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Research Update:

State of North Rhine-Westphalia 'AA/A-1+' Ratings Affirmed; Outlook Stable

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Overview

- Subdued economic growth, the cost of stimulus and support measures, and deficit-spending under now two special purpose accounts will weigh on the State of North Rhine-Westphalia's (NRW's) consolidated budgetary performance in 2023.
- Although we don't expect that NRW will need to make close to full use of this additional headroom, the state has suspended the balanced budget requirement of its debt brake rule for another year, created a new Ukraine war fallout-related special purpose account, and equipped it with a borrowing authorization of up to €5 billion of additional debt.
- Assuming a return to a more supportive macroeconomic environment, we anticipate pressure on NRW's budget will abate from 2024, putting the state back on a path toward more balanced accounts.
- We affirmed our 'AA/A-1+' long- and short-term ratings on NRW and maintained our stable outlook.

Rating Action

On Feb. 24, 2023, S&P Global Ratings affirmed its 'AA/A-1+' long- and short-term issuer credit ratings on the German State of North Rhine-Westphalia (NRW). The outlook is stable. At the same time, we affirmed our 'AA' issue ratings on NRW's senior unsecured debt.

Outlook

The stable outlook reflects our expectation that NRW will only face a mild recession this year. Although having to bear its share of the cost of Germany's various economic stimulus measures, we anticipate that deficit spending under the state's new Ukraine-war-related special purpose account will remain moderate and the renewed suspension of the debt brake law's zero deficit target limited to 2023. Furthermore, we believe that recent tax breaks will cause NRW's revenue growth to remain subdued, despite inflationary effects.

Downside scenario

We could take a negative rating action if NRW responds to a deteriorating economic environment with spending above our base-case assumptions or relaxes fiscal discipline for other reasons, and this leads to sustained weaker budgetary performance. The materialization of meaningful contingent liabilities, for example, in the municipal sector due to renewed distortions in the energy market, could be a contributing factor.

Upside scenario

We might consider a positive rating action if the state improves its budgetary performance significantly beyond our current expectations and markedly reduces contingent liabilities from legacy financial institutions and its municipal sector. This could signal stronger financial management than we currently assess.

Rationale

Our ratings on NRW are supported by its large, diversified, and resilient economy; sophisticated debt management that secured low funding costs through significantly extended maturities when rates were low; and high volume of liquidity reserves. In contrast, the state's very high debt burden, particularly once contingent liability risk from legacy financial institutions and its municipal sector is considered, constitutes the weakest aspect of the rating.

NRW's budgetary performance remains affected by macroeconomic and geopolitical events. Still grappling with the COVID-19 pandemic's fiscal legacy, the state now faces the budgetary fallout from the Russia-Ukraine war. Related support payments, stimulus measures, and cost increases due to general inflation imply deficits after capital accounts, even when tax revenue benefits from rising prices.

A shallow recession and only weak tax revenue growth are predicted for 2023

We consider a shallow recession likely in Germany in 2023, after the country's economy was more resilient than expected during 2022. Despite distortions in the energy market, last year's real GDP growth amounted to 1.9%. For 2023, we anticipate that lingering inflation, weaker hiring, and higher interest rates will cause German GDP to temporarily contract by about 0.5%, before recovering to growth rates of 1.0% and 1.3% in 2024 and 2025, respectively.

Despite its exposure to energy-intensive industries, NRW's economy should develop broadly in line with the national average. Already NRW's relative size--it is Germany's biggest, most populous state and represents above 20% of national GDP--ensures close alignment of growth rates. Although energy and energy-intensive companies such as utilities E.ON, RWE, and Uniper, or steel producer Thyssen Krupp and chemical giant Bayer, are headquartered in NRW, we consider the state's economy diversified enough to cushion such a burden. Our current projection for NRW's local GDP per capita amounts to almost €46,500 (about $48,100) for 2023, slightly below the anticipated national per capita GDP of just over €50,000 ($52,000) but nevertheless very high in an international comparison.

