SCOPE Scope Ratings

Scope's 2020 Sovereign Outlook: Key themes and regional views

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Scope's 2020 Sovereign Outlook

Key takeaways

- Sluggish 2020 global growth (~3%), high market volatility and policy unpredictability
  - Unresolved trade disputes, rising indebtedness, China's slowdown, overvalued asset markets
- Monetary policy even more limited to facilitate higher growth and inflation
  - But interest rates will remain very low, supporting global economy, debt dynamics and liquidity
  - Low rates fuel build-up of global debt, increasing significant macro-financial imbalances
- National governments to use available fiscal space and implement structural reforms
  - Fiscal policy will be somewhat more expansionary in 2020
  - Fiscal space limited in many countries expanding fiscal policy like Italy, China and Turkey
- Some possible upside for structural and institutional reform agenda in Europe
- Current "risk-on" market conditions contrast with 2020 challenges for sovereign ratings
  - Sovereigns with a Negative Outlook: the UK, China, Turkey and Romania
  - Greece, Portugal, Russia and Lithuania have a Positive Outlook
- Climate change risk assessments will gain greater public policy momentum

Scope's 2020 Sovereign Outlook

Overview

Key themes for 2020

1. Slow global growth continues in 2020
2. Build-up of global debt and financial imbalances
3. New EU leadership: EC priorities and prospects for Banking Union
4. Limits to monetary policy: going forward, what can the ECB do?
5. European fiscal space: yes, but will there be adequate stimulus?
6. Divergence between Scope's and the market's sovereign risk assessment
7. ESG: growing policy focus

Regional views for 2020

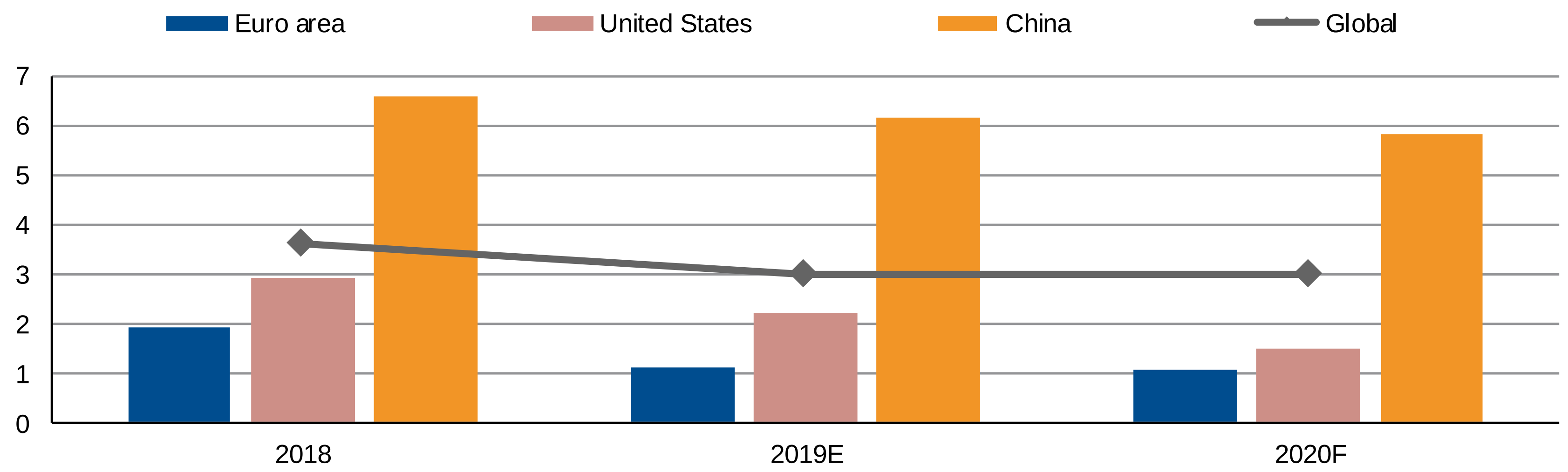
1. Core Europe: inverse policy action needed in Germany & France
2. Will Brexit "happen" at last?
3. Italy, Spain & Portugal: diverging political stability amidst high debt
4. Greece & Cyprus: debt and NPL reduction
5. CEE: slowing growth but improved resilience due to domestic demand
6. Cautious outlook on Turkey; Russia's policies bolster external resilience
7. Nordics & Switzerland: moderate growth and ongoing financial risks
8. Cyclical and structural factors to lower US growth during election year
9. China & Japan: fiscal and financial stability risks are areas to watch

