

Rating Object	Rating Information	
REPUBLIC OF FINLAND	Assigned Ratings/Outlook: AA+ /stable	Type: Follow-up Rating, unsolicited
Long-term sovereign rating Foreign currency senior unsecured long-term debt Local currency senior unsecured long-term debt	Initial Rating Publication Date: Rating Renewal:	28-10-2016 01-09-2017
	Rating Methodologies:	"Sovereign Ratings"

Rating Action

Neuss, 01 September 2017

Creditreform Rating has affirmed the unsolicited long-term sovereign rating of "AA+" for the Republic of Finland. Creditreform Rating has also affirmed Finland's unsolicited ratings for foreign and local currency senior unsecured long-term debt of "AA+". The outlook is stable.

Key Rating Drivers

1. Exceptionally high institutional quality which translates into a very favorable business environment; very reform-oriented and efficient policy-making
2. Stronger-than-expected economic recovery – this year's growth prospects brightened significantly on the backdrop of strengthening foreign trade; medium-term outlook moderate, as potential growth continues to be dragged down by demographics and low labor productivity
3. Government committed to fiscal sustainability, which we do not expect to be derailed by substantial reform efforts to boost growth and competitiveness
4. Contingent on current growth projections and on reform yields materializing as expected, debt-to-GDP should broadly stabilize in the medium term
5. Moderate current account deficit and broadly balanced NIIP expected to remain in place, as past losses in export market shares and competitiveness have not been reverted so far

Reasons for the Rating Decision

The Republic of Finland's very high creditworthiness continues to be buttressed by the exceptionally high quality of its institutional conditions. The government has a track record of identifying the economy's prevalent challenges and addressing these by implementing forward-looking reforms. The very reform-oriented, prudent and efficient policy-making of the Finnish state is underscored by the World Bank's World Governance Indicators (WGI), according to which the sovereign is persistently ranked among the world's top performers along all WGI dimensions. In particular, Finland serves as best practice in terms of rule of law (rank 1/209 economies) and control of corruption (rank 2/209 economies). The most recent evidence of the sovereign's good governance and consensus-

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driven policy-making is the ambitious structural reform package, known as the Competitiveness Pact (see below). Further labor and product market reforms to tackle the economy's preeminent structural impediments, as well as a thorough health and social services reform which will be complemented by a regional government reform, are also noteworthy in this respect.

We do not expect the recent political turbulences to have an adverse impact on the broad political consensus on the reform agenda going forward. To the contrary, the risk of a snap election may now be even lower than before. In June 2017 a collapse of the governing three-party coalition was avoided when the Finns party split into a rather EU-sceptic Finns Party Parliamentary Group and a new group of more moderate Finns members called the New Choice Parliamentary Group. The new coalition government consists of the New Choice Party (19 seats as of 24 August), the Centre Party Parliamentary Group (49) and the National Coalition Party Parliamentary Group (38), which still forms a majority in the Finnish Parliament (106/219 seats), boding well for the forthcoming reform process and efficient governance.

Moreover, the sovereign's credit rating is supported by Finland's wealthy economy and the pick-up in economic growth. According to IMF data, Finnish per-capita income was up to USD 42,165 (PPP terms) in 2016, thus posting its first notable increase in years. However, Finland's GDP per capita is still lagging European top-performers such as Denmark, Sweden or Germany by considerable margin, although the gap built up over the recent years has somewhat narrowed.

Growth performance surprised on the upside, as cyclical factors led to a stronger-than-expected GDP expansion. While its economy stagnated in 2015 (0.0%), Finland's GDP growth accelerated to 1.9% in 2016, being revised upwards from 1.4% earlier in the year and marking the strongest real GDP growth since 2011. The economic recovery was led by private consumption spending, which rose by 1.8% and benefited from rising employment and increasing real disposable income. Investment activity saw a strong 2016, as growth of gross fixed capital formation leapt to 7.2%. While residential investment was booming, posting a y-o-y growth rate of 10.5%, investment in machinery and equipment grew at a robust 9.8%. At the same time, net trade detracted from growth as recovering exports (+1.3%) were outpaced by brisk import growth (+4.4%).

