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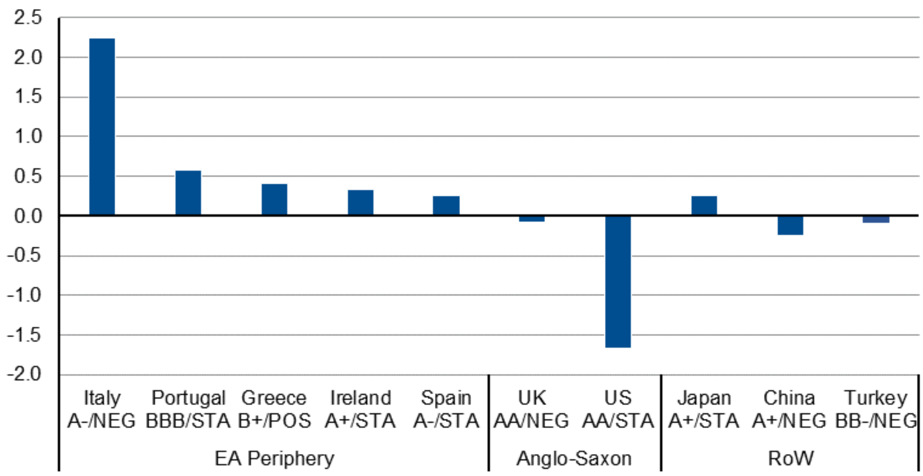
Sovereign Outlook 2019: Multiple stress factors and political uncertainty weigh on European and global growth outlook

In Scope's assessment, the global economic outlook for 2019 faces multiple risks including tightening financial conditions, protectionism and inward-looking policy agendas, Brexit and Italy, as well as China's economic slowdown. Together with the global build-up of debt since the great financial crisis, these stress factors represent key risks to the global economy and the sovereign credit outlook. In an environment increasingly characterised by nationalistic agendas, 2019 will see slower annual growth in the euro area and global economies, higher financial market volatility and exceptional policy unpredictability.

Figure 1: Scope ratings vs US agencies', as of 29 November 2018 (rating notches)



Source: Scope Ratings GmbH. NB: Calculated based on alpha-numeric conversion on a 20-point scale from AAA (20) to D (1). Positive/negative outlooks are treated with a +/-0.25 adjustment; Credit watch positive/negative with a +/-0.50 adjustment. RoW = Rest of World. The full list of Scope's sovereign ratings is linked here.

Scope's global sovereign rating outlook for 2019:

- While the credit quality of rated sovereigns remains supported by improvements made since the great financial crisis, a mix of country specific risks and broader developments including tightening financial conditions and trade protectionism present rating risks entering 2019. Scope expects slower annual growth in the euro area (see Scope's macro outlook 2019), and in major economies in the rest of the world.
- Scope highlights three key challenges, each rooted in populism, which will dominate the political agenda next year. These are: i) the inward-looking policies of the current US administration with adverse consequences for global growth; ii) the rise of nationalist agendas more broadly reducing the independence and authority of domestic institutions, leading to a rise in policy uncertainty and unpredictability; and iii) country specific political events, including Brexit and ongoing developments in Italy.
- Total global debt burdens remain at historically high levels, with sovereign debt levels stressed under a backdrop of pro-cyclical fiscal policies in many advanced economies. In the context of slowing growth and rising interest rates, Scope sees limited room for significant slippage in public finances at current rating levels for sovereigns already with elevated public debts or an uneven track record of fiscal consolidation.
- Emerging market sovereign pressures to remain a feature in 2019 with tighter global financial conditions affecting economies with external vulnerabilities. The escalation of trade tensions and sanctions risks, China's economic slowdown, as well as structural and institutional weaknesses in countries including Turkey are areas to watch.

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Sovereign Outlook 2019: Multiple stress factors and political uncertainty weigh on European and global growth outlook

Scope's 2019 Sovereign Outlook highlights:

- **Brexit: UK and EU to avoid no-deal, but uncertainty to linger well beyond 29 March 2019 ....(page) 5**

In a report released in August 2017, Scope stated its long-held view that the most likely end-state of negotiations is either a long-run soft Brexit (Scope's baseline) or an eventual no-Brexit 'Breversal' scenario. Building towards this long-run end-state, in the near term, Scope considers either: i) a transitional 'Brexit-in-name-only' with an agreement or ii) an Article 50 extension (and the UK's status inside the EU) as the most probable short-term outcome by 29 March 2019 (rather than a no-deal Brexit). As tumultuous as the final four-month period prior to 29 March 2019 will be, uncertainty surrounding Brexit will extend well beyond next March, with the accrued economic costs from uncertainty weighing on the UK's AA/Negative ratings.

- **Italy's confrontation with EU rules and markets to resume, with the government's longevity to be tested in 2019 ....7**

The European Commission will likely reopen an Excessive Deficit Procedure against Italy in December or January with sanctions only a prospect down the road. However, Scope believes that the extent to which Italy moderates its fiscal ambitions, with signals the government will lower the 2.4% of GDP 2019 deficit goal, and/or faces snap election risk given rising internal dissent, will depend crucially on market dynamics. Market weakness should remain relatively Italy-centric in 2019 with only modest contagion. Scope's next review on Italy's A-/Negative ratings comes on 7 December 2018, with Scope having cited significant rating risks.

- **United States outlook subject to significant downside risks 10**

The outlook for the United States is subject to downside risks, given the combination of the economic cycle peaking, rising interest rates in the context of a pro-cyclical fiscal policy stance and overvalued asset prices, and major uncertainties regarding the direction of President Trump's shifting trade policy agenda, particularly vis-à-vis China. Following the mid-term elections, a divided and polarised Congress will take office in January and is unlikely to develop and implement the needed policies to address the underlying structural challenges of the US economy. Scope maintains a AA/Stable rating opinion on the US.

- **Year of political change in Europe with further deepening of the EMU unlikely in 2019 ....11**

2019 promises to be a year of major political change in Europe. While Scope does expect Eurosceptic parties to gain seats at next May's European elections, pro-European parties will keep a governing majority which matters for key leadership appointments to the presidencies of the European Commission and ECB. However, a further deepening of the EMU next year appears unlikely.

- **Unstable German government with France the new European locomotive? 13**

Germany (AAA/Stable) and France (AA/Stable) are subject to different political and economic environments in 2019. Germany faces an unstable government with little scope for decisive policy making. By contrast, the French government under President Emmanuel Macron has initiated ambitious reforms for the labour market and tax system, which could help stimulate growth in 2019 and surpass German growth over the medium-term – becoming Europe's new growth engine.

- **Key elections to provide clarity on the outlook for the euro area periphery 14**

Greece (B+/Positive), Spain (A-/Stable) and Portugal (BBB/Stable) all face elections in 2019 which may affect their respective credit outlooks to varying degrees. For these three sovereigns, continued fiscal consolidation and growth-enhancing reforms are key credit-relevant themes.

- **CEE: Russia's sanction risks, Poland and Hungary stand-offs with the EU, and Bulgaria/Romania divergence 16**

Scope upgraded Russia (BBB-/Stable) to investment-grade in 2017. A key risk for Russia is the potential intensification of sanctions alongside the impacts from the ongoing US-China trade war. Poland (A+/Stable) and Hungary (BBB/Positive) maintain solid growth as Scope expects both to navigate current diplomatic disagreements with the EU without material impacts to their economies. Still, proposed 2021-27 EU funding cuts present medium-term challenges. Lastly, Bulgaria's (BBB/Positive) ratings could see upside in 2019 while Romania (BBB-/Negative)'s ratings were downgraded to just above non-investment-grade.

- **Turkey's and broader EM structural weaknesses unresolved entering 2019 ....17**

On 16 August, Scope downgraded the Republic of Turkey's sovereign rating to BB- from BB+ and assigned a Negative Outlook. Since September, lira sentiment has improved. However, Scope considers recent FX strength to be susceptible to reversal at stages next year, as Turkey's structural weaknesses have not been corrected. In addition, gradual monetary normalisation and the tightening global financial conditions will continue to expose underlying EM external vulnerabilities in 2019.

- **China's slowing economy and debt risks are concerns for the global economy in 2019 ....19**

On 21 September 2018, Scope revised the Outlook on China's A+ sovereign rating to Negative from Stable. This was a non-consensus rating decision, with peer credit rating agencies maintaining Stable outlooks on China's ratings. China's rising debt levels are a major systemic risk factor, with recent tariff conflicts with the United States exacerbating an economic deceleration to roughly 6.2% growth in 2019, supporting Scope's expected global slowdown next year.

Macro outlook for 2019:

Weaker annual growth in 2019 with significant risks on the horizon…

Scope believes several risks will crystallise in 2019 and result in a slowdown to around 3.0-3.5% global growth, down from about 3.7% in 2018, with slower euro area annual growth of 1.5% in 2019. While the euro area economy has maintained robust growth in 2018 of around 1.9% – consistent with Scope's constructive view on 2018 – quarterly growth in the euro area eased to 0.2% in the third quarter, driven in part by temporary factors, but nonetheless well below the average of 0.7% Q/Q over 2017. Even if quarterly growth recovers from Q4 onwards, annual growth in 2019 will suffer from base effects. The slowdown in 2018 compared with a euro area growth rate of 2.5% in 2017 combined with the 2019 outlook lead Scope to judge that 2017 was the *peak year* for regional growth this cycle, and that the expansion cycle is now in a mid-to-late phase with significant risks to its longevity looking ahead.

In 2019, Scope believes that risks to the European and global economies will come from several areas. First, tightening global financial conditions – precipitated by factors including reversals in overvalued US asset markets, movements towards normalisation of crisis-era monetary policies with Federal Reserve hikes and the end of net asset purchases by the European Central Bank (ECB) next month, alongside higher borrowing rates for many countries including Italy and Turkey – will restrain business sentiment and investment, and test areas of financial vulnerabilities. Second, the US government's trade disputes will remain a significant risk factor, with attention in the near term focused on conflicts with China alongside the threat of automotive import tariffs on global partners. Third, Brexit, the budget stand-off between Italy and the European Union, and the continued unpredictability of US policies will affect the outlook. Finally, China's slowdown and ongoing debt accrual pose globally-relevant implications.

There are however also supporting elements to regional and global growth, such as the more expansionary fiscal stance of the euro area next year, with an expected 0.3% of potential GDP stimulus. While the effects of the 2018 US tax cuts and spending increases may fade during 2019, Scope does not rule out the possibility for further expansionary fiscal measures in the US. In addition, a faster-than-expected US economic growth slowdown may also lead to a 'Powell Put', with the Federal Reserve possibly pausing rate hikes during H2 2019. In the euro area, interest rates will remain very low, and an ECB interest rate hike in Q3 2019 is not a given should risks to growth amplify. China is moreover rolling out significant monetary and fiscal easing in response to its slowdown. Moreover, Brent crude prices have recently fallen to ~USD 58/barrel at the time of this writing, from an October 2018 peak of USD 86/barrel, representing a boon to euro area consumers in 2019 should prices stay lower. Finally, banks are much better capitalised now than prior to the great financial crisis, as evidenced in the 2018 European Banking Authority/ECB bank stress test results, supporting resilience in the event of shocks. Still, acknowledging these buffers, the overall economic outlook faces significant risks, especially emanating from the policy sphere.

