Kingdom of the Netherlands
Rating Report

SCOPE AAA STABLE OUTLOOK

Credit strengths

- Wealthy, diversified and competitive economy
- Favourable public debt profile
- Resilient banking sector

Credit weaknesses

- High household debt
- Exposure to external shocks
- Labour market segmentation

Rating rationale and Outlook:

The AAA rating is supported by the Netherlands' wealthy, diversified and competitive economy with a strong external position, prudent fiscal policy and favourable public debt profile and a resilient banking sector. In addition, the rating also considers structural challenges posed by labour market segmentation, persistent external imbalances and high household debt. The Stable Outlook reflects Scope's expectation of a continuation of the government's prudent fiscal policy, with public debt steadily declining over the medium term.

Figure 1: Sovereign scorecard results

Scope's sovereign risk categories	Netherlands	Peer comparison: Average	Peer comparison: Germany
Domestic economic risk			
Public finance risk			
External economic risk			
Financial risk			
Political and institutional risk			
Qualitative adjustment (notches)	-		-
Final rating	AAA		AAA

AAA AA A BBB BB B CCC CC C

Source: Scope Ratings GmbH

Note: The comparison is based on Scope's Core Variable Scorecard (CVS), which is determined by the relative rankings of key sovereign credit fundamentals. The CVS peer group average is shown together with one selected country chosen from the entire CVS peer group. The CVS rating can be adjusted by up to three notches depending on the size of relative credit strengths or weaknesses.

Positive rating-change drivers

- Not applicable

Negative rating-change drivers

- Large global trade shock with a sharp decline in GDP
- Reversal of fiscal consolidation

Ratings and Outlook

Foreign currency

Long-term issuer rating	AAA/Stable
Senior unsecured debt	AAA/Stable
Short-term issuer rating	S-1+/Stable

Local currency

Long-term issuer rating	AAA/Stable
Senior unsecured debt	AAA/Stable
Short-term issuer rating	S-1+/Stable

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Domestic economic risk

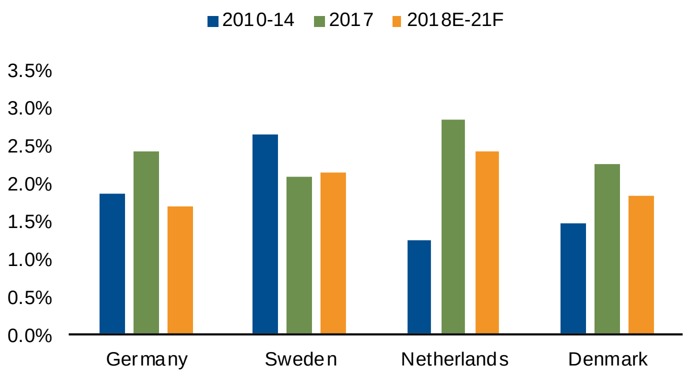
Growth potential of the economy

Robust growth but increasing uncertainty for 2019

Dutch economic growth was robust in 2018, although GDP growth was revised downwards from 2.8% to 2.6% after weaker-than-expected growth during the third quarter[1]. Economic growth is set to moderate in 2019 to around 2%. The recent downward revisions across institutions reflect the increasing uncertainty on the final Brexit outcome and uncertainty around global growth prospects.

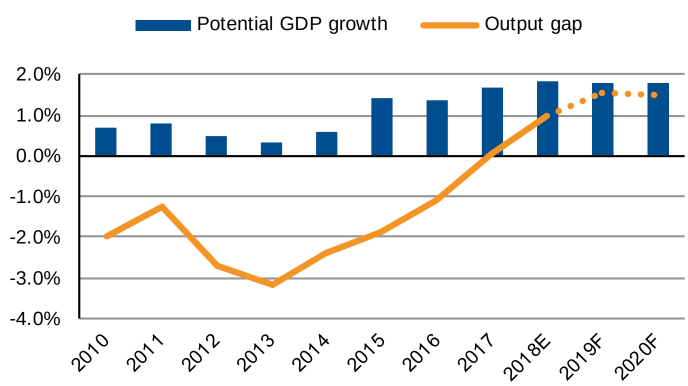
Compared to peers and the euro area average, the Netherlands has high potential growth at just below 2% (see **Figure 3**). While demographic challenges are constraining Dutch capacities – tightening the labour market and increasing pension and health care liabilities – the economy remains highly competitive, reflected in the strong net exports and growing investment. Going forward, supply-side labour reforms and higher fiscal spending could help to further raise productive capacity.

Figure 2: Real GDP growth
%



Source: Haver, European Commission (EC), Scope Ratings GmbH

Figure 3: Potential GDP growth (2018E-20F, average)
%



Source: Haver, Scope Ratings GmbH

Untapped labour market potential

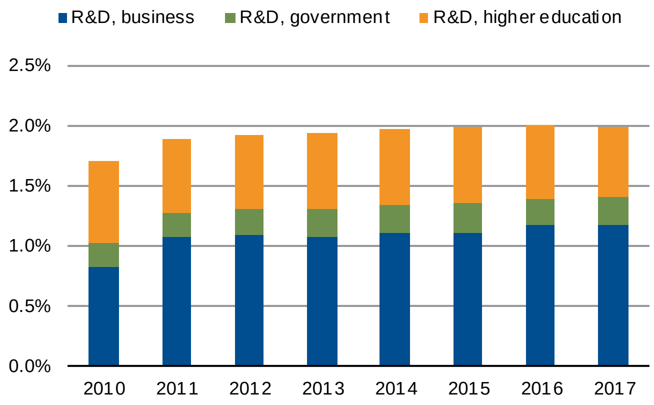
The Dutch government has launched a new initiative to broaden labour market participation in November 2018 (*Wet Arbeidsmarkt in Balans*), following a major reform in 2015, which should help to loosen regulations on hiring while increasing incentives for employers to offer permanent contracts. Yet, female labour force participation remains comparatively low, especially in full-time jobs. Furthermore, figures from 2017 show that immigrants have a significantly lower employment rate (59.9%) than the native population (80.5%). Children from weaker socio-economic backgrounds are also less likely to attain higher-education degrees. Thus, the level of economic mobility remains an impediment to higher potential growth in an economy already characterised by high-skilled labour shortages and a persistent segmentation between low- and high-income groups.

R&D growth mainly in sectors with low employment shares

The Netherlands has recently shown stronger investment growth (4.9% annual growth in 2018) but net investment remains low relative to savings. Small- and medium-sized enterprises (SMEs) in particular would benefit from increased R&D spending. Total R&D spending reached 2% of GDP in 2015, mainly driven by the business sector, while public spending on R&D remained at just 0.2% of GDP. **Figure 5** shows that most of the productivity gains were achieved in sectors with a smaller employment share, namely construction, manufacturing and agriculture, while productivity lags behind in sectors with the largest employment shares, especially the services sector (77% of employment in 2017).

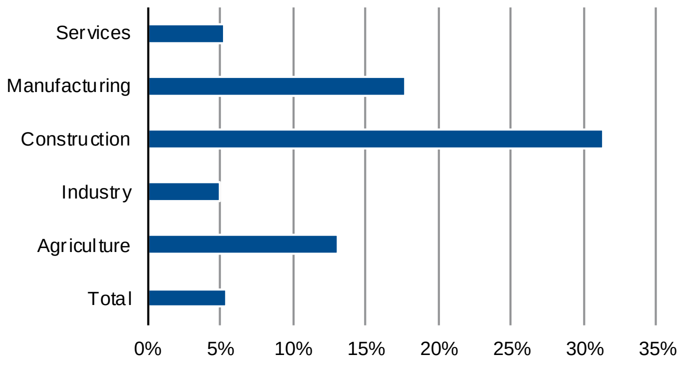
[1] State Treasury Agency, Outlook 2019

Figure 4: R&D spending
% of GDP



Source: Haver, Eurostat

Figure 5: Aggregate productivity change by sector
Change in %, 2010-2018



Source: Haver, ECB

Economic policy framework

Comprehensive euro area reforms and accommodative monetary policy are appropriate

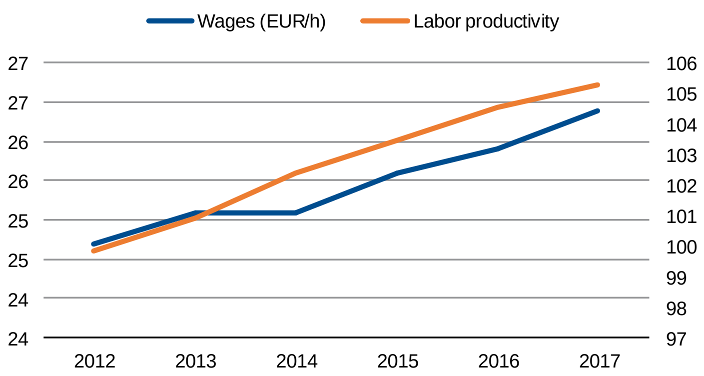
Economic growth has also benefitted from an effective economic policy framework. Along with other euro area member states, the Netherlands has profited from the overhaul of the euro area architecture, which now provides a greater degree of resilience to crises. While further progress is needed to deepen the Economic and Monetary Union – notably the completion of the Banking and Capital Markets unions – the establishment of the European Stability Mechanism as the conditional lender of last resort for sovereigns, together with the European Central Bank's unconventional and accommodative monetary policy programmes, has been supportive of the creditworthiness of all euro area member states.