With a view to the current year, the recovery is gaining steam and we forecast GDP to rise by 2.5%, despite our belief that growth slowed somewhat in the second quarter. Latest Statistics Finland data shows that quarterly GDP growth accelerated to 2.8% y-o-y (Q1-17), after increasing by 2.3% in Q3-16 and Q4-16, respectively. Notably, net trade, private consumption and investment contributed broadly equally to Finland's output expansion. Thanks to the benign economic prospects for Finland's key export markets and an improvement in Finland's cost competitiveness (see below) exports made a strong start into 2017 (Q1-17: +8.2% y-o-y) and are set to buttress GDP growth this year. Noteworthy, exports to the Russian Federation have been rebounding recently. Between January and May 2017 exports to Russia rose by 19.8% as compared to the previous year, while growth of exports to the euro area (+23.7%) and China (+31.4%) turned out to be

even stronger (Tulli data). On the whole, net export's growth contribution is likely to be rather modest, as imports should be facilitated by strong domestic demand.

Helped by vivid export growth, investment in machinery and equipment should follow; favorable financing conditions, improving business confidence and rising capacity utilization, which has recently passed its long-term average (2000-16: 81.0%; Q3-17: 82.6%), should also facilitate investment growth. Furthermore, there are indications that the decline in manufacturing is bottoming out. Since Q1-16 (17.1%), manufacturing gross value added (GVA) has risen to 18.2% of total GVA, after having fallen from 23.1% to 16.9% between 2007 and 2012 – with the wood and paper, machinery, and chemical industries recovering markedly. Private consumption remains the main driver of economic growth. We believe that the wage freeze due to the Competitiveness Pact and slowly rising inflation will be offset by personal income tax cuts, robust employment growth and buoyant consumer confidence, which hit an all-time high in July 2017 and is the highest in the EU-28 (Eurostat data). Residential investment is likely to remain robust this year, as indicated by the still increasing number of building permits and starts for dwellings, but we believe that growth will peak this year, levelling off thereafter.

Beyond 2017, we expect GDP expansion to slow (2018e: 1.7%), as stronger growth is held back by the economy's structural barriers. In this vein, potential growth is likely to recover only gradually as the Finnish authorities expect that TFP growth should prove to be only modest in the medium term. The projected pick-up in investment alone is not likely to be sufficient to significantly lift potential GDP growth to levels near its Nordic peers. Low labor productivity and an ageing population continue to weigh on Finland's trend growth. The working-age population declined by 2.6% in 2009-16, with the share of the working-age population falling from 66.4 to 62.9% of total population over the same period.

Hence, economic prospects are heavily dependent on making the Competitiveness Pact work. The Competitiveness Pact, which was agreed in June 2016 and came into effect this year, is geared towards improving the cost competitiveness of the Finnish economy, concurrently increasing exports and employment; the overarching goal of the Competitiveness Pact is to curb unit labor costs by around 4%. The authorities have also implemented additional labor market reforms to incentivize the acceptance of work and to shorten periods of unemployment. Since the beginning of this year, the eligibility of unemployment benefits has been modified and the maximum duration of unemployment benefits shortened. The government also envisaged adopting reforms aimed at the improvement of youth employment, vocational education and training, and the integration of immigrants.

There are tentative signs of early success and we expect that competitiveness will continue to improve going forward. Although real labor productivity per person employed has remained virtually unchanged since 2010, it increased by 1.4% in 2015-16 as compared to a euro area average of only 0.4% and higher than in most of its peers. Moreover, nominal hourly unit labor costs fell for the first time since 2010 (2016: -0.7%), after exhibiting an annual average of 2.1% over 2011-15 – significantly higher than its key trading partners (DK: 0.7%, DE: 1.6%; NL: 0.8%; SE: 2.0%). Importantly, quarterly data signals that

the downward trend of nominal unit labor costs may be firming. In this year's first quarter, hourly unit labor costs nose-dived, declining by 4.3% y-o-y (Q4-16: -1.2%, Q3-16: 0.0%), thus significantly improving compared to its peer economies. By the same token, Finland's ULC-based real effective exchange rate has been further improving, falling by 0.5% in 2015-16 and by 2.2% as compared to 2013. Also, the steady decline in export market shares has continued to slow down.

