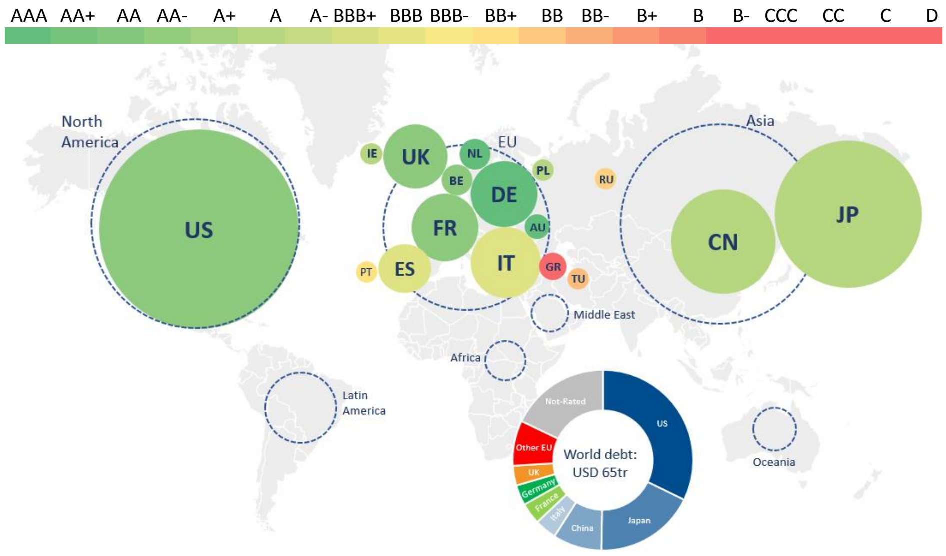
2018 Public Finance Outlook: European Resilience but Rising Global Risks

In Scope's assessment, 2018 promises continued economic recovery in Europe and robust global growth. However, Scope cautions that global risks are building. In Europe, reforms to the euro area institutional framework, the resolution of Brexit, Italian elections in the spring, the end of the Greek programme and any change in accommodative financial conditions are the key credit-relevant developments to watch. In the United States, political risks and the Federal Reserve's monetary tightening are the main risks for 2018. Concerns about high levels of public- and private-sector debt constrain China's rating. Meanwhile, geopolitical tensions require monitoring.

Figure 1: Distribution of Scope's global long-term sovereign ratings



Source: Scope Ratings AG

Circle area is proportional to the country's debt in USD.

Scope's 2018 outlook for global sovereign ratings balances:

- **Upside potential:**
  - **European reform:** A new German government supports ambitions for important institutional reform in the euro area, bolstering Scope's constructive view on euro area sovereign ratings.
  - **Avoiding the worst case:** Risks from Brexit, China's leverage levels, US policy uncertainty and higher global rates are manageable and thus fail to meaningfully alter global growth conditions.
- **Downside risks:**
  - **Increased risk of no Brexit deal:** Chance for a cliff-edge exit rises rather than Scope's expectation for either a 'soft' Brexit or no Brexit.
  - **End of the 'Central Bank Put':** Monetary tightening occurs faster than anticipated, resulting in a repricing of global risk.
  - **International risks crystallise:** China's debt risks threaten financial stability, US political risks escalate, or geopolitical tensions intensify.

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Scope's 2018 Public Finance Outlook also highlights:

- French ambitions, German constraints: A fading window of opportunity

While French President Emmanuel Macron fuelled optimism for a pro-integration process in the European Union (EU), the outcome of the 2017 German election, and the subsequent prolongation of political uncertainty, have weakened Chancellor Angela Merkel domestically, reducing her ability to push for some of the deliberated reforms in a speedy and comprehensive manner to the euro area architecture. Legislative changes to complete the Banking and Capital Markets unions and/or enhancing the euro area's fiscal capacity would be credit-positive for euro area member states.

- Ongoing rebound for the euro area periphery…

National and European reforms since the sovereign debt crisis have bolstered the EU's resilience and continue to support the outlook in the euro area periphery. While periphery ratings remain constrained by high levels of public- and private-sector debt, political uncertainties (such as Spain's Catalonia crisis) and banking system fragilities (Italy and Portugal), Scope holds a market-leading, more constructive opinion on the periphery, leading recent catch-up upgrades by the US rating agencies.

- … but Greek concerns remain.

Greece's EU financial assistance programme is scheduled to end on 20 August 2018. Scope expects EU oversight on Greece to continue after the conclusion of the programme; future oversight could be linked to additional debt measures, further financial assistance, and/or eligibility in the European Central Bank (ECB)'s asset purchase programme (currently scheduled to end in September 2018). In Scope's view, however, the configuration of the next German government will be critical in assessing the appetite for further EU support for Greece.

- Italian elections to avoid M5S government but may produce an unstable administration

The Italian parliament approved a reform that harmonises and introduces a mixed proportional and first-past-the-post electoral system. By changing the voting system in favour of broad pre-election coalitions, Italy may avoid the populist Five Star Movement (M5S) gaining power, but a stable and reform-oriented government may also prove elusive.

- 2018 critical to evaluation of Scope's non-consensus expectation on Brexit

Next year will prove critical for the UK's exit negotiations with the European Union, with the 29 March 2019 exit date from the EU (with or without a deal) fast approaching. In August 2017, Scope outlined that the most probable outcome from its standpoint is either an eventual soft Brexit (Scope's baseline) or a no-Brexit scenario. This owes to the inherent complexity of the exit negotiations hindering a successful 'hard' Brexit under any near- to medium-term horizon, as well as the significant and disproportionate costs of any immediate no-deal exit. However, Scope will monitor hard-Brexit downside risks over 2018.

- Russia-Turkey: Investment-grade vs non-investment-grade differential to stay

Scope expects Russia's economic recovery to continue in 2018. Despite Russia's strengthened economic resilience, the threat of additional sanctions remains a risk, with policy continuity anticipated after March 2018's presidential election. Scope expects Turkey's V-shaped recovery to endure in 2018. However, elevated external vulnerabilities in the form of large external financing needs, political risks and a weakening institutional framework constrain Turkey's ratings, evidenced in Scope's investment-grade (IG) assessment of Russia (BBB-/Stable) but non-IG rating on Turkey (BB+/Stable).

- Political risks constrain Scope's distinct AA rating on the US while Fed tightening could have systemic impact

Congressional elections, scheduled for 6 November 2018, are unlikely to foster a new spirit of bipartisanship to address the US's underlying structural challenges, including a weakening potential growth outlook (though 2018 growth will benefit from tax reform), high and rising public debt, and significant pension- and healthcare-related liabilities. In addition, Scope expects the Trump administration's demonstrated policy unpredictability as well as debt ceiling risks to continue in 2018. Lastly, the Federal Reserve's rate hike cycle, accompanied by reductions in its holdings of US Treasury (USD 2.5trn) and mortgage-backed securities (USD 1.8trn), could increase market volatility and financial risks if not managed well.

- East Asia: Risks concern economic adjustment in China and high debt; policy continuity in Japan

Scope considers China's debt and economic adjustment to be an important risk in 2018 and beyond, tying to systemic risks to the global economy. In Scope's September downgrade of China to A+, Scope noted that its forward assessment will depend on the extent to which the rising debt trajectory is redressed. In Japan, Prime Minister Shinzo Abe's recent electoral victory ensures political stability and a continuation of the 'Abenomics' reform agenda in 2018.

- Geopolitical risks to feature in 2018

Rising geopolitical instability could see North Korean tensions escalate – relevant for Scope's credit monitoring on Japan and China. Conflicts in the Middle East and North Africa threaten spill-over, which could affect neighbouring countries and regions, and Russian antagonism continues to represent a major force for destabilisation.

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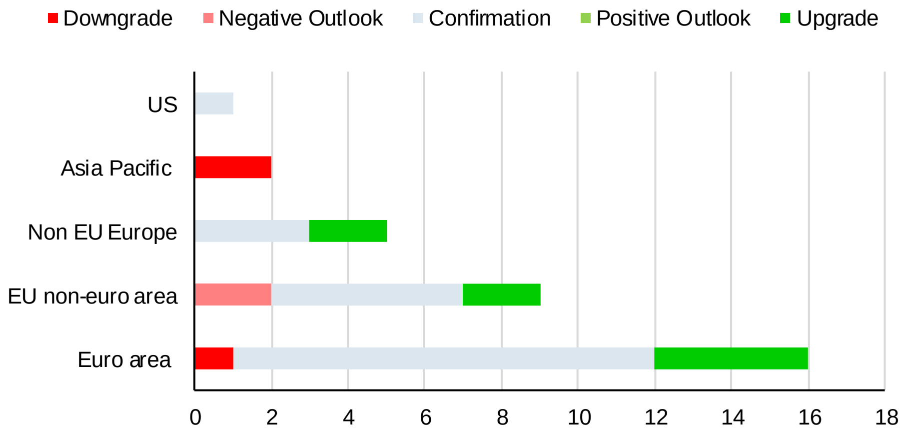
Scope's 2017 rating actions

Since June 2017, Scope has published sovereign ratings on 33 countries

Since June 2017, Scope has published long-term and short-term foreign- and local-currency issuer and debt ratings on European sovereigns as well as on major countries outside Europe, including China, Japan, Russia, Turkey, and the US. The European sovereigns carrying a Scope rating represent around 99% of total EU sovereign issuance. The aggregate amount of all sovereigns' long-term and short-term debt rated by Scope now exceeds EUR 34trn. An overview of the 33 rating actions[1] and drivers and the identified key credit strengths and weaknesses is provided in Annex III. To date, Scope has confirmed 20 ratings with a Stable Outlook, upgraded eight countries (Estonia, Greece, Hungary, Lithuania, Poland, Russia, Slovenia and Turkey), downgraded three (China, Finland and Japan), and assigned Negative Outlooks to the UK (AA) and Romania (BBB), indicating possible downgrade within 12-18 months of the action.

