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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 Morningstar DBRS' expectation that the government will rebalance fiscal accounts and stabilise the debt-to-GDP ratio over the medium term. The government's consolidation package, along with an improvement in the country's economic recovery, will gradually gain traction and facilitate the decline in the fiscal deficit starting in 2025. Fiscal accounts have been mainly strained by higher defense spending, larger-than-expected deficits in the wellbeing services counties and municipal administrations, along with economic slowdown and higher interest costs. However, the government remains strongly committed to rebalancing the fiscal accounts and the Ministry of Finance projects the deficit to shrink to 2.4% of GDP in 2027 from 3.7% in 2024. Further consolidation measures, amounting to 1.0% of GDP, announced in the Spring are reassuring and should help stabilise the debt ratio at around 85% of GDP in 2028. This will remain below the Euro area average and continue to benefit from a sound affordability and strong asset position. However, further delays in in government savings and weaker-than-expected economic recovery could slow fiscal repair. Therefore, Morningstar DBRS will continue to monitor the feasibility of the government's consolidation plan and the degree of its effectiveness.

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 of implementing sound economic policies. Moreover, the country benefits from very strong governance indicators, which, along with its wealthy economy, support the credit ratings. On the other hand, an ageing population will constrain potential growth and likely burden public finances over time. 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 is of the view that the high level of household debt, which could amplify economic downturns, along with a large and interconnected banking system, remain a vulnerability.

CREDIT RATING DRIVERS

One or any combination of the following factors could trigger a credit ratings upgrade: (1) a material improvement in Finland's medium-term economic performance due to structural reforms, and (2) sustained decline in fiscal deficit leading the public debt-to-GDP ratio on a firm and durable downward trajectory.

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 significant and persistent worsening in Finland's economic performance, and (3) a substantial crystallisation of contingent liabilities.

CREDIT RATING RATIONALE

Additional Consolidation Measures Expected to Help Repair Fiscal Accounts in the Medium Term, but Fiscal Outlook Remains challenging

The consequences of the conflict in Ukraine, in tandem with a weak economic cyclical position and government discretionary measures,
are putting pressure on Finland's fiscal accounts. After the rapid improvement in the budget deficit to 0.4% of GDP in 2022 from a peak of 5.6% in 2020, public finances have started to deteriorate again, reflecting a combination of weak growth, energy-related support, humanitarian aid, defence spending, and higher than expected deficits stemming from the impact of the wellbeing services reform. The deficit widened to 2.7% of GDP in 2023 and is anticipated to rise to 3.7% this year. Nevertheless, the government appears strongly committed to improving public finances, and on top of the measures to strengthen fiscal accounts totaling EUR 6 billion included in the government programme in 2023, in the Spring it planned a further package amounting to EUR 3 billion as it is facing a more challenging fiscal outlook. In total, the government is committed to implementing adjustment measures, including higher fiscal revenues and expenditures cuts, amounting to around 3% of GDP over time, with the aim to reduce the deficit to 2.2% of GDP by 2028. This plan is ambitious as part of higher fiscal revenues relate to an improvement in the labour market, which could be slower than expected. However, Morningstar DBRS expects that the overall package will gain traction starting in 2025. Should the improvement in fiscal accounts deviate from the target, further additional measures to reinforce the government's budgetary consolidation strategy going forward are likely. Morningstar DBRS will monitor the future evolution of public sector accounts, particularly in relation to expenditures, and the government's ability to successful deliver on a more prudent fiscal stance.

The main risks in the near term are linked to a weaker-than-expected evolution of the economy, which might result in lower fiscal revenues. 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. Morningstar DBRS 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.