… including the rise of nationalist agendas as a key risk to the world economy…

The rise of anti-establishment forces is challenging the rules-based multilateral governance system which over the past decades has provided governments, businesses and households with a broadly reliable and predictable decision-making environment. Led by the US administration, several G20 governments previously standing for multilateral cooperation – including the UK (AA/Negative), Italy (A-/Negative), Mexico and Brazil – are now, to varying degrees, alongside countries including Russia (BBB-/Stable) and Turkey (BB-/Negative), openly pursuing more inward-looking agendas, challenging the post-war order. Scope observes that 2019 general elections in Argentina (27 October), India (April or May), Indonesia (17 April), Belgium (26 May), the European Parliament (26 May) and South Africa (no later than August) will illustrate the extent to which nationalist agendas are an ephemeral 2016-18 episode or, indeed, the next major political mega-trend dominating the political outlooks of major economies for years to come.

In Scope's opinion, these outcomes are not trivial, and in fact, a major risk for the global economy affecting all credits in 2019 and beyond via i) direct trade, ii) consumer and business confidence and iii) global market sentiment (financial conditions) channels. Contrary to the great financial crisis in 2008, which was ultimately triggered by a largely unanticipated bust in market sentiment, a key risk this time is a somewhat predictable, but permanent shift in economic policy and subsequent rise in geopolitical tensions, undermining the predictable decision-making environment that has characterised past decades. This development could also come about via a gradual, albeit continuous erosion of independent institutions which to date have broadly safeguarded the rules-based order. The implications, in Scope's opinion, are unprecedented uncertainty as regards i) the range of possible outcomes of future economic developments and ii) the probability distribution of unknown future economic developments. In other words, the main consequence and risk from an increasing number of governments pursuing nationalist agendas and reducing the independence and authority of domestic institutions is a rise in unknown unknowns.

Table 1. G20 governments and upcoming elections

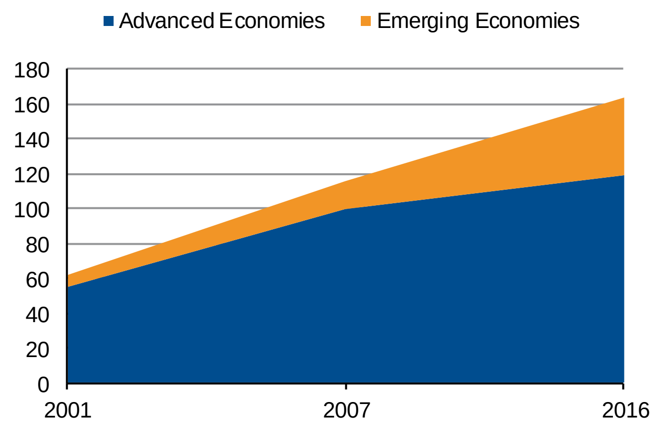
Autocratic leadership	Anti-establishment government		Elections 2019		Pro-establishment governments	
China	Brazil	United Kingdom	Argentina	European Union	Australia	Germany
Russia	Italy	United States	India	Belgium	Canada	Japan
Saudi Arabia	Mexico		Indonesia		France	Korea
Turkey						

Source: Scope Ratings GmbH

… stressing latent risks related to the build-up of global debt.

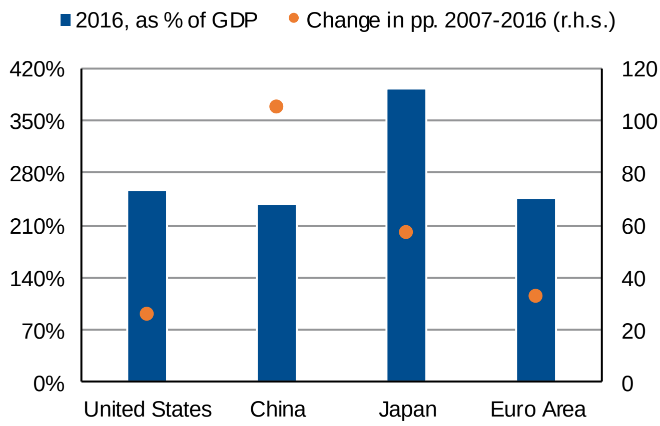
The high and increasing levels of global debt could re-enforce emerging risks to the world economy. According to the latest figures from the IMF's Global Debt database, total private and public debt ratios have reached a new high of 217% of GDP in 2016, up 12 p.p. since 2009. The recent increase is driven by a surge in private debt in EM and public debt in advanced countries.

Figure 2: Global debt, in USD trn



Source: IMF Global Debt database

Figure 3: Public and private debt-to-GDP



Source: IMF Global Debt database

In contrast to previous debt crises, emerging markets are better prepared for the risk of sudden capital outflows today as central banks have increased reserve buffers and exchange rate flexibility. Yet, sudden stops and flights-to-quality could result in debt crises in economies with large exposures to foreign currency such as Turkey or Argentina. Given the increase of dollar-denominated debt in emerging markets, these countries face financial stability risks if the Federal Reserve continues tightening.

In the advanced world, risks from high debt centre around public sectors. Fiscal policies have become pro-cyclical, as good economic times have resulted in a slowing or even reversal of fiscal adjustment (e.g. US, Italy). Elevated public debt-to-GDP ratios alone are not themselves sufficient to make a case for unsustainability; however, many governments are vulnerable to running into a debt trap were growth rates to decline and risk premia to increase. Simple calculations on public debt dynamics show that highly indebted countries such as the United States, Japan, Italy, France and the UK rely on very low central bank policy rates of 1% or even below to ensure stable debt ratios. Increasing global economic and financial risks could expose governments with limited fiscal space, especially with central banks only now gradually exiting crisis-era policies with very stretched balance sheets.

During the previous financial crisis, governments have partly compensated for the loss of private demand by increasing public expenditure and thereby bailing out not only banks but also, indirectly, non-financial sector companies and households. In the context of stretched central banks and unprecedented political uncertainty, reduced fiscal space will challenge governments in their abilities to cope with an adverse shock in the next crisis.

UK and EU to avoid no-deal Brexit, but uncertainty to linger well beyond 29 March 2019

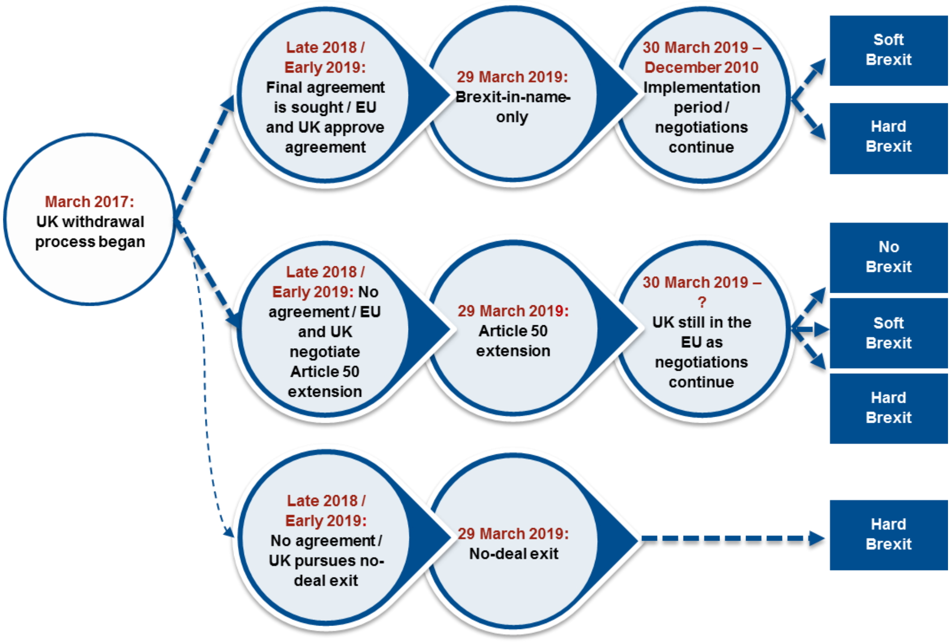
Brexit will feature in 2019

Brexit will feature centrally next year, as the UK's two-year Article 50 negotiation period concludes with its scheduled exit on 29 March 2019. While the UK and the EU have reached agreement on the terms of a draft withdrawal agreement (the so-called 'divorce') after some 17 months of negotiations (signed off at a European Council summit on 25 November), the divisive nature of Brexit has precipitated significant opposition in the UK.

Scope anticipates either soft Brexit or no Brexit in the long-run

In a report released in August 2017, Scope stated its view early on – and has maintained this view – that the most likely end-state of negotiations is a long-run soft Brexit (Scope's baseline). Next to this, an eventual no-Brexit 'Breversal' is the second most probable outcome, rather than hard Brexit (the latter defined as the UK exiting the single market and customs union). Building towards this long-run end-state, Scope has expressed that the most probable short-term outcome by 29 March 2019 is either: i) a transitional 'Brexit-in-name-only' with an agreement (and entry into a near-identical transition period in which true negotiations on the future relationship would begin) or ii) an Article 50 extension (and the UK's status inside the EU).

Figure 4: Brexit timeline and scenarios



Source: Scope Ratings GmbH

The lead-up to 29 March 2019 will be highly volatile

The lead-up to 29 March 2019 will be highly volatile, and the situation could easily get worse before it gets better. In the near term, Prime Minister Theresa May still faces the risk of a Tory leadership challenge, even if she would be well positioned to survive such a motion right now. Instead, an easier route for change in the Conservative Party is if Theresa May were to resign, which is possible if it becomes clear the Brexit deal cannot pass Parliament. However, even in that instance, a fresh Conservative leadership election becoming necessary (which would require about 10 weeks if there's more than one candidate) would present significant, undesirable disruption at this sensitive juncture.

The scenario of a Brexiteer-led government would not fundamentally change Scope's Brexit view

Even if, under one scenario, a more-hardline, pro-Brexit politician takes charge of the Conservative Party in the coming period, Scope does not believe this would change the outcome by 29 March 2019 from Brexit-in-name-only or an Article 50 extension. With just four months left before March 2019 (and time needed moreover for ratification by the UK and European parliaments), EU and UK policy makers have expressed doubts already on the degree of tolerance for renegotiation. Rather than achieving a "better Brexit", the time lost via replacement of PM May and adoption of a more confrontational stance could raise uncertainty, lack the parliamentary support needed for a 'no deal plus'[1], and could even increase the likelihood of no Brexit at all.

However, it's not clear that this draft Brexit deal will pass Parliament – especially on its initial go

At the same time, it is unclear that Mrs May's draft Brexit deal will pass in Parliament – especially on its initial go (the initial vote in Parliament is scheduled for 11 December). Certainly, the Prime Minister is currently *well* short of the needed majority. Were it not to pass, the question is if the UK government and the EU would be willing to tinker with some areas – including contentious withdrawal issues like the Irish backstop.

