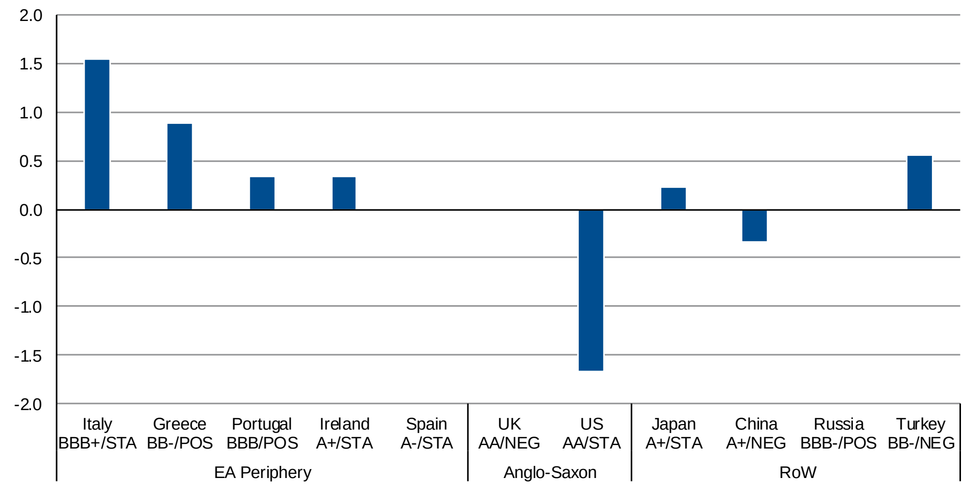
Q4 2019 Sovereign Update: weak growth and policy focus shifting from central banks to governments

Slowing global growth, high market volatility and persistent policy unpredictability continue to weigh on the sovereign outlook for the euro area in the fourth quarter. After two interest rate cuts from the Federal Reserve and a significant easing package from the ECB, the focus now turns to national policymakers to drive higher growth via fiscal and structural reform. Brexit will take centre stage in the coming quarter, with another extension of Article 50 expected by 31 October.

Figure 1: Scope's global long-term sovereign ratings, as of 1 October 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	BBB-/Stable	Georgia	BB/Stable
Cyprus	BBB-/Stable	Luxembourg	AAA/Stable	Czech Republi	AA/Stable	Japan	A+/Stable
Estonia	A+/Stable	Malta	A+/Stable	Denmark	AAA/Stable	Russia	BBB-/Positive
Finland	AA+/Stable	Netherlands	AAA/Stable	Hungary	BBB/Positive	Turkey	BB-/Negative
France	AA/Stable	Portugal	BBB/Positive	Poland	A+/Stable	United States	AA/Stable
Germany	AAA/Stable	Slovakia	A+/Stable	Romania	BBB-/Negative		
Greece	BB-/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 1 October 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
26-Jul	Finland	Affirmation	AA+/Stable
	Sweden	Affirmation	AAA/Stable
	Denmark	Affirmation	AAA/Stable
	Russia	Affirmation/Outlook change	BBB-/Positive
	USA	Affirmation	AA/Stable
23-Aug	Cyprus	Affirmation	BBB-/Stable

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Related Research

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Q4 2019 Sovereign Update: weak growth and policy focus shifting from central banks to governments

Entering Q4 2019, the focus turns from central banks to national governments…

- **Global slowdown and central bank easing, but will fiscal and structural policy changes follow?**

Policy makers face significant challenges from slowing economic growth, notably in Germany, where recent data points to the danger of recession, but also in China and the US. Scope's 2019 global growth forecast is 3.0%-3.5%, below the 3.6% growth of 2018, and just 1.1% for the euro area this year followed by 1.2% in 2020. Central banks have so far taken the lead in responding to weak growth, with the ECB and the Federal Reserve cutting rates – the ECB cut its deposit rate to an all-time low of -0.5% while the Fed reduced the federal funds target range to 1.75%-2.00% – with the ECB having also restarted asset purchases. The extent of third-quarter easing via two Fed cuts and the announcement of new ECB net asset purchases exceeded Scope's expectations. Lower rates will support debt-deleveraging efforts by reducing the cost of refinancing the large stock of private and public debt, but the additional benefits of these ultra-accommodative policy measures to foster growth and raise the inflation outlooks are limited without fiscal support. In fact, they will further amplify global financial system vulnerabilities in debt, equity and real estate markets with negative deposit rates in the euro area further challenging the profitability of the banking sector.