Public Debt-to-GDP Ratio is Rising but Strong Balance Sheet Position and Sound Debt Affordability Reassure

Morningstar DBRS is of the view that the government's adjustment measures will help stabilise the debt-to-GDP ratio over the medium term. After a slight decline to 72.6% of GDP in 2021 from a peak of 74.7% in 2020, the public debt ratio has started to increase again, rising to 75.8% in 2023, and further rises are projected until the government's consolidation measures gain more traction. High primary balance deficits along with the funding of military equipment and are expected to be the major drivers of the increase in the debt. The debt ratio will likely surge to 84.0% in 2026, but is expected to remain below the Euro area average, estimated at 88.2% of GDP by the International Monetary Fund (IMF). Moreover, debt affordability is projected to remain sound with interest costs as a share of GDP only gradually increasing to around 1.6% of GDP in 2026 from 1.1% in 2023. The average maturity central government debt of 7.9 years and minimal exchange-rate risk after swaps at end-August 2024 are also important mitigating factors.

The stock of explicit guarantees of the central government not included in the public debt is large and represents a vulnerability. However, contingent liability risk remains contained. Total guarantees estimated at around 17% of GDP as of December 2023, after excluding the guarantees of the national housing fund already included in the public debt, are among the largest in the European Union (EU). That said, these relate mainly to Finnvera, the state export agency and are not expected to exert significant pressure on public finance. Finland's ratings benefit from a strong public balance sheet position, with a net public financial asset position estimated at 58.9% of GDP as of Q1 2024. However, this favorable large net asset position mainly includes pension assets, which cannot be used for budgetary purposes but are key to fund future pension liabilities.

Economic Growth is Set to Gather Pace Although Gradually; Labour Market Holds Up

Finland's credit ratings benefit from a high per capita GDP, amounting to USD 54,008 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%, according to the IMF, which is constrained by a shrinking working-age population and relatively weak labour productivity growth.

After a rapid recovery from the pandemic, Finland's economic performance started deteriorating because of the impact of Russia's invasion of Ukraine, the steep rise in interest rates and the overall downturn in the housing market. The country slipped into recession last year, with GDP contracting by around 1.2%. Morningstar DBRS anticipates Finland's economy to remain stagnant this year, while growth momentum is expected to strengthen towards the end of the year. Real GDP is expected to expand by 1.6% in 2025 driven by a recovery in housing investment and stronger consumption as inflation moderates further and interest rates decline. However, despite the economic slowdown, and the increase in the unemployment rate, the labour market holds up with the employment rate remaining relatively resilient at 72.4% in July 2024 . This mitigates the risks stemming from the weak cyclical position.

The main risks to the outlook stem from an escalation in geopolitical tensions, which could intensify trade fragmentation and lead to a new spike in energy prices. Moreover, a prolonged period of high interest rates could constrain the recovery weighing on residential investment. 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 the downturn in the housing market and the increase in borrowers' interest expenses. Loan losses overall have remained contained and the increase in nonperforming loans (NPLs) in the construction sector is not a major concern for the banking system. Moreover, households' loan-servicing ability has remained broadly good while the household debt ratio has also declined from the peak in 2021. Nevertheless, at 125.0% as of Q4 2023, household debt as a share of the disposable income remains a source of risk if interest rates remain higher than expected and/or inflation makes a comeback. This is because interest expenses have increased significantly reflecting the large share of mortgages at variable rates vis-à-vis a relatively short refixing period. Nevertheless, Finnish banks are profitable and well capitalised with a CET1 capital ratio at 18.6% as of Q1 2024 and the NPL ratio at around 1.0% remains very low, according to the European Banking Authority (EBA). In addition, imbalances in the mortgage market appear to be relatively contained as a result of Finland's fully amortising mortgages, strict credit policies, and low tax deductibility. Moreover, most indebted households tend to also have high levels of financial wealth, which mitigates risks to financial stability. With the normalisation in interest rates and the recovery in the economy, lending for housing is expected to restart, but household debt will likely not rise significantly over the medium term, as interest rates are projected to remain higher than before the tightening in monetary policy.