We only anticipate muted tax revenue growth for NRW in 2023, since inflationary effects will largely be offset by the impact of Germany's recently decided tax breaks. Taxes expanded 8.6% in 2022, resulting in collections exceeding the budget by €2.4 billion in NRW. We anticipate inflation will remain elevated in 2023. However, its beneficial effects on revenue--direct via value-added tax and indirect via personal income tax, which are both shared between Germany's federal and state level--will presumably be negated by the various tax breaks the country introduced at year-end 2022 as an economic stimulus measure. These comprise tariff adjustments and a string of higher tax deductibles, causing us to only assume net tax revenue growth of 1%-2% for NRW in 2023.

In our view, Germany's federal institutional framework--which greatly supported NRW during the COVID-19 pandemic--will have an ambivalent effect over the coming months. On the one hand, the state will have to co-fund various policy measures recently decided at the federal level, for example, a heavily subsidized pan-German train pass and elevated housing subsidies. On the other hand, NRW and the other states obtained mitigating additional transfers from the federal government in return for not vetoing the proposed tax breaks in Germany's second chamber of parliament in November 2022. In any case, we believe that the strong cohesion between the federal level and the states continues to provide an effective mitigant against sudden outsized shocks.

NRW's financial management has taken legislative steps to enable the absorption of a significantly weaker budgetary outcome in 2023 but, for now, we consider this largely precautionary. Not being allowed to reallocate leftover funds in its segregated COVID-19 account, the state's parliament extended the suspension of the zero-deficit requirement of NRW's debt brake rule for another year, created a new special purpose account dedicated to funding Ukraine-war-induced costs, and equipped it with a maximum borrowing authorization of €5 billion. We understand this package is limited to 2023 and expect utilization to remain contained, thanks to recently more benign economic developments. Although, in our opinion, its installation reflects prudent management, it also points to fewer budgetary reserves at NRW than elsewhere. Furthermore, the maintenance of now two unconsolidated material spending envelopes, for COVID-19 and Ukraine-related costs, showcases limited transparency of accounts as an issue for all German states, in our view.

We predict a moderate deficit and stable, but high debt

Our revised forecast of a moderate deficit after capital accounts now extending into 2023, and then shrinking, incorporates the various headwinds that we expect to materialize. These include muted tax revenue growth and the cost of stimulus measures. Furthermore, we assume--arguably with considerable uncertainty--that residual disbursements to settle past years' COVID-19-related promises and support under the new Ukraine-war-related spending envelope total €3 billion in 2023, before falling away from 2024. Cost inflation is embedded into our modelling. However, since the current wage agreement for ordinary employees runs until almost year-end 2023, inflation-compensating salary hikes should only become material for NRW from 2024.

Pension payments under the state's pay-as-you-go system for civil servants continue to reduce budgetary leeway, in our opinion. They currently consume about 12% of annual adjusted operating revenue and are expected to peak toward the end of this decade. The €13 billion currently set aside in NRW's pension reserve account will only dampen, but not permanently offset the rise.

We consider NRW's tax-supported debt burden of more than 180% of consolidated operating revenue very high in an international peer comparison, once contingent liability risk is considered. However, the state benefits from sophisticated debt management. It is an established benchmark issuer in the capital market and active in various funding currencies, but always on a fully euro-hedged basis. NRW maintains a predominantly fixed-rate debt portfolio, with residual variable rate exposure matched by short-term assets. The debt portfolio's duration of almost 18 years should limit increases in interest costs. To calculate our tax-supported debt metric, we add the financial liabilities of Bau- und Liegenschaftsbetrieb NRW, the manager of government-used real estate, and a school investment program prefinanced by promotional lender NRW.Bank to the core budget's direct debt.

Contingent liability risk primarily arises from legacy financial institutions and the municipal sector, according to our view. Erste Abwicklungsanstalt (AA/Stable/A-1+) and Portigon (not rated), which both manage the orderly winddown of former state bank WestLB, are the most relevant institutions in this context. Furthermore, we understand that NRW and the German government are in discussions on restructuring parts of local municipalities' €20 billion legacy short-term loans (Kassenkredite). Any solution would likely see part of these obligations shift onto the state's balance sheet. A €5 billion guarantee framework that supports liquidity access for municipal utilities (Stadtwerke) amid distorted energy prices has so far not been used.

NRW's €18.5 billion cash balance and the €13 billion of securities held in its pension reserve account in early 2023 more than fully cover this year's debt service. Together with the state's proven borrowing ability in the capital market and its access to liquidity from other levels of government, we conclude an exceptional liquidity position. The state generally prefunds expenditure with long-term borrowings, but it does not maintain any committed bank credit facilities.