Figure 2: 2017 rating actions



Source: Scope Ratings AG

Euro Area

Austria	AAA/Stable
Belgium	AA/Stable
Estonia	A+/Stable
Finland	AA+/Stable
France	AA/Stable
Germany	AAA/Stable
Greece	B-/Stable
Ireland	A+/Stable
Italy	A-/Stable
Latvia	A-/Stable
Lithuania	A-/Stable
Netherlands	AAA/Stable
Portugal	BBB/Stable
Slovakia	A+/Stable
Slovenia	A-/Stable
Spain	A-/Stable

European Union and euro area membership is an important positive driver of Scope's rating levels and actions in Europe, providing institutional support with a large common market, a strong reserve currency, and a lender of last resort in the European Central Bank and European financial assistance institutions. Scope also views positively the European economic governance framework, which supports structural reform programmes, bolsters financial stability and strengthens fiscal discipline, thus increasing individual sovereigns' ability to stem macroeconomic imbalances. These support Scope's constructive view on the euro area, generating positive rating differentials relative to the US agencies' views, particularly regarding the periphery (discussed in more detail later).

In addition, Scope's rating levels and actions for euro area members reflect their relatively wealthy economies, substantial fiscal consolidation in recent years, the implementation of structural reforms, and progress on addressing external imbalances. However, ratings remain constrained by structural weaknesses including an ageing population, which places pressure on pension and healthcare systems, and leads to low potential growth rates and labour market bottlenecks. Lastly, euro area members still encounter challenges in the form of high public- and private-debt burdens in addition to cases of banking sector fragilities.

[1] Since June 2017, Scope has taken action on and converted 33 long-term local-currency issuer ratings from Subscription to Public.

Emerging Europe

Bulgaria	BBB/Stable
Croatia	BB/Stable
Czech Rep.	AA/Stable
Hungary	BBB/Stable
Poland	A+/Stable
Romania	BBB/Negative

In Emerging Europe, the main rating drivers are the ongoing (though gradual) income convergence with western Europe, supported by economic recoveries, sound public finances and increasing external buffers. However, low potential growth and productivity, the absence of resilient lenders of last resort and weakening institutions are key rating constraints. This constraint is exemplified by the backsliding on the rule of law and judicial independence in Poland and Hungary, resulting in legal conflict with EU institutions and the threat of sanctions.

Russia	BBB-/Stable
Turkey	BB+/Stable

For Russia and Turkey, the key drivers for 2017's upward rating revisions (to BBB- and BB+ respectively) were strengthening macroeconomic performance, low public-debt levels and improving external resilience. Nevertheless, geopolitical risks and weak governance, in addition to low growth potential in Russia and high external financing needs for Turkey, represent significant rating constraints.

United States of America

US	AA/Stable

Scope's AA rating on the United States reflects the country's wealthy, competitive and diversified economy, its transparent and accountable institutional framework, as well as the US dollar's unparalleled global reserve currency status, which enables the country to run fiscal and current-account deficits with limited sustainability concerns. The rating is constrained by a weakening potential growth outlook, combined with the high level of government debt and significant contingent liabilities from pension- and healthcare-related obligations. In Scope's assessment, given the divisions between the political parties and resulting lack of bipartisanship, measures to address these underlying structural challenges are unlikely to be implemented soon – reinforcing Scope's more cautious view on the US compared with the US rating agencies.

Asia Pacific

Japan	A+/Stable
China	A+/Stable

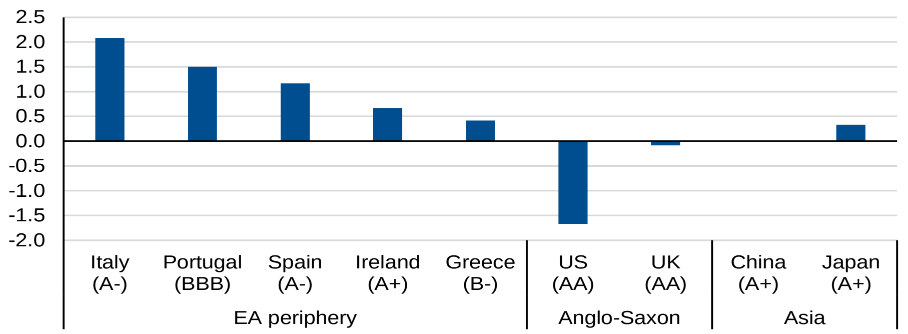
Scope's September downgrade of China to A+ reflected Scope's opinion that China's fundamentals are challenged by: i) significant and continued increases in non-financial sector debt since 2008, ii) large public-sector deficits and a growing public-sector debt stock, as well as iii) weaker current-account surpluses and international reserve levels. After President Xi Jinping's consolidation of power, forward assessments on China's rating will hinge on the acceleration of ongoing deleveraging initiatives that allow for rebalancing to a more sustainable growth model.

Scope's downgrade of Japan to A+ was driven by the country's weak fundamentals due to the high public-debt burden and weak long-term growth outlook. Abe's re-election in October 2017 will ensure political stability and a continuation of the Abenomics reform agenda, with efforts needed to counter unsustainable debt levels.

Scope's ratings differentiate from those of the US agencies

Based on these rating actions, Scope's ratings differentiate from those of the US rating agencies in multiple areas, as highlighted in the below chart.

Figure 3: Scope ratings vs US agencies', as of November 2017 (rating notches)



Source: Scope Ratings AG
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.

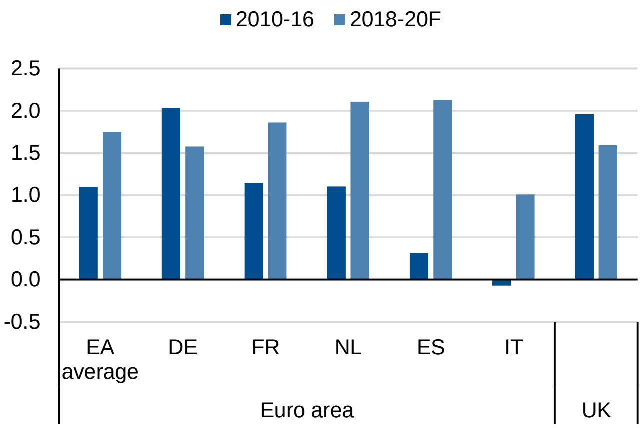
Divergence between robust euro area rebound, but a weakening UK

Institutional improvements support euro area economic recovery and ratings

European policymakers have, in Scope's assessment, made important structural reforms at both the national and European levels to strengthen the resilience of the monetary union and its member states, which in turn bolsters the agency's constructive view on European sovereigns. In fact, in the aftermath of the Great Financial Crisis and subsequent euro area crisis, real economic growth is now robust, broad-based and expected to average 1.8% over 2018-20 (with 1.9% in 2018). For 27 of the 28 EU member states, the European Commission anticipates debt levels to fall over the next two years (except in Romania), while deficits are expected to decline for 14 of the 19 euro area countries, with most if not all euro area sovereigns expected to record fiscal deficits below the 3% Maastricht criterion in 2018. This robust outlook is also supported by Scope's expectation of a relatively gradual withdrawal of stimulus by the ECB, with a further extension of quantitative easing not off the table after the current September 2018 end date in view of lagging inflation (averaging just 1.2% in 2018 according to ECB forecasts). Alongside key policy rates that are unlikely to rise before 2019, continued accommodative monetary conditions should maintain government and private yields at affordable levels, supporting debt sustainability.

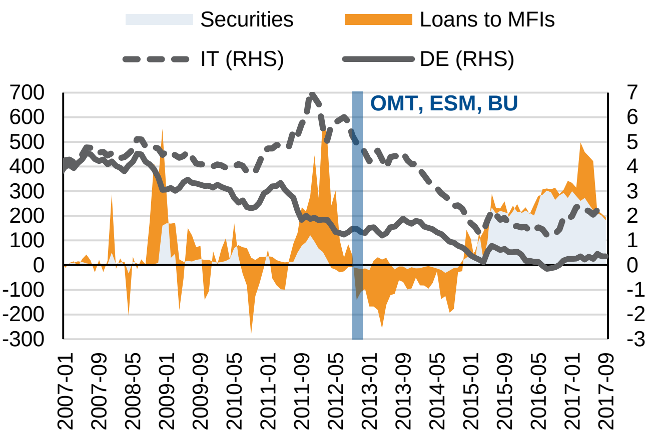
Conversely, the UK outlook has diverged owing to Brexit uncertainty (discussed later in this report), and the impacts on investment decisions and private consumption. Real earnings growth remains negative owing to the transitory boost to inflation (3% in October 2017) caused by the weaker sterling. Growth of 1.6% is expected over 2018-20, including 1.5% in 2018 – compared with 2.0% in the 2010-16 post-crisis period.

Figure 4: GDP growth average, %



Source: EC

Figure 5: ECB asset purchases and loans (EUR m, 4mms); long-term yields (%, RHS)



Source: European Central Bank; Flows are 4-month moving sum

French ambitions, German constraints: A fading window of opportunity

EMU resilience is key for euro area credits

In Scope's assessment, all euro area credits are affected by the resilience and shock absorption capacity of the Economic and Monetary Union (EMU). In this context, Scope's ratings reflect reforms already made, while keeping mindful of the shortcomings that constrain the resilience of euro area sovereigns, notably:

- Low investment levels
- Low private risk sharing
- Limited fiscal risk sharing

Addressing these fundamental challenges without backpedalling on progress already achieved is key for Scope's European sovereign rating outlook, and necessitates: i) the continuation of a lender of last resort without ex ante quantitative limits for euro area sovereigns, ii) a comprehensive strategy to address non-performing loans (NPLs), iii) private risk sharing via the completion of the Banking and Capital Markets unions, and iv) some form of public risk sharing.