All eyes on parliamentary dynamics as the window closes before March 2019

However, parliamentary mathematics could change over time. There could be a second time around in the House of Commons thereafter were the initial go to fail, perhaps without substantial or any changes to the deal. The end-outcome depends on whether: i) enough Brexiteers are forced to vote for some form of a less-than-sought-for withdrawal arrangement out of fear Brexit will be stopped altogether, and/or ii) enough Remainers vote for the deal out of fear of a hard Brexit. However, there is a meaningful possibility that Remainers obtain enough support to block the deal altogether, which precipitates the Article 50 extension scenario (which is the scenario to facilitate the space of time to continue negotiations, if not hold early elections and/or a second referendum).

Scope has suggested five factors will force negotiators to avoid no-deal

Implicit here, in the case of Parliament rejecting the deal and no deal then before 29 March 2019, Scope considers a last resort extension of Article 50 talks to be much more probable than a no-deal Brexit from the EU. Scope has suggested five factors that compel negotiators to reach some form of arrangement with the EU that avoids no-deal:

1. The significant and asymmetric economic impact 'no deal' would have on the UK;
2. Far from adequate no-deal exit preparations with limited time remaining;
3. Inadequate UK parliamentary support for a no-deal exit alongside a UK civil society that does not back no-deal;
4. A no-deal Brexit jeopardises the open border between North and South Ireland, and would increase questions about Scotland's future in the Union;
5. UK plans to swiftly enter WTO trading terms under no-deal are unlikely.

Brexit will remain a cause of uncertainty for well beyond March 2019

Whether the UK exits the EU next March and enters a transition or Article 50 is extended, Brexit will remain a central source of uncertainty well beyond March 2019 and easily over the run of 2019. An option exists in the withdrawal agreement to extend Britain's transition out of the single market and customs union up to December 2022, if the current transition to December 2020 proves inadequate (as seems probable) to reach a new trade deal and manifest required new customs systems. The UK Treasury argued in 2016 that the process for a successful full Brexit from the single market and customs union could require a decade.[2]

An Article 50 extension could facilitate new elections and/or a second referendum

In the scenario that the deal is blocked and Article 50 extended (with the UK still in the EU after next March), this could come on the condition of an early parliamentary election in 2019 during the extension period. Fresh general elections would favour a pro-European coalition being formed involving the Labour Party and perhaps the Liberal

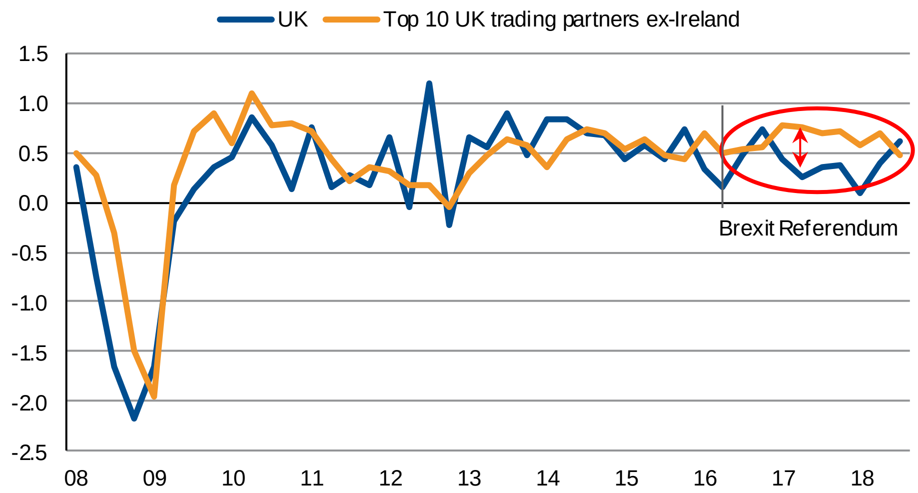
[1] MP Jacob Rees-Mogg has proposed a 'no deal plus' that would involve a reduced Brexit Bill of GBP 20bn (from the agreed GBP 39bn) and maintenance of the 21-month transition period, but the UK would become a third country outside of the EU orbit at the end of the transition period which would "provide both sides with time to prepare for a departure on to World Trade Organization terms, or for the activation of the comprehensive free trade deal that the EU has offered".
[2] HM Government. "The process for withdrawing from the European Union", Cm 9216, February 2016.

Democrats and/or the Scottish Nationalist Party. Such a coalition could hypothetically call a second Brexit referendum, with the date on such a referendum unlikely to be any sooner than six months after it is called[3] – edging the hypothetical referendum time horizon into late 2019 if not 2020.

Uncertainty will continue raising the economic cost of Brexit, even if no-deal is avoided

As such, economic uncertainty will remain substantial in 2019. Scope estimates that, even before Brexit itself happens, the process has already cost the economy well above 1% of GDP since the referendum (**Figure 5**). Brexit costs, including the impact on long-run growth potential, are observed in Scope's Negative Outlook on the UK's AA rating. Even if the UK avoids the worst case of a no-deal exit, the accumulating economic costs of Brexit uncertainty can nonetheless be consequential for the UK's fiscal and monetary policy frameworks, long-run debt sustainability alongside for UK credit strengths such as the pound sterling's global standing. Scope affirmed the UK's AA rating in August 2018 along with the Negative Outlook. But absent no-deal Brexit, the impact of Brexit on the broader European economy in 2019 will remain more modest and gradual, and linked to the ongoing subpar growth of the UK in affecting regional trade.

Figure 5: UK economy versus top 10 trading partners, %QoQ GDP growth



Source: National statistics institutes, Scope Ratings GmbH

Italy's confrontation with EU fiscal rules and markets to resume, with the government's longevity to be moreover tested in 2019

A new EDP on the horizon

The European Commission is likely to reopen an Excessive Deficit Procedure against Italy in December or January with the threat of sanctions next year a prospect down the road. However, Scope believes that the extent to which Italy moderates its expansionary fiscal ambitions and/or indeed the speed to which internal dissent in the government raises the likelihood of an early election both depend crucially on market pressure and the extent to which spreads rise beyond the current 290 bps (10-year BTPs).

EU disciplinary process to move forward in late 2018 and 2019

With Italy earlier maintaining its 2.4% of GDP deficit and 1.5% growth assumptions for 2019, the European Commission concluded on 21 November that Italy is in non-compliance with the EU's debt criterion, formally starting the process for a new EDP. The European Commission could now recommend an Excessive Deficit Procedure as soon as next month and has the option to request a non-interest-bearing deposit of 0.2% of GDP within 20 days of the formal opening of a disciplinary procedure. Italy will pass the budget in parliament before year-end, with recent government signals of compromise on

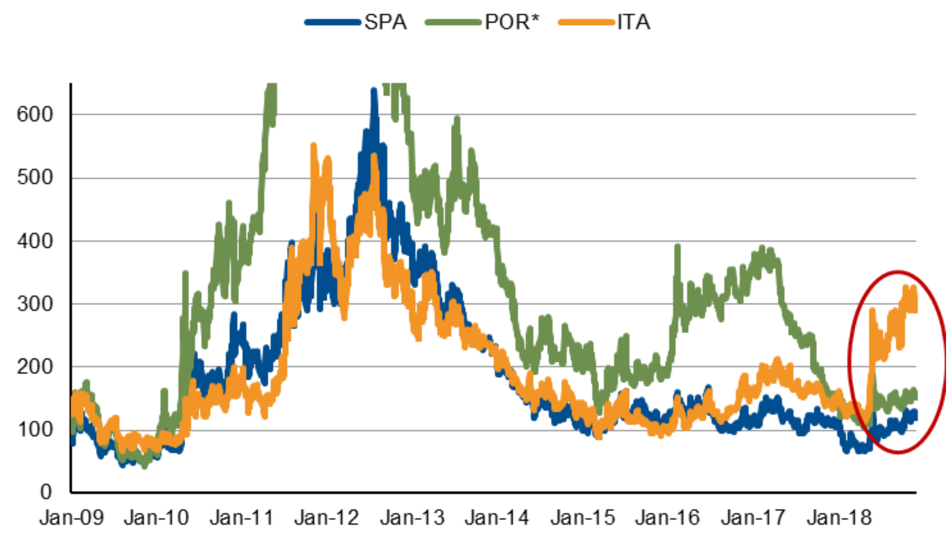
[3] Sargeant, J., A. Renwick and M. Russell. "How long would it take to hold a second referendum on Brexit?" LSE Brexit Blog, 5 September 2018.

a lower deficit goal than 2.4% of GDP. Henceforth, Italy would have 3-6 months from either December 2018 or January 2019 to find a compromise with the EU. If Italy does not meet certain targets at the end of this period, it could face sanctions including the fine of 0.2% of GDP alongside temporary suspension of European structural and investment fund inflows[4] and/or closer fiscal monitoring by European institutions[5]. However, such sanctioning mechanisms have never been tested, and the EU may be unwilling to escalate the stand-off given the 23-26 May 2019 European parliamentary elections.

Market pressure is key to the speed of convergence between the two sides

The official European disciplinary process notwithstanding, it is Scope's view that, in the end, the degree of pressure from the global financial community will be the *most* crucial factor that determines the speed of convergence between competing positions. Italian 10-year spreads have risen to 290 bps as of 29 November, from lows at about 115 bps in late-April (**Figure 6**) – although, even with elevated spreads, nominal yields are currently still much lower than during debt crisis peaks at 3.2% on 10-year BTPs, just under half the ~7% at crisis peaks in 2011. Nonetheless, the failure of a November BTP Italia bond auction with domestic investors showing limited appetite signalled the risks facing the government's programme even near current spread levels.

Figure 6: 10-year government spread to Bunds, bps



*Portugal's 10-year spread to Bunds peaked at 1,560 bps in 2012.
Source: Bloomberg

Market conditions could easily reverse again after the recent rally

Party leaders Luigi Di Maio and Matteo Salvini have of recent commented that they could accept a lower 2019 deficit goal than 2.4% of GDP – possibly 2.2% of GDP, with minor changes to the pension reform and deferrals on the start-date of the citizen's income on the table. From its angle, the EU would probably be willing to accommodate a level of deviation from the 0.6% of GDP structural adjustment originally sought absent recourse to sanctions if it meant stemming a wider crisis. However, this requires a much greater degree of compromise from both sides alongside a change in the government's rhetoric towards the EU. In Scope's view, the distance still between Italy's and the EU's negotiating positions (the European Commission estimated the 2019 deficit at 2.9% of GDP with a 1.2% of GDP structural deterioration), the likelihood of underperformance of any new 2.2% of GDP deficit target as the economy worsens, as well as mounting risks for the banking system mean that market dynamics could easily reverse again after the

[4] The EU has committed to EUR 44.7bn in structural and investment fund flows to Italy over 2014-20.
[5] With continued non-compliance, the fine could hypothetically be increased to include a variable component imposed annually until effective action is taken; loans from the European Investment Bank could moreover be trimmed, and the EU could launch monitoring over Italian debt issuance plans.

