

Morningstar DBRS Confirms Republic of Finland at AA (high), Stable Trend

SOVEREIGNS

DBRS Ratings GmbH (Morningstar DBRS) confirmed the Republic of Finland's (Finland) Long-Term Foreign and Local Currency – Issuer Ratings at AA (high). At the same time, Morningstar DBRS confirmed Finland's Short-Term Foreign and Local Currency – Issuer Ratings at R-1 (high). The trends on all ratings remain Stable.

KEY CREDIT RATING CONSIDERATIONS

The Stable trend reflects DBRS Morningstar's view that, despite a challenging macroeconomic environment, the government will rebalance fiscal accounts, placing the debt-to-GDP ratio on a more sustainable trajectory over the medium-term. The consequences of Russia's invasion of Ukraine, followed by higher living costs and tightening financing conditions, are weighing on Finland's economic performance, with GDP contracting by 1.0% of GDP last year. Economic activity will recover only gradually as the weak finish of last year does not bode well for growth in 2024. The fiscal deficit, after declining to 0.5% of GDP in 2022, is estimated to have increased to around 2.5% last year, but after peaking at 3.5% of GDP in 2024 it is likely to return to more moderate levels in the medium term. The public debt-to-GDP ratio is projected to have increased to around 76% of GDP last year and will likely continue to rise to around 80% until the government's consolidation measures start to gain traction.

Finland's AA (high) credit ratings are underpinned by its strong public-sector balance sheet, which reinforces its ability to fund future liabilities, and the Finnish government's track record and commitment to sound economic policies. Moreover, governance indicators are very strong. Finland's wealthy economy, with significant human capital and high-value-added sectors, also supports the credit ratings. On the other hand, an ageing population will constrain potential growth and burden public finances over the medium term. As an open and small economy, Finland's economic prospects are exposed to swings in external demand and to global financial conditions. Furthermore, Morningstar DBRS takes the view that the high level of household debt, which could amplify economic downturns, remains a vulnerability.

CREDIT RATING DRIVERS

One or any combination of the following factors could trigger a credit ratings upgrade: (1) an improvement in Finland's medium-term economic performance due to structural reforms, and (2) sustained decline in fiscal deficit and in the public debt ratio due to successful government's consolidation measures.

One or any combination of the following factors could trigger a credit ratings downgrade: (1) the government's failure to improve fiscal accounts leading to a prolonged and material increase in Finland's public debt ratio over the medium-term (2) a material and persistent worsening in Finland's economic performance, and (3) a substantial crystallisation of contingent liabilities.

CREDIT RATING RATIONALE

Government's Fiscal Measures Expected to Improve Public Accounts Over Time, but Fiscal Outlook is Worsening in the Near-Term

The consequences of the conflict in Ukraine in tandem with a weak cyclical position are putting pressure on fiscal accounts. After the rapid improvement in the fiscal deficit from a peak of 5.6% of GDP in 2020 to 0.5% in 2022, public finances have started to deteriorate again reflecting a combination of weak growth, energy related support, humanitarian aid, defence spending and the start of the wellbeing service reform. The deficit is estimated to have widened again to 2.5% in 2023 and is anticipated to remain above 3% in the 2024-2026 period, even including earnings-related pension providers, according to the Ministry of Finance. Morningstar DBRS views positively, the new government's agenda to rebalance the fiscal accounts by cutting expenditures by EUR 4 billion (1.4% of GDP) along with EUR 2 billion of additional revenues stemming from higher employment. However, bringing the deficit to around 1.0% of GDP by 2027 appears ambitious. Challenges include the weak cyclical economic position, rising interest costs, high defence investments and planned cut in taxes and social security contributions. Morningstar DBRS will monitor the future evolution of public sector accounts, particularly in relation to expenditures, and the government's ability to successfully deliver on a more prudent fiscal stance. Nevertheless, additional measures could be implemented to reinforce the government's budgetary consolidation strategy going forward.