➢ The outlook for the global economy remains challenging in 2020

- Global growth: around 3% next year (similar to 3.0% estimated in 2019), materially below 2018 (3.6%) and 2017 (3.8%)
- Main drivers of soft growth: i) the ongoing structural slowdown in China; ii) the cyclical and structural slowdown in the US; and iii) low growth in the euro area
- Against this, recoveries in some EM, including Russia and Turkey, are raising global growth

Global growth, 2018-20F

%

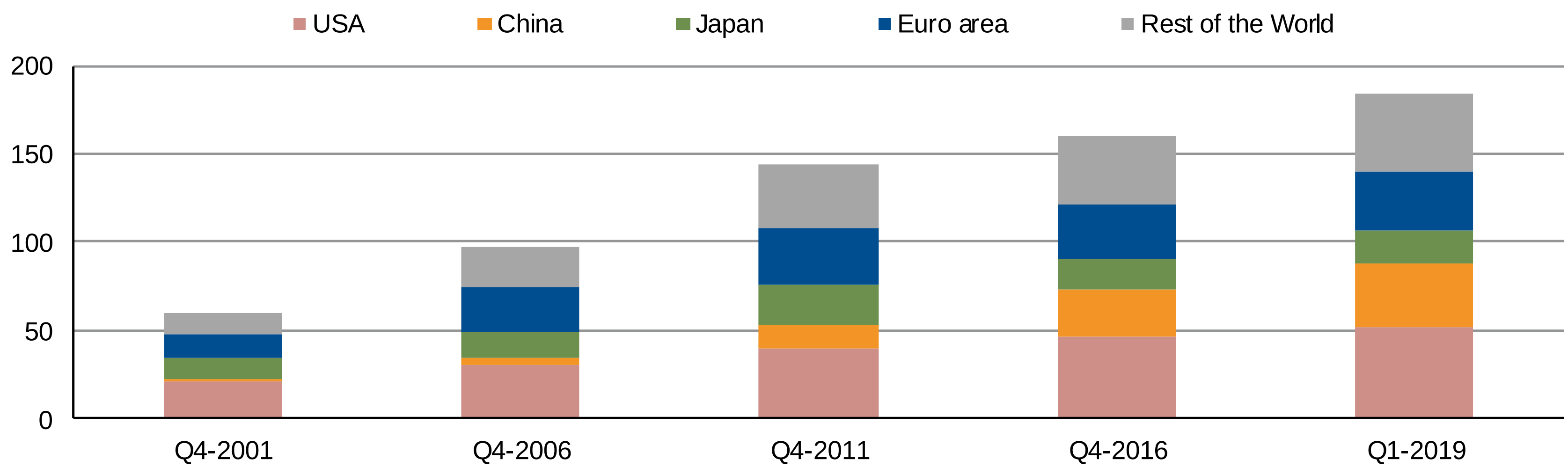


Source: IMFWEO, Scope Ratings GmbH

Continuous rise of global debt and risk of asset price imbalances

- New high in global non-financial-sector debt, at USD 184trn in Q1 2019, or 238% of total GDP
- With slower global growth, sustaining debt stocks now depends even more on very low rates
- Low rates prompt investors to take on riskier and less liquid assets to meet return targets
- Signs of overvaluation in equity markets and excessive compression in bond yield spreads