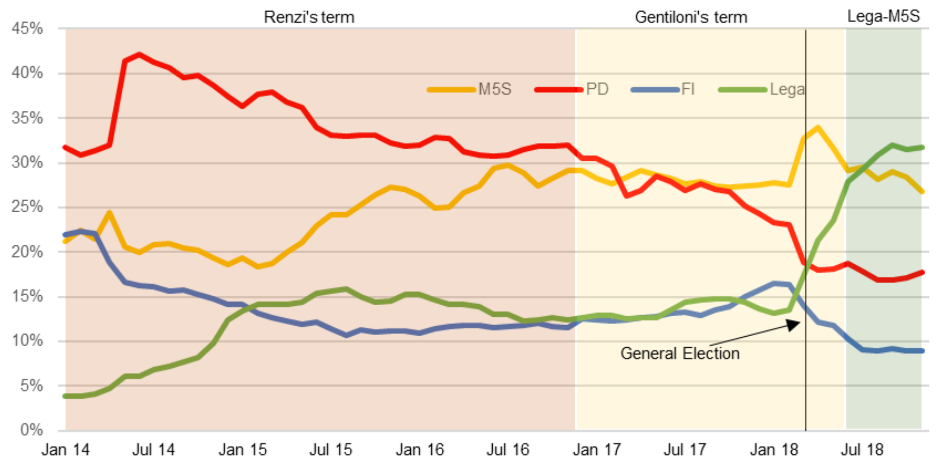
recent rally. As was the case in 2018, market volatility should, however, remain relatively Italy-centric in 2019 with only modest contagion.

In addition, given Italy's systemic economic, financial and political weight in the European Union, Scope acknowledges the improved European architecture to deal with serious crises. Still, for such measures to be used, there would have to be a serious escalation from the current crisis. Even then, activation of Outright Monetary Transactions, for instance, would be contingent on Italy applying for a European Stability Mechanism (ESM) financial assistance programme – a prospect which we are still distant from.

Early election risk in 2019 hanging over the crisis

Finally, hanging over the entire calculus on the direction of the Italian budget crisis is the longevity of this government. Lega's popularity has increased since the election (**Figure 7**) – with about 32.5% of voting intentions (compared with 17.4% in the March election), while Five Star has declined to 26% (from 32.7% in March). Lega's centre-right bloc, with about 45.5% of voting intentions altogether, could form a new majority government were early elections called right now. The likelihood of early elections during 2019 is not insignificant and will depend on: i) the degree of stress placed on the coalition government by markets and the EU, with any forced compromises between the parties inevitably leading to infighting as well as ii) potentially the results in the European elections for the two parties. With the likelihood of a Lega-led government to follow a scenario of such elections, an early election would only mean that the budget crisis and confrontation with Europe could enter a new phase.

Figure 7: Percentage of voting intentions, poll of polls, by party



Source: Various polling companies, Scope Ratings GmbH calculations

Scope noted significant risk to Italy's sovereign ratings

On 8 June 2018, Scope affirmed Italy's sovereign rating of A- but revised the Outlook to Negative. This reflected: i) changes in the Italian political landscape raising questions over the will and capacity of current and <u>future</u> governments to resolve Italy's significant structural challenges; and ii) the current government's programme in the context of pre-existing debt-sustainability concerns.

Still, Scope maintains a higher credit rating for Italy than that from rating agency peers, reflecting acknowledgement of the benefits of euro area membership, Italy's large and diversified economy, the systemic nature of Italy's EUR 2.3trn debt stock, raising the likelihood of multilateral support in severe crisis scenarios, moderate levels of non-financial private debt, and a relatively-long 6.8-year average public debt maturity.

United States outlook subject to significant downside risks

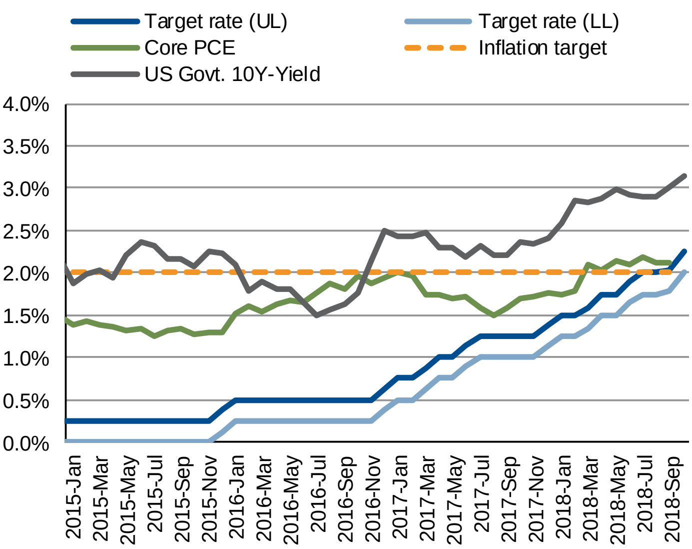
Significant risks to US outlook

It is Scope's opinion that the outlook for the United States (AA/Stable) is subject to significant downside risks, given the combination of the economic cycle peaking, rising interest rates in the context of a pro-cyclical fiscal policy stance and asset price over-valuations, alongside major uncertainties regarding the direction of President Donald J. Trump's shifting trade policy agenda, particularly vis-à-vis China. The mid-term elections have amplified the existing divisions between the political parties, and, taking office in January, this divided and polarised Congress, with Democrats winning the House and Republicans keeping the Senate, is highly unlikely to develop and implement the needed policies to address the underlying structural challenges of the US economy. In addition, a Democrat House and ongoing law enforcement and counter intelligence investigations may increase the unpredictability of the administration's policies.

US economy at the peak of the growth cycle and further rate increases expected in 2019

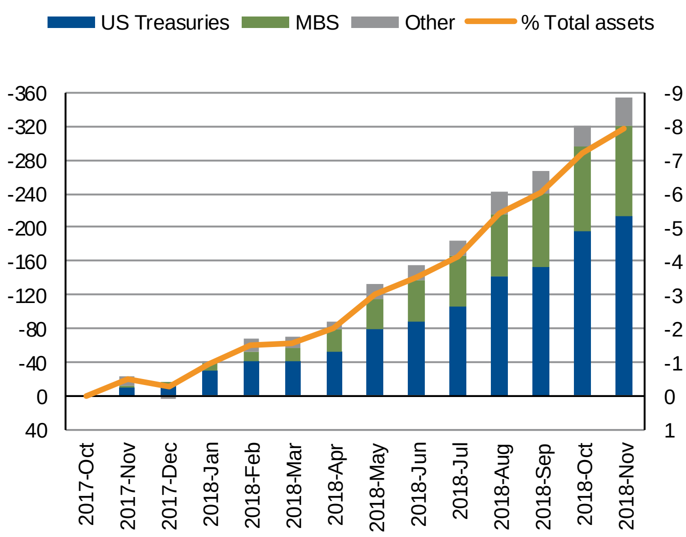
In Scope's opinion, the US economy's growth rate will have peaked in 2018, recording a comparatively high annual rate of just above 3%, markedly beyond the US' potential growth rate of around 2%. Scope expects the US economy to slow down in 2019, as the fiscal impulse fades and policy tightens financial conditions. It is Scope's expectation that the Federal Reserve will continue increasing rates, in December 2018 and again in 2019 raising the federal funds rate a further 50 bps to 2.75%-3.00% by end-2019. In addition, the Fed will also continue its balance sheet normalisation programme, which since its start in October 2017, has led to a USD 354bn (or 8% of total Fed assets) reduction.

Figure 8: Federal funds rate, core inflation, and US 10-yield (%)



Source: Federal Reserve, Bureau of Economic Analysis

Figure 9: Federal Reserve balance sheet, USD bn



Source: Federal Reserve. NB. Axis in reverse order. % Total assets refer to assets held in October 2017 when balance sheet normalisation programme started.

As a result, the 10-year US Treasury yield has steadily increased to a level of about 3% and could rise further in 2019. This matters for fiscal policy as well as asset price valuations:

High and rising fiscal deficits

First, the IMF estimates that the combined effect of the administration's tax and spending policies will cause the federal government deficit to exceed 5% of GDP this year and stay above that level over the coming years. As revenues are projected to be roughly flat over the next few years, averaging 17.5% of GDP, this increase is mainly driven by a significant rise in expenditures, averaging 22.4% over the next decade. As real GDP growth is expected to slow, and policy rates set to rise further, Scope expects the general government debt-to-GDP ratio to increase steadily from about 106% in 2018 to around 120% by 2023, slightly above IMF projections. This is also due to Scope's expectation that if a Democratic House and President Trump can agree on anything, it is likely to be greater expenditure (e.g. on infrastructure), contributing to an already high and rising fiscal deficit (and not including significant pension- and healthcare-related liabilities).

Asset price over-valuations set for revaluation?

Second, compressed yields have been, together with share buybacks and possibly overly optimistic earnings projections, a major driver behind asset price over-valuations, with the cyclically adjusted S&P 500 price-earnings ratio at around 31, almost double its long-term average since 1945 and approaching the all-time high of 44.2 recorded in Q4 1999. Thus, the expected increase in US yields to a level closer to its "natural" rate, estimated at close to nominal GDP of around 5%, will likely induce a revaluation of financial market risks.

'America First' agenda a source of uncertainty

Finally, the US government's 'America First' agenda has become a major source of uncertainty for the global economy. Notwithstanding the still-to-be-ratified new trade agreement between the United States, Mexico and Canada (USMCA) – a deal reached with minor concessions in exchange for President Trump's claim of victory – it is the growing escalation of a "trade war" between the United States and China that poses severe risks to global growth, financial conditions, expectations and confidence.

Will the shift in trade policy be temporary or permanent?

Two specific risks stand out: First, a permanent increase in trade barriers would lower potential growth, adding to inflationary pressures and possibly leading to a faster-than-anticipated interest-rate-hike cycle. Second, even if trade barriers are not permanently raised, the repeated threat from the US administration to revisit existing deals in conjunction with its focus on bilateral deals – with the stated objective of closing bilateral trade deficits despite a fiscal policy that amplifies deficits – could in itself lead to heightened financial market uncertainty, and thus lower investment and real GDP growth. Both risks are likely to unfold and affect the real economy in 2019 and beyond, including in the run-up to the next presidential elections in 2020. As a result, the US outlook for 2019 is one of major question marks and significant downside risks which are captured in Scope's AA rating with a Stable Outlook.