The main risks in the near term are linked to a weaker than expected evolution of the economy, which might require further support in the context of high inflation and elevated interest rates. On the other hand, pressure on Finland's public sector accounts in the medium to long term will likely depend on the fiscal effects of the ageing and shrinking working-age population. In relation to this, the healthcare reform, although expected to create transitional costs for several years, could potentially generate savings around the turn of the decade and onward. DBRS Morningstar will continue to monitor Finland's implementation of this reform, in order to assess its effectiveness in curbing age-related spending in the medium to long term.

A Healthy Public-Sector Balance Sheet Mitigates the Risk of a Persistent Rise in the Public Debt-to-GDP Ratio

Morningstar DBRS takes the view that the government's fiscal consolidation measures will limit the rise in the debt-to-GDP ratio over the medium-term. However, with a high degree of uncertainty, additional efforts might be needed to avoid a persistent rise in the public debt ratio in coming years. After a slight decline to 72.6% of GDP in 2021 from a peak of 74.7% in 2020, the public debt ratio increased slightly again to 73.5% in 2022 and a further rise to around 76% is estimated in 2023. Public finance repair measures highlighted by the government will likely not be enough to offset the shrinking nominal GDP growth as well as higher debt servicing costs, along with the impact of higher public investment for military equipment. The public debt ratio, although remaining lower than the Euro area average, could increase beyond 77% of GDP this year.

The stock of explicit guarantees of the state not included in the public debt is large and represents a vulnerability. However, contingent liability risk remains contained and the government benefits from sound debt affordability as well as a strong public asset position. State guarantees estimated at around 19% of GDP as of June 2023, after excluding the guarantees of the national housing fund already included in the public debt, are among the largest in the EU. These relate mainly to Finnvera, the state export agency and are not expected to exert significant pressure on the debt ratio. Nevertheless, Finland's strong public balance sheet and good debt affordability position reinforce the government's ability to fund its liabilities. The general government's net financial assets ratio stood at 55.1% of GDP in Q3 2023, although around two-thirds of the assets are ring-fenced for pension payments and are, therefore, not available for budgetary purposes. Risks related to debt affordability appear contained. Finland's central government debt has an average maturity of 7.7 years and minimal exchange-rate risk after swaps at end-February 2024. Interest rates have been increasing rapidly, but Finland's relatively long maturity debt profile means higher funding costs will permeate only gradually.

A Resilient Labour Market Mitigates Risks Stemming from Weaker Economic Performance

Finland's credit ratings benefit from a high per capita GDP, estimated at USD 54,507 in 2023, reflecting a skilled labour force, high-value-added sectors, and a relatively strong research and development investment intensity. This is offset by a moderate GDP growth potential estimated at around 1.0%, which is constrained by a shrinking working age population and relatively weak productivity growth.

After a rapid recovery from the pandemic, Finland's economic performance started to deteriorate due to the impact of Russia's invasion of Ukraine, followed by the rise in interest rates and the downturn in housing investment. The country slipped into recession last year, with GDP contracting by around 1.0%, and Morningstar DBRS anticipates economic prospects to remain weak this year. The latest projections from the Ministry of Finance, which do not incorporate the negative GDP revision in 2023, pointed to GDP growth recovering to 0.7% in 2024 before accelerating to 2.0% in 2025, supported by easing financing conditions, an improvement in purchasing power and tax cuts. However, the poor performance of GDP in the last quarter of 2024 will weigh on the economic activity this year, and GDP could expand only slightly in 2024. A still resilient labour market, which benefits from an elevated, although declining, employment rate trend of 73.2% as of January 2024, remains supportive and mitigates the risks stemming from a weaker cyclical position.