Political risks not as significant a constraint on European ratings

Notably, in Scope's assessment, Europe will remain resilient to multiple political risks in 2018, with these risks not as significant a constraint on sovereign ratings in the region. Scope's base case does not include tail risks (like a Greek exit from the euro area) nor more possible but unexpected events (like the election of a euro-sceptic/anti-establishment government in Italy). Moreover, Scope believes the EU's institutional framework provides for a degree of resilience to adjust to crises as and when these emerge. In Scope's view, the ultimate influence of euro-sceptic parties advocating for an exit from the monetary union fades in the legislative process once the difficulties and consequences of a possible exit become apparent, exemplified in the dilemmas faced by the UK in its exit process from the EU.

Macron's EMU reform agenda may run into a German political vacuum

In terms of pro-integration reform, Scope believes the optimism fuelled by the arrival of French President Emmanuel Macron has been somewhat tempered by the German election outcome[2]. It is Scope's opinion that the 2017 German election weakened Chancellor Angela Merkel domestically, reducing her ability to push for some of the deliberated areas of reform in a speedy and comprehensive manner. In addition, Scope points to the materialising risk scenario related to the latest political developments in Germany, in which the 'Jamaica'[3] coalition talks have, at this stage, ended without an agreement. This creates a momentary political vacuum in Germany which may well run into early 2018, and which may ultimately only be resolved via new elections in early 2018, reducing the potential window of opportunity for European reforms.

The prolongation of German government formation notwithstanding, 2018 could still pave the way for important institutional steps that bolster and support Scope's European sovereign outlook. Ideas abound[4]: In Scope's view, maintaining and developing the lender-of-last-resort function (vis-à-vis the European Central Bank's various programmes and the reform of the European Stability Mechanism (ESM)) is paramount for Scope's euro area ratings, while legislative changes to the existing framework to complete the Banking and Capital Markets unions alongside the development of fiscal capacity in the euro area would be credit-positive (see Annex I).

German focus on rules to avoid next crisis likely to overpower French focus on discretion to manage crises

Regarding the form of future integration, Scope notes two developments. First, the crisis years saw a clear power shift away from Brussels to the capitals of member states. Second, as the crisis is left behind, and with a future German government centred around still Chancellor Merkel's Christian Democratic Union (CDU), Scope expects that progress on the European policy agenda will reflect the German preference for focusing on instruments that avoid the next crisis, rather than the French preference for discretionary tools that respond to existing ones[5]. The implementation of the EMU reform agenda is likely to remain primarily driven by member states as opposed to the European Commission, but may become more incremental, as noted, compared with previous

[2] As France's election cycle is every five years, and Germany's is four, both countries elect their leaders simultaneously only once every twenty years.
[3] Named after the party colours in such a coalition, which match the colours of the Jamaican flag.
[4] See the European Commission's 'Blueprint for a Deep and Genuine EMU' (2012), the so-called Four Presidents' report 'Towards a Genuine Economic and Monetary Union' (2012), the Five Presidents' report titled 'Completing Europe's Economic and Monetary Union' (2015) and the Commission's 'Reflection paper on the deepening of the economic and monetary union' (2017). In addition, see President Macron's speech at the Sorbonne, Banque de France Governor François Villeroy de Galhau's speech 'On the future of the euro area' or ESM Managing Director Klaus Regling's speech on 'European integration and the ESM'.
[5] Brunnermeier, Markus et. al., 'The Euro and the Battle of Ideas', 2016.

years during which a significant amount of discretion shaped the reforms of the European governance framework.

Timing likely sometime in 2018

In Scope's view, greater clarity on the scope for euro area reform is likely to be seen during the first half of 2018, but only after the formation of the next German government. The next significant political deadline is the European Parliament elections in June 2019; while the end of 2018 is likely to see considerable demands, with negotiations on Brexit and on the EU's next multi-annual budgetary framework. However, Scope cautions against excessive optimism: Europe is entering 2018 with a growing economy and relative political stability, which could sow the seeds for complacency among policymakers.

Scope's ratings on euro area periphery ahead of the curve

Scope's periphery ratings reflect structural reforms in the countries and regional framework

Scope's view is that the multi-notch downgrades of many peripheral euro area sovereigns by the US rating agencies during 2009-12 went beyond the levels suggested by the underlying deterioration in fundamentals, a view affirmed by an emerging consensus, based on several studies[6] which rely on different estimation techniques.

In this context, Scope's assessment of euro area sovereign ratings has led recent catch-up upgrades by the US agencies[7]. Scope upgraded peripheral ratings, starting around 2013/14, after the establishment of the European Stability Mechanism, the ECB's announcement of its Outright Monetary Transactions programme, the initiation of a European banking union, and the implementation of economic stabilisation and structural reforms in member states. In Scope's view, the institutional evolution of the EU marked the turning point of the crisis and continues to bolster Scope's outlook on the periphery and the rest of the euro area. At the same time, however, ratings remain constrained by still-high public- and private-debt levels in the periphery, political uncertainties (for example, in Spain owing to the crisis in Catalonia) and banking system fragilities (Italy and Portugal).

Figure 6: Rating history, Ireland

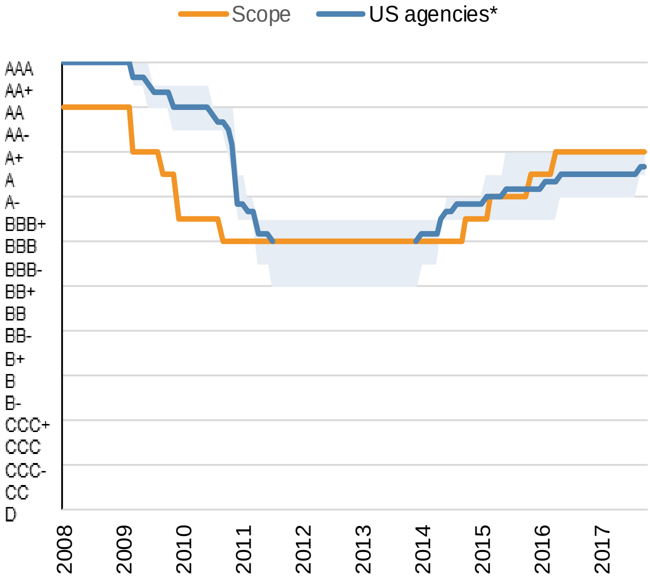
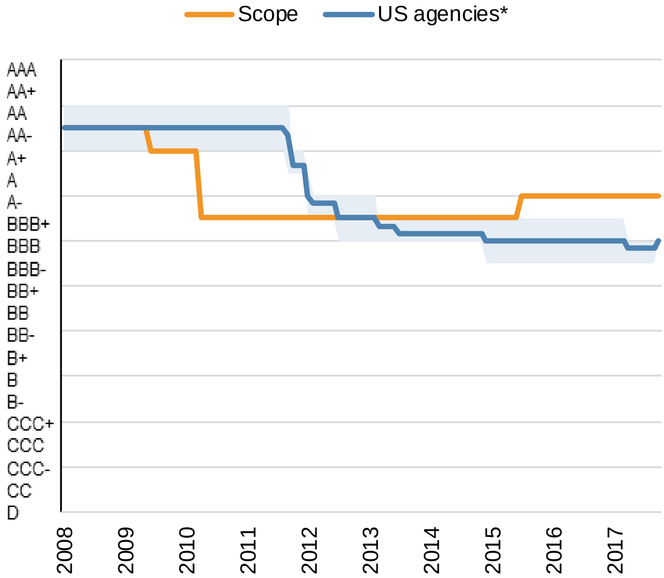
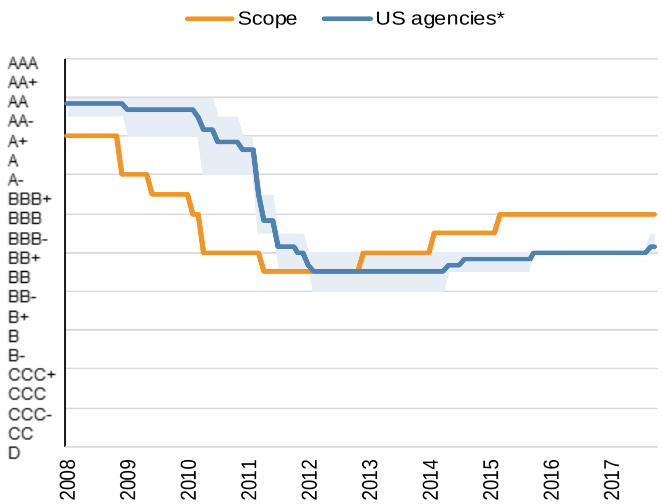


Figure 7: Rating history, Italy



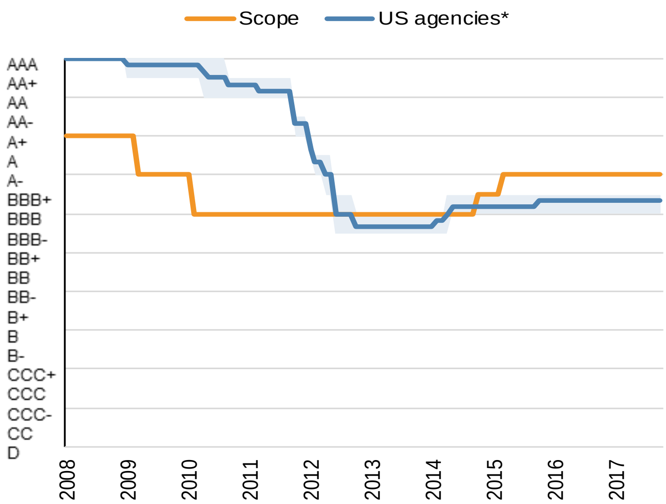
[6] See for instance Gärtner et al. 2011; Vernazza and Nielsen 2015; D'Agostino and Lennkh 2016; Bruha et al. 2017.
[7] In recent months, these revisions have included S&P's upgrade of Italy to BBB from BBB-, S&P's upgrade of Portugal to investment-grade at BBB- from BB+ and Moody's upgrade of Ireland to A2/Stable from A3/Positive.