Year of political change in Europe with further deepening of the EMU unlikely in 2019

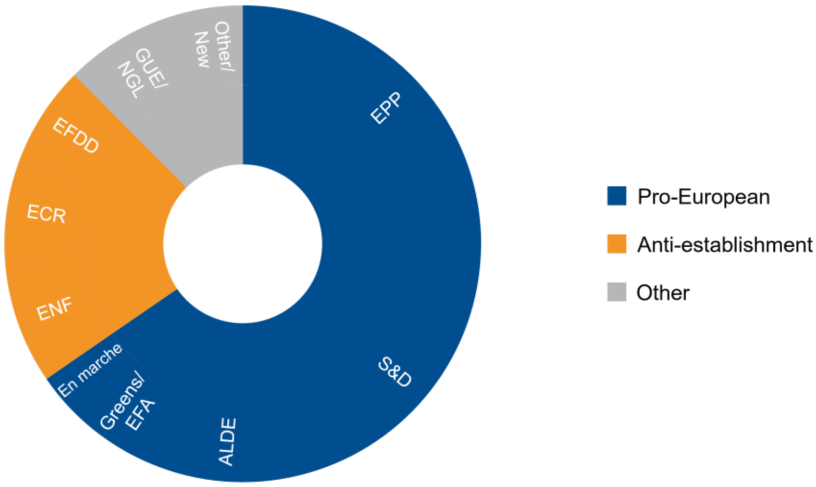
Political and institutional changes with the European elections in 2019

2019 promises to be a year of major political changes in Europe, politically and institutionally. The European Parliament elections next May will show to what extent the surge of anti-establishment and Eurosceptic parties – at the expense of traditional pro-European parties like the centre-right European People's Party and the Party of European Socialists – continues, and indeed to what extent it shapes the European policy making agenda going forward. A key risk is that the observed alienation from traditional parties in Germany, France, Spain and Italy results in a low voter turnout and significant seat losses especially for the European Socialists.

Pro-European parties to keep seat majority after May 2019 elections

While Scope expects the Greens to capture some of those losses, the risk of anti-establishment forces gaining on the European stage is not trivial. Still, despite Eurosceptic parties foreseen gaining more seats, Scope's baseline scenario is for pro-European parties to keep a governing majority. This will matter for the appointments to key European leadership positions in 2019, including the European Council president, ECB president and the European Commission president.

Figure 10: European Parliament elections 2019, seat projections



*EPP-European People's Party group, S&D-Progressive Alliance of Socialists and Democrats, ALDE-Alliance of Liberals and Democrats for Europe group, ENF-Europe of Nations and Freedom, GUE/NGL-European United Left/Nordic Green Left, ECR-European Conservatives and Reformists, EFDD-Europe of Freedom and Direct Democracy, Greens/EFA-Greens/European Free Alliance, New-New Parties, En marche-La République En Marche!, NI-Non-attached members. Source: pollofpolls.eu

Temporary political vacuum at a demanding time in the EU

This rotation is likely to result, at least temporarily, in a political vacuum at the European level, at a time when EU leadership is needed to address the competing needs of securing its borders and agreeing on a common asylum policy, continuing negotiations with the UK, deliberating the EU's next multi-annual budgetary framework, and strengthening the euro area architecture. Scope notes that the discussions surrounding the next EU multi-annual budgetary framework and completion of the Capital Markets Union are heavily intertwined with the Brexit process. Uncertainties relate to the UK's budgetary contribution and possible (if any) compensations from the remaining EU-27 member states as well as the agreed budgetary ceilings and expenditure priorities.

At the same time, Scope is mindful that the Brexit process could be a catalyst for further European capital markets integration. The Capital Markets Union is the EU's initiative to tackle investment shortages and diversify the funding sources for Europe's businesses. Further financial integration and complementary bank-financing with alternative sources, including capital markets, venture capital, crowdfunding and asset management vehicles, would not only widen companies' access to funding but also mitigate the impact of domestic banking crises. However, to increase cross-border investments, specific measures are needed to harmonise corporate, tax, and bankruptcy laws across Europe. Some of these measures could be advanced once policy makers have greater clarity as regards to the Brexit outcome.

Further deepening of EMU unlikely in 2019

In this context, while significant progress on the deepening of the Economic and Monetary Union (EMU) seems unlikely in 2019, Scope notes positively progress made on agreeing to a common backstop for the Single Resolution Fund, in the form of a credit line from the ESM, as well as efforts made for a European strategy for non-performing loans. While a European Deposit Insurance Scheme (EDIS)[6] would reduce the risk of bank runs in any single euro area country, in turn enhancing regional financial stability, the completion of this final building block of the Banking Union is unlikely in 2019.

[6] The Banking Union has led to a single rule-book, the creation of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM).

Member states, not institutions, to drive reforms

Scope notes that to date, major institutional advancements have mostly happened during the heights of a crisis. Indeed, the robust economic recovery accompanied by the ECB's unconventional and highly accommodative monetary policy may have seeded complacency among policy makers in recent years. Still, the increasing fragility of the international multilateral system and greater insecurity in international alliances could provide the necessary impetus for further reform at this juncture, despite strong divisions. In this context, Scope notes that the EU reform agenda will remain primarily driven by member states via intergovernmental agreements as opposed to via initiatives of the European Commission. This reflects the clear power shift away from Brussels to the capitals of member countries during the last crisis, particularly Paris and Berlin.

Symbolic steps towards euro area budget but re-emergence of Franco-German engine gives reason for optimism in 2019

Against this background, Scope acknowledges the preliminary agreement by Germany and France on a common euro area budget and a common European army. Although the details are subject to further discussion, especially on budget size and individual country contributions, and awaiting other EU members' approval, the agreement signals the re-emergence of Franco-German willingness to undertake further steps for deeper integration, even if based on minimum consensus. It is Scope's view that this first symbolic step could lead to more productive negotiations in 2019, including a final agreement on the multiannual framework for 2021-2027.

Unstable German government with France the new European locomotive?

Germany's economic strength obscures structural weaknesses and low growth potential

Germany's AAA ratings are underpinned by its strong economic performance and a highly diversified and competitive economy. Unemployment has fallen to levels not seen since the reunification, despite challenges in integrating recent migrants. At the same time, the ageing of German society is causing a meaningful decline in the working-age population, creating uncertainties around the country's economic growth potential over the medium- to long-term. For 2019, Scope expects a softening in real growth to around 1.6-1.7% year-on-year, in line with forecasts from the OECD and German economic forecasting institutions. Going forward, Germany's potential growth rate will be negatively affected by labour shortages, with Scope estimating the growth potential at around 1.3% – amongst the lowest in the euro area.

Unfavourable demographics, weak investment, declining entrepreneurship, and limited progress on the digital transformation restrict the country's productive capacity, which is unlikely to be advanced significantly without major supply-side reforms. Together with rising unfunded pension liabilities, this may impact the long-run sustainability of public finances. To help mitigate this, further adjustments to the social security and pension systems are needed. Even so, Scope believes the government will face challenges in addressing these issues, including achieving the needed consensus on reforms with an ageing electorate.

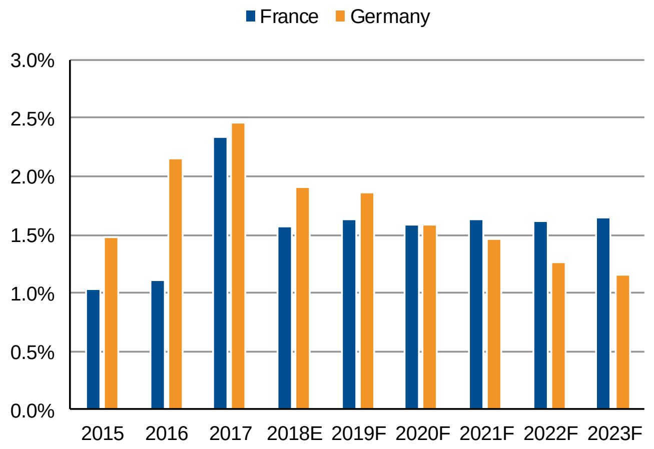
Political instability in Germany next year

The recent policy actions of the German government reflect its difficulties passing structural reforms due to the coalition parties seeing fading voter support. The coalition parties have lost vote shares in regional elections in Bavaria and Hesse, followed by Chancellor Angela Merkel's announcement that she's stepping down as leader of the Christian Democrats (CDU) after 18 years. Scope expects the current coalition government to remain unstable as European parliamentary elections approach in May 2019. While a split of the current coalition could trigger early elections, this is unlikely for now as the governing parties would risk losing seats in the Bundestag.

Ongoing structural reforms to strengthen French growth potential

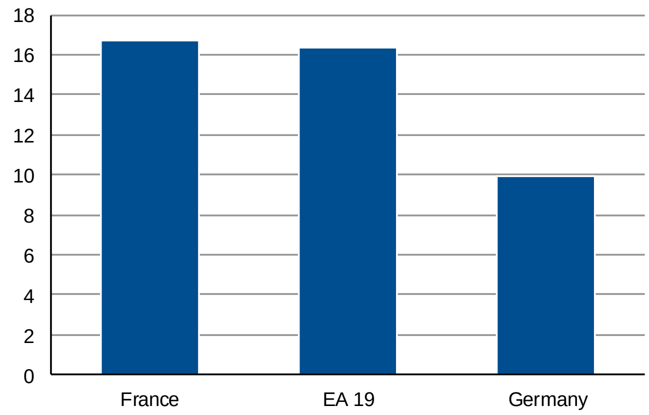
By contrast, France (AA/Stable) has implemented broad-based structural reforms at only a modest near-term cost to public finances. The immediate economic impact is limited; however, the reforms hold the promise over the medium-term of reducing government debt ratios as unemployment falls in line with the economy's higher growth potential. France may become the fastest growing major economy in Europe over the medium-run, ahead of Germany, the UK and Italy, according to the latest IMF forecasts.

Figure 11: Real growth forecast, % change YoY



Source: IMF, World Economic Outlook, October 2018

Figure 12: Low-skilled employment in 2017, as a % of low-skilled persons (20-64 yrs)



Source: Eurostat, 2018

Significant labour market reforms envisaged in France

A comparison of the French and German labour markets shows that the percentage of low-skilled persons who are employed is considerably higher in Germany than in France. France's reform programme (PNR) published in April 2018 seeks to combine the merits of higher employment without creating a large low-wage sector like in Germany. In addition to enacted tax reforms, which are supposed to lower the burden of employees and firms, the government has announced a set of measures to facilitate higher profit sharing by employees alongside their involvement in decision-making processes ("liberation"). The government also seeks to regulate the use of very short-term contracts ("protection").

The unemployment insurance reform entails a universal extension of unemployment insurance duration and a broadening of eligibility for resigned workers and the self-employed ("rights"). At the same time, unemployed workers will be monitored more closely in their job-search efforts ("obligation"). In order to soften the immediate impact of enacted reforms, the government has delayed budget consolidation plans for 2019, with government debt remaining close to 100% of GDP (compared with 98.5% at year-end 2017). Yet, the decision to further postpone fiscal consolidation to preserve growth momentum is a response to the government's rapid loss of public support.

Key elections to provide clarity on the outlook for the euro area periphery

Key elections in Greece, Portugal and Spain

Aside from Italy, Greece (B+/Positive), Spain (A-/Stable) and Portugal (BBB/Stable) all face elections in 2019 which may affect their respective credit outlooks to varying degrees. For these three sovereigns, continued fiscal consolidation and the implementation of reforms to enhance growth potential are key credit-relevant themes. Conversely, Ireland's (A+/Stable) local elections are not expected to be credit relevant; however, the country's susceptibility to external shocks may be tested in 2019.

