Credit Rating Announcement

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Scope affirms Norway's sovereign credit rating at AAA with a Stable Outlook

Fiscal and current account surpluses, significant savings via the sovereign wealth fund, and strong macroeconomic governance support the ratings. Challenges include financial imbalances, low productivity growth, and the long-run economic transition.

Scope Ratings GmbH has today affirmed the Kingdom of Norway's long-term local-currency rating at AAA. The agency has also affirmed the country's long-term foreign-currency issuer rating at AAA, along with its short-term issuer rating at S-1+ in both local and foreign currency. The sovereign's senior unsecured debt in both local and foreign currency was also affirmed at AAA. All Outlooks are Stable.

Rating drivers

Norway's AAA rating is underpinned by sizeable dual fiscal and current account surpluses; a significant net public asset position rather than a net public debt position, driven by savings accumulated through the sovereign wealth fund, Government Pension Fund Global (GPFG); and strong fiscal, monetary and financial governance institutions. Norway also benefits from low public debt, issued only to finance capital expenditure, and institutional strengths as a mature economy with one of the world's highest per capita income levels (USD 82,372 in 2018). Challenges include imbalances in the residential and commercial property sectors, high and rising household debt, and the difficult long-run transition to a non-commodity-dependent economy. The Stable Outlook reflects Scope's assessment that the risks Norway faces remain manageable given the country's commensurate credit strengths.

In 2018, Norway's headline gross domestic product expanded by 1.4% YoY, slowing from 2% in 2017. The stabilisation in oil prices has supported a recovery in investment in the offshore oil and gas sector as well as bolstered the mainland economy, the latter which grew by 2.2% YoY in 2018. Scope expects growth to be near its potential in 2019 in the 1.5%-2% range. Unemployment (LFS) peaked in the three months to February 2016 at 142,000 (5.1% of the labour force) and has since fallen to 3.8% in the three months to December 2018. Recovering investment in the petroleum, manufacturing and mining sectors along with strengthening employment will support growth; however, the global slowdown, moderation in oil prices since October, softness in housing investment and gradually rising policy rates are growth constraints. One risk in the near term relates to the UK's exit process from the European Union – although Scope considers a no-deal exit unlikely.

Norges Bank raised rates in September 2018 for the first time in this cycle to 0.75%, with another hike anticipated in March. The objective of monetary policy was modified in 2018, including the reduction of the inflation target to 2% (from 2.5%) and the recognition of monetary policy's role in counteracting financial imbalances. The latter's explicit acknowledgement of financial stability risk in the inflation-targeting framework is prudent, in Scope's view.

Scope expects headline GDP growth to be somewhat contained over the medium term, averaging around 1.75%. Implicitly, this assumes labour productivity growth of around 1.0% (similar to a 2009-18 average of 1.0%). In the future, rebalancing the Norwegian economy away from an economic model dependent on the oil and gas sector will remain an important objective. Strengthening growth in non-oil sectors is a challenge, however, due to low productivity growth, high labour costs, and falling labour force participation rates owing to an ageing population. The government recognises this and has considered the petroleum sector's declining contribution to economic growth in the coming decades, with projections that oil and gas production will decrease to about 25% of 2015 production by 2060.

In 2019, the impulse from fiscal policy is expected to be neutral. The general government surplus improved to 7.5% of GDP in 2018, exceeding expectations of a 3.9% of GDP surplus. In the 2019 budget, a strong surplus of around 7.6% is envisioned – although there is downside risk to this owing to weaker oil prices. The 2016 fiscal year was the first time since the sovereign wealth fund's inception that GPFG transfers to the central government budget exceeded net petroleum revenues. However, 2018 saw a reversion to net fund inflows.

Norway's rating is bolstered by the country's fiscal strengths. While general government debt stood at 35% of GDP in Q3 2018, Norway holds substantial net financial assets (at 308% of nominal GDP as of end-2017) rather than net liabilities. This net asset ratio is by far the highest in a 'aaa' peer analysis. Since its launch in 1990, the GPFG has grown to its current level of about USD 1trn, or 297% of mainland GDP. Prudent investment of Norway's oil wealth, buttressed by the fiscal rule targeting annual transfers to the budget of 3% of GPFG assets, is a significant credit-positive. Using the fund to delink the generation and use of petroleum revenues – to ease the effects of oil price volatility on the mainland economy, decrease the potential for short-term overspending, invest in the long term and in future generations, and provide a formidable tool for business cycle smoothing – bolsters fiscal and economic sustainability.

Norway held substantial current account surpluses (of more than 10% of GDP) from 2000 to 2014. This surplus fell below 10% in 2015 owing to lower Brent prices. The IMF expects surpluses of 7.8% and 7.6% in 2019 and 2020, roughly unchanged from an estimated 7.8% in 2018, along with a medium-term current account surplus of about 7.1% of GDP by 2023. Norway has an extremely strong net external asset position of 208% of GDP (or around 417% of current account receipts) as of Q3 2018, which is underpinned by the GPFG's investments abroad.