The benefits to debt dynamics from low rates could moreover come at a policy cost. Ultra-loose monetary policy risks encouraging government complacency over the urgency of needed reforms to sustain fiscal consolidation, particularly among highly indebted sovereigns, and, in Europe, the importance of institutional enhancements in the euro area. Here, the onus now falls on governments to pursue reforms given the declining benefits from additional monetary stimulus, the incomplete euro area architecture, a decade of subdued investment and rising demographic pressures. To increase growth rates in the near and medium term depends on growth-friendly stimulus from those sovereigns with room for more expansive fiscal policy, structural labour and product market reforms and further strengthening of euro area institutions.

Scope Policy Insights: Automatic fiscal policy – stabilising the economy in a low interest rate environment, Sep 30

Supranational risk-taking: Assessing EU budget guarantees, EIB credit enhancements and member states' contingent liabilities, Sep 26

EU-28: A supply-side approach to explaining growth differences across member states since 2000, Sep 25

ECB negative rates and relaunched QE face diminishing returns, rising adverse side-effects, Sep 13

The rise of central banks as sovereign debt holders: implications for investor bases, Aug 27

- **Brexit: another extension of Article 50 looms as uncertainty weakens the UK economy**

Brexit-related uncertainty continues to weigh on both the UK and European economies. Scope forecasts only 1.3% growth in the UK in 2019 and 1.1% in 2020. The British government will most likely request another extension to Article 50 negotiations before 31 October, with the exact duration on any further extension to depend on parliamentary discussions as well as negotiations between the UK and the EU. With the Prime Minister lacking a parliamentary majority, he cannot get a Brexit deal through a parliamentary vote, or win authorisation to leave without a deal, or trigger the early election on his terms. The most likely route out of the impasse could be early elections, unless a significant change in negotiations with the EU – most importantly around the Irish backstop – takes place, facilitating a deal that can *pass in Parliament*. Any general elections would most likely be held after 1 November (i.e. after an extension). Our long-standing baseline is for a soft Brexit after extension(s) of Article 50 and/or post-Brexit transitional arrangements. Second to this, we consider 'Breversal' – an eventual revocation of Brexit – a second most probable end-game.

Brexit: another extension of Article 50 looms as uncertainty weakens the UK economy, Sep 30

Suspending Parliament does not mean a no-deal Brexit on 31 October, Aug 30

… and Scope's Major Calls and Views on:

- **Italy, Spain and Portugal**

Scope's BBB+/Stable rating on Italy, which is one to two notches higher than the rating assessments on Italy from the US agencies, balances the country's record of primary surpluses, a favourable debt structure and Italy's systemic economic importance against concerns over public debt sustainability. The new Five Star Movement-Democratic Party government has an opportunity to address some of the country's structural issues in a low yield environment. Low yields support our forecast of a flat path for debt-to-GDP, as the new government pursues an expansionary 2020 budget in upcoming talks with the EU.

The Positive Outlook on Portugal's BBB rating reflects the country's sustained debt reduction and resilient debt structure as well as the gradual unwinding of economic imbalances, expected to continue after the general elections on 6 October. Repeat elections in Spain (A-/Stable) set for 10 November, the fourth in as many years, the country's fragmented politics and resulting policy inertia are leaving credit challenges unaddressed, constraining the rating at the current level.