The labor market situation is also brightening. While the annual average dropped from 9.4 to 8.8% in 2015-16, the labor participation rate climbed to 75.9% (2015: 75.8%). Still, the labor market performance is worse than in its peer economies. Furthermore, Finland's long-term and very-long-term unemployment rates stand higher than in the other Nordic countries. In Q2-17, the quarterly average remained at 8.8% as in the previous quarter, and slightly above the 8.7% recorded in Q4-16. On the positive side, persistent unemployment rates appear to be mainly driven by rising labor supply, with the activity rate coming in at 76.3% (Q1-16: 76.0%). What is more, there has been a favorable employment trend among the elderly workers (55-64y).

The impact of accelerating GDP growth was also felt in Finland's public finances. With regard to the correction of its budget deficit, the Finnish government continued to make progress last year. After net borrowing came in at 2.7% of GDP in 2015, the headline deficit improved to 1.8% of GDP – the lowest figure since 2011 (-1.0% of GDP). Thus, Finland's budgetary performance surprised on the upside in 2016, as the government had projected a deficit of 2.5% of GDP in its 2016 stability program. The better-than-expected budget outturn was mainly driven by the ongoing economic recovery and an improving labor market. As a result, taxes and social security contributions experienced robust growth and expanded by 3.3%. Additionally, the budget benefited from revenue enhancing measures implemented in 2016, such as a 1 p.p. hike of unemployment insurance contributions and an increase of excise duties on energy and tobacco. At the same time, the budgetary improvement was supported by favorable developments affecting the expenditure side of the budget. Both spending on unemployment benefits and compensation of state employees were lower than anticipated.

This year we expect Finland's fiscal policy stance to loosen somewhat. According to the government's stability program 2017, the implementation of the Competitiveness Pact will imply lower revenues in the short term. To boost the competitiveness of the corporate sector and stimulate growth, the Finnish government cut taxes and social security contributions for employers. In total, revenue measures related to the Competitiveness Pact should lower government receipts by approx. EUR 1.6bn this year. This revenue shortfall should be partly compensated by consolidating measures on the expenditure side of the budget. To curb expenditure growth in the public services sector, the compensation of state employees will not be increased in 2017, holiday bonuses have been temporarily reduced, and annual working hours extended. Moreover, some expenditure items are subject to an index freezing this year. Central government transfers to the local governments, as well as some social spending (e.g. child allowance) have not been raised in line with CPI-inflation in 2017. We expect a transitory increase in net borrowing this year, with the budget deficit reaching 2.0% of GDP.

Going into 2018, the budget deficit should narrow again, assuming a GDP growth in line with our expectations and a stringent implementation of the government's fiscal plan 2018-21. In our view, the containment of age-related costs will be key for preserving fiscal sustainability in the medium term. We acknowledge the government's commitment to curb spending on pensions and healthcare which is underpinned by structural reforms. While changes to the pension legislation adopted in 2015 became effective in Jan-17, a comprehensive reform of health and social services (SOTE reform) was delayed by one year and should come into effect in 2020. Revamping the national healthcare framework should not only improve the quality of services, but also yield efficiency gains. According to the Finnish government, the implementation of the reform would save EUR 3bn per year by 2029.

The gradual narrowing of the budget deficit and the pick-up in economic activity should also contribute to a stabilization of the government's debt-to-GDP ratio, which has almost doubled since 2008, but is relatively low as compared to the EA-19 average (2016: 63.6% vs. 89.2% of GDP). Notwithstanding the rapid debt accumulation seen in the past, we believe that medium-term debt sustainability risks are mitigated by a number of factors.