Despite these strengths, persistently low interest rates, while bolstering Norway's economic recovery, have advanced latent financial system imbalances, such as those in the housing and commercial real estate markets. Average nominal house prices have increased substantially (by more than 80%) since 2008 lows. Measured relative to per capita disposable income, house prices are substantially higher than pre-crisis levels. A temporary house price correction in 2017 has since reversed, with prices up 3.6% from January 2018 to January 2019. In this context, Scope views the tighter mortgage lending requirements since 2015 as a credit-positive, with a new regulation on residential mortgage loan extensions in force until end-2019. A deeper market correction represents a significant economic vulnerability that could adversely impact both the economy and financial stability, compounded by Norway's high home-ownership rate (82.6% in 2017). Equally important is the sustained rise in commercial real estate prices, especially in Oslo. Norges Bank concluded that commercial property price imbalances heightened financial vulnerabilities during 2018.

Housing risks are intertwined with high and rising levels of household debt. Currently, household debt stands at 241% of disposable income (in Q3 2018), up from 160% in 2005. Coupled with increases in corporate debt from domestic sources, with nearly half of bank exposures to Norwegian corporates relating to commercial real estate, this is a cause of concern. Loan losses in the commercial real estate sector have been high in past global crises. Norwegian households' financial assets represent about 322% of disposable income, offsetting liabilities in nominal terms. However, more than one-third of these assets comprise pension entitlements, insurance assets and long-term loans, which cannot be easily monetised in a stress scenario.

An assessment by Norges Bank on prevailing financial imbalances forms the basis for the setting of the countercyclical capital buffer – per Basel III, of between 0% and 2.5%. The buffer rate shall be raised to the 2.5% cap from 31 December 2019, which will put Norway on par with Sweden and Hong Kong in having the world's highest such rate. New deposit guarantee rules and bank recovery and resolution rules entered into force on 1 January 2019. Scope has a constructive view on the macroprudential governance steps being taken to address financial imbalances in consideration of the outstanding risks.

The largest banks continue to increase capital ratios and have met individual capital targets, which are themselves somewhat higher than regulatory requirements. An annual bank stress test by Norges Bank in 2018 showed bank buffers can absorb losses, even in a scenario of a severe downturn in the Norwegian economy with two years of recession and the associated unwinding of financial imbalances. In the stress test, house prices fall by more than 25% with rising default rates on both household and commercial loans. Weighted average CET1 capital ratios decline near 3pp over the stress test period. Nonetheless, banks' buffers cushion the shock without the need for sovereign intervention. Even so, in such a situation, Norges Bank concluded that banks may tighten lending and raise collateral requirements, which could accentuate a crisis. While Scope is cautious regarding prevailing imbalances, Norway's available financial, fiscal and external buffers to counter a severe downturn are a significant credit strength.

Sovereign rating scorecard (CVS) and Qualitative Scorecard (QS)

Scope's Core Variable Scorecard (CVS), which is based on relative rankings of key sovereign credit fundamentals, signals an indicative "AAA" ("aaa") rating range for the Kingdom of Norway. This indicative rating range can be adjusted by the Qualitative Scorecard (QS) by up to three notches depending on the size of relative credit strengths or weaknesses versus peers based on qualitative analysis.

For the Kingdom of Norway, the following relative credit strengths have been identified: i) economic policy framework; ii) fiscal policy framework; iii) market access and funding sources; iv) excellent resilience to short-term external shocks; and v) financial sector oversight and governance. Relative credit weaknesses are: i) current account vulnerabilities; and ii) macro-financial vulnerabilities and fragility.

The combined relative credit strengths and weaknesses indicate a sovereign rating of AAA for Norway.

A rating committee has discussed and confirmed these results.

Factoring of Environment, Social and Governance (ESG)

Scope considers ESG sustainability issues during the rating process as reflected in the sovereign methodology. Norway's performance on ESG factors supports the country's AAA sovereign rating. Governance-related factors are explicitly captured in Scope's assessment of 'Institutional and Political Risk' in its methodology, within which Norway has the highest CVS score on a composite index of six World Bank Worldwide Governance Indicators among Scope's rated sovereign universe, earning especially high scores on Voice & Accountability, Government Effectiveness, Rule of Law, and Control of Corruption. Qualitative governance-related assessments reflect Scope's QS evaluations of 'neutral' on 'recent events and policy decisions' as well as on 'geo-political risk' compared with Norway's sovereign peer group.

