

# Q2 2019 Sovereign Update: Easier monetary policy amidst economic slowdown and political uncertainties

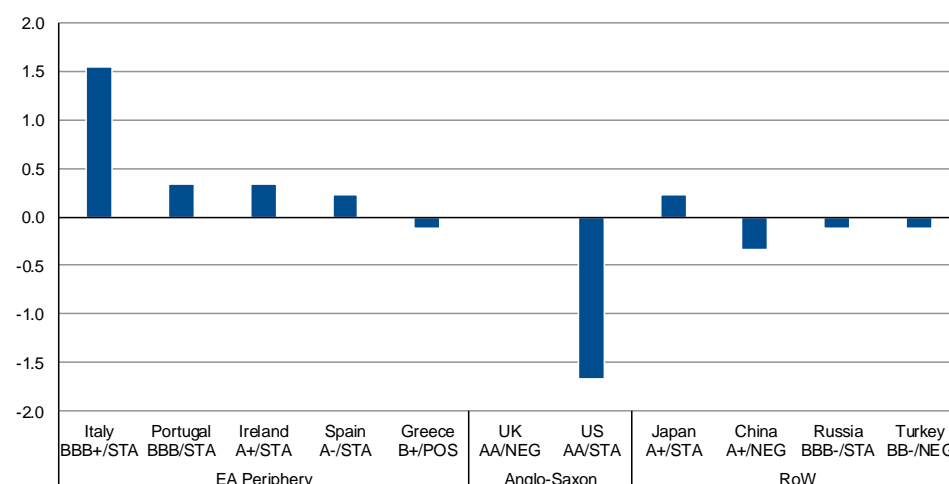
Scope  
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In line with its **2019 Outlook**, entering Q2, Scope's economic outlook for this year remains one for slower euro area and global growth, higher financial market volatility and exceptional policy unpredictability. This combination of factors has induced a pause in the rate hike cycle of the Federal Reserve and brought additional liquidity provision by the ECB. For this quarter, Scope highlights an expected stabilisation in the global slowdown supported by a dovish shift in central bank policies, an extension of Article 50 in Brexit talks and prolonging of UK economic uncertainty, and an upcoming season of elections inside the EU.

Figure 1: Scope's global long-term sovereign ratings, as of 4 April 2019

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

Figure 2: Scope ratings vs US agencies', as of 4 April 2019 (rating notches)



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 +/-0.33 adjustment. Credit Watch positive/negative with a +/-0.67 adjustment.

Figure 3: Scope's sovereign rating actions since the last quarterly update

Date	Sovereign	Rating Action	Rating & Outlook
19-Oct	Romania	Downgrade	BBB-/Negative
	Luxembourg	First-time credit assignment	AAA/Stable
	Cyprus	First-time credit assignment	BBB-/Stable
02-Nov	Germany	Affirmation	AAA/Stable
09-Nov	Malta	First-time credit assignment	A+/Stable
07-Dec	Italy	Downgrade/Outlook change	BBB+/Stable
08-Feb	Norway	Affirmation	AAA/Stable
22-Feb	Bulgaria	Upgrade/Outlook change	BBB+/Stable
08-Mar	Austria	Affirmation	AAA/Stable

## Team leader

Dr Giacomo Barisone  
+49 69 6677389 22  
[g.barisone@scoperatings.com](mailto:g.barisone@scoperatings.com)

## Analysts

Alvise Lennkh, CFA  
+49 69 6677389 85  
[a.lennkh@scoperatings.com](mailto:a.lennkh@scoperatings.com)

Dennis Shen  
+49 69 6677389 68  
[d.shen@scoperatings.com](mailto:d.shen@scoperatings.com)

Jakob Suwalski  
+49 69 6677389 45  
[j.suwalski@scoperatings.com](mailto:j.suwalski@scoperatings.com)

Dr Bernhard Bartels  
+49 69 6677389 19  
[b.bartels@scoperatings.com](mailto:b.bartels@scoperatings.com)

Levon Kameryan  
+49 69 6677389 21  
[l.kameryan@scoperatings.com](mailto:l.kameryan@scoperatings.com)

Giulia Branz  
+49 69 6677389 43  
[g.branz@scoperatings.com](mailto:g.branz@scoperatings.com)

Thibault Vasse  
+49 69 6677389 57  
[t.vasse@scoperatings.com](mailto:t.vasse@scoperatings.com)

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## Scope Ratings GmbH

Lennéstraße 5  
10785 Berlin

Phone +49 30 27891 0  
Fax +49 30 27891 100

[info@scoperatings.com](mailto:info@scoperatings.com)  
[www.scoperatings.com](http://www.scoperatings.com)

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### Several major themes as we enter Q2 with uncertainty clouding the economy and politics...