Global debt (of reporting countries)
USD trn

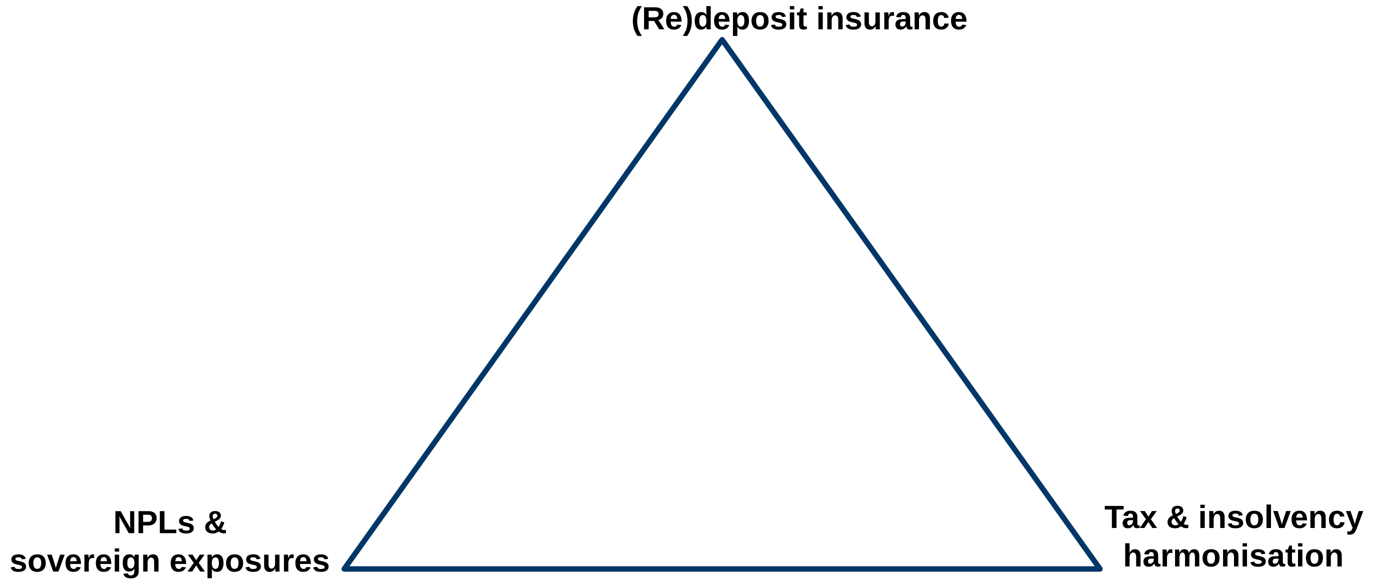


Source: Bank for International Settlements, Scope Ratings GmbH

External pressures bring EU leaders together to tackle challenges

- Priorities: greening economy, digitalisation, defence, deepening EMU
- Deposit insurance vs tax and insolvency harmonisation vs NPLs & sovereign exposures
- Brexit, trade disputes and lower growth may provide impetus for progress towards integration

Political trade-offs for Banking Union



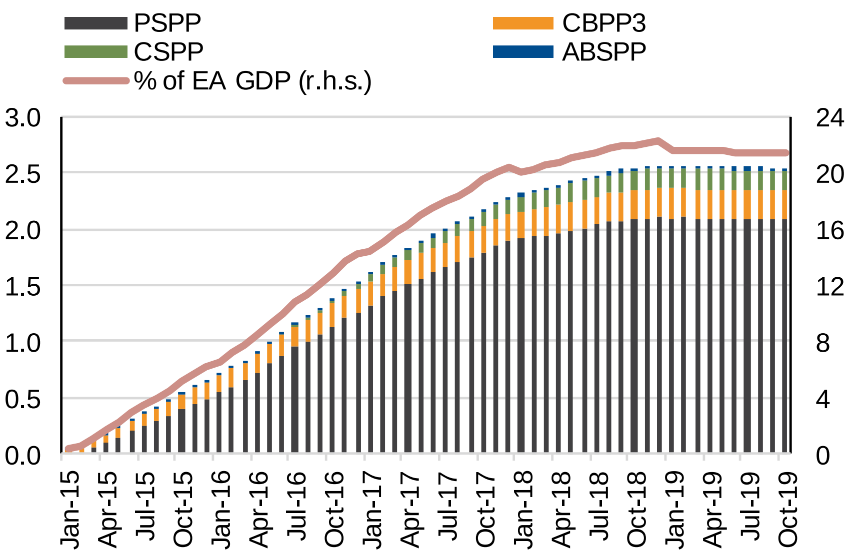
Source: Scope Ratings GmbH

➢ Dissipating economic benefits of and increasing political limits to further easing

- ECB to maintain accommodative policy but *additional* stimulus in 2020 less likely than in 2019
- ECB policy review to focus on definition of price stability, inflation target, additional instruments
- Will asset purchases be directed toward "green" assets?

