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Research Update:

Finland Long-Term Ratings Lowered To 'AA+' On Weak Economic Growth; Outlook Stable

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Overview

- We have revised downward our assessment of Finland's economic growth prospects, as we believe that continuing subdued external demand adds to structural economic and demographic challenges.
- The weaker economic backdrop will further complicate efforts to consolidate public finances and reduce public debt, in our view.
- We are therefore lowering our long-term sovereign credit ratings on the Republic of Finland to 'AA+' from 'AAA'.
- The outlook on the long-term ratings is stable.

Rating Action

On Oct. 10, 2014, Standard & Poor's Ratings Services lowered its long-term foreign and local currency sovereign credit ratings on the Republic of Finland to 'AA+' from 'AAA'. At the same time, we affirmed the 'A-1+' short-term sovereign credit ratings. The outlook on the long-term ratings is stable.

Rationale

The downgrade reflects our view of the risk that the Finnish economy could experience protracted stagnation because of its aging population and shrinking workforce, weakening external demand, loss of global market share in the key information technology sector, structural retrenchment of the important forestry sector, and relatively rigid labor market.

Over the past decade, Finland's economy has lagged most peers, with GDP per capita shrinking by an estimated 0.26% (based on an average of actual and projected per capita GDP growth for 2008-2017). This is well below the level we consider to be the norm for economies at a similar level of economic development. We expect 2014 to be the third consecutive year of negative real GDP growth. The estimated 2014 real output remains 6% below the 2008 level. Moreover, Finnish exports have underperformed world trade since 2008, which we interpret as a sign of lower competitiveness, rendering an export-driven recovery unlikely. Despite weak economic performance, and low underlying inflation, between end-2007 and 2013, Finnish labor costs increased by over one-fifth compared with about one-eighth for the eurozone as a whole (based on Eurostat data).

Downside risks to the weak economic growth outlook exist if global demand softens further. We also consider that Finland remains vulnerable to Russia's economic weakness and, more significantly, to any slowdown of economic activity in the eurozone. Exports to Russia account for one-tenth of total Finnish exports or about 4% of GDP. We estimate that a slowdown in exports to Russia could impede Finnish growth, causing a one-off reduction in GDP growth of 0.8%.

At the same time, we expect that the measures introduced by the government will moderately increase labor market participation, which in turn should support moderate growth in domestic demand from 2015. Even so, we consider that per capita GDP growth is unlikely to systematically exceed 1% over the medium term. This is partly a reflection of an adverse demographic profile. Finland's labor force has been shrinking since 2011 and its effective retirement age (at 61.8 years according to OECD data) is one of the lowest in Europe.

In our opinion, it remains uncertain whether other sectors can consistently compensate for the output loss in Finland's wood and paper industry and its electronics industry. In this respect, the collective wage agreement to cap salary increases, which was agreed in the third quarter of 2013, may help Finland recover the cost competitiveness it lost as labor costs rose over the past seven years.

Protracted low growth also makes it more difficult to implement new policies, in our view. The government is likely to find it harder to maintain broad support for reforms aimed at addressing structural imbalances and attaining its fiscal targets over the medium term.

Finland's innovative and wealthy economy continues to support our sovereign ratings. We estimate Finland's per capita income at around $49,800 in 2014. Furthermore, net general government debt is low at an estimated 22% of GDP in 2014, supported by large amounts of liquid assets. The ratings also reflect Finland's high degree of institutional and governance effectiveness. We also consider that the political commitment and societal consensus in favor of prudent policies is stronger than in most other advanced economies.

These strengths are somewhat constrained by Finland's external performance, which has recently been weaker than expected. In our view, depressed global demand and decreased competitiveness have caused Finland's current account position to shift into deficit since 2011. We forecast that the current account will have a deficit of 1.6% of GDP in 2014, before it returns to balance by 2016. We acknowledge that the outlook for the current account remains uncertain, not least in light of the volatility of the income account over the past few years.

Despite this, Finland remained a net external creditor as of end-2013, when we estimate that it had a net external position of about 9% of GDP. We expect it to preserve its position throughout the two-year forecast horizon. Although Finland's net international investment data indicates rising external debt, at over 200% of current account receipts (CARs) this year, in our view, most of this debt is not related to the domestic economy. The two large Scandinavian parent bank groups finance most of their eurozone operations, including their derivatives books, through their Finnish subsidiaries.

