record in monetary authority independence with clear objectives and a wide array of policy instruments, including nonconventional tools. The CPI is low and in line with that of its trading partners. Finland is a member of the Economic and Monetary Union.
Indicative rating	aa+	As per Table 1 of "Sovereign Rating Methodology."
Notches of supplemental adjustments and flexibility	0	None
Final rating		
Foreign currency	AA+	
Notches of uplift	0	Default risks do not apply differently to foreign-and local-currency debt.

Table 2

Ratings Score Snapshot (cont.)

Key rating factors	Score	Explanation
Local currency	AA+	

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: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Banking Industry Country Risk Assessment Update: August 2020, Aug. 21, 2020
- Sovereign Ratings History, Aug. 17, 2020
- Sovereign Ratings List, Aug. 17, 2020
- Sovereign Risk Indicators, July 14, 2020
- Default, Transition, and Recovery: 2019 Annual Sovereign Default And Rating Transition Study, May 18, 2020
- Banking Industry Country Risk Assessment: Finland, Oct. 9, 2019

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.

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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 for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceld/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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