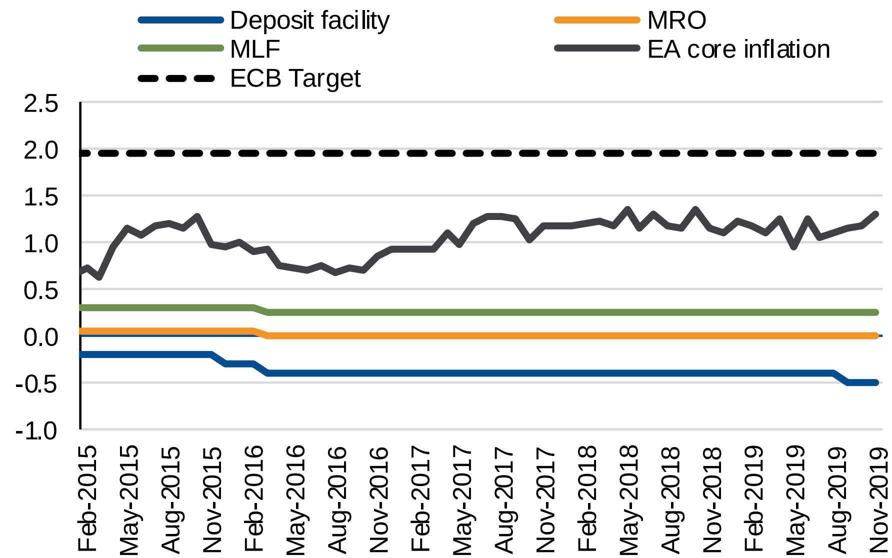
ECB balance sheet

EUR trn (l.h.s.); % of euro area GDP (r.h.s.)



ECB rates and euro area core inflation

%



*PSPP = Public Sector Purchase Programme; CSPP = Corporate Sector Purchase Programme; CBPP3 = Third Covered Bond Purchase Programme; ABSPP = Asset-Backed Securities Purchase Programme

Source: ECB, Eurostat, Scope Ratings GmbH

Most countries have at least *some* fiscal space in low interest rate environment

- Discretionary fiscal stimulus or more gradual pace of fiscal consolidation may be warranted
- Fiscal rules and policy objectives may act as constraints on stimulus
- But investment / funds for green projects likely to increase (France, Netherlands, Germany)
- European institutions can provide additional investment spending

Scope's fiscal space assessment (click here for the study)

Region	Scope's fiscal space assessment								
	Limited			Some			Significant		
Euro area		IT		BE	CY	FR	AT	EE	FI
				GR	MT	PT	DE	IE	LV
				SI	ES		LT	LU	NL
							SK		
Non-euro area				HR	HU	PL	BG	CZ	DK
				RO	UK		SE		
EFTA							NO	CH	
Other	CN	JP*	TR		RU				
	US*								

*Does not account for reserve currencies. Source: IMF, Scope Ratings GmbH.

Scope's 2020 Sovereign Outlook

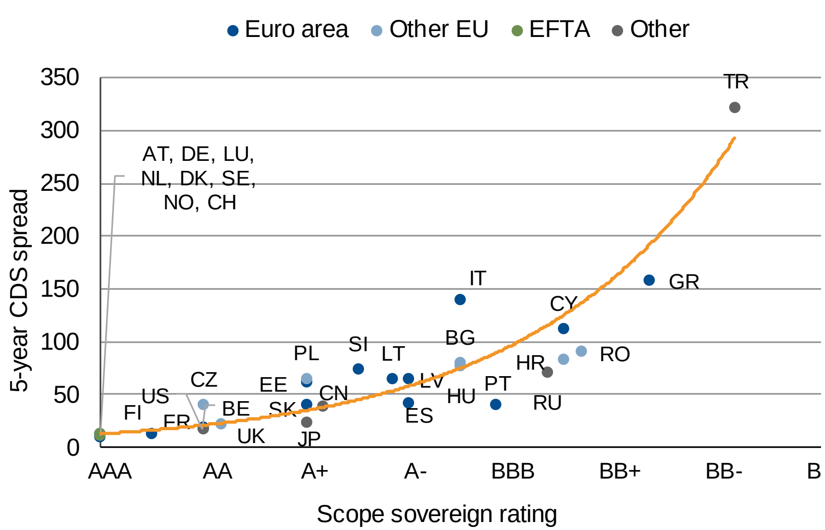
Divergence between Scope's and the market's sovereign risk assessment