After several years of persistent growth, house prices have dropped in the Nordic region and in Finland these are now below 10% of the peak reached in 2022. The fall in property prices seems to have slowed down, but the overall situation in the housing market remains challenging in light of high interest rates. Given the banks' large exposure to the real estate market, Morningstar DBRS does not rule out a potential, although contained, negative impact on Finnish banks over the medium term, should the housing market recover more slowly than expected. The financial sector continues to face structural vulnerabilities, including a large and interconnected banking system, highly exposed to the real estate market with a large amount of external wholesale funding. However, in this regard, contingent liability risks have remained limited.

Current Account Deficit will Remain Contained; External Debt Linked to the Financial Sector is a Source of Concern

Despite the impact of Russia's invasion of Ukraine, and the subsequent need to re-orient export markets, Finland's external position remains good. It continues to benefit from a restored price-competitiveness in the context of moderate current account deficits and a positive 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 improvement in the trade balance, also as a result of demand compression, led the current account deficit to narrow to 1.1% of GDP in 2023 after the 2.4% recorded in 2022. Lower numbers of tourists from Russia and Asia as well as higher dividends paid from the Finnish banks have weighed on the service and the primary income balance, respectively. Returning to a current account surplus appears challenging as the recovery in domestic demand as well as high investment, particularly for military equipment, will likely continue to be a drag over the medium term. However, the current account deficit will likely remain moderate, slightly above 1% of GDP over 2024-2027, according to the government. Finland's NIIP, after hovering around a balanced position until end of 2021, is now positive at around 17% of GDP as of Q2 2024 and it is not expected to deteriorate significantly in the medium term. However, the country's elevated gross external debt-to-GDP ratio at 218.6% in Q2 2024, remains a source of vulnerability, given the cross-border exposures of the financial sector, including liquidity risks as a result of the large wholesale funding.

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

Finland's credit ratings benefit from its political and institutional framework, which is among the strongest in the world. This is reflected also in the country's consistent ranking among the top performers on the World Bank's Worldwide Governance Indicators. Finland now is part of NATO and this reinforces its security including the defence of its external borders. The government coalition, including the center-right National Coalition Party, the right-wing Finns Party, along with the Swedish People's Party, and the Christian Democrats,
is expected to rule for the full term even though frictions among the coalition partners could emerge. Rebalancing fiscal accounts, higher security, and a reinforced commitment to the West after accession to NATO are expected to remain the main government priorities reflecting consensus-oriented stance.

ENVIRONMENTAL, SOCIAL, AND GOVERNANCE CONSIDERATIONS

There were no Environmental, Social and Governance factors that had a significant or relevant 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 Morningstar DBRS Criteria: Approach to Environmental, Social, and Governance Factors in Credit Ratings (13 August 2024) https://dbrs.morningstar.com/research/437781.

For more information on the Rating Committee decision, please see the Scorecard Indicators and Building Block Assessments.

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 (15 July 2024) https://dbrs.morningstar.com/research/436000. In addition, Morningstar DBRS uses the Morningstar DBRS Criteria: Approach to Environmental, Social, and Governance Factors in Credit Ratings https://dbrs.morningstar.com/research/437781 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 (Summer Economic Survey, June 2024), Bank of Finland (Bank of Finland's interim forecast: Finland's economy is gradually moving out of recession- July 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 respect to FCA and ESMA regulations in the United Kingdom and European Union, respectively, these are unsolicited credit ratings. These credit ratings were not initiated at the request of the issuer.

With Rated Entity or Related Third Party Participation: YES
With Access to Internal Documents: NO
With Access to Management: NO

Morningstar DBRS does not audit the information it receives in connection with the rating process, and it does not and cannot independently verify that information in every instance.

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 credit 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/DOCUMENT ID NUMBER/.

These credit ratings are endorsed by DBRS Ratings Limited for use in the United Kingdom.

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For more information on this credit or on this industry, visit dbrs.morningstar.com.

Ratings

Finland, Republic of

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

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