Inflationary pressures increase with higher wage demands

While headline inflation remained low at 1.6% in 2018, consumer prices are expected to increase towards 2.3% in 2019. Energy price increases are expected to remain modest, but Scope expects higher prices for goods and services to result in higher inflation in 2019. This primarily reflects higher wage growth and a tighter labour market, but only in the short term as unfavourable demographics will neutralise this in the long run.

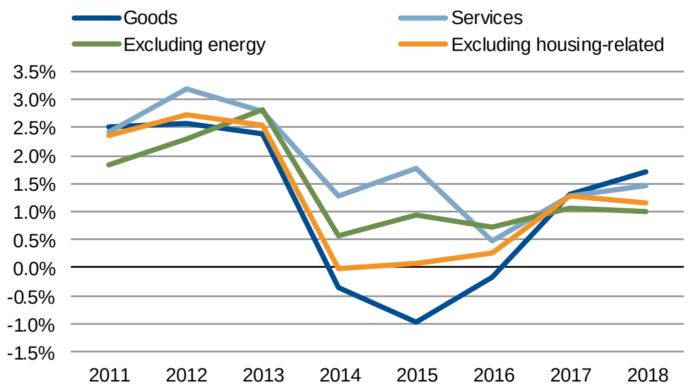
The expected wage growth compensates for previous years, during which productivity growth outpaced compensation growth (**Figure 6**). This is reflected in the negative contribution of goods prices to overall inflation between 2014 and 2016. Given the catch-up process of wages to past productivity growth, Scope does not expect inflationary pressures to be a serious concern in 2019.

Figure 6: Wages and productivity in industry, construction and services sectors
in euros/hour (l.h.s.) and index=100 in 2010 (r.h.s.)



Source: Haver, ECB, Eurostat

Figure 7: Harmonised index of consumer prices
% Year-over-Year change



Source: Haver, National Statistical Office (CBS)

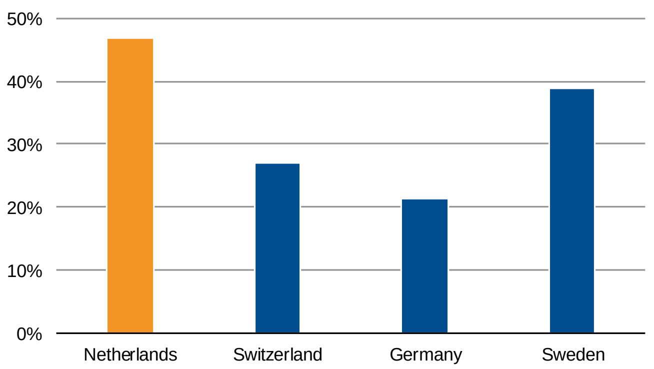
Macroeconomic stability and sustainability

High part-time and self-employment levels weigh on the labour market

While the economy is close to full employment, the labour market shows strong duality. Many part-time and self-employed workers earn lower wages on average than full-time employees and have no social protection coverage. The European Commission and the IMF have encouraged the Dutch government to implement policies that help reduce labour market segmentation and increase wage growth for low-income groups. Compared to in Germany or France, wage growth in the Netherlands has been below average relative to productivity gains. Higher wages could further support a reduction of the large trade surplus.

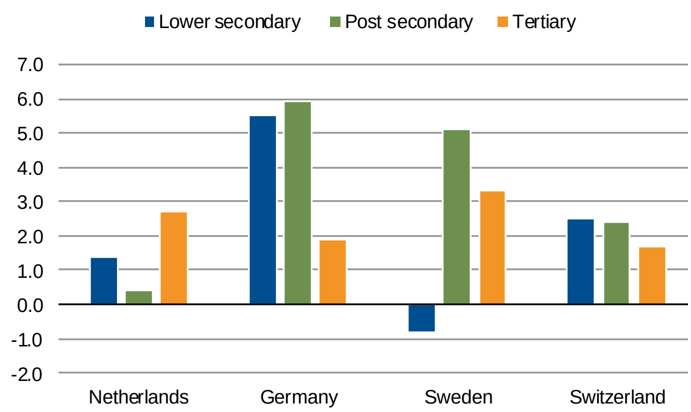
Although the upcoming increase in the low VAT rate from 6% to 9% could lead to extra wage demands from unions, Scope does not expect overall wage levels to change much over the forecast horizon, even given labour shortages. While demand for high-skilled labour remains strong, the number of low-wage jobs continues shrink as a result of digitalisation, especially in the services and manufacturing sectors.

Figure 8: Part-time employment
% of total employment, seasonally adj., Q3 2018



Source: Eurostat, EC

Figure 9: Employment by level of education
change in percentage points, 2010-2018



Source: Eurostat, Scope Ratings GmbH

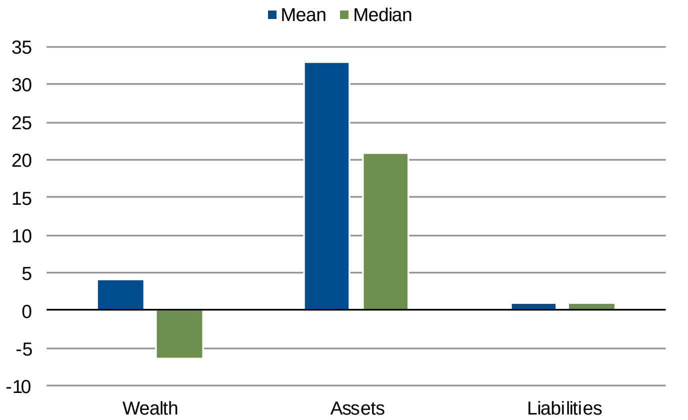
The Netherlands has a generous welfare state, which includes progressive taxes, universal health care and unemployment allowances, and social housing programmes. Income inequality in the country remains one of the lowest among OECD countries (see **Figure 11**). However, the welfare system was reformed from 2013 onwards, following the introduction of more restrictions on unemployment benefits. Yet, favourable global

Low income inequality but increasing wealth inequality

conditions have tempered the impact of social benefits cuts for now. At the same time, inequality among private households is rising. **Figure 10** shows that while the median wealth level declined between 2006 and 2017 (to EUR 28,000), average wealth increased (to EUR 163,800), indicating a widening gap between poor and rich. Although the levels of both median and average assets increased during the same period and liabilities changed only slightly, the overall distribution of wealth has become more unequal for private households, with wealthy households benefitting from a significantly higher value of additional wealth than poorer ones.

Figure 10: Private household wealth

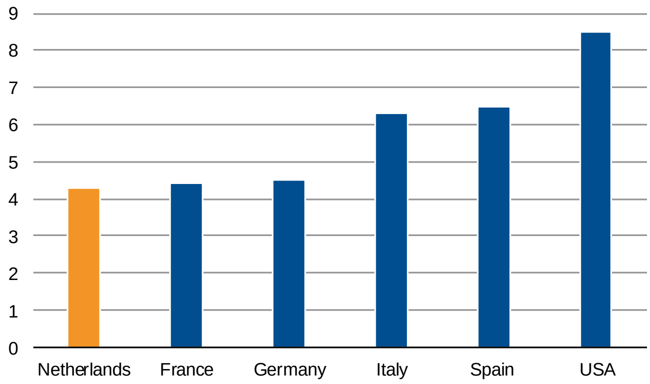
in 1,000 euros, change 2006-2017



Source: CBS, Scope Ratings GmbH

Figure 11: Income distribution

share of 80th to 20th income decile (S80S0), 2016



Source: World Income Inequality Database, United Nations

Public finance risk

Fiscal policy framework

Effective fiscal policy formulation at the national level…

The Dutch government applies a trend-based approach to fiscal policy with its multiannual focus. Expenditure ceilings are fixed (adjusted for inflation) for the four-year government term. On the revenue side, automatic stabilisation mechanisms mitigate the impact of changes in the business cycle. Fiscal policy formation benefits from credible macro-economic forecasts from the Bureau for Economic Policy Analysis (CPB), an independent fiscal authority. At the same time, the Advisory Division of the Council of State monitors compliance with quantitatively defined fiscal rules. All of this supports a strong and well-established fiscal framework, which constitutes a credit strength.

… anchored by EU fiscal rules.