#### ➤ Global slowdown to ease, but central banks' shift to more dovish policy sustainable into 2020

The global slowdown poses significant challenges. Scope's 2019 global growth forecast is at 3.0%-3.5%, below the 3.6% growth of 2018, and just 1% for the euro area compared to 1.8% last year. Still, the global and regional slowdown could ease in the period ahead helped by a pause in monetary policy tightening, a détente in US-China trade conflicts and fiscal stimulus in Europe and China.

Economic softness and tepid inflation have prompted the Federal Reserve and the ECB to alter tightening plans. The Fed paused – earlier than anticipated – its interest-rate hike cycle at the current 2.25%–2.50% level and intends to pause its balance sheet normalisation from October on. Scope does not expect another Fed hike in 2019 and in fact foresees a rate cut in 2020. Similarly, the ECB cemented its accommodative policy stance by: i) confirming that interest rates will remain at their present levels at least through the end of 2019; ii) assuring that reinvestments of the principal of maturing securities under its asset purchase programme will continue well past the date when it starts raising rates; and iii) announcing a third wave of targeted long-term refinancing operations (TLTROs) starting in September this year. While low rates for longer will support the refinancing of large private and public debt stocks, they will also continue to increase financial system vulnerabilities stemming from asset price bubbles, a lack of bank and insurance profitability, and low global productivity.

[Tighter financial conditions, rise in populism weigh on sovereign outlook: Q&A with Giacomo Barisone](#), January 21

#### ➤ Another extension of Article 50 on the cards in Brexit talks, with the Brexit deal in the balance

The extension of the UK's stay inside the EU to 12 April from 29 March was minimal and Scope expects it will be followed with a further extension, especially after the failure of the Brexit deal in a third meaningful vote in the UK Parliament and House of Commons vote against a no-deal Brexit on 3 April. The UK and the EU could in the end agree on another short extension of Article 50 of several weeks to continue attempts at ratification in the UK Parliament and an orderly exit in Q2 with May's deal in hand (potentially with modifications given negotiations with Jeremy Corbyn and the Labour Party) or, if a short extension is not feasible, the UK may be forced into a longer extension past 1 July – requiring potentially the participation in forthcoming European elections. However, a longer extension could come with a condition of an earlier exit were the Brexit deal ratified in Parliament. In any scenario, the resignation of the Prime Minister and an ensuing Tory leadership contest are possible and, in the case of a longer Article 50 extension, an early general election and/or a second referendum also cannot be ruled out, which may result in a more significant rethink on the Brexit approach. Scope maintains an expectation of a soft Brexit baseline, with no Brexit at all being the second probable endgame.

[Brexit risks and implications for the ratings of the UK, Ireland and the EU](#), March 15

[Brexit-hit investment, weak exports and consumer spending show growing impact on UK economy](#), February 19

[An Article 50 extension remains on the table despite parliamentary setback, with Brexit costs rising](#), January 30

[Brexit Outlook: Chronic uncertainty to endure as UK teeters between soft Brexit and no Brexit](#), January 8

#### ➤ Electoral tests in Spain and Belgium, while a governing pro-European majority is expected after European elections

Scope observes that, in Europe, important elections will be held in the second quarter, including in Spain – the third such election in four years in its case – with general elections on 28 April (followed by regional and local elections on 26 May), Belgium (26 May) and the European Parliament (26 May). The outcomes will illustrate the extent to which the euro area's fourth and sixth largest economies will be able to form stable governments while the European elections will show whether the rise in nationalist agendas seen in recent years is ephemeral or, indeed, more structural, increasingly impacting Europe's institutional and policy outlooks. Scope's baseline is for pro-European parties to keep a governing majority in the European Parliament, which matters for key leadership appointments to the presidencies of European institutions later in the year.

[Spain's budget in the balance: Parliamentary vote highlights political division, policy paralysis](#), February 12

### ... and Scope's Major Calls and Views on:

#### ➤ Italy

Scope downgraded Italy's sovereign ratings to BBB+, and assigned a Stable Outlook, on 7 December 2018. The assignment of a Stable Outlook acknowledged signs of moderation in the government's budget objectives and preceded the announcement of a budget agreement between Italy and the European Commission on 19 December. It moreover recognised the risk of early parliamentary elections given the polling strength of Lega. Scope's sovereign assessment on Italy is one to two notches higher than the assessment from its US rating agency competitors, inherently recognising factors like support for Italy from European institutions and Italy's systemic financial importance.