The main risks to the outlook are related an increase in geopolitical tensions, including an escalation with Russia, which could intensify trade fragmentation and lead to a new spike in energy prices. Moreover, the impact of monetary tightening might put further pressure on indebted households, housing investment and on the labour market. At the same time, over the medium- to long-term, successfully countering the effects of unfavourable demographics and relatively weak productivity growth, will remain key to Finland's economic prospects. In this regard, Morningstar DBRS will continue to monitor the effectiveness of the government's reforms and investments in raising employment, investment, and productivity.

Financial System is Sound and Risks to Financial Stability are Contained

The Finnish banking system is well placed to withstand the economic slowdown amid falling house prices and the deterioration in households' debt affordability. Nevertheless, banks remains exposed to liquidity risks due to high reliance on short-term wholesale funding. Morningstar DBRS foresees non-performing loans (NPLs) to increase going forward, although from low levels, but banks will likely absorb losses supported by a high level of capitalisation and good profitability. This reduces the risk of contingent liabilities.

Households' debt as a share of disposable income remains very high at 124.5 % as of Q4 2023 and a large share of households face high debt servicing costs as a result of the steep and rapid rise in interest rates. This mainly reflects a high share of mortgages at variable rates in tandem with a relatively short refixing period. Nevertheless, banks are well capitalised with a CET1 capital ratio at 17.9% as of Q3 2023 and the NPL ratio at around 1.1% remains very low, according to the European Banking Authority (EBA). In addition, imbalances appear to be relatively contained as a results of Finland's fully amortising mortgages, stricter credit policies, and low tax deductibility. Moreover, most indebted households tend have also high levels of wealth which mitigates risks to financial stability

After several years of persistent growth, housing prices are correcting in the Nordic region and in Finland they declined by around 13% from the peak reached in 2022. A prolonged fall in residential property prices could further weigh on investments in the construction sector, with a potential negative impact for banks in Finland due to the large exposure. Moreover, the Finnish banking system's size, concentration, interconnectedness, and reliance on wholesale funding are concerning, as these could amplify shocks to the economy, especially if investor confidence deteriorates. Therefore, retaining the strong confidence among investors that Finnish banks enjoy will remain paramount under a more challenging environment.

A Gradual Improvement in the Current Account Position is Expected; External Debt Linked to the Financial Sector Remains a Source of Concern

Finland's external position is good and reflects a restored price-competitiveness in the context of moderate deficits and a broadly balanced net international investment position (NIIP). Past improvements in cost competitiveness, in the event that unit labour cost dynamics remain in line with trading partners, mitigate the risk of a material and persistent current account deterioration. The country has also reduced its energy dependence on Russia, particularly oil, relying instead on alternative sources. The current

account shifted to a negative deficit position of 2.4% of GDP in 2022 from a surplus of 0.4% in 2021, owing to high energy prices, lower Russian and Asian tourist arrivals, and the abolishment of the suspension of dividend payments for financial institutions. Lower import demand and a normalization in energy prices led the current account deficit to narrow to 1.4% of GDP in 2023. Morningstar DBRS does not expect a material widening in the deficit going forward but future improvements will be likely constrained by stronger domestic demand as well as high investments, particularly for military equipment. Finland's negative international investment position tends to hover around a balanced position over the last years and it is not expected to deteriorate significantly. However, the country's elevated gross external debt-to-GDP ratio at 215.1% of GDP in Q4 2023, remains a source of concern, given the cross-border exposures of the financial sector, including wholesale funding.

Country's Strong Institutional Framework and Political Stability Support the Ratings

Finland's credit ratings benefit from its political and institutional framework, which is among the strongest in the world, as well as from the country's consistent ranking among the top performers on the World Bank's Worldwide governance indicators. Last year's elections resulted in a new coalition government including the center-right National Coalition Party, the right-wing Finns Party, along with the Swedish People's Party, and the Christian Democrats, following a centre-left coalition government led by Social Democrats. The government, under Prime Minister Petteri Orpo, is expected to rule for the full term even though frictions among the coalition partners are likely to emerge. Rebalancing fiscal accounts, higher security, and a reinforced commitment to the West after Finland's accession to NATO are expected to be the government priorities. The Presidential election of Mr Stubb, of the centre-right National Coalition Party further reinforces Finland's commitment to the EU and to NATO.