Netherlands is a member of both the EU and the euro area, meaning it must observe European rules laid out by the Stability and Growth Pact (SGP). To this effect, the Dutch government has embedded EU fiscal rules into national law, through the 2013 law on sustainable public finances (Wet Houdbare Overheidsfinanciën). The European Commission notes, however, that the national framework does not necessarily prevent pro-cyclical fiscal policy. It also highlights that, as of 2017, the country deviated from the medium-term objective (MTO) in most years since the SGP was implemented[2].

Recent improvement in the budgetary stance and public debt levels

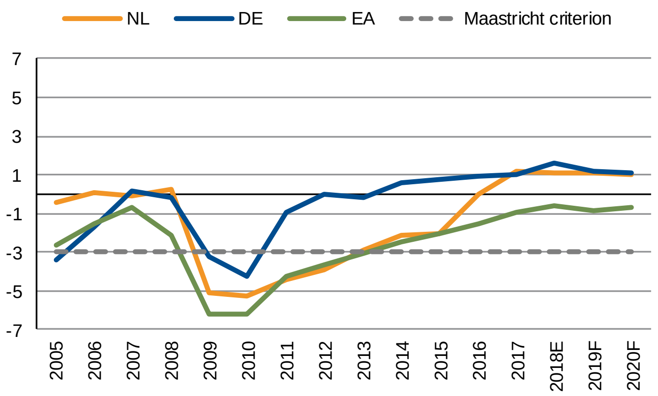
Netherlands' public finances have improved in recent years. Supported by favourable cyclical conditions, the fiscal balance increased from a 2009 low of -5.1% of GDP to a 1.1% surplus in 2018. This was also due to lower public investment expenditure, which declined by over 50% in nominal terms over the same period. Moving forward, the budget is expected to stabilise at around a 1% of GDP surplus over 2019-20. A shift in the

[2] European Commission, The Dutch Budgetary Framework and European Fiscal Rules, May 2017

structural budget balance is projected, from a 0.7% surplus of GDP in 2017 to a 0.5% deficit in 2019. This remains, however, compliant with fiscal rules given low and declining debt levels.

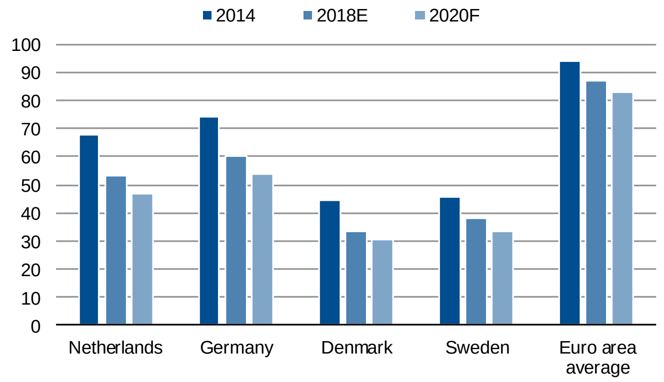
As a result of sustained primary surpluses since 2016, which are expected to be maintained going forward, Scope expects public debt to drop to 47% of GDP in 2020, down from the 2014 peak of 68%. This is below both the German public debt projections for 2020 as well as the euro area average, but above that of Denmark and Sweden (see **Figure 13**).

Figure 12: Fiscal balances
% of GDP



Source: Haver, EC

Figure 13: Public debt levels
% of GDP



Source: Haver, EC

Increasing expenditure in growth friendly areas…

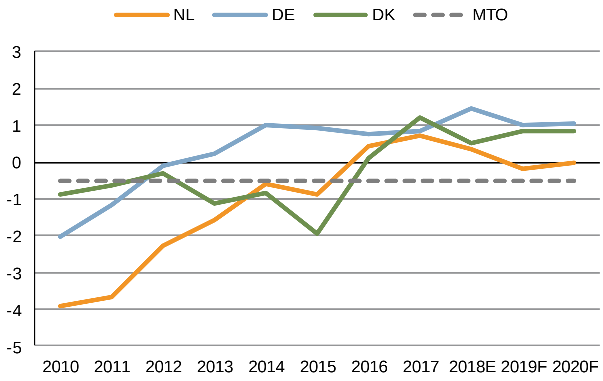
In 2017, the four-party coalition government agreed on spending priorities for 2017-21. Public spending has since increased in growth-friendly areas, with public investment in education, R&D, defence and security as well as infrastructure set to continue increasing by a total of EUR 4.6bn (or 0.55% of GDP) in 2019. Increasing public spending on investment is likely to benefit potential growth and could help to ease lingering supply-side economic constraints.

… and a reduction of the tax burden will benefit the economy.

At the same time, the government plans to shift the focus from direct to indirect taxation. Cuts to personal income taxes amount to 0.7% of GDP in 2019 – helping to reduce the labour tax wedge, currently one of the highest among EU member states. The government will also reduce the number of tax brackets, from four to two, as well as both the top and base tax rates (top: 38% to 37%; base: 51.75% to 49.5%). The statutory corporate income tax rate will fall from 25% to 20.5%. Overall, these measures are likely to increase incentives to work and improve the investment climate.

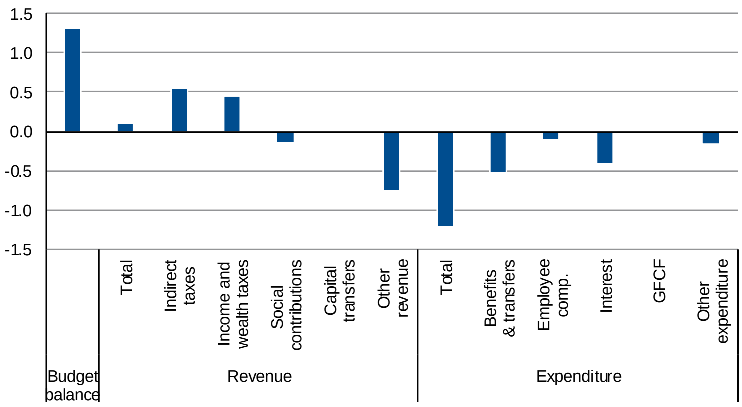
The decrease in direct tax revenue is expected to be offset by higher indirect taxes such as via VAT (6% to 9%) and excise environmental taxes. The IMF expects the cumulative impact of these measures to be revenue-neutral for 2019.

Figure 14: Structural budget balance
% of potential GDP



Source: Haver, EC

Figure 15: Change in Netherlands' budget balance
% of GDP, diff. between avg. 2018-20F vs avg. 2015-17



Source: Haver, EC

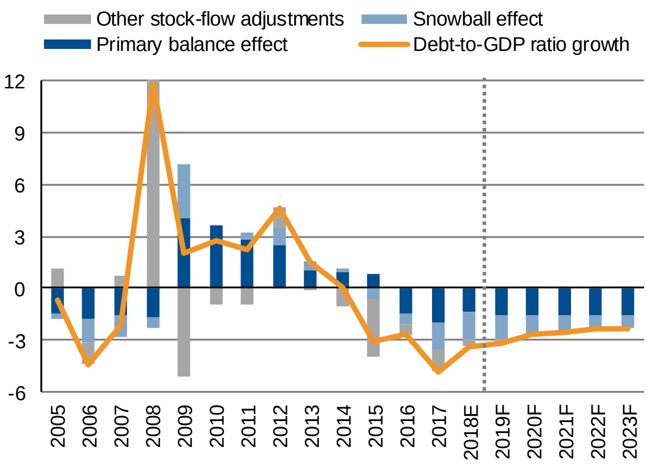
Debt sustainability

Adequate debt dynamics, even in a stressed scenario

Scope's sustainability analysis of the Netherland's public debt stock – based on IMF forecasts and a combination of growth, interest-rate and primary-balance shocks – confirms the opinions of the IMF and the European Commission: namely, the Netherlands follows a sustainable path of fiscal policy, which complies with requirements under the preventive arm of the Stability and Growth Pact.

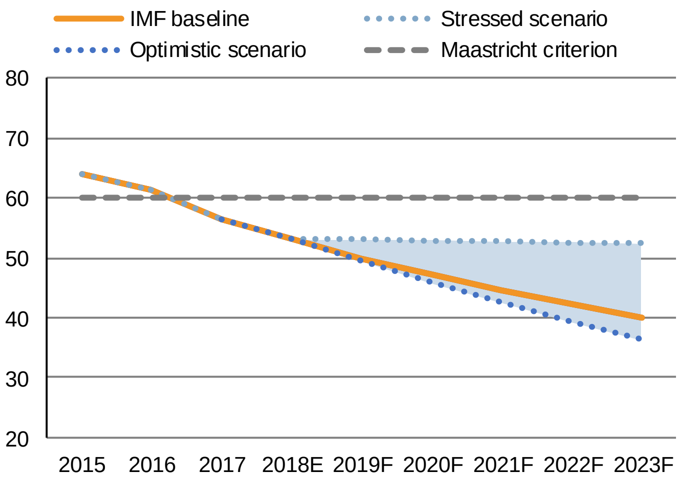
Scope's baseline scenario shows a continuous debt reduction towards 40% of GDP by 2023. A more adverse scenario, assuming a 1.0pp shock in potential growth, higher interest payments and a lower but still positive primary fiscal balance, would keep the debt-to-GDP level stable at around 52%. Thus, the Netherlands would not only comply with the Maastricht criteria but, more importantly, it maintains a stable debt-to-GDP ratio even in the scenario of a prolonged recession. The country's debt sustainability is therefore considered a credit strength.