Figure 8: Rating history, Portugal



Source: Scope Ratings AG

Figure 9: Rating history, Spain



Source: Scope Ratings AG
*Refers to the average rating of Fitch, Moody's and S&P; the grey shaded area refers to the rating-range between the three agencies.

Catalan independence is unlikely, with Scope anticipating no impact on Spain's rating or outlook

Spain's A- rating with a Stable Outlook reflects Scope's assessment that the Catalonia crisis, where the next step is regional elections scheduled for 21 December 2017, is unlikely to result in Catalan independence owing to multiple legal, institutional, economic, and financial reasons. In a special comment[8] published on 6 October 2017, Scope wrote that Catalan independence is unlikely over the medium term, regardless of any unilateral declaration of independence (which was made on 27 October).

Going forward, whether fresh regional elections result in a pro-independence majority in a new Catalan parliament or not, the long-term outcome will, in Scope's view, be greater fiscal and/or political autonomy for Catalonia. Scope outlined that the Catalan secession movement is unlikely to result in a change to Spain's ratings or outlook. However, a re-escalation of tensions in 2018 could still be credit-negative, owing to effects on business and consumer confidence.

Greece to remain subject to EU oversight after current programme

Greece's current ESM financial assistance programme ends in August 2018

Under Greece's third financial assistance programme, the ESM has to date disbursed about EUR 40bn to Greece of the total committed EUR 86bn, with only technical participation from the IMF (which has not provided any funds at this stage). Scope notes that the availability of the ESM funds terminates on 20 August 2018, while the recent *in principle* IMF approval of a EUR 1.6bn precautionary stand-by arrangement will also expire on 31 August 2018.

As Greece's ESM programme ends, the next steps remain unclear. The programme aims to assist Greece in regaining its market access at sustainable rates. In this context, Scope views positively that Greece issued a EUR 3bn five-year bond in July at 4.625%. However, this was only after soliciting owners of existing Greek debt to swap holdings in addition to an EUR 40mn sweetener[9] paid by the Greek government. Despite this issuance and drops in Greek yields, Scope believes Greece has yet to demonstrate sustainable market access and notes that July's issuance and further planned issuances are being conducted under the auspices of the financial assistance programme and its

[8] 'Catalonia to remain in Spain despite referendum, but tensions escalate' published by Scope on 6 October 2017.
[9] https://www.ft.com/content/c11daa34-711f-11e7-aca6-c6bd07df1a3c

inherent safeguards to the investment community. Market access could easily take a turn for the worst were the confidence induced via EU/ESM support lost.

Scope expects EU oversight on Greece to continue after the current programme

Next year, Scope expects EU/ESM oversight on Greece to continue in some form after the current programme concludes, with supervision possibly linked to additional debt measures, further financial assistance (perhaps vis-à-vis a precautionary credit line), and/or eligibility in the European Central Bank's asset purchase programme (scheduled to end in September 2018, but may be extended).

While Greece's financing obligations are low in the coming years, thanks to private and official sector debt restructuring alongside Greece's fiscal consolidation, Scope believes there is uncertainty on whether Greece can raise enough cash buffers by next summer to prove it can meet reduced future financing requirements without having to rely on EU assistance. Scope expects the Eurogroup will want some form of conditionality in exchange for further maturity and grace-period extensions on European official loans and/or participation in the ECB's quantitative easing (QE) programme – on the latter, the terms for entry of which are tied to Greek debt relief, per ECB comments. In addition, even in the scenario of a 'clean exit' from the programme (without further financial assistance), Greece would still be bound by commitments under the ESM's post-programme surveillance until the full loans are repaid, restricting the room for manoeuvre.

A phase of heightened uncertainty in 2018

Scope considers that a future new German government led by the CDU would make further financial support for Greece more onerous. This, combined with the Greek government's intent to pursue a clean exit (whether prudent or not), ensures a phase of heightened uncertainty in 2018 as next steps are hashed out. However, Scope does not expect a repeat of a crisis to the scale of that in 2015 (which occurred at a similar juncture with the second financial assistance programme at that time ending).

Greece's rating subject to review

While uncertainties surrounding Greece's future financing programme constrain its B- rating with a Stable Outlook, Scope considers the Greek issue to be idiosyncratic and not systemically important to its outlook on other European sovereigns. Alternatively, improvements in Greece's market access, assurance of a sustainable medium-run financing plan, attainment of debt relief and/or inclusion in the ECB's QE would be credit-positive, in Scope's view.

Italy: Uncertain election outlook poses some downside risks

Despite a new electoral law, risks of inconclusive election results remain

Italy will hold a general election by May 2018. Following the approval of the new electoral law[10] in October this year, which is expected to reduce political fragmentation and favour more-cohesive pre-election alliances, the risk of the anti-establishment Five Star Movement (M5S) forming a government has markedly fallen, given M5S's open refusal to join broader coalitions with other parties.

2018 election outlook

However, a stable and reform-oriented government may also prove elusive, which, in Scope's view, may impede economic recovery and the implementation of reforms. The latest opinion polls suggest that support is split equally between three competing political groups, a trend also evidenced by Sicily's regional election outcome on 5 November: the centre-left (the ruling Democratic Party (PD) and its junior coalition partners), the centre-right (Forza Italia, Northern League, and Fratelli d'Italia), and anti-establishment M5S. Notably, as much as 40% of voters are still undecided[11], and historically about a third of voters change parties at each election, undermining the predictability of polling. At present, Scope does not expect an absolute parliamentary majority for any existing

[10] The law harmonises the voting system for both houses of parliament and in addition introduces two main changes: First of all, two-thirds of the seats will be allocated on a majoritarian representation with the remaining third allocated on a proportional basis; secondly, the minimum threshold to gain seats in both chambers will be uniform at 3% of the votes for individual parties and 10% for coalitions.
[11] Istituto Cattaneo, October 2017.

political group because the new electoral system is predominantly proportional. Scope's baseline scenario is an unstable, broad centre-left/centre-right coalition. While such a coalition would ensure economic policy continuity, it is unlikely to result in a stable government that adopts far-reaching structural reforms.

Italy's economic growth is above potential

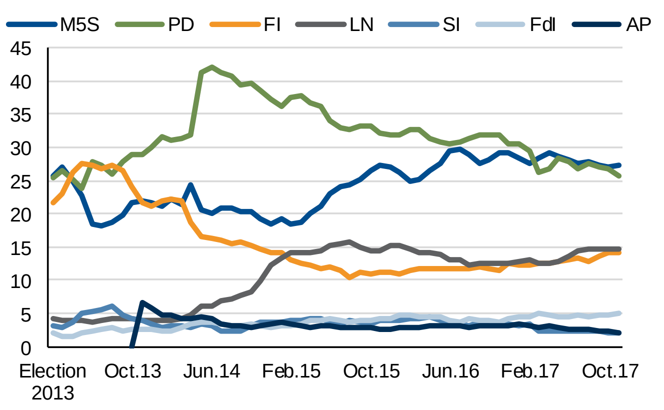
The political uncertainty notwithstanding, Scope expects Italy's recovery to continue to gain traction. Boosted by accommodative fiscal and monetary policies, Italy's economy is set to expand by 1.5% this year according to the IMF, its best performance since 2010. In 2018, growth is expected to slow to 1.1% as fiscal and monetary policies become less supportive, but is set to remain above its potential rate. Government measures to strengthen the banking sector, including the recapitalisation of Monte dei Paschi di Siena and the liquidation of two large regional banks in Veneto, should support the ongoing economic recovery. Italian banks' stock of non-performing loans is still high compared with the European average, but is declining thanks to a lower rate of deterioration in loan quality and to sizeable disposals of bad loans. With the economy growing steadily, Scope expects this trend to continue over the medium term.

Gradual fiscal consolidation, favourable debt structure and modest contingent liabilities mitigate debt sustainability risks

Italy's large stock of public debt remains a key vulnerability for its A- rating (and Stable Outlook); however, Scope is mindful of the country's gradual fiscal consolidation, favourable debt structure and relatively low implicit debt arising from moderate healthcare and pension liabilities. The budget deficit improved, reaching 2.5% of GDP in 2016. Italy also maintained a high average primary surplus of 1.4% of GDP over the last 10 years, well above that of most euro area countries. According to the 2018 draft budgetary plan, the budget deficit is expected to continue to fall in 2017 to 2.1% of GDP and 1.6% in 2018, supported by better-than-expected economic growth as well as deficit-reducing measures worth 0.2% of GDP.

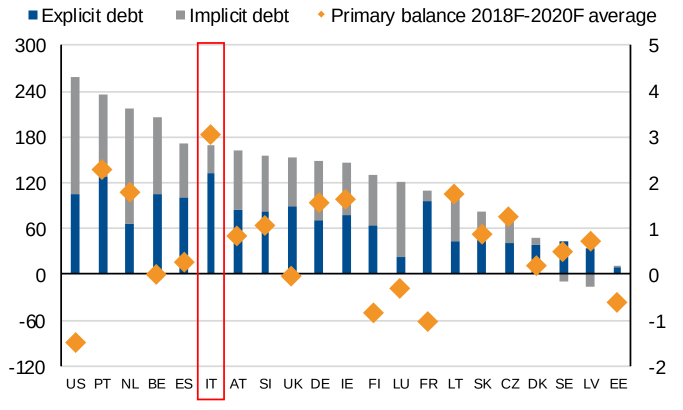
In addition, financing risks are mitigated by the relatively long average maturity of the debt stock (seven years), nearly 70% of which is held by residents (compared with 56.7% in 2010). Italy is, as such, less exposed to sudden shifts in international investor confidence. Moreover, rising interest rates, beyond the current average cost of the overall debt of stock of 3%, take time to feed through to the relatively long government bond maturity structure. Lastly, once pension- and healthcare-related liabilities are included, Italy's debt burden is in line with that of many euro area peers. Thus, Scope views risks to Italy's debt sustainability as largely muted in 2018, supporting an A- rating assessment, provided the exit from the ECB's asset purchase programme is orderly and there is no negative political shock.