Key Statistics

Table 1

North Rhine-Westphalia (State of) Selected Indicators

Mil. €	2021	2022e	2023bc	2024bc	2025bc
Operating revenues	90,372	95,489	90,931	93,349	98,113
Operating expenditures	84,719	89,160	88,714	88,636	91,552
Operating balance	5,653	6,329	2,217	4,713	6,561
Operating balance (% of operating revenues)	6.3	6.6	2.4	5.0	6.7
Capital revenues	1,797	2,387	2,186	2,474	2,658
Capital expenditures	8,772	12,047	9,170	9,964	10,535
Balance after capital accounts	(1,322)	(3,331)	(4,767)	(2,777)	(1,316)
Balance after capital accounts (% of total revenues)	(1.4)	(3.4)	(5.1)	(2.9)	(1.3)
Debt repaid	16,969	15,610	14,731	14,353	15,125
Gross borrowings	22,130	19,842	16,113	11,853	14,025
Balance after borrowings	3,717	744	(3,050)	(5,425)	(2,086)
Direct debt (outstanding at year-end)	162,215	166,359	167,741	165,241	164,141
Direct debt (% of operating revenues)	179.5	174.2	184.5	177.0	167.3
Tax-supported debt (outstanding at year-end)	169,552	173,445	174,727	172,127	170,927
Tax-supported debt (% of consolidated operating revenues)	187.6	181.6	192.2	184.4	174.2

Table 1

North Rhine-Westphalia (State of) Selected Indicators (cont.)

Mil. €	2021	2022e	2023bc	2024bc	2025bc
Interest (% of operating revenues)	1.7	1.5	2.8	3.1	3.1
Local GDP per capita (single units)	40,951	43,818	46,447	48,304	49,802
National GDP per capita (single units)	43,314	47,149	50,247	52,421	54,056

The data and ratios above result in part from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. The main sources are the financial statements and budgets, as provided by the issuer. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario. N/A--Not applicable. N.A.--Not available. N.M.--Not meaningful.

Ratings Score Snapshot

Table 2

North Rhine-Westphalia (State of) Ratings Score Snapshot

Key rating factors	Scores
Institutional framework	1
Economy	1
Financial management	2
Budgetary perfomance	3
Liquidity	1
Debt burden	5
Stand-alone credit profile	aa
Issuer credit rating	AA

S&P Global Ratings bases its ratings on non-U.S. local and regional governments (LRGs) on the six main rating factors in this table. In the "Methodology For Rating Local And Regional Governments Outside Of The U.S.," published on July 15, 2019, we explain the steps we follow to derive the global scale foreign currency rating on each LRG. The institutional framework is assessed on a six-point scale: 1 is the strongest and 6 the weakest score. Our assessments of economy, financial management, budgetary performance, liquidity, and debt burden are on a five-point scale, with 1 being the strongest score and 5 the weakest.

Key Sovereign Statistics

- Sovereign Risk Indicators, Dec. 12, 2022. An interactive version is available at http://www.spratings.com/sri

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- Criteria | Governments | International Public Finance: Methodology For Rating Local And Regional Governments Outside Of The U.S., July 15, 2019
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017

- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Russia-Ukraine Military Conflict: Key Takeaways From Our Articles, Feb. 2, 2023
- Global Ratings List: International Public Finance Entities 2023, Jan. 9, 2023
- Local And Regional Governments Outlook 2023: Rougher Seas Ahead, Nov. 29, 2022
- Economic Outlook Eurozone Q1 2023: Reality Check, Nov. 28, 2022
- Germany 'AAA/A-1+' Ratings Affirmed; Outlook Stable, Sept. 23, 2022
- Erste Abwicklungsanstalt, Sept. 21, 2022
- Institutional Framework Assessments For International Local And Regional Governments, Sept. 13, 2022
- NRW.Bank, Feb. 16, 2022
- Institutional Framework Assessment: German States, Dec. 7, 2021

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's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

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

Ratings Affirmed	
North Rhine-Westphalia (State of)	
Issuer Credit Rating	AA/Stable/A-1+
Senior Unsecured	AA

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; or Stockholm (46) 8-440-5914