Figure 16: Contribution to gov. debt changes, % of GDP



Source: IMF, Scope Ratings GmbH. NB. Other includes stock-flow adjustments.

Figure 17: Government debt, % of GDP



Source: Scope Ratings GmbH

Scenario	Time period	Real GDP growth (%)	Primary bal. (% of GDP)	Real eff. int. rate (%)	Debt, end period (% of GDP)
History	2014-2018	2.2	0.6	0.9	53.1
IMF baseline	2019-2023	1.9	1.5	0.0	40.0
Optimistic scenario		2.4	2.0	-0.2	36.3
Stressed scenario		0.9	0.5	1.7	52.4

Source: IMF, Scope Ratings GmbH

A strong pension system...

The Dutch pension system rests on three pillars: i) a pay-as-you-go pension fund that grants a minimum flat pension to the entire population; ii) a mandatory occupational scheme, which covers 90% of all employees and provides additional benefits based on lifetime wages; and iii) a voluntary tax-exempt scheme. The system benefits from the combined features of these pillars and allows for high coverage rates, risk pooling and risk sharing. As a result, the Dutch pension system is regarded as one of the most advanced and robust in the world[3].

… with remaining challenges from insufficient coverage and an ageing populace…

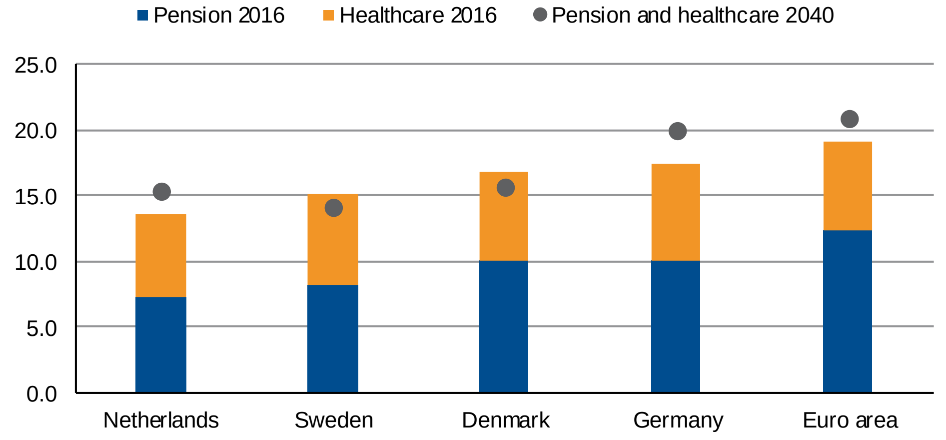
Nevertheless, the pension system faces several challenges. Firstly, the recent rise in self-employment, which is not covered by the system, increasingly puts pressure on the solvency of pension schemes. On top of this, the current low interest rate environment has weighed down on pension funds' investment returns and increased the present value of liabilities. This is exacerbated by demographic headwinds, with the country's ageing population making the transfer from young to old employees less viable but mitigated by the statutory retirement age being linked to life expectancy. Pension and healthcare spending in the Netherlands is expected to increase from 13.5% of GDP to approximately 15.4% by 2040, though the latter remains below the projected levels for Germany, Denmark and the euro area average (see **Figure 18**).

… prompting a comprehensive reform.

The pressures from ageing and insufficient coverage of the self-employed have spurred a debate on the future of the pension system. More specifically, talks have focused on including the self-employed in occupational schemes and enhancing the system's transparency, fairness and flexibility. Progress has been slow, with no agreement reached between major stakeholders, including a halt to negotiations in November 2018. Despite this, the government is determined to move ahead with the reform, remaining open to consultations with stakeholders. In February 2019, the government published a letter outlining reform plans for the pension system, but this was met with scepticism on the part of the workers union.

[3] In 2018, the Dutch pension system ranked first out of 34 countries according to the Melbourne Mercer Global Pension Index, which assesses the sustainability and financial integrity of pension schemes across 40 indicators.

Figure 18: Pension and health care expenditure
% of GDP



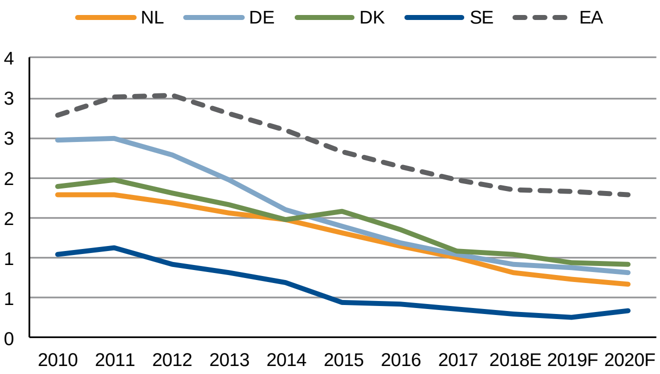
Source: EC, Scope Ratings GmbH

Market access and funding sources

Improved public debt profile and decreasing cost burden

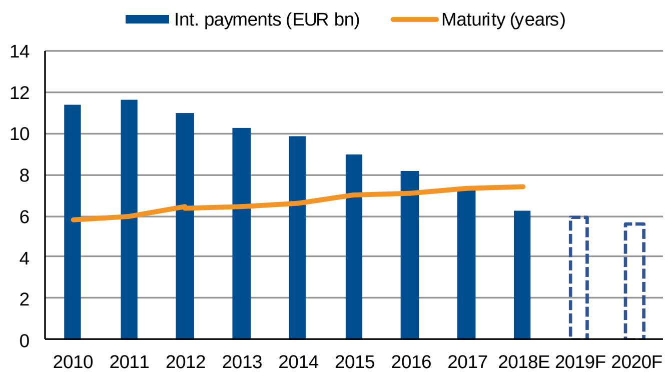
The Netherlands has effectively lengthened the average maturity of its public debt from below 5.8 years in 2010 to about 7.4 years in 2018. This is above the levels for Germany and Sweden (6.2 and 4.7 years, respectively) and the euro area average (7.3 years). The Dutch public debt profile is favourable, with 99% of total debt issued in national currency and less than 9% of it being short-term debt. The country benefits from the euro's reserve currency status and the low interest rate environment. Coupled with the decreasing debt stock, this has resulted in decreasing interest payments, declining to 0.8% of GDP as of 2018, a trend that is expected to continue into 2020 (see **Figure 20**).

Figure 19: Interest payment burden
% of GDP



Source: Haver, EC

Figure 20: Cost and maturity of outstanding debt
EUR bn, years



Source: Haver, ECB, EC, Scope Ratings GmbH

External economic risk

Current account vulnerabilities

Internationally competitive economy and successive current account surpluses

Netherlands' current account has been in surplus for three decades. In 2018, the current account balance reached a historic high of 9.85% of GDP, from 6.3% in 2015 (see **Figure 21**). This large surplus – among the highest in the euro area – is largely due to a persistently high trade surplus in goods.

The Dutch economy is the third most competitive in Europe, according to the World Economic Forum's Global Competitiveness Index[4]. Similarly, the country maintains relative price competitiveness. The real effective exchange rate (deflated by unit labour costs for the total economy) has depreciated slightly since 2010, in line with the euro area (see **Figure 22**).

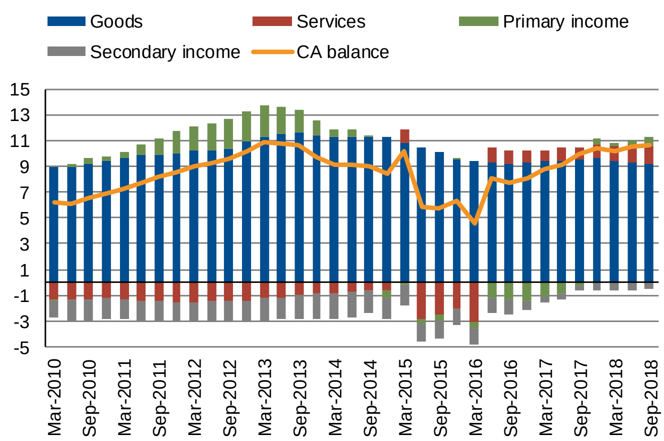
Internal imbalances are reflected in the current account

Although the historically strong current account balance highlights the competitiveness of the Dutch economy, it also reflects the persistent imbalance between domestic savings and investments. This is most salient in the non-financial corporate (NFC) sector. Due to relatively high levels of profitability and low levels of domestic investment, Dutch firms have the highest net savings rate among advanced European economies. This sector is therefore the largest contributor to the current account[5].