Lifting of capital controls, market access and fiscal consolidation key factors for Greece's rating

Following Greece's (B+/Positive) successful exit from the ESM programme in August 2018, 2019 will provide some clarity as regards the key questions for Greece's long-term credit outlook. Specifically, Scope expects the full lifting of capital controls (which could support a 1-notch rating uplift to BB-) and will monitor closely the country's capital market access, with a sustained fall in bond yields and successful placement of debt also possible supportive factors for rating upside. These factors are even more critical after the loss of eligibility of Greek government securities as collateral for ECB monetary policy operations. The period before and after elections to be held no later than 20 October 2019 will provide additional guidance as regards the Greek authorities' emphasis on continued fiscal consolidation in the context of cooperation with Greece's European partners – including vis-à-vis the post-bailout enhanced surveillance framework.

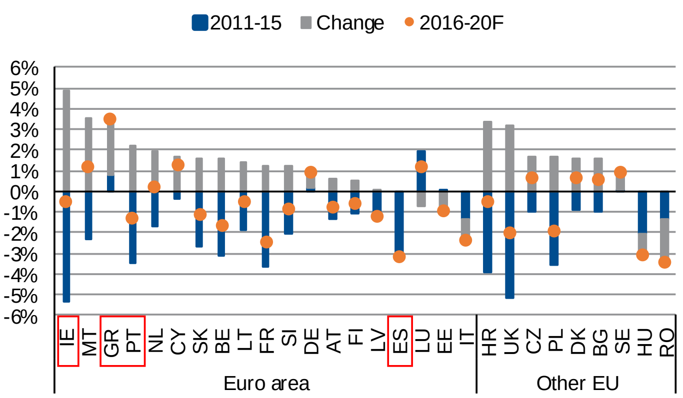
Spain's regional and local elections could serve as a catalyst for snap general elections ending successive minority governments

Spain (A-/Stable) will hold regional and local elections on 26 May 2019 to elect 13 governments in the autonomous communities, all councillors in the municipalities of Spain and all seats in 38 provincial deputations. Given greater political fragmentation since the last general elections in 2016, with the landscape now dominated by four political parties as opposed to the previous two, with the arrival of the left-wing, anti-austerity Podemos and the centrist Ciudadanos, the regional and local election outcome may also lead the current minority government of Prime Minister Pedro Sánchez to call snap elections, ahead of scheduled general elections to be held no later than 26 July 2020. In Scope's view, a government with a stable majority is needed to implement reforms to increase Spain's growth potential and adopt structural fiscal adjustments. Scope notes that Spain's debt-to-GDP ratio has only fallen modestly in recent years despite real growth rates markedly above potential. Absent further fiscal consolidation and pro-growth reform, Spain's ratings will remain constrained at the A-/Stable level.

Will Portugal's sustained debt reduction continue after general elections in 2019?

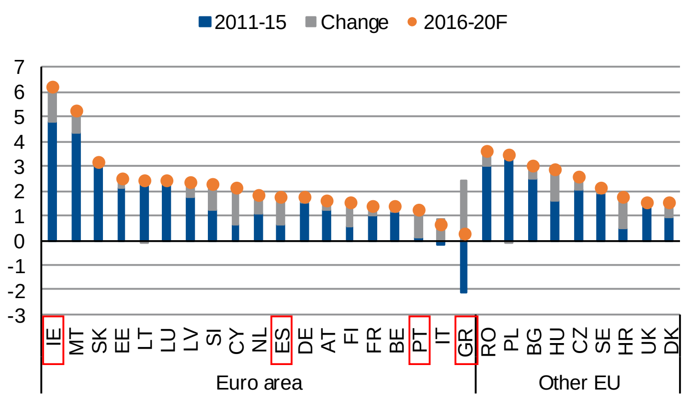
Similarly, the key question in Portugal (BBB/Stable), which faces a legislative election to be held no later than October 2019, is whether the next government will continue implementing policies that raise the country's growth potential whilst reducing the still-too-high public debt level of 124.9% of GDP as of Q2 2018. Scope notes positively that, on the basis of Portugal's high debt level, an assumed narrowing of fiscal deficits going forward, and more moderate growth rates, its baseline scenario is for the debt-to-GDP ratio to fall to around 105% by 2023, a 26pp reduction from its peak of 131% in 2014. Gradual debt reduction as well as a higher potential growth rate could provide the grounds for a rating uplift as stated in Scope's latest rating report.

Figure 13: Structural balance, % of GDP



Source: Haver, AMECO. NB. Chart in order of largest average structural adjustment comparing 2016-2020F to 2011-2015 periods.

Figure 14: Potential GDP growth, %



Source: Haver, AMECO

Ireland's susceptibility to international shocks may be tested in 2019

Finally, Ireland's A+/Stable ratings acknowledge the country's robust growth potential, improving public finances and declining public-debt ratios, long maturity of public debt, Ireland's elevated current account surplus alongside private-sector debt reductions and the mending of financial system weaknesses. Still, as a small, open economy, Scope notes the country's susceptibilities to both domestic and international shocks given the meaningful leverage within the financial system and non-financial private sector. Ireland's resilience to shocks could be tested in 2019 given an uncertain global trade environment, Brexit, alongside the continued normalisation of global monetary policies.

CEE: Russia's sanction risks, Poland and Hungary stand-offs with the EU, and Bulgaria/Romania rating divergence

Russia faces sanctions risks; tight labour markets in the Baltics

Favourable near-term growth outlook in Russia

Russia's rating (BBB-/Stable Outlook) is supported by a recovering economy and strong macroeconomic policy framework put in place over the past few years, strengthening the country's robustness to weather external shocks. Scope expects fiscal and monetary policy to remain tight in 2019. Fiscal policy is focused on rebuilding fiscal buffers. At the same time, monetary policy is anchored by the 4% inflation target. GDP growth is projected at 1.8% in 2019, following 1.7% in 2018.

Five key risks in 2019

Scope sees the following key risks for Russia in 2019: i) intensification of sanctions on Russia, ii) impacts from the development of the trade war between China and the US and other protectionist measures in world trade, iii) pronounced oil price volatility, iv) weakening credit supply in a stressed scenario, reflecting the weak competitive position of state banks in the Russian banking industry, and v) escalation of geopolitical risks, including as it relates to ongoing strife with Ukraine.

Sanctions weigh on access to external funding

The risk of new sanctions, as indicated by recently proposed legislation in the United States including sanctions related to Russian sovereign debt issuances, may put capital flows under renewed pressure in 2019 and trigger non-resident outflows from government debt. However, positively, Scope notes that the latest sanctions were absorbed relatively quickly. After the imposition of sanctions in April 2018, the share of non-residents holding Russian government bonds fell from around 35% to 30% in the period from April to June, below the change recorded in the second half of 2014, when the share fell from 26% to 19%. Following a period of weakness in 2014-15, capital flows recovered and have become net sources of external borrowing since last year. If sanctions on Russia were to intensify, Scope does not expect Russia's reduced international market access to have material domestic repercussions in the short term.

The domestic economy will be supported by some ongoing reform progress as illustrated, for example, by i) the recent gradual increase in the country's retirement age to 60 from 55 years for women and to 65 from 60 for men, ii) counter-sanctions supporting domestic production, iii) sizable fiscal reserves, and iv) Scope's projections that Russia will run a significant fiscal surplus in 2019. A 'reopening of international capital market access for the private sector' could result in a positive rating action, as noted in Scope's last rating action on Russia. Conversely, an escalation of geopolitical risks diminishing effective policy making would weigh on the ratings in 2019.

Sound public finances for the Baltic states, but labour-market constraints curb potential growth

For the Baltic states, the economies are growing above potential, as reflected in increasing labour-market capacity constraints. Wages have started to rise faster than productivity in Latvia, as is also the case in Lithuania and Estonia. As European Structural and Investment Funds diminish, pressures increase on the three small, open economies to improve growth, which stood at an average 3.1% for Estonia, 3.4% for Latvia and 2.9% for Lithuania during the period 2015-18, via greater emphasis on R&D and innovation. Scope expects an ongoing broad consensus on key issues including EU and NATO integration, commitment to a favourable business environment and policies to address tight labour markets. Estonia (A+/Stable), Latvia and Lithuania (both A-/Stable) have sound public finances, marked by low and declining debt ratios, commitment to fiscal consolidation, and favourable debt structures.

Poland and Hungary outlooks amid stand-offs with the EU

Risk of lower inflows from future EU budget, but low risk of sanctions

For Poland (A+/Stable) and Hungary (BBB/Positive), Scope sees the potential risk of lower inflows from the EU budget, which may be reduced in the post-2020 fiscal plan if the EU decides to make some funds conditional on a member state's respect for democratic values. Scope would consider lower-than-expected EU fund absorption and any reversal in FDI inflows to be negative rating drivers. However, in terms of Article 7 disciplinary procedures, sanctions via this channel are unlikely. Sanctions on Poland or Hungary would require the unanimous decision of the European Council, in which Poland, Hungary and Romania have repeatedly assured that were such a Council vote to occur, they would veto it. Instead, the European Commission's successful referral in the case of the Polish Supreme Court judges to the European Court of Justice, with the ECJ ruling against Poland forcing the government to soften its stance, and pursuit of changes in the EU's multi-annual financial framework, offer a roadmap of a strategy going forward.

Poland and Hungary to navigate rule of law disputes without significant economic impact

Scope also notes that the conflict with the EU has been supporting the Polish PiS-government in securing votes ahead of parliamentary elections to be held no later than in November 2019. Scope expects Poland and Hungary to navigate the current diplomatic disagreements without material impact on their economies or debt sustainability outlooks. For instance, Scope expects Poland to grow by 4% in 2019, following 5.2% in 2018. Still, to secure future investment, both governments need to maintain a stable, predictable policy and regulatory environment – a key to their recent economic success.

Bulgaria and Romania moving on opposite rating trajectories entering 2019

Risk to Bulgaria's ratings on the upside with ERM II and Banking Union on the horizon

Bulgaria has approved an Action Plan of reforms in August 2018 for entry into ERM II, and targets ERM II and Banking Union entry by July 2019 after a green light from the Eurogroup was given in July 2018 for a series of procedural steps. At the same time, Bulgaria sent a request in July 2018 to enter into close cooperation with the ECB – including support to the ECB's comprehensive assessment, in order to enhance banking supervision and build a more resilient financial sector. Scope revised the Outlook on Bulgaria's BBB rating to Positive on 27 April 2018, and is monitoring closely fundamental developments as well as those related to ERM II for potential rating upside.

Romania downgraded to BBB- with a Negative Outlook, risks non-investment-grade status

Meanwhile, on 19 October 2018, Scope downgraded Romania's credit rating to BBB-, one level above non-investment-grade, from BBB, and maintained a Negative Outlook. Scope's downgrade was based on i) continued deterioration of fiscal performance with pro-cyclical budgets at the peak of the economic cycle and ii) a weak debt trajectory with the public debt ratio projected to return to its 2014 peak of 40% of GDP by 2020.