Figure 10: Voting intentions, %



Source: Italian Chamber of Deputies

Figure 11: Explicit and implicit debt levels (% of GDP) and expected primary balance (% of GDP, RHS)



Source: IMF, EC, Scope Ratings AG

Brexit enters critical phase in 2018

Very tight window for Brexit negotiations

The year 2018 promises to be critical in the UK's exit negotiations with the EU. With the 29 March 2019 exit date (with or without a deal) fast approaching, the European Commission's Chief Negotiator Michel Barnier moreover warned that 'the period of actual negotiations will be shorter than two years', noting that EU institutions need time to ratify the agreement before March 2019. Barnier stated last December that talks must end by October 2018, though, presumably, there is flexibility to this – with emergency procedures on hand, if needed, to pass an agreement in both the EU and the UK parliament. This pushes a firm deadline on a deal to early 2019. However, in all scenarios, the window is very tight, and negotiations over 2018 are likely to be tense and unpredictable.

Scope sees either a soft Brexit or no Brexit

In 'Uncertainties around Brexit Challenge UK Credit Outlook' published on 23 August 2017, Scope outlined that the two most probable outcomes are either i) an eventual form of soft Brexit or ii) a no-Brexit scenario. In Scope's baseline, the UK eventually concludes a soft-Brexit arrangement with the EU. Due to the tight two-year window of Article 50, the infeasibility of a successful hard Brexit over such short horizons[12] will push for a gradual reversion towards the status quo – over the near term, and probably over the longer term. A soft Brexit could be accompanied with a transitional arrangement of at least two years, and/or an extension of Article 50 negotiations (in the latter case, postponing the UK's departure).

Next, Scope views a no-Brexit scenario as the second most probable outcome. With negotiations taking place over multiple years, public opinion can continue shifting. In an October 2017 YouGov poll, 47% of respondents said it was wrong for the UK to vote Leave, while 42% consider Brexit as the right decision. In Scope's view, limited successes in Brexit talks, a weakening UK economy, and shifting public sentiment could bring about political instability and force an eventual rethink on the Brexit strategy. Of note, the opposition Labour Party shifted its Brexit position in August, to support remaining in the single market and customs union transitionally for up to four years, and possibly permanently (in a form of Norway+ model, which is not far from favouring remaining in the EU). This is meaningful, given a fractured minority Tory government and the risk of early parliamentary elections.

Soft Brexit, extension of Article 50 or Brexit reversal the most probable scenarios by March 2019

Scope's view is moreover reinforced by the negotiation process. In the near term, it remains unclear whether phase-two talks on the trade and transitional framework can begin by December 2017, as hoped for by the UK and the EU. But irrespective of this, Scope considers it unlikely that there will be substantive breakthroughs before March 2019 on any new framework for trading and institutional relationships (including customs and migration arrangements) with the EU, except one that rather resembles that which already exists. As such, in Scope's view, the destination by March 2019 will be either a soft Brexit and/or transitional framework, an extension of Article 50 negotiations (and postponement of Brexit) or reversal. But, given the lack of foresight driving negotiations, the government's intention to seek a hard Brexit, and the probable absence of a credible transition agreement in the near term, concerns on hard Brexit will continue to dominate and grow in scale if no deal emerges over the course of 2018. Scope will monitor the risk of hard Brexit vis-à-vis its anticipated scenarios, with a rise in hard Brexit risks a core downside scenario affecting the 2018 regional outlook.

2018 will also see further political instability in the UK. A change in UK leadership is a distinct possibility before the end of 2018 given sustained pressures on Theresa May's minority government, marked by internal dissent and recent turnover in major cabinet positions. Even if May were forced out as prime minister, it is not obvious whether the UK

[12] Government estimates suggest a successful hard Brexit may require up to a decade or more. See HM Government. (2016) 'The process for withdrawing from the European Union'. Cm 9216, February 2016.

would immediately head to an early parliamentary election. While a Conservative Party leadership contest might initially take place bringing in an alternative approach on Brexit, a parliamentary election is not precluded later on, with Labour currently being the more likely to lead a new government in this scenario. However, under any scenario, Scope believes the significant and disproportionate costs of a no-deal Brexit will exert pressure on policymakers to soften and/or prolong the Brexit approach.

Scope's assessment on the UK concentrates on Brexit, related uncertainty, and the macroeconomic framework

Scope's UK rating of AA with a Negative Outlook reflects uncertainties around negotiations and the future trading relationship with the EU, the impact of this uncertainty on consumption and investment, and a weakened macroeconomic policy framework, including slippage in fiscal consolidation targets and more short-term-focused economic policies. These Brexit-related consequences weaken the robustness of the UK's credit profile. Scope outlined in its August special comment on Brexit the conditions under which the UK's rating could be downgraded or the Outlook revised to Stable over the coming period to early 2019.

Russia-Turkey investment-grade differential to stay

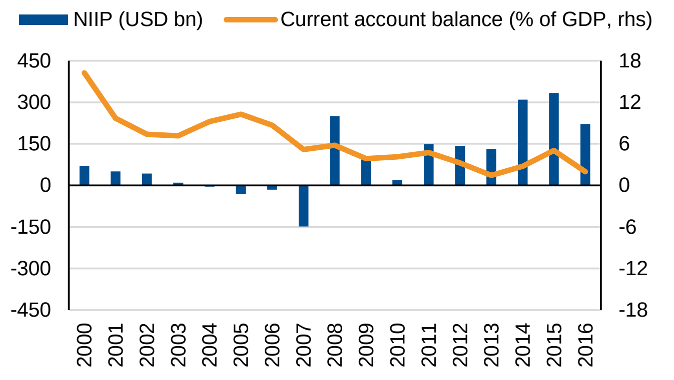
Russia's strengthened macroeconomic framework and resilience drives IG rating…

Scope's October upgrade of Russia's rating to investment grade (BBB-/Stable) reflects declining credit risks, owing to Russia's strengthened macroeconomic framework (including a free-floating exchange rate) and greater resilience to external shocks, which have enhanced the economy's defences against risks like lower oil prices and international sanctions. Russia's higher foreign-exchange-reserve adequacy, robust current-account surpluses since 1999, higher degree of economic self-sufficiency, and net external-creditor position underpin macroeconomic stability. In addition, Russia's net external asset position has improved since 2013, also reflecting sizeable external USD-repayments by the banking sector in recent years.

… though major structural constraints remain.

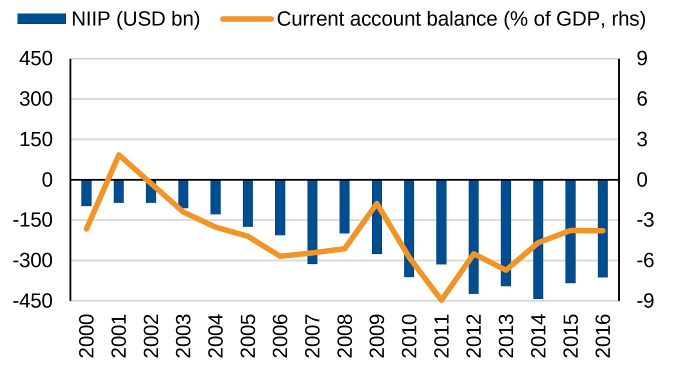
Conversely, Scope notes that these positive developments are counterbalanced by structural constraints such as the country's low growth potential and high vulnerability to geopolitical risk, which has led to limited international market access for the private sector and weak governance, among other effects. The conflict in Ukraine and the threat of additional sanctions remain significant event risks and a key constraint to Russia's credit rating. Still, Scope expects Russia's economic outlook to remain positive in the short to medium term, with real growth set to rise to 2.0% in 2018, driven by rising oil prices and a recovering domestic sector.

Figure 12: Russia's current account and net international investor position (NIIP)



Source: Russian Federation Treasury

Figure 13: Turkey's current account and NIIP



Source: Central Bank of the Republic of Turkey

Scope's non-IG rating on Turkey reflects a weaker credit profile than that of Russia

Scope's ratings on Turkey (BB+/Stable), on the other hand, remain under investment grade, indicating a comparatively higher vulnerability to adverse shocks than in Russia's case. This reflects Turkey's weaknesses in the event of adverse changes in global economic conditions and in the availability of external financing, given the country's large external financing needs (of around a quarter of GDP in 2018) and only modest forex reserves.

Turkey's current account has been persistently in deficit, reflecting a reliance on energy imports and elevated investment. The coverage of these current-account deficits through volatile forms of capital inflows has been inadequate of late, weighing on Turkey's modest international reserves. In Scope's view, Turkey will remain vulnerable to risks to international investor sentiment. However, external debt servicing costs are low due to benign global financing conditions. Moreover, in 2018, Scope expects Turkey's V-shaped recovery to continue, with real GDP growth of around 4%.

Risks surrounding US (fiscal and trade) policies and Fed tightening

Fiscal outlook to be determined by budget and debt ceiling risks

The year 2018 has the potential for continued risks in the United States. The end of 2017 will prove critical for the US's fiscal outlook, with Congress in the final stages of completing a tax reform plan. As the Senate's budget resolution allows reductions in revenue and changes in outlays to raise the deficit by USD 1.5trn over the next 10 years, Scope expects the final law signed by President Donald Trump to include significant tax cuts that will only be offset partially by cuts in discretionary spending. Scope considers that such a reform would adversely affect the US's longer-term fiscal outlook. In addition, Scope notes the immediate credit risk stemming from the debt-limit deadline on 8 December 2017. Scope expects policymakers to remove the urgency to conform to the limit and push the deadline down the road. In that, a repeat of the debt ceiling debate is not precluded sometime in 2018, and Scope considers the now-frequent risk of the US Treasury being legally unable to issue new debt to cover government spending to present continued operational risks which weigh on the US's rating. Given the polarised Congress, a temporary government shutdown, moreover, cannot be ruled out in December, and the central issue of ensuring fiscal discipline while avoiding political brinkmanship remains unresolved.