The net lending position of the corporate sector is likely to be influenced by the high number of multinational enterprises (MNEs). These organisations typically have complex corporate structures, and their liabilities may not be recorded as foreign direct investment or portfolio investment liabilities, which could lead to an overestimation of the current account surplus.

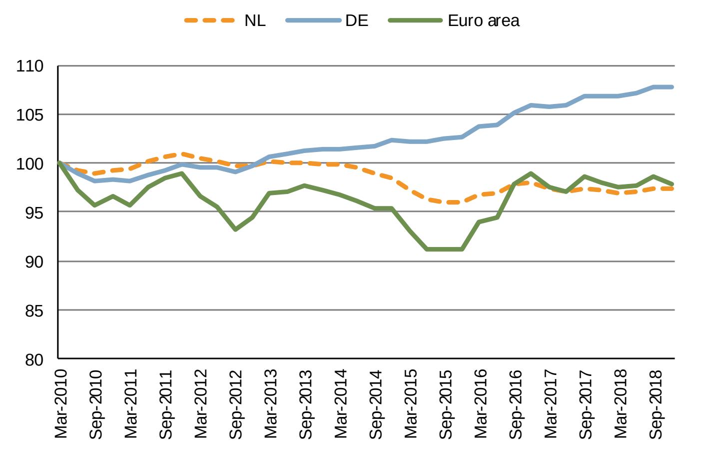
Moving forward, the current account is expected to decrease due to solid domestic demand growth, which is likely to be supported by wage increases and the fiscal stimulus package. The IMF projects a gradual decline in the current account surplus of 2.5pp by 2024[6].

Figure 21: Sustained current account surpluses
% of GDP



Source: Haver, DNB, Scope Ratings GmbH

Figure 22: Unit labour cost-deflated real effective exchange rate
2010 = 100



Scope: Haver, European Commission, Scope Ratings GmbH

External debt sustainability

Strong and increasing international investment asset position

The Netherlands' net international investment position (NIIP) turned positive in 2009 owing to sustained current account surpluses averaging 8.8% of GDP since 2010. The NIIP reached 65.3% of GDP in Q3 2018, after dropping in 2017 due to negative valuation effects and high nominal GDP growth (see **Figure 23**). The Netherlands' NIIP as a percentage of GDP is currently on par with that of Denmark (64.9%) and Germany (59.5%), but well above Sweden's (10.6%) and the euro area average (-5.2%).

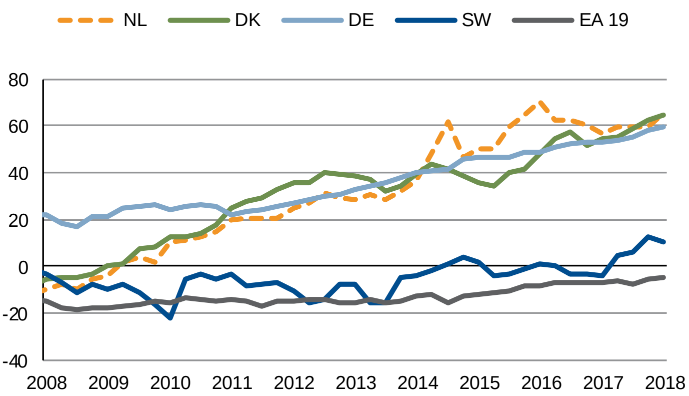
[4] The Global Competitiveness Index assesses the microeconomic and macroeconomic foundations of national competitiveness that determine a country's level of productivity.
[5] IMF, Kingdom of the Netherlands: Selected Issues, February 2019
[6] IMF, Kingdom of the Netherlands: 2019 Article IV, February 2019

High external debt levels distorted by the presence of MNEs

The country's external debt levels are high, at 507% of GDP at year-end 2018, well above the levels for comparable peers, which range from 168% (Sweden) to 144% (Denmark). This is driven largely by the corporate sector, as the government's and central bank's share of external debt only totals a moderate 39% of GDP (see **Figure 24**). This reflects the country's appeal to MNEs through the favourable international corporate taxation regime and well-integrated financial sector. MNE cross-border debt tends to be intragroup, which mitigates the risk posed by high external debt stocks.

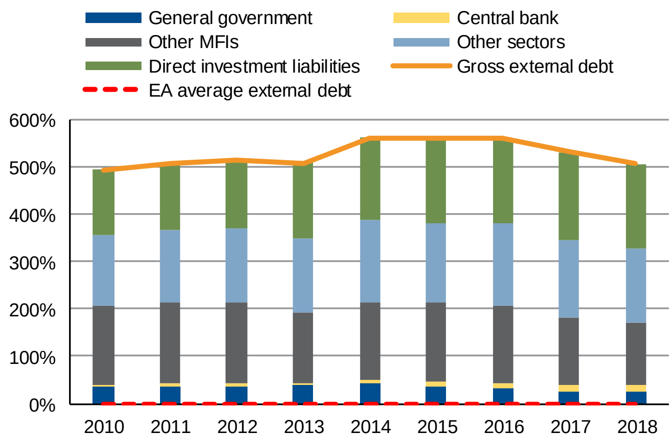
As a positive development, external debt levels have decreased since peaking in 2015 at 580% of GDP, driven mainly by deleveraging among banks (-44pp) and the public sector (-20pp). Similarly, the maturity structure of external debt mitigates risks as short-term external debt represented less than a fourth of the total external debt stock.

Figure 23: Net international investment position
% of GDP



Source: Haver, Eurostat, ECB, Scope Ratings GmbH

Figure 24: External debt composition
% of GDP



Source: Haver, DNB, Dutch Statistical Bureau, Scope Ratings GmbH

Vulnerability to short-term external shocks

Low external vulnerability but exposed to shifts in global trade

Netherlands' strong NIIP, bolstered by its competitive economy and sustained current account surpluses, constitute a credit strength, enhancing resilience against short-term external vulnerabilities. Furthermore, the country benefits from the euro area architecture, which reduces the risk of external shocks.

Global trade uncertainties present downside risk

Nevertheless, the Dutch economy remains small and very open, with exports in goods and services representing over 83% of GDP in Q3 2018. On the other hand, rising protectionist sentiment, disruptions to the global trading system and a weakened global economic outlook present downside risks to the external position.

Notably, Brexit-related uncertainties have increased risks. The UK is Netherlands' third largest trading partner and both countries have extensive investment links. Thus, the possibility of a no-deal Brexit poses a risk to Dutch trade and investment flows. According to the Dutch Court of Audit, a harder form of Brexit could cost the Dutch economy up to EUR 2.3bn (1.2% of 2018 GDP) over 2018-23. As a contingency, the government has earmarked funds to prepare for Brexit, which Scope views as a positive mitigating factor.

Financial stability risk

Financial sector performance

Improving banking sector profitability

Supported by a benign economic environment, Dutch banks' profitability has been increasing. In 2017, the sector's return on equity (ROE) reached 8.8%, higher than that of Germany and the EU average but below that of Sweden and Denmark (see **Figure 26**). Given low interest rates, Dutch banks have increasingly relied on non-interest income sources and cost-cutting measures to generate profitability. The cost-to-income ratio for the banking sector stood at 58.1% as of Q3 2018 compared to 65.1% for the euro area.

Sound asset quality and capitalisation levels…

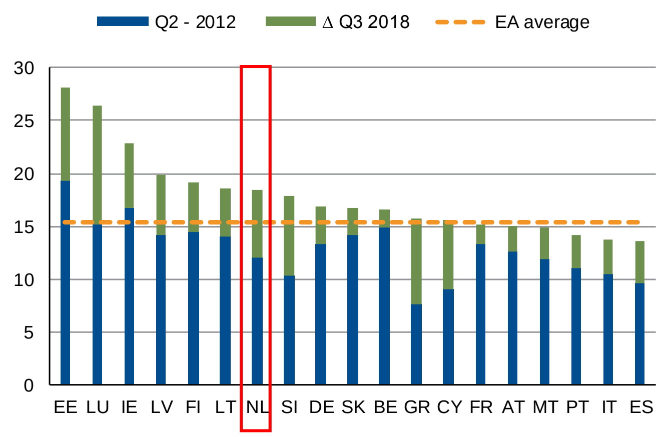
Asset quality and capitalisation in the banking sector remain strong. The non-performing loan (NPL) ratio declined from a 2014 peak of 3% to 1.7% in Q3 2018, on par with peers' but below the EU average of 3.4%. Similarly, the tier 1 ratio has steadily improved since the 2008 financial crisis, reaching 18.6% of risk-weighted assets in Q3 2018, above the euro area average of 15.4% (see **Figure 25**).