ENVIRONMENTAL, SOCIAL, AND GOVERNANCE CONSIDERATIONS

Environmental (E) Factors

There were no Environmental factors that had a relevant or significant effect on the credit analysis.

Social (S) Factors

There were no Social factors that had a relevant or significant effect on the credit analysis.

Governance (G) Factors

There were no Governance factors that had a relevant or significant effect on the credit analysis.

A description of how Morningstar DBRS considers ESG factors within the Morningstar DBRS analytical framework can be found in the DBRS Morningstar Criteria: Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings (23 January 2024) <https://dbrs.morningstar.com/research/427030/morningstar-dbrs-criteria:-approach-to-environmental,-social,-and-governance-risk-factors-in-credit-ratings>.

For more information on the Rating Committee decision, please see the Scorecard Indicators and Building Block Assessments at <https://dbrs.morningstar.com/research/430067/>.

EURO AREA RISK CATEGORY: LOW

Notes:

All figures are in Euros unless otherwise noted. Public finance statistics reported on a general government basis unless specified.

The principal methodology is the Global Methodology for Rating Sovereign Governments (6 October 2023) <https://dbrs.morningstar.com/research/421590/global-methodology-for-rating-sovereign-governments>. In addition, Morningstar DBRS uses the Morningstar DBRS Criteria: Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings <https://>

dbrs.morningstar.com/research/427030/morningstar-dbrs-criteria:-approach-to-environmental,-social,-and-governance-risk-factors-in-credit-ratings in its consideration of ESG factors.

The credit rating methodologies used in the analysis of this transaction can be found at: <https://dbrs.morningstar.com/about/methodologies>.

The sources of information used for these credit ratings include Ministry of Finance (Winter Economic Survey, December 2023; State budget 2024), Bank of Finland (Bank of Finland's interim forecast: Finland's economy is in recession and the recovery will be slow-January 2024), Central Government Debt Management Office, Statistics Finland, European Commission, EBA, The Social Progress Imperative (2024 Social Progress Index), European Central Bank, Statistical Office of the European Communities, Bank of International Settlements, Organisation for Economic Co-operation and Development, IMF (2024 Article IV Consultation-Press Release; Staff Report; and Statement by the Executive Director for Finland, March 2024), World Bank, and Haver Analytics. Morningstar DBRS considers the information available to it for the purposes of providing these credit ratings to be of satisfactory quality.

With Rated Entity or Related Third Party Participation: YES

With Access to Internal Documents: NO

With Access to Management: NO

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The conditions that lead to the assignment of a Negative or Positive trend are generally resolved within a 12-month period. Morningstar DBRS' outlooks and ratings are under regular surveillance.

For further information on Morningstar DBRS historical default rates published by the European Securities and Markets Authority (ESMA) in a central repository, see: <https://registers.esma.europa.eu/cerep-publication>. For further information on Morningstar DBRS historical default rates published by the Financial Conduct Authority (FCA) in a central repository, see <https://data.fca.org.uk/#/ceres/craStats>.

The sensitivity analysis of the relevant key credit rating assumptions can be found at: <https://dbrs.morningstar.com/research/430065/>.

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Ratings

Finland, Republic of

Date Issued	Debt Rated	Action	Rating	Trend	Attributes
22-Mar-24	Long-Term Foreign Currency - Issuer Rating	Confirmed	AA (high)	Stb	 
22-Mar-24	Long-Term Local Currency - Issuer Rating	Confirmed	AA (high)	Stb	 
22-Mar-24	Short-Term Foreign Currency Debt - Issuer Rating	Confirmed	R-1 (high)	Stb	 
22-Mar-24	Short-Term Local Currency Debt - Issuer Rating	Confirmed	R-1 (high)	Stb	 

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