Socially related factors are captured in Scope's CVS in Norway's high GDP per capita (the second highest in Scope's rated sovereign universe, only after that of Switzerland), low unemployment levels, and average level of risk on old-age dependency ratios. Norway ranked first in the world on the United Nation's 2018 Human Development Index – an indicator predicated on life expectancies, educational achievement and income levels. The current government's platform has signalled measures to encourage people to return to the workforce and to improve integration into Norwegian society. The government's support for social inclusivity and employment is considered in Scope's QS evaluation of 'good' on 'economic policy framework'.

Norway maintains a strong record on environmental sustainability, despite having relied on the oil and gas sector as the main economic engine over its modern history. The government has prudently prioritised the restructuring of the national economy to reach climate goals and further diversify sources of economic growth. In 2017, Norges Bank Investment Management (which manages the sovereign wealth fund) proposed to divest oil and gas stocks entirely from the GPFG's benchmark index. Oil and gas equities accounted for around 4% of the GPFG's value or about NOK 315bn at end-2017. While approval of this recommendation is unclear, the proposal for the world's largest sovereign fund to divest from such stocks exemplifies Norway's risk management priorities relating to the economy's overexposure to fossil fuels. About 80% of greenhouse gas emissions in Norway are taxed and/or regulated through the emissions trading system (Norway participates in the EU ETS). A general CO2 tax applies in non-ETS sectors – although exemptions and reductions by use and industry exist. With the inclusion of the Liberals into government since 2018, the government platform was adapted to include protective measures like the safeguarding, until 2021, of waters around the Arctic regions of Lofoten, Vesterålen and Senja from oil exploration. New guarantees were also secured on maintaining tax exemptions for electric cars, achieving zero emissions from all vehicles by 2025, and dismantling fur farms.

Outlook and rating-change drivers

The confirmation of a Stable Outlook reflects Scope's view that the risks Norway faces remain manageable given the nation's material credit strengths.

The Outlook could be downgraded if: i) a significant weakening in macroeconomic policy threatened Norway's long-run net public/external asset positions; and/or ii) a sustained period of lower oil prices than current levels and/or a significant financial crisis, potentially exacerbated by domestic imbalances, were to occur, which materially damage Norway's public sector and financial system balance sheets. At present, Scope does not judge the likelihood of a rating downgrade to be high.

Rating committee

The main points discussed by the rating committee were: i) the strength of the Norwegian banking sector; ii) potential vulnerabilities related to overreliance on the oil and gas sector; iii) developments in the external and fiscal accounts; iv) Norway's public finances; and v) developments in the sovereign fund's investment strategy.

Methodology

The methodology used for this rating and/or rating outlook, 'Public Finance Sovereign Ratings', is available on www.scoperatings.com.
Historical default rates of the entities rated by Scope Ratings can be viewed in the rating performance report on https://www.scoperatings.com/#governance-and-policies/regulatory-ESMA. Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope's definition of default as well as definitions of rating notations can be found in Scope's public credit rating methodologies at www.scoperatings.com.
The rating outlook indicates the most likely direction in which a rating may change within the next 12 to 18 months.

Solicitation, key sources and quality of information

The rating was not requested by the rated entity or its agents. The rated entity and/or its agents did not participate in the ratings process. Scope had no access to accounts, management and/or other relevant internal documents for the rated entity or related third party.
The following material sources of information were used to prepare the credit rating: public domain and third parties. Key sources of information for the rating include: Statistisk Sentralbyrå (Statistics Norway), Norges Bank, Norway Ministry of Finance, Real Estate Norway, European Commission, Statistical Office of the European Communities, IMF, OECD, and Haver Analytics.

Scope considers the quality of information available to Scope on the rated entity or instrument to be satisfactory. The information and data supporting Scope's ratings originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data.
Prior to the issuance of the rating, the rated entity was given the opportunity to review the rating and/or outlook and the principal grounds upon which the credit rating and/or outlook is based. Following that review, the rating was not amended before being issued.

Regulatory disclosures

This credit rating and/or rating outlook is issued by Scope Ratings GmbH.
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The ratings/outlook were first assigned by Scope in January 2003. The ratings/outlooks were last updated on 16.02.2018.
The senior unsecured debt ratings as well as the short-term issuer ratings were last updated by Scope on 16.02.2018.

Potential conflicts

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About Scope Ratings GmbH

Scope Ratings GmbH is part of the Scope Group with headquarters in Berlin and offices in Frankfurt, London, Madrid, Milan, Oslo and Paris. As the leading European credit rating agency, the company specialises in the analysis and ratings of financial institutions, corporates, structured finance, project finance and public finance. Scope Ratings offers a credit risk analysis that is opinion-driven, forward-looking and non-mechanistic, an approach which adds to a greater diversity of opinions for institutional investors. Scope Ratings is a credit rating agency registered in accordance with the EU rating regulation and operating in the European Union with ECAI status.

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