… but overreliance on market funding increases liquidity risk.

Despite the sound capitalisation levels, the banking sector continues to rely heavily on market funding: deposits account for only 49% of total funding while short-term market funding represents 28%, according to the IMF[7]. Furthermore, the sector is highly leveraged, with a fully phased-in leverage ratio (capital to total assets) of 4.4% as of September 2018. This increases exposure to market fluctuations and could present a risk in the case of tightening global financing conditions.

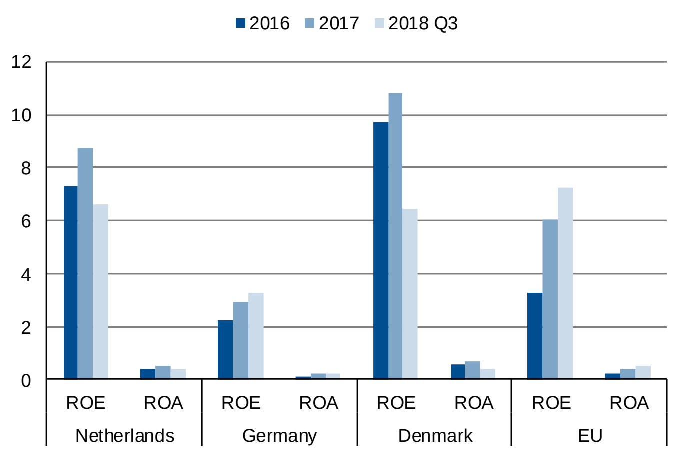
In this context, the IMF has recommended strengthening capital and liquidity buffers to reinforce resilience to shocks. The Dutch central bank has kept the counter-cyclical buffer rate at 0%, a decision motivated by the strong capital base and modest lending growth. As a positive development, additional buffers imposed on systemically important banks have been increased gradually over 2016-19.

Figure 25: Banking sector capitalisation
Tier 1 capital to risk-weighted assets, %



Source: Haver, IMF, Scope Ratings GmbH

Figure 26: Banking sector profitability
% of total assets



Source: Haver, ECB, EBA, Scope Ratings GmbH

Financial sector oversight and governance

Strong supervisory and regulatory frameworks

The regulatory framework has strengthened significantly since the 2008 financial crisis. Financial sector legislation is derived mostly from EU law, with nation-specific rules increasingly shrinking in share. The Netherlands applies a dual model: prudential supervision is undertaken by DNB and market conduct is supervised by the Netherlands Authority for the Financial Markets (AFM). Prudential supervisory authority is also shared with the ECB, which is responsible for the direct supervision of systemically important banks[8].

DNB has had to modify its supervision of small- and medium-sized banks in the country following far-reaching changes to banking supervision introduced at the EU level. DNB

[7] IMF, Kingdom of the Netherlands: 2019 Article IV, February 2019
[8] In the Netherlands, the ECB has been responsible for supervising ING, ABN AMRO, Rabobank, de Volksbank, Nederlandse Waterschapsbank and Bank Nederlandse.

has largely adopted the ECB's methods for financial sector supervision. For instance, the European Supervisory Review and Evaluation Process (SREP) has been implemented at the national level. The Dutch Court of Audit's review of banking supervision in 2017 assessed DNB's methods to be "effective, intensive and strict"[9].

Macro-financial vulnerabilities and fragility

Private sector indebtedness remains high

Private debt remains very high, at 286% of GDP in 2018, a 4pp decrease from 2017 levels (see **Figure 27**). Household debt (106% of GDP) and NFC debt (180%) levels were above the European Commission prudential thresholds of 65% and 93%, respectively. However, the level of corporate debt is mitigated by the prevalence of MNEs in the Dutch economy. The high level of corporate debt is largely attributable to MNEs (60% of NFC debt), which mostly consists of intragroup debt and does not pose an immediate macro-economic risk. Excluding MNE debt, the debt ratio for NFCs does not exceed the prudential threshold, according to the European Commission[10].

High household debt as a result of housing market inefficiencies and tax incentives

Despite a steady decline to 106% from the 2010 high of 128% of GDP, household debt remains a key economic risk. This is partly due to imbalances in the housing market, dominated by social housing and owner-occupied houses that are in short supply. With the underdeveloped private rental market, households have turned to homeownership financed through debt, encouraged by generous mortgage-interest deductibility (MID) mechanisms. As a result, households' debt-to-income ratio (209.9% in Q3 2018) and debt service-to-income ratio (19.6%) are the highest and the second highest in the euro area, respectively[11]. Such levels make the Dutch economy more susceptible to shocks as consumption may become more budget constrained.

As a welcome development, the government plans to phase down the MID by 3pp per year from 2020 onward, which will reduce the debt bias. Similarly, initiatives to support the private rental market may provide alternatives to debt-inducing homeownership, though their impact remains to be seen.

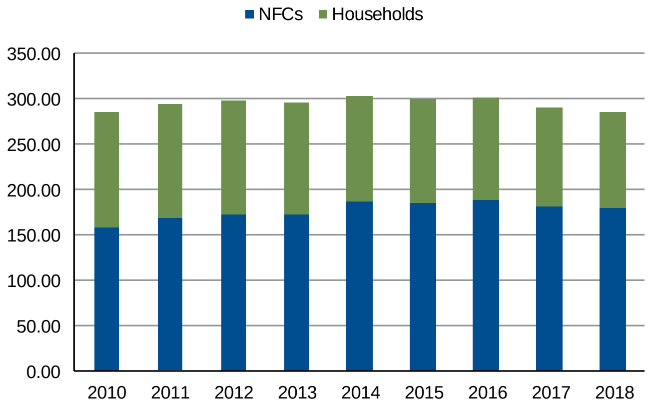
House prices exceeded pre-crisis levels in 2018

After declining markedly after the financial crisis, house prices started picking up in 2013. In 2018, the house price index for the Netherlands even exceeded pre-crisis levels (see **Figure 28**). This increase was led by major cities, with Amsterdam, Rotterdam and Utrecht having average annual house price increases of 11.9%, 8.9% and 9.0% over the last five years, respectively (versus a 5.4% national average).

A persistent supply-demand mismatch in housing has driven the price rises. In 2017, price-to-income and price-to-rent ratios were broadly in line with historical averages. The growing number of Dutch households, rising disposable incomes and favourable financing conditions have supported housing demand whereas supply has been relatively inelastic. The number of existing dwellings for sale has decreased by more than 70% between 2012 and 2018. Dutch authorities are taking actions to increase the supply by improving coordination among stakeholders, streamlining building preparation times, and supporting construction of new properties.

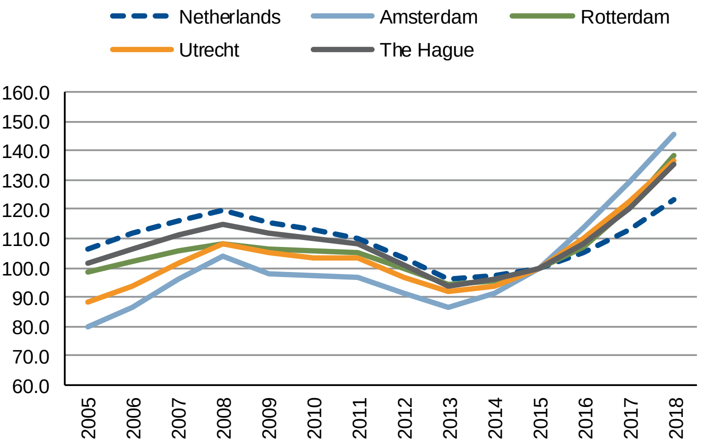
[9] Algemene Rekenkamer, Banking supervision in the Netherlands, September 2017
[10] EC, Country Report: The Netherlands 2019, February 2019
[11] ECB, Macroprudential analysis of residential real estate markets: https://www.ecb.europa.eu/pub/financial-stability/macroprudential-bulletin/html/ecb.mpbu201903_03~16f6101896.en.html#toc3

Figure 27: Private-sector debt
% of GDP



Source: Haver, CBS, Scope Ratings GmbH

Figure 28: House price index developments
2015 = 100



Source: Haver, CBS, Scope Ratings GmbH

Institutional and political risk

Perceived willingness to pay

The Netherlands has not defaulted on its debt in modern times and is not expected to risk a default or delayed service on obligations given the country's predictable political environment and institutional safeguards.

Recent events and policy decisions

Coalition government loses majority in the first chamber

In the provincial elections on 20 March 2019, the four-party coalition of Prime Minister Mark Rutte lost its majority in the first chamber ('Senate'), which is politically important as the first chamber must agree on all legislative proposals from the Parliament (Second Chamber). The new coalition requires the government to include the opposition in future law-making, which could lead to political stalemates going forward.