Senate to remain Republican-controlled, House a tight race; but political polarisation to stay

Scope believes that the Congressional elections, scheduled for 6 November 2018, are unlikely to materially change the current balance of power. The Senate is likely to remain under Republican control, because out of the 33 seats up for election, Democratic Senators hold 25, implying Democrats would need to not only keep the 25 seats but also win an additional three to obtain a 51-seat majority. In addition, even if Democrats were to win the House, the resulting divided Congress would need to cooperate with the presidency, which will safely remain in Republican hands. Thus, in Scope's view, it is unlikely that a new spirit of bipartisanship will emerge post-election to address the country's underlying structural challenges – a weakening potential growth outlook, high and rising public debt, and significant pension- and healthcare-related liabilities. These collective challenges underscore Scope's cautious AA rating on the United States.

Risks from the US's trade policies

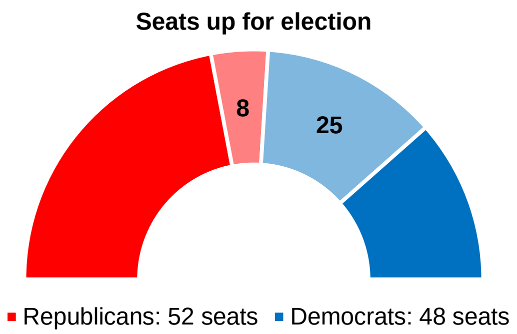
In addition to domestic policies, the Trump administration could also adversely affect global trade arrangements. Scope notes that the protectionist trade rhetoric of President Trump's election campaign has, so far, not materialised into significant unilateral trade measures from the US government. Nevertheless, given the sustained emphasis of the US administration on reviewing US trade agreements around the world (pulling out of the Trans-Pacific Partnership alongside ongoing NAFTA renegotiations), reducing bilateral trade deficits, and making conditions more favourable for US manufacturers, the possibility of a more disruptive US approach is a risk in 2018. In Scope's view, increased protectionism poses a risk for productivity growth and the potential growth rate of the global economy, with impact on US trading partners, especially in Asia, which accounts for 67% of the US goods trade deficit.

Fed tightening a possible trigger for a market correction in a low-volatility environment

Scope believes that the Federal Reserve's intention to gradually reduce its holdings of US Treasury (USD 2.5trn) and mortgage-backed securities (USD 1.8trn)[13] marks a systemic change in market dynamics which, combined with its current interest rate hike cycle, could increase market volatility and global capital flow reversals if not managed well. In February 2018, Fed Governor Jerome Powell will take over as Federal Reserve Chairman when Janet Yellen's single term concludes. While Powell is expected to continue the Fed's existing policies of gradual tightening, his inexperience, combined with still-outstanding vacancies in the Federal Reserve's Board of Governors, raises the risk of miscommunication with markets and policy error.

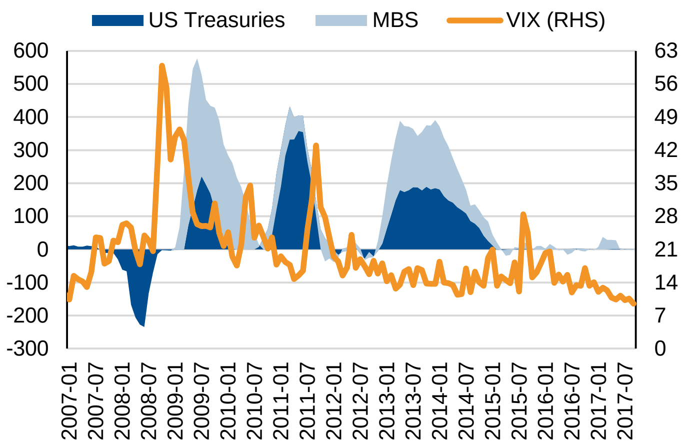
Scope highlights that an economy is most prone to a hidden build-up of imbalances when measured volatility is low, also known as the *volatility paradox*. In this context, a sudden repricing in fixed-income markets could lead to substantial capital losses for investors with large holdings of bonds; whereas an equity market correction, although historically less consequential in terms of its economic impact (such as in 1987 and 2000), could amplify pressures on US private but also state & local pension funds, as their equity-related assets range between 50% and 67% of total assets, on average[14].

Figure 14: 2018 Senate elections, seats



Source: US Congress

Figure 15: Federal Reserve flows (USD m), VIX (RHS)



Source: Federal Reserve, WSJ; Flows are 4-month moving sum.

Economic adjustments in China; policy continuity in Japan

Scope downgraded China in September, with the focus remaining on debt risks

On 29 September 2017, Scope downgraded China's long-term ratings to A+ from AA-, based on high and continued rises in levels of economy-wide debt, representing both direct and contingent liabilities of the government. In a special comment[15] published on 15 November 2017, Scope re-iterated that the 'extent to which a continued unfavourable debt trajectory is redressed through the proactive initiatives of authorities' is a key factor in its forward-looking assessment of China's ratings and outlook. If economic and financial reforms accelerate significantly, including moves away from 'hard' growth targets (which drive leverage expansion), and these reforms improve productivity growth, reduce financial imbalances, and break the trajectory of rising debt, Scope could affirm China's

[13] For payments of principal that the Federal Reserve receives from maturing Treasury securities, the Committee anticipates that the cap will be an initial USD 6bn per month initially, increasing in steps of USD 6bn at three-month intervals over 12 months until it reaches USD 30bn per month. For payments of principal that the Federal Reserve receives from its holdings of agency debt and mortgage-backed securities, the Committee anticipates that the cap will be USD 4bn per month initially, increasing in steps of USD 4bn at three-month intervals over 12 months until it reaches USD 20bn per month. FRS, Monetary Policy Report, July 2017.
[14] https://www.federalreserve.gov/releases/z1/current/z1.pdf Pp94-100
[15] See 'China's sovereign ratings hinge on deleveraging initiatives' published on 15 November 2017.

rating at A+, and/or consider rating upgrades in the long run. Conversely, Scope identified that if non-financial-sector debt ratios continue to rise, threatening financial stability, this could be a main trigger in 2018 and beyond for further negative revisions in the ratings or outlooks. Scope considers China's significant debt stock and necessary economic adjustment to be a core area of attention in 2018, tying to systemic risks to the global economy.

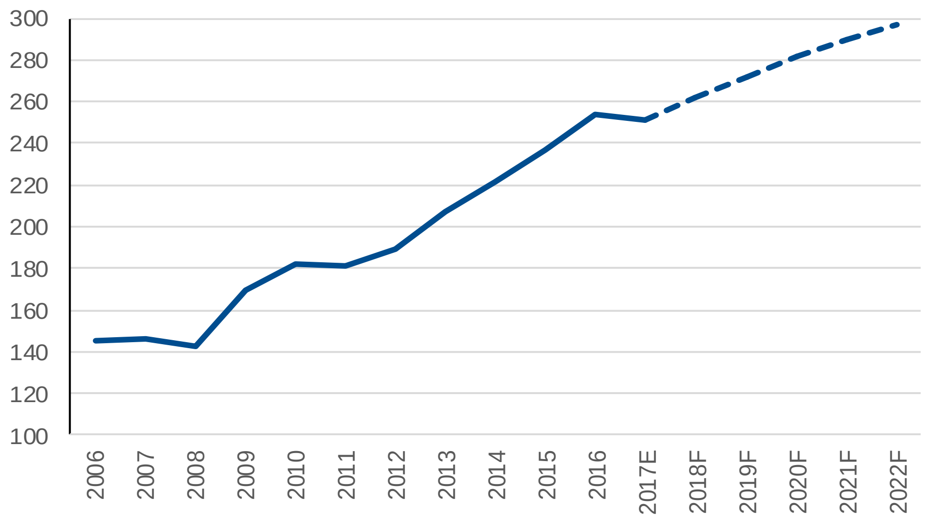
At October 2017's National Congress, during which President Xi Jinping consolidated power, reform announcements were broad and unspecific (per the standards of previous party congress addresses) on initiatives to address debt and unbalanced growth. However, the period leading up to and surrounding the Central Economic Work Conference in December 2017, the National People's Congress in March 2018 and the Third Plenum in the autumn of 2018 may provide greater clarity on the post-congress policy agenda. Scope considers decisions on the 2018 growth target and appointments to key economic posts – including the governorship of the People's Bank of China and the head of the finance ministry – to be signals of the government's intent.

Total non-financial sector debt rose to 258% of GDP as of Q1 2017, according to data from the Bank for International Settlements, having risen sharply from 141% of GDP as of Q4 2008. In the latest Article IV, the IMF estimated total non-financial sector debt (which under its definition stood at a lower 236% of GDP at end-2016) to continue its rise to 297% of GDP by 2022 (Figure 16). Scope notes that such significant debt increases over such a short time have been associated with sharp growth slowdowns and, frequently, financial crises.

Deleveraging initiatives are underway, but meaningful long-term risks remain

However, important supervisory and regulatory action has been taken to contain critical segments of financial sector risks. Scope considers such reform initiatives – to deepen state-owned enterprise reform, strengthen financial sector regulation and combat local government debt – to be critical to China's outlook. In this, the government's commitment and ability to reform represents a continued credit strength. The tightening in financial conditions has cut intra-financial sector credit. In addition, total lending to the non-financial sector rose 10.8% YoY in October 2017, a drop from over 17% in late 2015. While President Xi's consolidation of power surrounding the 19th National Congress affords the opportunity to deepen deleveraging initiatives – which support China's ratings – Scope considers meaningful long-term risks to remain.