Spain's political impasse continues: policy vacuum constrains the sovereign credit rating outlook, Sep 20

Italy's new government brings economic opportunities, yet faces debt-sustainability challenge, Sep 10

Re-establishing fiscal accountability could stabilise the euro area: some lessons from Italy, Jul 25

- **Greece and Cyprus**

For Greece, a modest renegotiation of previously agreed targets for primary budget surpluses in conjunction with growth-enhancing reforms could currently be justified, particularly after the significant decline in Greek bond yields, to improve the country's debt sustainability. Scope upgraded Greece to BB-/Positive in May. Moreover, the declining debt trajectory due to strong growth and fiscal discipline underpin Scope's investment-grade rating on Cyprus (BBB-/Stable).

Greece must improve private-sector liquidity, raise investment to tackle economic constraints, Aug 30

Greece: Seeking a new balance between growth-enhancing measures and large primary surpluses, Aug 22

- **Germany, France and core Europe**

For Germany, looser, counter-cyclical fiscal policy is appropriate amid current recession concerns. In addition, a temporary fiscal deficit in excess of 3% of GDP in France in 2019 is not necessarily credit-negative if monies are invested effectively, leveraging current near record low yields. For 2020, Scope expects French growth to slightly moderate to 1.2%, mostly driven by fiscal stimulus following recent tax cut announcements. German growth prospects of 1.0% for next year show high uncertainty, balancing rebounding growth after stagnation this year and a continuous lack of support from fiscal and external demand factors. While the French government continues to implement supply-side reforms, German politics remain unpredictable, including possible snap elections in 2020.

France: Long-run impact of policy measures matters more than temporarily wider deficits, Aug 19

Germany's economy set for stagnation in 2019 amid trade conflict and lack of fiscal stimulus, Aug 8

Austria's difficult coalition politics could delay reform progress after snap elections, Aug 5

- **Turkey and Russia**

On 26 July, Scope raised the Outlook on Russia's BBB- sovereign ratings to Positive, given Russia's low general government debt and sizeable state cash deposits, which provide greater room for fiscal manoeuvre, raising the capacity of the Russian government to tolerate somewhat higher debt in coming years. These fiscal buffers safeguard the government's debt repayment capacity even under conditions of intensifying US sanctions, including those signed into law sanctioning Russian sovereign debt on 1 August. Scope upgraded Russia to investment-grade in 2017, ahead of similar upgrades from S&P in 2018 and Moody's in 2019.

In Turkey (BB-/Negative), economic policy predictability and credibility pose significant credit challenges. The recent rapid rate cuts and related scepticism regarding the independence of Turkey's monetary policy suggests pressure remains on the central bank to demonstrate its commitment to price stability.

Russian policies bolster resilience to new US sanctions, but growth faces constraints, Aug 6

Politicisation of Turkish central bank highlights institutional degradation, raises ratings risks, Jul 8

- **Central & Eastern Europe**

Upcoming negotiations between the European Council and the European Parliament around the EU's next long-term budget 2021-27, based on the EC's draft proposal foreseeing significant reductions in EU fund allocations to CEE, matter for the investment and growth outlooks of CEE economies, the largest beneficiaries of EU funds relative to their economic size.

Effective fiscal measures in Romania (BBB-/Negative) are needed to preserve the country's investment-grade ratings, given the country's current pro-cyclical fiscal stance and the upward trajectory of public debt. Money-laundering scandals in the Baltic states have created unexpected uncertainty about their financial stability, though these risks do not necessarily challenge the countries' sovereign ratings. Poland (A+/Stable), Slovakia (A+/Stable) and Hungary (BBB/Positive) maintain solid growth helped by strong domestic consumption and infrastructure spending.

Romania's 2019 budget revisions could set stage for reassessment of sovereign credit risk, Aug 14

EU funds for Central and Eastern Europe: 2021-27 budget matters for sovereign outlooks, Jul 31

- **United States**

The economic outlook for the US is subject to downside risks. Growth has peaked for the current 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 Donald Trump's shifting trade policy agenda, particularly vis-à-vis China. A divided and polarised Congress, now overseeing a formal impeachment inquiry into the President, is unlikely to address the underlying structural challenges. Scope maintains a AA/Stable rating on the US – challenging the consensus of US Treasuries as the global risk-free asset.