Electoral success of new populist right-wing party

The elections saw a major success for a new right-wing populist party, the Forum for Democracy (FvD), founded three years ago and led by Thierry Baudet. The Forum finished in second place, only behind the right-liberal VVD party of Prime Minister Rutte. The new party even took the majority of votes in the most heavily populated province of *South Holland*.

The FvD has advocated the exit of Netherlands from the European Union and opposes both the Paris Agreement on climate change and current immigration policies. The increased polarisation in Dutch society is also underpinned by the electoral success of the Greens, which doubled its share of votes received.

Increasing political fragmentation is an emerging credit weakness

The upcoming elections for the European Parliament in May could put the coalition parties under pressure from both sides of the political spectrum. While a stronger shift in either direction could be exploited by the left or right, the maintenance of the status quo brought losses in recent provincial elections. In any case, the increasing fragmentation of the political system could further complicate decision-making processes, and Scope considers this to be an emerging credit weakness.

Geopolitical risk

Scope does not identify geopolitical risks in the Netherlands that could affect the country's credit ratings in the foreseeable future.

Methodology

The methodology applicable for this rating and/or rating outlook, Public Finance Sovereign Ratings, is available at www.scoperatings.com.

Historical default rates of the entities rated by Scope Ratings can be viewed in Scope's rating performance report at 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) at http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope's definition of default and 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 of the rating if the rating were to change within the next 12 to 18 months. A rating change is not automatically ensured, however.

I. Appendix: Factoring of environment, social & governance (ESG)

Scope considers ESG sustainability issues during the rating process, as reflected in its sovereign ratingmethodology. Governance-related factors are explicitly captured in our assessment of 'Institutional and Political Risk', for which the Kingdom of the Netherlands achieves a high score according to the World Bank's Worldwide Governance Indicators. Qualitative governance-related assessments in the 'geo-political risk' category of our Qualitative Scorecard are assessed as 'neutral' compared with Dutch sovereign peers. Socially related factors are captured in our Core Variable Scorecard in the Netherlands' high GDP per capita (USD 53,106 in 2018) and low unemployment but increasing old-age dependency ratio. Qualitative assessments of social factors are reflected in 'macroeconomic stability and sustainability', for which we assess the Netherlands as 'neutral' given a relatively equal income distribution but increasingly diverging wealth distribution.

Environmental factors are considered during the rating process if they are material for the country's ratings. In the longer term, the Netherlands' financial system could face disruptions from the global energy transition towards low-carbon economies. A new climate law proposal aims at reducing greenhouse gas emissions by 49% of current levels by 2030 and carbon-neutrality by 2050. DNB tested a set of stress scenarios for the financial sector regarding the potential risks from the energy transition. The tests used input-output models to measure the exposure to CO_2 in asset portfolios and four different shock scenarios combining regulatory disruption with technology and uncertainty shocks. The study concluded that the macro-economic impact could be severe in both directions in the short term, while positive for growth in the long term except for the confidence shock[12].

Although climate-relevant policies become increasingly important for the Netherlands and other signatories of the Paris Agreement, we identify no material impact of environmental risks on the credit ratings of the Kingdom of the Netherlands.

[12] De Nederlandsche Bank, Occasional Studies, Volume 16-7, 2018

II. Appendix: CVS and QS results

Sovereign rating scorecards

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

For the Kingdom of the Netherlands, the following relative credit strength has been identified: i) growth potential of the economy; ii) fiscal policy framework; iii) debt sustainability; and iv) market access and funding sources. Relative credit weaknesses are signalled for: i) vulnerability to short-term external shocks; and ii) financial imbalances and financial fragility. The combined relative credit strengths and weaknesses indicate a sovereign rating of AAA for the Kingdom of the Netherlands. A rating committee has discussed and confirmed these results.

Rating overview	
CVS category rating range	aaa
QS adjustment	AAA
Final rating	AAA

To calculate the rating score within the CVS, we use a minimum-maximum algorithm to determine a rating score for each of the 24 indicators. We calculate the minimum and maximum of each rating indicator and place each sovereign within this range. Sovereigns with the strongest results for each rating indicator receive the highest rating score; sovereigns with the weakest results receive the lowest rating score. The score result translates to an indicative rating range that is always presented in lower case.

As part of the QS assessment, analysts conduct a comprehensive review of qualitative factors. This includes but is not limited to an economic scenario analysis, a review of debt sustainability, fiscal and financial performance reviews and policy implementation assessments.

There are three assessments per category for a total of 15. For each assessment, the analyst examines the relative position of a given sovereign within its peer group. For this purpose, additional comparative analysis beyond the variables included in the CVS is conducted. These assessments are then aggregated using the same weighting system as in the CVS.

The result is the implied QS notch adjustment, which is the basis for the analysts' recommendation to the rating committee.

Foreign- versus local-currency ratings

The Kingdom of the Netherlands has almost no foreign-currency-denominated public debt. Consequently, we see no reason to believe that authorities would differentiate between any of its contractual debt obligations based on currency denomination. Furthermore, the recent history of sovereign defaults does not provide a strong justification for a rating bias in favour of either local-currency or foreign-currency debt.

III. Appendix: CVS and QS results

Kingdom of the Netherlands

Maximum adjustment = 3 notches

CVS: Rating indicator	Category weight	QS	+2 notch	+1 notch	0 notch	-1 notch	-2 notch
Domestic economic risk	**35%**	Growth potential of the economy	○ Excellent outlook, strong growth potential	◉ Strong outlook, good growth potential	○ Neutral	○ Weak outlook, growth potential under trend	○ Very weak outlook, growth potential well under trend or negativ
Real GDP growth Real GDP volatility GDP per capita Nominal GDP Inflation rate		Economic policy framework	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Unemployment rate Old-age dependency ratio		Macro-economic stability and sustainability	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Public finance risk Primary balance	**30%**	Fiscal policy framework	○ Exceptionally strong performance	◉ Strong performance	○ Neutral	○ Weak performanc	○ Problematic performa
Interest payments		Debt sustainability	○ Exceptionally strong sustainability	◉ Strong sustainability	○ Neutral	○ Weak sustainability	○ Not sustainable
Gross debt Gross financing needs		Market access and funding sources	○ Excellent access	◉ Very good access	○ Neutral	○ Poor access	○ Very weak access
External economic risk External debt	**15%**	Current account vulnerability	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Currency turnover/reserves		External debt sustainability	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Net international investment position (NIIP) Current account balance		Vulnerability to short-term external shocks	○ Excellent resilience	○ Good resilience	○ Neutral	◉ Vulnerable to shock	○ Strongly vulnerable to shocks
Institutional and political risk	**10%**	Perceived willingness to pay	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
World Bank Worldwide Governance Indicators		Recent events and policy decisions	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
		Geopolitical risk	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Financial risk Non-performing loans (NPLs)	**10%**	Banking sector performance	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Tier 1 ratio Credit to GDP gap (bubble)		Banking sector oversight and governance	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Credit to GDP gap (imbalance)		Financial imbalances and financial fragility	○ Excellent	○ Good	○ Neutral	◉ Poor	○ Inadequate

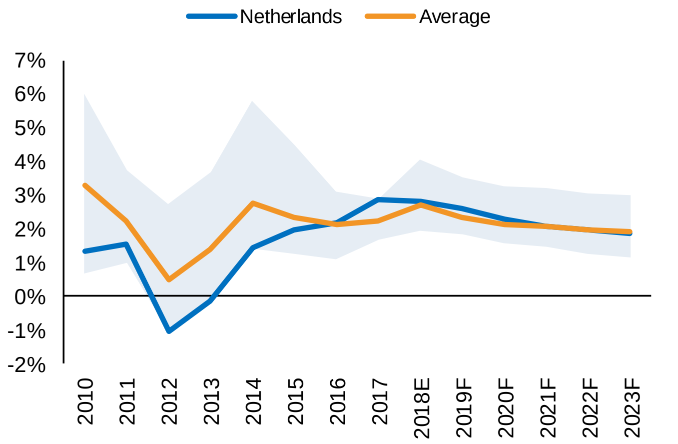
Indicative rating range	**aaa**
QS adjustment	**AAA**
Final rating	**AAA**

*** Implied QS notch adjustment = (QS notch adjustment for domestic economic risk)*0.35 + (QS notch adjustment for public finance risk)*0.30 + (QS notch adjustment for external economic risk)*0.15 + (QS notch adjustment for institutional and political risk)*0.10 + (QS notch adjustment for financial stability risk)*0.10**