[Challenges regarding Italy's credit outlook remain, even as sovereign bond yields moderate](#), March 28

[Italy's economic and fiscal underperformance may pose rating implications](#), February 27

#### ➤ Euro area periphery

Scope has led its US rating agency peers in ratings actions on the euro area periphery – Scope upgraded Greece to B+/Positive before similar actions by peers, and published ratings on Spain (A-/Stable), Portugal (BBB/Stable) and Ireland (A+/Stable) in 2017 at these levels, preceding convergence upgrades by US rating agencies.

[EU-28's vulnerability to external shocks diminishes but divergences prevail](#), February 28

[Fiscal divergence in southern Europe: Debt reduction separates Portugal from Italy and Spain](#), February 1

[Greece's return to normality faces new tests despite government's survival of confidence vote](#), January 18

### ➤ Germany and France

Germany faces an unstable government with little scope for longer-term-oriented policy-making. Current decisions are mainly targeted to satisfy voters with social programmes and industrial policy interventions. By contrast, the French government under President Emmanuel Macron has combined a growth-enhancing structural reform programme with concessions to *gilets jaunes* protesters that will result in another postponement of fiscal consolidation.

[Scope Policy Insights: A State Pension Fund for Germany](#), April 2

[Tax cuts in Germany to head off slowdown miss the mark](#), January 16

[France's Macron concedes to protests with fiscal stimulus at the cost of testing 3% deficit limit](#), December 11

### ➤ Turkey and EM

Scope named Turkey to its "Risky-3" of economies most exposed to external risks, along with Georgia and Ukraine, in a 13 December study and ranking. Scope [downgraded](#) Turkey to BB- with a Negative Outlook last August and noted correctly that lira stabilisation since September was susceptible to reversal in 2019, as Turkey's structural weaknesses have not been properly addressed. Scope considers recent bouts of lira volatility to be in part associated with recent unorthodox policy actions, including coercive tactics aimed at stabilising the exchange rate and high inflation.

[Turkey at a crossroads: Unorthodox pre-election economic policies raise longer-term risks](#), March 29

[Turkey's structural weaknesses remain credit rating focus despite economic rebalancing](#), February 21

[External risk and trade wars: Scope presents dual framework to capture sovereign external risks](#), December 13

### ➤ Central & Eastern Europe

Scope upgraded Russia to investment-grade in 2017, ahead of similar upgrades to IG by S&P and Moody's. Scope's outlook on Russia will be determined going forward by the interplay between: i) rising geopolitical risks, ii) Russia's robust external economic risk-profile, iii) low public finance risks, and iv) the drag of sanctions on structurally-weak growth. Poland (A+/Stable) and Hungary (BBB/Positive) maintain solid growth as Scope expects both to face challenges from demographic transitions and low levels of industrial digitalisation and automation. Scope upgraded Bulgaria's (BBB+/Stable) ratings in February, moving 1-2 notches above the ratings on Bulgaria from rating agency peers, while Scope [downgraded](#) Romania's (BBB-/Negative) ratings to just above non-investment-grade last October, signalling risks to Romania's IG rating.

[Russia's credit outlook: Relative resilience to sanctions leaves structural weaknesses unattended](#), March 28

[Policy continuity expected in Estonia despite populist gains](#), March 5

[Romania's unusual bank tax risks curtailing central bank independence](#), February 15

### ➤ United States

The economic outlook for the United States is subject to downside risks, as evidenced by the Federal Reserve's pause of rate hikes. The peak US growth rate has already been reached this cycle, the push from fiscal policy is fading, asset prices are overvalued, and corporate debt levels are at an all-time high. In addition, major uncertainties remain 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 has taken office in January and is unlikely to develop and implement the needed reforms to address the underlying structural challenges, as evidenced, for instance, by the longest government shutdown in US history. [Scope maintains a AA/Stable rating on the US](#) – challenging the consensus of US Treasuries as the risk-free asset.

[US debt ceiling deadline highlights weak fiscal framework amid deteriorating public finances](#), March 1

### ➤ China and Japan

Scope has been ahead with regards to its decisions on China, having [revised](#) its Outlook on China's A+ sovereign rating to Negative from Stable last September. This was a non-consensus rating decision at the time, with DBRS last month following suit. China's rising debt levels are a major systemic risk factor, with Scope expecting an economic deceleration to 6.2% growth in 2019, supporting the call for a global slowdown this year.

### ➤ Nordics and Switzerland

While Scope identifies imbalances in the housing market as one of the core challenges for Nordic sovereigns, housing risks are contained by favourable macroeconomic conditions, high standards for lending, and macro-prudential measures.

### ➤ ESG & sovereign risk

Environmental, Social and Governance (ESG) risks play an increasing role in financial markets. Scope's Public Finance team reviewed the [distinct nature of ESG factors and sovereign credit risks](#), their areas of overlap and inter-dependence as well as some of the challenges the financial community faces when integrating both concepts into decision-making processes. Scope views the further exploration of sustainability in sovereign risk as an important ongoing area of research.