- **China and Japan**

Scope revised its Outlook on China's A+ sovereign rating to Negative from Stable last September – a non-consensus rating decision at the time. China's rising debt levels are a major systemic risk, exacerbated by present fiscal and monetary easing responding to economic slowdown. Japan's A+/Stable rating recognises the government's efforts to revive the economy and enhance the labour supply as well as the Bank of Japan's credibility and resolve to keep an ultra-accommodative monetary policy, easing debt sustainability concerns.

- **Nordics and Switzerland**

Imbalances in the housing and commercial real estate markets are core challenges for Nordic sovereigns. Switzerland and the EU will eventually agree on a new framework arrangement, despite ongoing challenges.

- **ESG & sovereign risk**

Environmental, Social and Governance (ESG) risks play an increasing role in financial markets. Scope views the further exploration of sustainability in sovereign risk as an important ongoing area of research. Scope's rating action releases include dedicated sections on sovereigns' performance on ESG factors and relevance for rating outcomes, including achievements towards fulfilling the Sustainable Development Goals and goals of the Paris Climate Change Agreement.

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	1.9	1.1	1.2	1.2	2.0	1.8	1.3	1.3	0.00	0.00	0.00
Germany	1.4	0.5	1.0	1.3	2.0	1.9	1.4	1.3			
France	1.7	1.3	1.2	1.5	2.0	2.1	1.3	1.3			
Italy	0.9	0.1	0.6	0.7	2.0	1.2	0.8	1.0			
Spain	2.4	2.0	1.7	1.7	2.0	1.7	1.0	1.2			
United Kingdom	1.4	1.3	1.1	1.5	2.0	2.3	1.8	2.0	0.75	0.75	1.00
Russia	2.3	1.6	1.7	1.0-1.5	4.0	2.9	3.5	4.0	7.00	6.75-7.0	6.0-6.5
Turkey	2.6	-1.9	3.0	3.9	5.0	16.3	15.3	12.5			
United States[1]	2.9	2.0	1.5	<2.0	2.0	2.1	1.8	1.8	1.75-2.00	1.75-2.00	1.50-1.75
China	6.6	6.3	6.1	5.0	3.0	1.9	2.5	2.8			
Japan	0.8	1.0	0.5	<1.0	2.0	1.0	1.0	1.1			
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	2024F	2018E	2019F	2020F
Euro area	8.2	8.0	7.7	-0.6	-0.9	-0.7	85.1	75.7	3.0	2.9	2.8
Germany	3.4	3.4	3.3	1.7	1.1	1.1	60.9	43.7	7.4	7.1	6.8
France	9.1	8.8	8.4	-2.6	-3.1	-2.1	98.4	96.2	-0.7	-0.4	0.0
Italy	10.6	10.0	9.7	-2.1	-2.0	-1.9	132.2	132.2[2]	2.6	2.9	2.6
Spain	15.3	13.9	13.0	-2.5	-2.3	-2.3	97.1	92.3	0.9	0.8	0.8
United Kingdom	4.1	4.2	4.4	-1.4	-1.3	-1.2	86.8	80.3	-3.9	-4.2	-4.0
Russia	4.8	4.8	4.7	2.8	1.3	1.0	14.0	16.9	7.0	5.7	5.1
Turkey	11.0	14.1	13.5	-1.9	-3.3	-3.5	29.1	26.7	-3.5	0.0	
United States	3.9	3.8	3.7	-4.3	-4.6	-4.4	105.8	110.3	-2.3	-2.4	-2.6
China	3.8	3.8	3.8	-4.2	-7.5		50.5	72.4	0.4	2.0	1.0
Japan	2.4	2.4	2.4	-3.2	-2.8	-2.1	237.1	238.3	3.5	3.5	3.6
World	-	-	-	-	-	-	-	-	-	-	-

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

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

[2] By 2021

[3] China's general budget figures exclude fiscal stabilisation fund transfers

[4] Turkey's budget figures reflect the general budget institutions deficit/surplus

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