Source: Scope Ratings GmbH

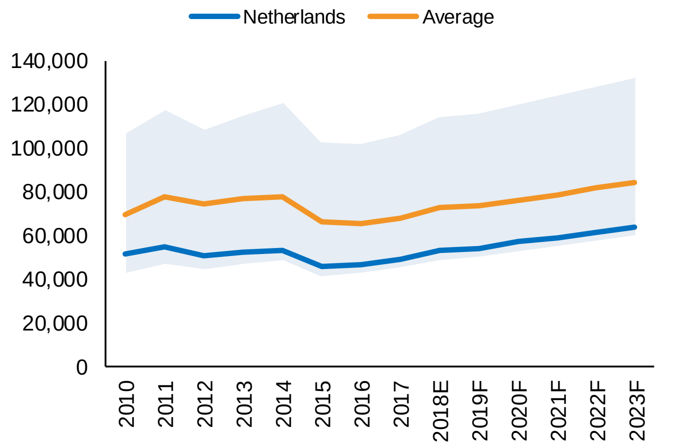
IV. Appendix: Peer comparison

Figure 29: Real GDP growth



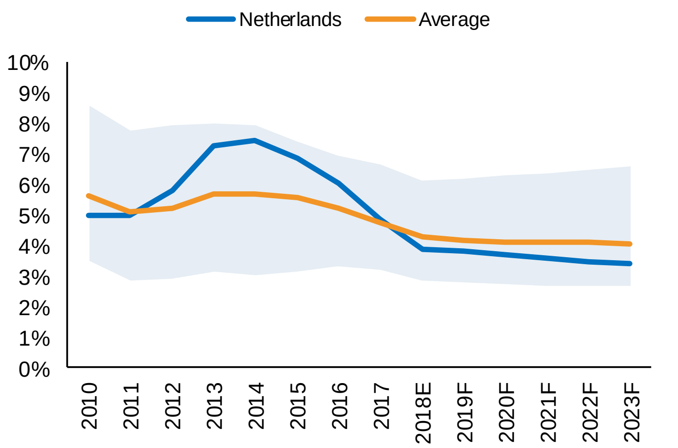
Source: IMF, calculations Scope Ratings GmbH

Figure 30: GDP per capita, USD



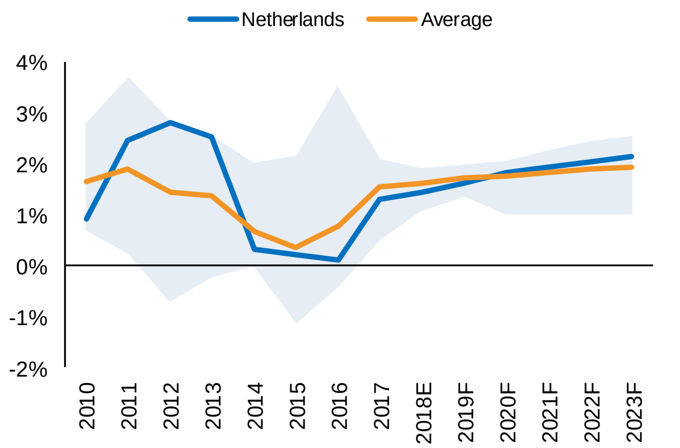
Source: IMF, calculations Scope Ratings GmbH

Figure 31: Unemployment rate, %



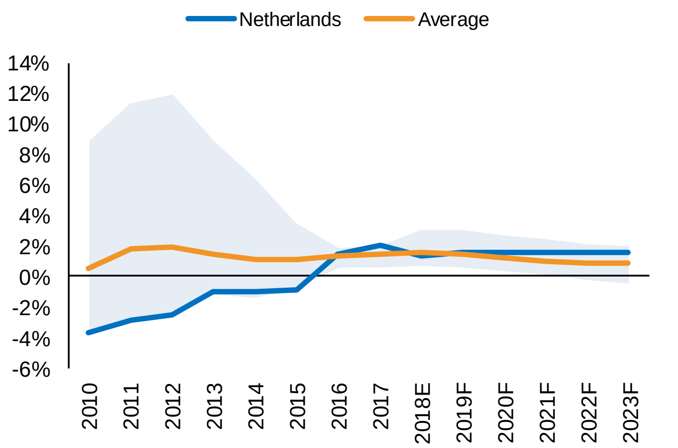
Source: IMF, calculations Scope Ratings GmbH

Figure 32: Headline inflation, %



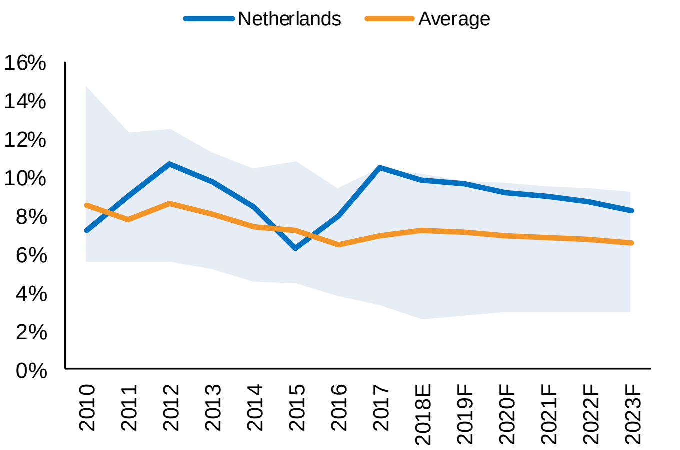
Source: IMF, calculations Scope Ratings GmbH

Figure 33: General government primary balance, % of GDP



Source: IMF, calculations Scope Ratings GmbH

Figure 34: Current account balance, % of GDP



Source: IMF, calculations Scope Ratings GmbH

V. Appendix: Statistical tables

	2014	2015	2016	2017	2018E	2019F	2020F
Economic performance							
Nominal GDP (EUR bn)	671.6	690.0	708.3	737.0	772.7	799.3	826.1
Population ('000s)	16,865.0	16,937.0	17,030.0	17,140.0	17,190.0	17,240.0	17,290.0
GDP per capita PPP (USD)	48,606.3	49,527.7	50,538.6	52,503.3	-	-	-
GDP per capita (EUR)	39,819.8	40,739.7	41,593.5	43,001.6	44,950.2	46,361.2	47,780.8
Real GDP, % change	1.4	2.0	2.2	2.9	2.5	1.8	1.7
GDP growth volatility (10-year rolling SD)	2.2	2.2	2.1	2.0	2.0	1.2	1.2
CPI, % change	0.3	0.2	0.1	1.3	1.6	2.3	1.6
Unemployment rate (%)	7.4	6.9	6.0	4.9	3.8	3.7	3.6
Investment (% of GDP)	17.9	22.5	20.5	20.7	21.1	21.5	22.0
Gross national savings (% of GDP)	26.4	28.8	28.5	31.2	31.0	30.9	30.9
Public finances							
Net lending/borrowing (% of GDP)	-2.2	-2.0	0.0	1.2	1.1	1.0	0.8
Primary net lending/borrowing (% of GDP)	-0.8	-0.8	1.1	2.1	1.8	1.6	1.4
Revenue (% of GDP)	42.8	41.8	42.8	43.7	43.5	44.4	44.2
Expenditure (% of GDP)	44.9	43.8	42.8	42.6	42.4	43.4	43.5
Net interest payments (% of GDP)	1.3	1.2	1.1	1.0	0.8	0.6	0.6
Net interest payments (% of revenue)	3.1	2.9	2.6	2.2	1.7	1.4	1.4
Gross debt (% of GDP)	67.9	64.7	61.9	57.0	54.4	52.0	49.9
Net debt (% of GDP)	54.7	52.9	50.6	46.6	44.5	42.6	40.8
Gross debt (% of revenue)	158.6	154.7	144.6	130.3	125.1	117.3	112.8
External vulnerability							
Gross external debt (% of GDP)	563.1	561.6	561.2	531.5	507.0	-	-
Net external debt (% of GDP)	53.0	56.0	51.1	42.4	24.5	-	-
Current-account balance (% of GDP)	8.5	6.3	8.0	10.5	9.9	9.3	8.9
Trade balance (% of GDP)	9.5	9.5	9.3	9.6	9.2	9.1	8.9
Net direct investment (% of GDP)	0.3	9.4	14.4	2.0	3.4	-	-
Official forex reserves (EOP, EUR mn)	8,275.0	8,205.0	5,678.0	4,046.0	4,195.0	-	-
REER, % change	0.0	-3.3	1.3	0.5	1.4	-	-
Nominal exchange rate (AVG, USD/EUR)	1.3	1.1	1.1	1.1	1.2	-	-
Financial stability							
Non-performing loans (% of total loans)	3.0	2.7	2.5	2.3	1.9	-	-
Tier 1 ratio (%)	15.4	16.6	17.9	18.6	-	-	-
Private debt (% of GDP)	268.1	264.2	262.1	252.1	-	-	-
Credit-to-GDP gap (%)	6.2	-0.5	-3.4	-15.6	-	-	-

Source: IMF, European Commission, European Central Bank, Eurostat, Central Bank of the Netherlands, Bureau for Economic Policy Analysis, World Bank, Haver Analytics, Scope Ratings GmbH

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