While we consider that membership of the eurozone provides Finland with a strong monetary anchor, giving the economy access to funding at low nominal interest rates, we also believe that membership in a fixed exchange rate area increases the onus on member governments to both ensure fluid labor, product, and services markets, and to build up fiscal buffers against future shocks. This is more the case now than before given that the European Central Bank is undershooting its medium-term price stability target of close to, but below, 2% for the euro area as a whole. Harmonized Indices of Consumer Prices (HICP) inflation in Finland in August was 1.2% year-on-year, while the core consumer price index (CPI) was 0.8% year-on-year.

We anticipate that Finland's economy will be one of the hardest hit by rising age-related spending over the medium-to-long term (see "Global Aging 2013: Rising To The Challenge," published on March 20, 2013). In addition, persistent fiscal deficits in the municipal sector continue to weigh on the general government balance. We forecast a further widening of the general government deficit to 2.7% of GDP in 2014 as a result of the continuing recession, exacerbated by the slow implementation of reforms to counter negative fiscal pressures. Accordingly, we expect Finland's gross general government debt to exceed 60% of GDP in 2015 (and 64% by 2017), from a low level of 33% in 2008.

The government has worked consistently to implement the reforms it originally set out in its 2013 strategic plan, but has made slow progress, in our view. The spending limit package it announced in March 2014 builds on the consolidation measures it announced in the third quarter of 2013. On March 26, 2014, the government announced a frontloaded package of structural consolidation totaling €6.8 billion (over 3% of 2014 GDP) over 2015-2018, of which we estimate that €2.3 billion (1% of 2014 GDP) will have an immediate effect on finances over the current parliamentary term. The government has complemented its consolidation measures with measures to support growth. These measures include selling €1.9 billion in assets (less than 1% of 2014 GDP), of which the government will use €1.3 billion (or over 68% of the total) to reduce its borrowing requirement. The rest will be invested in growth-enhancing projects.

The draft budget for 2015 supports previous fiscal consolidation efforts and also introduces tax changes to promote social justice, increase excise duties, lower transfers to municipalities, and reduce child benefits.

Certain key reforms, such as the pension and the social and health care services reforms, are expected to be implemented by 2017. We anticipate that these will improve the long-term sustainability of public finances. Given that parliamentary elections are scheduled for early April 2015, we see the success of the structural package as hinging on the next government continuing to pursue reform. We expect that further structural reform initiatives will remain on hold during the run-up to the elections. More fundamentally, we believe that Finnish policymakers will remain strongly committed to pursuing fiscal and structural reforms, and that policymaking will remain prudent, transparent, and consensus-based.

Despite the deterioration in public finances, Finland's government balance sheet is strong, in our view, primarily because of its holdings of publicly mandated defined-benefit pension assets for public-sector workers, and we have factored this strength into our analysis. We anticipate that general government debt, net of pension and liquid assets, will reach 25% of GDP in 2017, up from 2% in 2007. Our measure of general government debt excludes the guarantees related to the European Financial Stability Facility (see "S&P Clarifies Its Approach To Accounting For EFSF Liabilities When Rating The Sovereign Guarantors," published on Nov. 2, 2011, on RatingsDirect).

The banking system appears well-capitalized and is dominated by pan-Nordic banks (see "Banking Industry Country Risk Assessment: Finland," published Jan. 3, 2014). In our assessment, the system poses only limited contingent liability to the Finnish government.

Outlook

The stable outlook reflects our view that the sovereign benefits from generally strong policy settings, a wealthy and relatively resilient economy, and a net external creditor position. We consider that fiscal consolidation and structural reforms have sufficient momentum to contain further deterioration in public finances, enabling general government debt levels to stabilize in the medium term.

We could lower the rating if political support for the current reform agenda waned, increasing the likelihood that public debt levels could increase by significantly more than we expect. We could also lower the rating if monetary policy actions at the eurozone level fail to prevent the risk of outright deflationary pressures eroding Finland's fiscal and growth performance.

We could raise the rating if we see more dynamic and sustainable growth rates supported by effective mitigation of Finland's structural economic challenges, coupled with an improved external position.

The stable outlook indicates that we currently do not expect either of these scenarios to occur during the next two years and that the rating is likely to remain unchanged during this period.