Turkey's and broader EM weaknesses unresolved entering 2019

Scope downgraded Turkey to BB- in August 2018

On 16 August, Scope downgraded the Republic of Turkey's sovereign rating to BB- from BB+ and assigned a Negative Outlook. The downgrade of Turkey reflected three drivers: i) deterioration in economic policy predictability and credibility, in view of monetary, fiscal and structural economic policies inconsistent with the rebalancing of the economy, ii) accentuated macroeconomic imbalances, and iii) the impact of balance of payment weaknesses on modest levels of international reserves.

Rates raised in September; however, this did not mark a change from unorthodox policy

Since Scope's decision in August, inflation has continued to rise owing to past deterioration of the lira, to 25.3% YoY in October (five times the central bank's 5% inflation target), from 10.2% as of March. In response to rising inflation, the Turkish central bank raised rates more-than-anticipated to 24% in September from 17.75%. However, this action did not mark a structural change from *reactive* rather than *proactive* monetary policy, in Scope's view. Instead, an easing bias remains in place with President Recep Tayyip Erdoğan having repeatedly stated a preference for lower interest rates, with central bank governance changes since June 2018 elections reducing monetary independence.

Lira sentiment has improved; however, depreciation forces could easily rearise in 2019

Lira sentiment has improved after September's significant rate hike, as the currency now stands at 5.2 to the US dollar, appreciating some 33% from August lows, though still 26% weaker compared with year-end 2017. Still, given the weakening in Turkey's institutional and policy making environment, the lack of correction in *structural* imbalances even though there has been reversal of *cyclical* imbalances, the chance for further monetary and fiscal policy mistakes next year, and the fact that global financial conditions are likely to continue tightening as Federal Reserve rate hikes resume, Scope considers recent lira strength to be susceptible to reversal at stages next year.

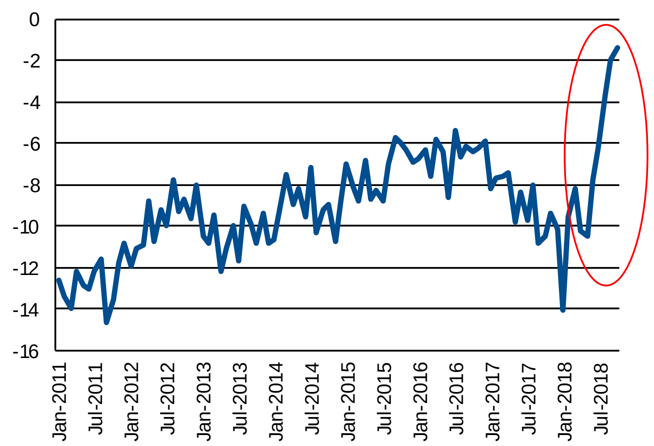
Signs of a slowing Turkish economy…

There are multiple signs that growth is slowing sharply, including weaker industrial production and retail sales, and higher unemployment (the rate rose to 11.2% from 9.9% earlier in the year) and non-performing loans (3.2% of total loans in September, from 2.85% in August). In 2019, a key question will be the extent of private sector bankruptcies owing to the currency crisis and slowing economy.

… with competing developments on the external side.

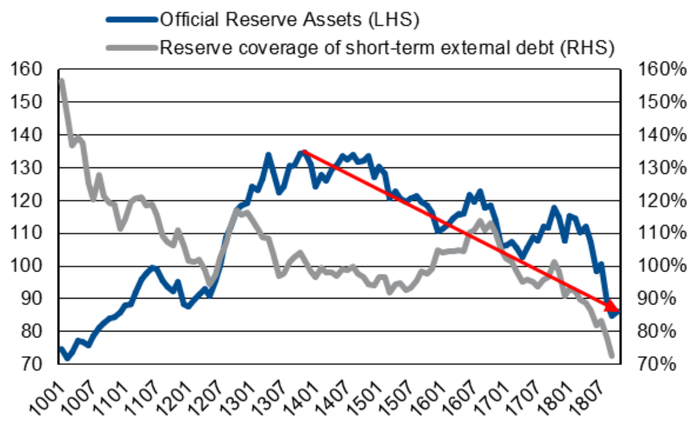
This year's FX depreciation and slowing economy have contributed to a significant improvement in Turkey's trade balance (**Figure 15**). But the correction mostly owes to import contraction and could reverse once the Turkish economy stabilises next year. However, official reserves are down to USD 86bn in October 2018 from a 2013 peak of USD 135bn (**Figure 16**). Weakened reserve buffers mean that Turkey is now less resilient should capital outflow pressures escalate in 2019.

Figure 15: Turkey monthly trade balance, seasonally-adjusted, % of GDP



Source: Turkish Statistical Institute, Scope Ratings GmbH calculations

Figure 16: Official reserve assets and coverage of short-term external debt, Turkey



Source: Central Bank of the Republic of Turkey, Scope Ratings GmbH calculations

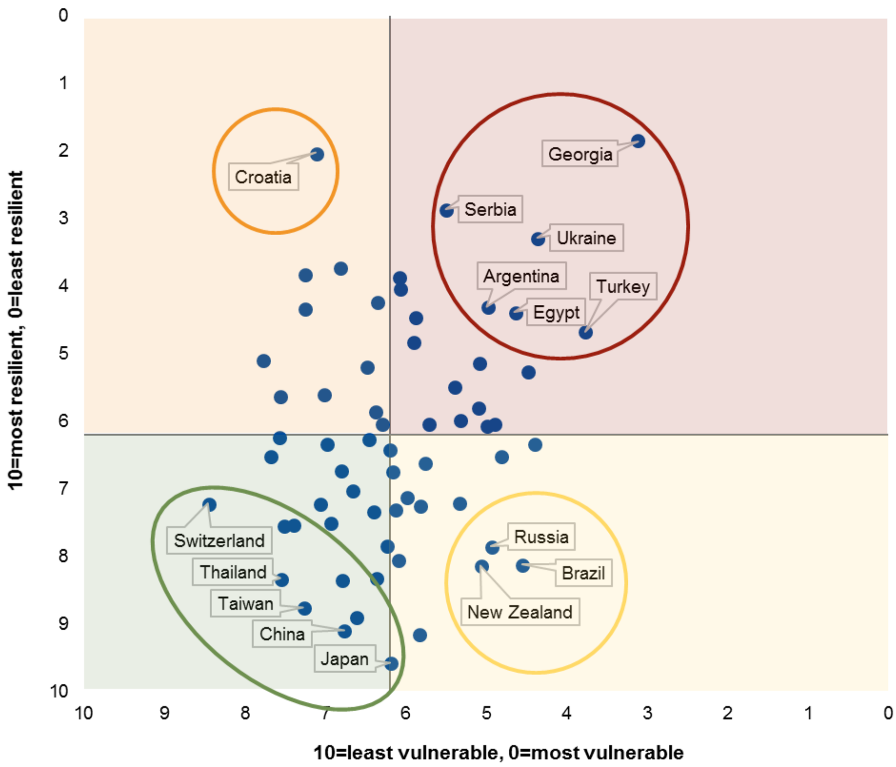
Turkey's rating an area of focus next year

Going forward, should credible fiscal, monetary and economic policies be implemented, the country's external vulnerabilities be reduced, including its reliance on volatile capital inflows, and/or the deterioration in Turkey's governance framework be reversed, Scope could stabilise Turkey's rating Outlook in 2019. Otherwise, should the policy and macroeconomic environment deteriorate further, Scope could downgrade Turkey's rating further into non-investment-grade. With local government elections scheduled for March 2019, it's hard to foresee a reversal of expansionary fiscal policy in the coming period – which bolsters the economy against downside risks but worsens fiscal strengths.

Lingering EM external vulnerabilities

Beyond Turkey, Scope notes that monetary normalisation and a sharp tightening in global financial conditions have exposed vulnerabilities of emerging countries with a high dependence on global capital inflows, large stocks of external debt and prevailing balance of payment weaknesses. Even though emerging market stresses have somewhat eased at the time of this writing, the underlying vulnerabilities remain entering 2019. In a forthcoming report, Scope will publish its external vulnerability and resilience matrix observing Georgia (BB/Stable), Ukraine and Turkey as the three countries most at risk while Switzerland, Japan and China are the most well positioned economies against external sector risks.

Figure 17: External vulnerability and resilience matrix, 2018 scores



Source: Scope Ratings GmbH

China's slowing economy and debt risks are concerns for the global economy in 2019

Scope revised the Outlook on China's rating to Negative

On 21 September 2018, Scope revised the Outlook on China's A+ sovereign rating to Negative from Stable. This represented a non-consensus decision, with peer credit rating agencies maintaining Stable outlooks to now. The Outlook revision reflected two drivers: i) significant public-sector deficits despite recent consolidation initiatives as well as a growing public-sector debt stock, and ii) high levels of total non-financial sector debt, after increases since 2008, with ongoing economic slowdown pressures, including those related to trade conflicts with the United States, pressuring targeted policy easing, which exacerbate pre-existing macroeconomic imbalances.

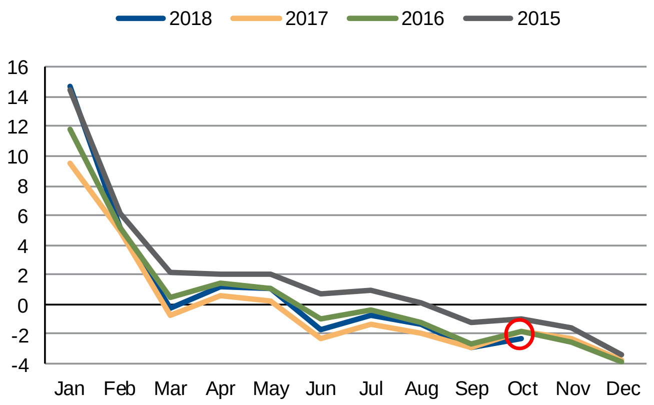
Next year, Scope's assessment on China will hinge on the interplay between conflicting forces on policy makers to: i) maintain, if not accelerate, significant economic reforms to redress macro-financial imbalances and those concurrently to ii) ease policy and delay reforms so as to counteract a slowing economy. The resolution of this underlying tension is fundamental to China's public- and private-sector debt trajectories going forward.