Firstly, interest rate risks should be limited against the background of the balanced maturity profile. As indicated by Treasury data, the average fixing of central government debt was 5.07y in Jul-17, up from 4.96y a year before, and short-term debt accounted only for a negligible part of the Finnish debt stock (5.0%). Moreover, Finland's refinancing conditions remain favorable as mirrored by vivid demand for the country's recently issued long-term debt. In Apr-17, Finland conducted a tap auction of a 5-year and a 30-year bond. While the longer issue yielded 1.296%, the bond maturing in 2022 came with a negative yield of -0.168%.

Secondly, Finland's public accounts display a significant net asset position enhancing the government's fiscal flexibility. As measured by GDP, the government features the largest net asset position in the EU-28. In Q1-17, total government assets (129.2% of GDP), mainly consisting of equity and investment fund shares, exceeded liabilities by 54.5 p.p.

Thirdly, we expect no immediate materialization of contingent liability risks in the country's large banking sector (2016: asset-to-GDP ratio 250.1%). In our view, risks related to banks are limited by the large presence of foreign-owned banks and generally healthy bank balance sheets. High asset quality coupled with a competitive cost structures translate into above average profitability and capital ratios. While the cost-to-income ratio continued to decline from 48.6% (Q1-16) to 42.3% (Q1-17), the NPL ratio stabilized at 1.6% in Q1-17, the lowest level in EU-28. However, similar to its Swedish and Danish peers, Finnish banks are carrying comparably large funding risks. Intragroup-funding and the issuance of debt securities play an important role in the funding strategy of the domestic banking sector. According to EBA data, Finnish banks exhibit the strongest reliance on market funding in the EU-28, with debt securities accounting for more than a third (Mar-17: 36.6%) of total liabilities. Admittedly, funding risks related to the term structure of outstanding securities have markedly abated over the recent years. Short-term debt accounted for only 13.9% of outstanding securities in Jun-17, down from 26.4% in 2012. Further risks arise from strong cross-border linkages with its Nordic neighbors. Credit

supply for the Finnish economy could be adversely affected in the event of a significant house price correction in Denmark or Sweden, as Nordea Pankki and Danske Bank Oyj account for more than half of total banking assets (end-16: 57.4%). Since the Swedish Nordea bank converted its Finnish subsidiary into a branch (Jan-17), FIN-FSA lost its supervisory authority over the country's largest bank, which could complicate risk monitoring going forward.

With regard to the domestic financial market, FIN-FSA recently adopted additional macroprudential measures to limit a further increase in household debt. Starting from elevated levels, the debt burden of Finnish households continued to climb in 2016. Last year, the debt-to-GDP ratio of Finnish households increased from 71.3 to 73.4% of GDP, which is somewhat lower than in Denmark and Sweden but well above the EA-19 average. To prevent potential financial stability risks, the regulatory authority decided to set a minimum risk weight level of 15% for banks using the IRB approach to calculate capital requirements for residential mortgage loans (Mar-17). Meanwhile, data on house prices and mortgage lending activity do not point to adverse developments in housing at present. While lending for house purchase continued to expand at a moderate pace, with monthly y-o-y growth in the 2%-range since Jan-17, the 3-year growth rate of house prices stood at 1.3% in Q1-17, after -0.3% in Q1-16.

Turning to Finland's external position, the country's current account balance somewhat deteriorated in 2016, driven by its lower trade in goods surplus. After a deficit of 0.6% of GDP in 2015, the current account balance slipped to a modest -1.1% of GDP last year. Looking ahead, we expect the current account balance to remain at the levels seen over the recent years. In the same vein, we do not expect Finland's net international investment position (NIIP), which came in at 7.1% of GDP, to deteriorate substantially in the near term. Notwithstanding the positive NIIP, some sectors within the Finnish economy are displaying large external liabilities. According to Statistics Finland, NFCs as well as the financial sector are characterized by significant levels of net external liabilities, indicating high external funding needs. The same holds for the central and local government. As of 2016, the bulk (approx. 75%) of Finnish government debt was held by foreign investors. However, at the general government level external financing risk should be tempered by the strong net asset position of social security funds. Foreign assets of social security funds exceeded liabilities by EUR 130.8bn in 2016.