Key Statistics

Table 1

Republic of Finland - Selected Indicators

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Nominal GDP (bil. US$)	255	284	252	248	274	256	267	272	257	272	282

Table 1

Republic of Finland - Selected Indicators (cont.)											
GDP per capita (US$)	48,396	53,531	47,218	46,308	50,910	47,352	49,272	49,766	46,887	49,256	50,811
Real GDP growth (%)	5.2	0.7	(8.3)	3.0	2.6	(1.5)	(1.2)	(0.5)	0.8	1.5	1.8
Real GDP per capita growth (%)	4.8	0.3	(8.7)	2.5	2.1	(1.9)	(1.7)	(1.0)	0.3	0.9	1.2
Change in general government debt/GDP (%)	(1.3)	(0.1)	6.8	6.8	3.6	3.7	3.3	4.6	4.2	3.6	3.2
General government balance/GDP (%)	5.2	4.2	(2.6)	(2.7)	(1.0)	(2.1)	(2.3)	(2.7)	(2.4)	(1.7)	(1.1)
General government debt/GDP (%)	34.0	32.7	41.7	47.1	48.4	51.5	54.3	58.2	61.1	62.9	63.9
Net general government debt/GDP (%)	1.8	6.3	7.9	10.1	15.6	17.1	19.3	22.0	23.8	24.8	24.9
General government interest expenditure/revenues (%)	2.8	2.7	2.6	2.6	2.6	2.6	2.2	1.9	2.0	2.0	2.1
Other dc claims on resident non-govt. sector/GDP (%)	78.6	82.4	89.2	91.1	92.8	95.8	98.0	100.4	102.3	104.2	105.5
CPI growth (%)	1.6	3.9	1.6	1.7	3.3	3.2	2.2	1.1	1.5	1.8	1.9
Gross external financing needs/CARs +use. res (%)	207.6	223.3	347.8	358.6	378.4	504.8	476.8	387.9	403.1	372.6	334.1
Current account balance/GDP (%)	3.8	2.3	1.9	1.2	(1.8)	(1.9)	(1.4)	(1.6)	(1.2)	0.0	0.7
Current account balance/CARs (%)	7.1	4.1	4.4	2.6	(3.8)	(4.0)	(3.1)	(3.5)	(2.6)	0.0	1.5
Narrow net external debt/CARs (%)	104.1	88.9	155.7	149.0	143.8	181.9	200.5	206.2	223.0	209.1	197.8
Net external liabilities/CARs (%)	100.6	25.0	22.9	(3.7)	(6.5)	6.4	(20.7)	(16.4)	(14.5)	(13.2)	(13.8)

Note that the data reflects ESA 2010 adjustments made to Finland's National Accounts data in July 2014. Other depository corporations (dc) are financial 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 assets held by nonresidents minus financial sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. CARs--Current account receipts.

The data and ratios above result from S&P's own calculations, drawing on national as well as international sources, reflecting S&P's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Ratings Score Snapshot

Table 2

Ratings Score Snapshot	
Key Rating Factors	
Institutional and governance effectiveness	Strength
Economic structure and growth	Strength
External liquidity and international investment position	Neutral
Fiscal performance and flexibility	Neutral
Debt burden	Strength
Monetary flexibility	Strength

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Table 2

Ratings Score Snapshot (cont.)
Standard & Poor's analysis of sovereign creditworthiness rests on its score and scoring of five key rating factors: (i) institutional and governance effectiveness; (ii) economic structure and growth prospects; (iii) external liquidity and international investment position; (iv) the average of government debt burden and fiscal flexibility and fiscal performance; and (v) monetary flexibility. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). The fiscal score is the average of the fiscal performance and flexibility score and the sovereign debt burden score. Section V.B of Standard & Poor's "Sovereign Government Rating Methodology And Assumptions" (June 24, 2013) summarizes how the various factors are combined to derive the foreign currency rating, while section V.C details how the scores are derived. The rating score snapshot summarizes whether we consider that the individual rating factors listed in our methodology constitute a strength or a weakness to the sovereign credit profile, or whether we consider them to be neutral. The concepts of "strength", "neutral," or "weakness" are absolute, rather than being in relation to sovereigns in a given rating category. Therefore, highly rated sovereigns will typically display more strengths; lower rated sovereigns will display more weaknesses. In accordance with Standard & Poor's sovereign ratings methodology, a change in our view of the aforementioned factors does not always 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.

Related Criteria And Research

Related Criteria

- Sovereign Government Rating Methodology And Assumptions, June 24, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Nordea Bank AB, July 11, 2014
- Danske Bank A/S, June 30, 2014
- Sovereign Defaults And Rating Transition Data, 2013 Update, April 18, 2014

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 agreed that the economic structure and growth rating factor had deteriorated. All other key rating factors were unchanged.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. 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

Downgraded; CreditWatch/Outlook Action

	To	From
Finland (Republic of)		
Sovereign Credit Rating	AA+/Stable/A-1+	AAA/Negative/A-1+
Senior Unsecured	AA+	AAA
Finnvera PLC		
Senior Unsecured*	AA+	AAA

Ratings Affirmed

Finland (Republic of)	
Short-Term Debt	A-1+
Transfer & Convertibility Assessment	AAA

*Guaranteed by Republic of Finland.

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