China's debt levels remain a key global risk

Scope expects China's general government deficit in 2018 to again exceed 3% of GDP (before stabilisation fund transfers). Selective easing to address the ongoing slowdown has meant that year-to-date deficit figures are underperforming prior year figures through October. In addition, Bank for International Settlements data showed the first meaningful quarterly increase in non-financial sector economy-wide debt to 261% of GDP in Q1 2018, after it had plateaued at around the 256% of GDP level of Q4 2017 since the end of 2016 (helped in the latter case by significant supervisory and regulatory actions). As

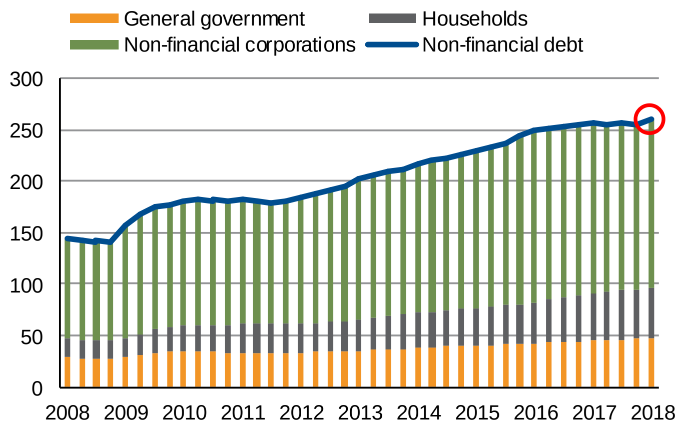
China rolls out easing, the renewed increase in the non-financial debt ratio, already near double the 141% of GDP as of Q4 2008, spells risks for the domestic and global economies. In the latest Article IV, the IMF estimated total non-financial sector debt (which under its definition stood at 253% of GDP at end-2017) to rise to 290% of GDP by 2023.[7] However, non-performing loans remain low at 1.9% of total loans in Q3 2018.

Figure 18: China, year-to-date general government balance ex-stabilisation transfers, % of GDP



Source: China Ministry of Finance, Scope Ratings GmbH calculations

Figure 19: Credit to the non-financial sector, by sub-sector, % of GDP



Source: Bank for International Settlements

Trade disputes are a risk

Risks to China's policy setting have increased owing to the escalation of trade conflicts with the United States and implications for China's growth and external sector dynamics. This September, the US administration implemented 10% tariffs on a sizeable USD 200bn in Chinese goods, with this tariff rate possibly stepping up to 25% starting 1 January 2019 with the US administration moreover threatening tariffs on the remaining USD 257bn of Chinese goods exports to the US (assuming 2017 import figures). Escalating tariffs and investment restrictions could disrupt supply chains and accentuate market stresses. In this context, Scope notes that China's continued growth slowdown to 6.2% in 2019 from 6.6% in 2018 presents challenges to European and global growth and informs its view of a global slowdown next year, as China's economy accounted for 15% of the global economy and 27% of global growth in 2017.

Current account moving into balance marks a significant change in the global economy

China's current account is an area to watch, having declined in line with the rebalancing in the economy and edged into a small deficit of 0.2% of GDP seasonally-adjusted in the first three quarters of 2018 – after a peak surplus of 9.9% of GDP in 2007. While reductions in China's current account support global rebalancing and reduce global risks, a balanced position represents a major change in the global economy as China posted the world's largest current account *surplus* in nominal terms as recently as in 2015.

[7] International Monetary Fund. (2018) 'People's Republic of China: 2018 Article IV Consultation-Press Release; Staff Report; Staff Statement and Statement by the Executive Director for the People's Republic of China'. 26 July 2018, Country Report No. 18/240.

Annex I: Scope's 2018 rating actions

Scope's sovereign coverage includes all European Union countries as well as major countries outside Europe, including China, Japan, Russia, Turkey and the US. The European sovereigns carrying a Scope rating represent around 100% of total EU sovereign issuance. The aggregate amount of all sovereigns' long-term and short-term debt rated by Scope now exceeds EUR 34trn. In 2018, Scope affirmed 22 ratings with a Stable Outlook, upgraded Greece by 2-notches to B+/Positive and Croatia by 1-notch to BB+/Stable, changed the Outlook to Positive on Hungary (BBB) and Bulgaria (BBB), downgraded Turkey to BB-/Negative and Romania to BBB-/Negative, and changed the Outlook to Negative on Italy (A-) and China (A+). Finally, Scope issued first-time credit ratings for Cyprus (BBB-/Stable), Luxembourg (AAA/Stable) and Malta (A+/Stable).

Date	Sovereign	Rating Action	Rating & Outlook
26-Jan	Czech Republic	Affirmed	AA/Stable
16-Feb	Denmark	Affirmed	AAA/Stable
	Finland	Affirmed	AA+/Stable
	Norway	Affirmed	AAA/Stable
	Kingdom of Sweden	Affirmed	AAA/Stable
23-Feb	Slovakia	Affirmed	A+/Stable
	Hungary	Outlook change	BBB/Positive
16-Mar	Japan	Affirmed	A+/Stable
27-Apr	Bulgaria	Outlook change	BBB/Positive
	Latvia	Affirmed	A-/Stable
18-May	Belgium	Affirmed	AA/Stable
	Spain	Affirmed	A-/Stable
	Greece	Upgrade/Outlook change	B+/Positive
08-Jun	Italy	Outlook change	A-/Negative
	Portugal	Affirmed	BBB/Stable
	Georgia	Affirmed	BB/Stable
20-Jul	Ireland	Affirmation	A+/Stable
	Poland	Affirmation	A+/Stable
26-Jul	Turkey	Under Review Negative	BB+/CW Negative
27-Jul	Croatia	Upgrade	BB+/Stable
10-Aug	United Kingdom	Affirmation	AA/Negative
16-Aug	Turkey	Downgrade/Outlook change	BB-/Negative
17-Aug	Slovenia	Affirmation	A-/Stable
21-Sep	United States of America	Affirmation	AA/Stable
	China	Outlook change	A+/Negative
19-Oct	Cyprus	First-time Rating	BBB-/Stable
	Luxembourg	First-time Rating	AAA/Stable
	Romania	Downgrade	BBB-/Negative
02-Nov	Germany	Affirmation	AAA/Stable
09-Nov	Malta	First-time Rating	A+/Stable

Annex II: Scope's sovereign ratings as of 29 November 2018

Europe						Other Countries	
European Union				European Free Trade Association			
Euro area		*Non-euro area*					
Austria	AAA/Stable	Bulgaria	BBB/Positive	Norway	AAA/Stable	China	A+/Negative
Belgium	AA/Stable	Croatia	BB+/Stable	Switzerland	AAA/Stable	Georgia	BB/Stable
Cyprus	BBB-/Stable	Czech Republic	AA/Stable			Japan	A+/Stable
Estonia	A+/Stable	Denmark	AAA/Stable			Russia	BBB-/Stable
Finland	AA+/Stable	Hungary	BBB/Positive			Turkey	BB-/Negative
France	AA/Stable	Poland	A+/Stable			United States	AA/Stable
Germany	AAA/Stable	Romania	BBB-/Negative				
Greece	B+/Positive	Sweden	AAA/Stable				
Ireland	A+/Stable	UK	AA/Negative				
Italy	A-/Negative						
Latvia	A-/Stable						
Lithuania	A-/Stable						
Luxembourg	AAA/Stable						
Malta	A+/Stable						
Netherlands	AAA/Stable						
Portugal	BBB/Stable						
Slovakia	A+/Stable						
Slovenia	A-/Stable						
Spain	A-/Stable						

Annex III: Macro-economic Outlook 2019

In 2019, Scope expects slower global economic growth of 3.0-3.5%, after 3.7% in 2018 as growing risks crystallise. While the euro area economy has maintained robust growth in 2018 of around 1.9%, Scope expects weaker euro area annual growth of 1.5% in 2019, with base effects dragging this figure down. The slowdown in 2018 compared with a euro area growth rate of 2.5% in 2017 combined with Scope's 2019 outlook lead Scope to judge that 2017 was the peak year for regional growth this cycle, and that the expansion cycle is now in a mid-to-late phase with significant risks to its longevity looking ahead.

In Scope's opinion, the US economy's growth rate will have peaked in 2018, recording a comparatively high annual rate of just above 3%, markedly beyond the US' potential growth rate of around 2%. Scope expects the US economy to slow down in 2019, as the fiscal impulse fades and policy tightens financial conditions. China is seen slowing to 6.2% in 2019, from 6.6% in 2018, presenting additional challenges to European and global growth. The slowdown in China reflects ongoing efforts to reduce financial excesses and mitigate debt risks, gradual declines in China's potential rate of growth alongside uncertainties precipitated by trade disputes with the United States and associated domestic financial market stresses. Turkey's economy has slowed sharply entering 2019, owing to the crisis this year.

Despite stronger growth in domestic demand, core inflation has remained below target in many advanced economies, informing Scope's ongoing expectation for just gradual monetary policy tightening. The Federal Reserve will continue increasing rates, in December 2018 and again in 2019 raising the federal funds rate a further 50 bps to 2.75%-3.00% by end-2019 (the latter is under the Federal Reserve's median expectation of 75 bps). While the ECB will end net asset purchases next month, interest rates in the euro area remain very low, and an ECB interest rate hike in Q3 2019 is not a given should risks to growth amplify.

Fiscal consolidation efforts in the euro area are expected to continue notwithstanding an overall expansionary fiscal position in 2019 and, together with continued growth, debt-to-GDP ratios are expected to gradually fall for most European sovereigns. However, the IMF estimates the US federal government deficit at above 5% of GDP this year and to stay above that level over the coming years. Scope expects the US' general government debt-to-GDP ratio to increase steadily from about 106% of GDP in 2018 to around 120% by 2023, slightly above IMF projections. Meanwhile, Scope expects China's general government deficit in 2018 to again exceed 3% of GDP (before stabilisation fund transfers), with government debt levels gradually rising.

Macro-economic overview 2019-21 (IMF and European Commission forecasts):

Region	Real GDP growth (%)		Inflation (%)		Fiscal balances (% GDP)		Debt level (% of GDP)		Current account (% of GDP)	
	2016-18E	2019-21F	Target	2019F	2016-18E	2019-21F	2018E	2021F	2016-18E	2019-21F
Euro area	2.1	1.7	2.0	1.8	-1.0	-0.6	84.4	77.9	3.4	2.9
Germany	2.2	1.6	2.0	1.9	1.1	1.2	59.8	49.7	8.2	7.7
France	1.7	1.6	2.0	1.7	-2.9	-2.5	96.7	94.9	-0.7	-0.5
Italy	1.2	0.9	2.0	1.5	-2.2	-1.9	130.3	126.7	2.4	1.4
Spain	2.9	1.9	2.0	1.7	-3.4	-2.4	97.2	93.8	1.7	1.3
Netherlands	2.6	2.3	2.0	2.5	0.7	0.9	53.1	44.7	9.5	9.3
United Kingdom	1.6	1.5	2.0	2.0	-2.2	-1.5	87.4	85.9	-4.2	-3.1
Russia	1.0	1.7	4.0	5.1	-1.2	1.3	15.3	16.6	3.4	4.5
Turkey	4.7	1.7	5.0	15.4	-2.9	-5.6	32.3	36.1	-5.0	-1.8
United States	2.2	2.0	2.0	2.4	-4.1	-4.9	106.1	112.4	-2.4	-3.2
China	6.7	6.1	3.0	2.4	-3.9	-4.3	50.1	60.1	1.3	0.6
Japan	1.3	0.6	2.0	1.0	-3.9	-2.3	238.2	235.6	3.9	4.0
World	3.6	3.7	-	-	-	-	82.1	82.5	-	-

Source: IMF, ECB, EC, BoE, CBR, CBRT, FRB, BOJ.

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