## Annex I: Macro-economic Outlook

### Macro-economic overview, 2018-20

Region	Real GDP growth (%)				Inflation (%)				Policy Rates (%)		
	2018E	2019F	2020F	Medium-run potential	Target	2018E (AVG)	2019F (AVG)	2020F (AVG)	Current	End-2019	End-2020
Euro area	1.8	1.0	1.2		2.0	1.8	1.4	1.5	0.00	0.00	0.00
Germany	1.5	1.0	1.3	1.3	2.0	1.9	1.5	1.5			
France	1.5	1.4	1.5	1.5	2.0	2.1	1.4	1.7			
Italy	0.8	0.0	0.6	0.75	2.0	1.2	1.0	1.3			
Spain	2.5	2.1	1.8	1.7	2.0	1.7	1.2	1.5			
United Kingdom	1.4	1.0	1.5	1.5	2.0	2.3	1.9	2.3	0.75	0.75	1.00
Russia	1.7	1.6	1.7		4.0	2.9	5.1	4.8			
Turkey	2.6	-1.8	3.2		5.0	16.3	14.6	8.2			
United States <sup>1</sup>	2.9	2.0	1.5	<2.0	2.0	1.9	2.0	2.0	2.25-2.50	2.25-2.50	2.00-2.25
China	6.6	6.2	6.2	5.0	3.0	1.9	2.4	2.7			
Japan	0.9	1.1	0.5	<1.0	2.0	1.0	1.3	1.7			
World	3.6	3.0-3.5			-	-	-	-			

Region	Unemployment rate			General government balance (% of GDP)			Public debt level (% of GDP)		Current account (% of GDP)		
	2018E	2019F	2020F	2018E	2019F	2020F	2018E	2023F	2018E	2019F	2020F
Euro area	8.3	8.0	7.7	-0.6	-0.8		84.4	74.5	3.0	2.9	2.9
Germany	3.5	3.4	3.3	1.6	1.2		59.8	44.6	8.1	7.9	7.7
France	8.8	8.5	8.1	-2.6	-2.8		96.7	93.9	-0.9	-0.7	-0.5
Italy	10.8	10.5	10.3	-1.9	-2.5	-2.5	131.7	133.0 <sup>2</sup>	2.0	1.6	1.4
Spain	15.6	14.7	14.3	-2.7	-2.5	-2.2	97.2	~95	1.2	1.2	1.3
United Kingdom	4.1	4.2	4.5	-2.0	-1.7	-1.5	87.4	84.0	-3.5	-3.2	-3.0
Russia	5.5	5.3	5.1	1.6	1.8	1.3	15.3	19.0	6.2	5.2	4.3
Turkey	11.0	12.3	10.6	-4.0	-5.1	-5.8	32.3	39.1	-5.7	-1.4	-1.8
United States	3.8	3.5	3.4	-4.7	-5.0	-4.8	106.1	~120	-2.5	-3.0	-3.2
China	4.0	4.0	4.0	-4.1	-4.4	-4.3	50.1	53.9	0.7	0.7	0.7
Japan	2.9	2.9	2.9	-3.7	-2.8	-2.1	238.2	235.4	3.6	3.8	4.1
World	-	-	-	-	-	-	-	-	-	-	-

Source: Scope, European Commission, IMF, Federal Reserve, Bank of England and CBRT forecasts, Haver Analytics.

<sup>1</sup> Inflation for the United States is the YoY change in Core PCE prices. Headline inflation shown for all other countries/regions.

<sup>2</sup> By 2021



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### Scope Ratings GmbH

#### Headquarters Berlin

Lennéstraße 5  
D-10785 Berlin

Phone +49 30 27891 0

#### London

Suite 301  
2 Angel Square  
London EC1V 1NY

Phone +44 20 3457 0444

#### Oslo

Haakon VII's gate 6  
N-0161 Oslo

Phone +47 21 62 31 42

#### Frankfurt am Main

Neue Mainzer Straße 66-68  
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

#### Madrid

Paseo de la Castellana 95  
Edificio Torre Europa  
E-28046 Madrid

Phone +34 914 186 973

#### Paris

1 Cour du Havre  
F-75008 Paris

Phone + 33 1 8288 5557

#### Milan

Via Paleocapa 7  
IT-20121 Milan

Phone +39 02 30315 814

[info@scoperatings.com](mailto:info@scoperatings.com)  
[www.scoperatings.com](http://www.scoperatings.com)

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Scope Ratings GmbH, Lennéstraße 5, 10785 Berlin, District Court for Berlin (Charlottenburg) HRB 192993 B, Managing Directors: Torsten Hinrichs and Guillaume Jolivet.