Figure 16: Non-financial sector debt in China, % of GDP



Source: IMF (including latest Article IV forecasts)

Political stability and continuity of Abenomics in Japan

Prime Minister Shinzo Abe's victory in an early parliamentary election in October 2017, in which his Liberal Democratic Party (LDP) bloc emerged re-strengthened with a mandate until 2021 alongside a two-thirds majority in the Diet. Should Abe win another three years in 2018's LDP primary contest (as is expected), he would become the longest-serving prime minister in post-war Japanese history. In Scope's view, LDP's victory in October's election ensures the continuation of recent political stability and that the Abenomics reform agenda will continue into 2018.

Momentary robust growth but significant debt sustainability challenges

Japan's economy is growing at a robust pace (compared with its recent record), at 1.3% in 2017, and is expected to receive a sustained boost in 2018 due to preparations for the 2020 Olympic Games and accompanying urban redevelopment. With headline and core inflation both at just 0.7% YoY as of September 2017, the decision to reappoint Governor Haruhiko Kuroda to helm the Bank of Japan (Kuroda's current term ends in April 2018) will be critical to determining the trajectory of the reflationary large-scale bond purchase programme that already sees the central bank holding about 45% of outstanding Japanese government bonds – monetising a significant segment of Japan's sovereign debt.

But with Japan's gross public debt projected at 240% of GDP in 2017 (along with an estimated fiscal deficit of 4.1% of GDP), Scope's assessment continues to centre on the extent that this outsized debt burden is corrected. In this regard, Scope assesses negatively the recent omission of a pledge to achieve a primary surplus by 2020 from LDP's campaign platform alongside plans to use revenues from a planned VAT hike in October 2019 for various spending programmes. These risks were considered in Scope's September downgrade of Japan's long-term credit rating from AA- to A+.

Geopolitical concerns in 2018

A world in transition

Geopolitical surprises are expected in 2018. In a more uncertain and unstable global environment, the changing balance of global leadership and rise of regional spheres of influence have made for a more ambiguous and discordant global response to major issues – from climate change to global trade, to conflicts in the Middle East. The greater absence of global leadership has become considerably more pronounced since the 2016 US election and subsequent reorientation in the country's policy framework.

North Korean tensions

One central risk in 2018 will revolve around tensions on the Korean peninsula. An increased frequency of North Korean ballistic missile and nuclear tests have coincided with the escalation of heated rhetoric between US President Donald Trump and North Korean dictator Kim Jong-un. Tensions surrounding North Korea are bound to re-emerge over 2018. Even if such strains do not intensify into direct military confrontation in the near term, the threat of provocative acts by the Kim regime and the Trump administration still represents a destabilising risk hanging over the East Asia and Pacific, bolstering remilitarisation in the region (such as steps towards reforming Article 9 of Japan's Constitution). Scope accounts for North Korea risk in its forward-looking assessment of regional credits, notably in the reviews on China and Japan.

Instability in the Middle East and North Africa

Risks also emanate from Sunni-Shiite tensions in the Middle East. Proxy conflicts in Syria and Yemen between Saudi Arabia-aligned and Iran-aligned elements spilled over in November into a direct attack on Saudi soil, with the interception of a missile launched from Yemen. Moreover, Sunni tensions with Qatar, continued Russian involvement bolstering the Bashar al-Assad regime in Syria, civil war in Libya, alongside uncertainty on the future of Iran's nuclear programme after the US moved to back out of the 2015 nuclear deal raise regional stresses. While conflicts in the Middle East and North Africa have long been simmering, the escalation of these conflicts threatens spill-overs and further displacement of persons affecting neighbouring countries and regions. Such conflicts could also meaningfully impact global markets, in more adverse scenarios.

Destabilisation linked to Russia

Lastly, in Scope's view, geopolitical risk also stems from Russia. The war in the Donbass region of Ukraine will continue into 2018 amid sporadic ceasefires; the occupation of Crimea appears frozen absent resolution, enforcing renewal of Western sanctions on Russia. Threats to other states in eastern Europe remain with calls from the United States for greater self-defence capabilities of NATO member states.

Annex I: European reform agenda

Completing Banking Union requires comprehensive NPL strategy to resolve legacy assets

In Scope's assessment, two key components of the Banking Union remain outstanding: a common backstop for the Single Resolution Fund, which would strengthen its credibility, and a European Deposit Insurance Scheme (EDIS)[16]. However, given risks associated with legacy assets in various euro area banks, a European strategy for non-performing loans would have to be established before EDIS is in place, which in Scope's assessment would reduce, if not eliminate, the risk of bank runs in any single euro area country, in turn enhancing financial stability across euro area borders. In this context, Scope views positively the latest proposals by the ECB to tackle this issue[17].

Reduce 'home bias' in banks' balance sheets

In addition, Scope would view positively efforts to reduce the high domestic bias in banks' sovereign exposures, for instance, via regulatory curbs or risk-weights. These would mitigate the bank-sovereign vicious circle in crisis situations, reducing the likelihood of banks defaulting once their respective sovereign restructures its debt. While such legislation would likely result in significantly enhanced market discipline for the sovereign issuers themselves – since there would no longer be a presumption that domestic banks would act as buyers of last (or next-to-last) resort of their debt[18] – it is Scope's view that such a measure would ultimately be credit-positive for euro area sovereigns, including highly indebted ones.

Capital Markets Union key for spurring investments

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 of finance, including capital markets, venture capital, crowdfunding and asset management, would not only widen companies' access to finance 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 law across Europe.

Targeted EU budget could enhance shock-absorption capacity of EA sovereigns

In line with French President Macron's proposal, a euro area budget to counter asymmetric shocks would be a further step towards a more resilient monetary union. In Scope's view, such a fiscal stabilisation tool would contribute to deliver the right fiscal stance at the aggregate level as well as provide cross-country risk-sharing against large asymmetric shocks that individual countries find difficult to cope with without running into market access or debt sustainability concerns. In Scope's assessment, however, a large additional budget is not only politically unfeasible but also unnecessary. In fact, several smaller and targeted options currently being discussed would already markedly enhance the EMU's resilience. These include a European Investment Protection Scheme[19], a European Unemployment Reinsurance Scheme[20] and a so-called 'rainy day' fund[21]. In addition, Scope recalls the already-existing exception clause in the Stability and Growth Pact that allows the 3% deficit maximum to be breached in case of a severe crisis.

Effective lender of last resort paramount for ratings

No matter how the proposal for transforming the ESM into a European Monetary Fund evolves, whether by assuming control of fiscal policy monitoring (currently undertaken by the European Commission) or by becoming a form of euro area treasury, the function of a

[16] The Banking Union has led to a single rule-book, the creation of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM).
[17] https://www.bankingsupervision.europa.eu/press/pr/date/2017/html/ssm.pr171004.en.html
[18] http://bruegel.org/wp-content/uploads/2017/09/PC-23-2017-fourfold-union-1.pdf
[19] A European Investment Protection Scheme would protect investment in the event of a downturn, by supporting well-identified priorities and already-planned projects or activities at national level, such as infrastructure or skills development. With the protection scheme, which could be in the form of a financial instrument, investment projects could still be continued.
[20] A European Unemployment Reinsurance Scheme would act as a 'reinsurance fund' for national unemployment schemes. Unemployment benefits are an important part of the social safety net and their uptake tends to increase in a downturn, when resources are constrained by the need to contain fiscal deficits. The scheme would provide more breathing space for national public finances and help economies to emerge from crises faster and stronger. The unemployment reinsurance scheme would, however, probably require some prior convergence of labour market policies and characteristics.
[21] A rainy-day fund could accumulate funds on a regular basis. Disbursements from the fund would be triggered on a discretionary basis to cushion a large shock and would normally limit its payments strictly to its accumulated contributions. Its capacity might thus be too small in case of a large shock. Alternatively, the fund could be equipped with the capacity to borrow. This would need to be accompanied by a design that clearly provides for savings at other times and limits indebtedness.

lender of last resort for euro area countries is paramount to Scope's euro area ratings. In this context, Scope will closely monitor the evolving role of the European Central Bank (ECB), and, in particular, the future application of the ECB's unconventional monetary programmes, specifically the Outright Monetary Transactions (OMT), which in principle provide a (conditional) backstop with no ex ante quantitative limits to euro area sovereign markets. This de facto unlimited aspect stands in contrast to the ESM's present maximum lending capacity of EUR 500bn, of which EUR 378bn remain available, which in Scope's opinion might in itself be insufficient to counter a self-fulfilling crisis on the sovereign debt market. However, so long as the ECB's OMT programme remains in place, the ESM's lending capacity need not be extended to support euro area sovereign ratings.

Annex II: Macro-economic Outlook 2018-20

For the 2018-20 period, Scope expects robust and broad-based economic growth of around 2% in the euro area and the US, slightly lower for the UK (1.6%) and Japan (0.6%), and slowing for Turkey (down to 3.5% from 4.8%) and China (down to 6.3% from 6.8%). Global growth conditions will be supported by strong consumer and business confidence, an acceleration in global trade, and benign financing conditions. Despite stronger growth in domestic demand, core inflation has remained weak and below target in most advanced economies, reflecting still-weak wage growth and driving Scope's baseline for a very gradual monetary policy reversal. Fiscal consolidation efforts in the euro area are expected to continue and, together with continuous solid growth levels, the debt-to-GDP ratio is expected to gradually fall for most European sovereigns. Lastly, no significant changes are expected in current-account balances, though China's current account surplus will continue to fall while the UK's current account deficit will correct to an extent owing to the weaker sterling and weaker domestic demand conditions.