Rating Outlook and Sensitivity

Our Rating outlook on the long-term sovereign rating of AA+ is stable as we assume that the risk situation underlying the key factors affecting sovereign credit risk – including macroeconomic performance, institutional structure, fiscal sustainability, and foreign exposure – will remain fundamentally unchanged in the near term.

We could downgrade Finland's rating if adverse developments lead to lower-than-expected medium-term growth. This could also entail risks for fiscal sustainability, as lower GDP growth would have a detrimental impact on fiscal metrics via the denominator effect. More importantly, the rating could be lowered if we see substantial delays in im-

plementing structural reforms or if the reforms already adopted turn out to have a weaker-than-expected impact on unit labor costs, unemployment and public finances.

Conversely, upside risks, which could translate into a rating upgrade, pertain to a faster-than-anticipated improvement of external competitiveness and medium-term growth prospects as a result of the recently implemented structural reforms, with positive repercussions on GDP per capita. Also, we could lift our ratings if we see a sustained improvement of Finland's public finances.

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Ratings*

Long-term sovereign rating	AA+ /stable
Foreign currency senior unsecured long-term debt	AA+ /stable
Local currency senior unsecured long-term debt	AA+ /stable

*) Unsolicited

Economic Data

[in %, otherwise indicated]	2011	2012	2013	2014	2015	2016	2017e
Real GDP growth	2.6	-1.4	-0.8	-0.6	0.0	1.9	2.5
GDP per capita (PPP, USD)	40,378	40,340	40,490	40,770	41,164	42,165	43,545
Inflation rate, y-o-y change	3.3	3.2	2.2	1.2	-0.2	0.4	0.9
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	80.5	80.6	81.0	81.2	81.4	n.a.	n.a.
Fiscal balance/GDP	-1.0	-2.2	-2.6	-3.2	-2.7	-1.8	-2.0
Current account balance/GDP	-1.8	-1.9	-1.6	-1.3	-0.6	-1.1	n.a.
External debt/GDP	193.4	229.2	211.7	200.2	206.6	186.9	n.a.

Source: International Monetary Fund, World Bank, Eurostat, Statistics Finland, own estimates

Appendix

Regulatory Requirements

This sovereign rating is an unsolicited credit rating. Neither the rated sovereign nor a related third party participated in the credit rating process. Creditreform Rating AG (CRAG) had no access to the accounts, representatives or other relevant internal documents for the rated entity or a related third party.

The rating was conducted on the basis of CRAG's "Sovereign Ratings" methodology. CRAG ensures that methodologies, models and key rating assumptions for determining sovereign credit ratings are properly maintained, up-to-date, and subject to a comprehensive review on a periodic basis. A complete description of Creditreform Rating's rating methodologies is published on the following internet page: www.creditreform-rating.de.

To prepare this credit rating, CRAG has used following substantially material sources: International Monetary Fund, World Bank, Organisation for Economic Co-operation and Development, Eurostat, European Commission, European Banking Authority, European Central Bank, Treasury Finland, Bank of Finland, Statistics Finland.

A Rating Committee was called consisting of highly qualified analysts of CRAG. The quality and extent of information available on the rated entity was considered satisfactory. The analysts and committee members declared that the rules of the Code of Conduct were complied with and that the rating action was and is free of any existing or potential conflicts of interest. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant quantitative and qualitative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all risk factors is described in CRAG's "Sovereign Ratings" methodology. The main arguments that were raised in the discussion are summarized in the "Reasons for the Rating Decision".

In the case of a rating outlook, the time horizon is provided during which a change in the credit rating is expected. This information is available within the credit rating report.

There are no other attributes and limitations of the credit rating or rating outlook other than displayed on the CRAG website. In regard to the rated entity CRAG regarded available historical data as sufficient.

In case of providing ancillary services to the rated entity, CRAG will disclose all ancillary services in the credit rating report.

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