Macro-economic overview

Region	Real GDP growth (%)		Inflation (%)		Fiscal balances (% GDP)		Debt level (% of GDP)		Current account (% of GDP)	
	2015-17E	2018-20F	Target	Core*	2015-17E	2018-20F	2017E	2020F	2015-17E	2018-20F
Euro area	2.0	1.8	2.0	1.6	-1.6	-0.7	87.4	81.1	3.2	2.9
Germany	1.8	1.6	2.0	1.7	0.7	1.0	65.0	55.7	8.3	7.5
France	1.3	1.9	2.0	1.4	-3.3	-2.7	96.8	95.6	-0.9	-0.5
Italy	1.1	1.0	2.0	1.5	-2.5	-0.6	133.0	125.8	2.2	2.0
Spain	3.2	2.1	2.0	2.0	-4.3	-2.2	98.7	94.5	1.7	2.0
Netherlands	2.5	2.1	2.0	1.6	-0.3	1.2	57.4	48.4	9.0	9.8
United Kingdom	1.9	1.6	2.0	2.6	-3.4	-1.6	89.5	87.6	-4.1	-3.0
Russia	-0.4	1.5	4.0	4.2	-3.1	-1.0	17.4	18.2	3.3	3.5
Turkey	4.8	3.5	5.0	10.1	-2.3	-2.3	27.9	27.2	-4.0	-4.4
United States	2.2	2.0	2.0	2.2	-4.1	-3.9	108.1	108.3	-2.4	-2.7
China	6.8	6.3	--	2.4	-3.4	-3.9	47.6	57.0	1.9	0.9
Japan	1.2	0.6	2.0	1.0	-4.0	-2.8	240.3	237.2	3.5	3.7

* Latest observation

Source: IMF, ECB, EC, BoE, CNBS, RSSTAT, TRSTAT, FRBSF, BOJ; Core inflation is PCE in the US.

Annex III: Scope's 2017 rating actions & publications

Country	Rating	Rating action	Strengths	Weaknesses	Publications
Austria	AAA/Stable	Confirmed	1) Wealthy & diversified economy 2) Strong external position 3) Sound public finances	1) Banking sector vulnerability 2) High public debt 3) Ageing population	Rating Report
Belgium	AA/Stable	Confirmed	1) Wealthy & diversified economy 2) Sound external position 3) Reform efforts	1) Slow fiscal consolidation 2) High public debt 3) Labour market rigidities	Rating Report
Estonia	A+/Stable	Upgraded from A to A+	1) Solid eco. fundamentals* 2) Strong public finances* 3) Euro area membership*	1) Small size of the economy 2) External vulnerability 3) Eroding competitiveness	Rating Report
Finland	AA+/Stable	Downgraded from AAA to AA+	1) Wealthy & diversified economy 2) Commitment to structural reforms 3) High debt affordability	1) Low potential growth outlook* 2) Increase of public debt ratio*	Rating Report
France	AA/Stable	Confirmed	1) Large & diversified economy + Euro area membership 2) Macro-financial stability 3) Favourable debt structure	1) High public debt and deficit 2) Labour market rigidities	Rating Report
Germany	AAA/Stable	Confirmed	1) Large and diversified economy 2) Sound public finances 3) Sound external position	1) Ageing population 2) Banking sector fragilities	Merkel's government to push ahead, despite weakened authority German elections: Low risk event but important for reform prospects in Europe Rating Report
Greece	B-/Stable	Upgraded from CC to B-	1) Compliance adjustment prog.* 2) Improving budget performance* 3) Stabilising macroeconomy*	1) High public debt 2) Fragile recovery prospects 3) Banking sector risks	Rating Report
Ireland	A+/Stable	Confirmed	1) Large & diversified economy + Euro area membership 2) Declining public debt 3) Strong institutions	1) High public & private debt 2) External vulnerabilities	Rating Report
Italy	A-/Stable	Confirmed	1) Large & diversified economy + Euro area membership 2) Primary surpluses & reforms 3) Resilient debt structure	1) High public debt 2) Growth below potential 3) Banking fragilities 4) Political uncertainties	Rating Report
Latvia	A-/Stable	Confirmed	1) Sound economic performance 2) Commitment to structural reforms 3) Effective fiscal consolidation 4) Euro area membership	1) Vulnerability to external shocks 2) Subdued potential growth 3) Unfavourable demographics	Rating Report
Lithuania	A-/Stable	Upgraded from BBB+ to A-	1) Continued fiscal consolidation* 2) Euro area membership* 3) Commitment to structural reforms*	1) Unfavourable demographics 2) Low potential growth 3) Vulnerability to external shocks	Rating Report
Netherlands	AAA/Stable	Confirmed	1) Wealthy & diversified economy 2) Solid external position 3) Sound public finances	1) High private debt 2) Vulnerability to external risks 3) Labour market inefficiencies	Rating Report
Portugal	BBB/Stable	Confirmed	1) Euro area membership 2) Improving public finances 3) Commitment to structural reforms	1) High private & public debt 2) Structural rigidities 3) Banking sector fragilities	Rating Report
Slovakia	A+/Stable	Confirmed	1) Euro area membership 2) Robust economic performance 3) Improving public finances	1) Strong regional disparities 2) Adverse demographics 3) Labour market rigidities	Rating Report

Slovenia	A-/Stable	Upgraded from BBB to A-	1) Euro area membership* 2) Improved macro & fiscal performance* 3) Improved external position*	1) Reform implementation 2) Ageing population	Rating Report
Spain	A-/Stable	Confirmed	1) Large & diversified economy + Euro area membership 2) Resilient economic recovery 3) Improving banking sector	1) High unemployment 2) High external debt 3) Fiscal imbalances 4) Political uncertainties	Catalonia to remain in Spain, but tensions escalate Rating Report
			EU non-euro area		
Croatia	BB/Stable	Confirmed	1) EU membership 2) Moderate recovery 3) Reduced fiscal deficits	1) Low growth potential 2) High public & private debt 3) Institutional shortcomings	Rating Report
Bulgaria	BBB/Stable	Confirmed	1) EU membership 2) Low & declining public debt 3) CA surplus & sound reserve coverage	1) Private sector spillover risks 2) No lender of last resort 3) Institutional weaknesses	Rating Report
Czech Republic	AA/Stable	Confirmed	1) Large & diversified economy + EU membership 2) Sound public finances 3) Resilient banking sector	1) Ageing population 2) Skilled-labour shortages 3) Dependency on capital inflows	Rating Report
Denmark	AAA/Stable	Confirmed	1) Wealthy & diversified economy 2) Prudent fiscal management 3) Strong external position	1) High household debt 2) Housing market pressures 3) Banking sector vulnerabilities	Rating Report
Hungary	BBB/Stable	Upgraded from BB+ to BBB	1) Better economic performance* 2) Improving public finances* 3) Reduction of ext. imbalances*	1) High public debt 2) Poor non-price competitiveness 3) Weak institutional credibility	Rating Report
Poland	A+/Stable	Upgraded from A to A+	1) Improving economic prospects* 2) Reduced CA vulnerabilities* 3) Increasing external buffers*	1) Reliance on capital inflows 2) Budgetary pressures 3) Political uncertainties	Rating Report
Romania	BBB/Negative	Confirmed	1) EU membership 2) Convergence process 3) High growth rate	1) Pro-cyclical fiscal policies 2) Vulnerabilities to short-term shocks 3) Institutional weaknesses	Rating Report
Sweden	AAA/Stable	Confirmed	1) Wealthy & diversified economy 2) Solid GDP & fiscal performance 3) Low external risks	1) Financial sector vulnerabilities	Rating Report
UK	AA/Negative	Confirmed	1) Large & diversified economy 2) Monetary & FX flexibility 3) Reserve currency status	1) Brexit-related uncertainty 2) Weaker eco. & fiscal outlook 3) Less predictable policy frame	Uncertainties around Brexit challenge UK credit outlook Rating Report
			EFTA		
Norway	AAA/Stable	Confirmed	1) Fiscal & CA surpluses 2) Sovereign Wealth Fund 3) Strong macro governance	1) Lower oil price 2) Low productivity growth 3) Domestic imbalances	Rating Report
Switzerland	AAA/Stable	Confirmed	1) Wealthy & diversified economy 2) Prudent fiscal management 3) Strong external position 4) Deep capital markets	1) Adverse demographics 2) Large and concentrated banking sector 3) Exposure to real estate risks	Rating Report
			Non-Europe		
China	A+/Stable	Downgraded from AA- to A+	1) Large and diversified economy 2) High external resilience 3) Scope for reforms	1) High and rising economy-wide debt* 2) Worsening public finances* 2) Weaker external position*	Rating Report China's sovereign ratings hinge on deleveraging initiatives
Georgia	BB/Stable	Confirmed	1) Economic resilience 2) Moderate public debt 3) Commitment to structural reforms	1) High CA deficit 2) Reliance on capital inflows 3) Large contingent liabilities 4) Political risks	Rating Report

Japan	A+/Stable	Downgraded from AA- to A+	1) Wealthy & diversified economy 2) Great funding flexibility 3) Strong external position	1) High debt levels* 2) Challenging debt dynamics* 3) Weak growth potential*	Rating Report
Russia	BBB-/Stable	Upgraded from BB- to BBB-	1) Strengthening macro stability* 2) Improving external position* 3) Sound public finances* 4) Declining financial risks*	1) Low growth potential 2) Geopolitical risks 3) Weak governance	Rating Report
Turkey	BB+/Stable	Upgraded from BB to BB+	1) Growing & resilient economy* 2) Improving public finances* 3) Effective economic policy response*	1) High external financing needs 2) Political uncertainties 3) Worsening business environment	Rating Report
USA	AA/Stable	Confirmed	1) Wealthy & competitive economy 2) Accountable institutions 3) USD reserve currency	1) Weakening potential growth 2) High public debt 3) Significant contingent liabilities 4) Political polarisation	US government obligations & contingent liabilities: a high and rising fiscal risk The unparalleled status of the US dollar in an evolving global environment Polarisation in US politics is leading to policy inaction and uncertainty Why the United States is no longer AAA Rating Report

* Refers to rating drivers.

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