➢ Scope's ratings contrast with market perception and US rating agencies' views

- Italy: Scope more constructive given Italy's systemic relevance and 'too-big-to-fail'
- Greece & Portugal: Scope's ratings higher than US agencies' but market even more optimistic
- US: Scope more negative, challenges view of US treasuries as being the global risk-free asset
- China: Scope slightly more negative than US agencies

Five-year CDS spreads vs Scope's ratings[1]

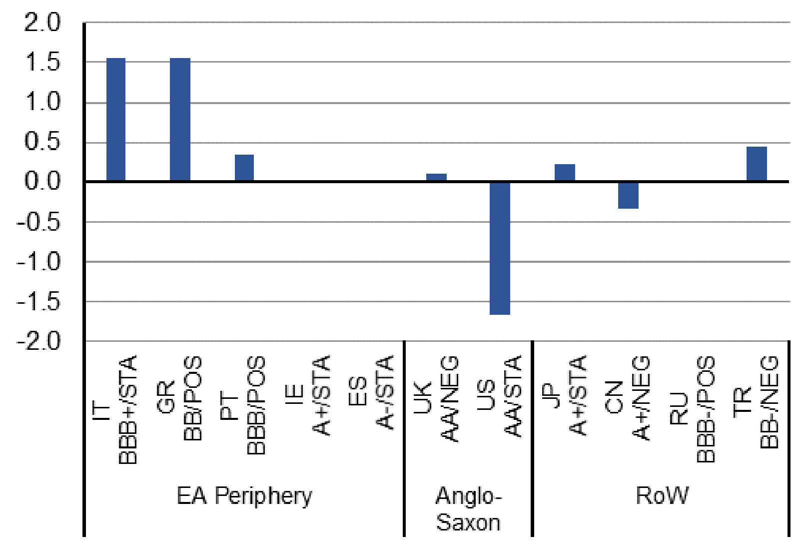
bps (as of 29 November 2019)



Source: Bloomberg, Scope Ratings GmbH

Scope's ratings vs US rating agency average[1]

notches



*RoW = Rest of World.

Source: Reuters Eikon, Scope Ratings GmbH

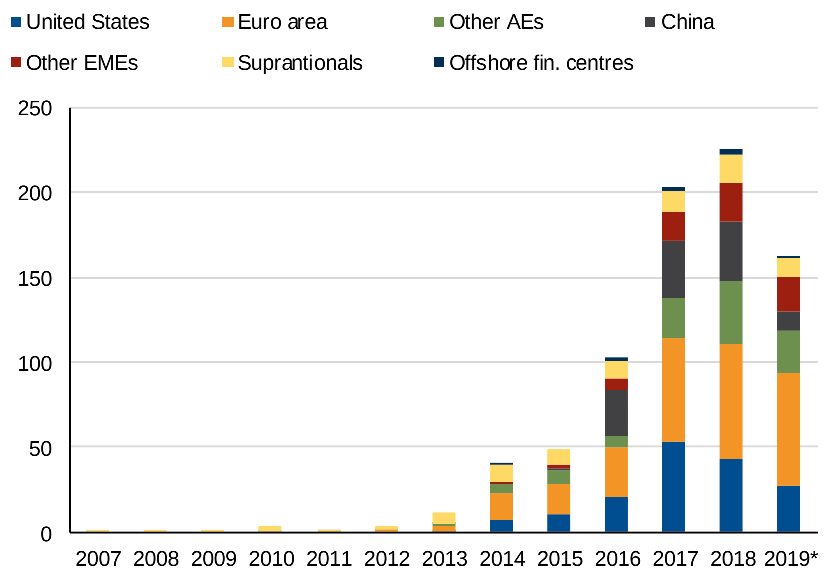
[1]Calculated based on alpha-numeric conversion on a 20-point scale from AAA (20) to D (1). Positive/negative outlooks are treated with a +/-0.33 adjustment. Credit Watch positive/negative with a +/-0.67 adjustment. As of 29 November 2019.

➢ ESG: increasing green bond issuance but EU taxonomy key

- The market for sustainability bonds is growing strongly, albeit from a low base
- A common definition for the use of proceeds would lead to still higher issuance volumes
- After the first bond issue in 2016 by Poland, sovereign green bonds grow in importance

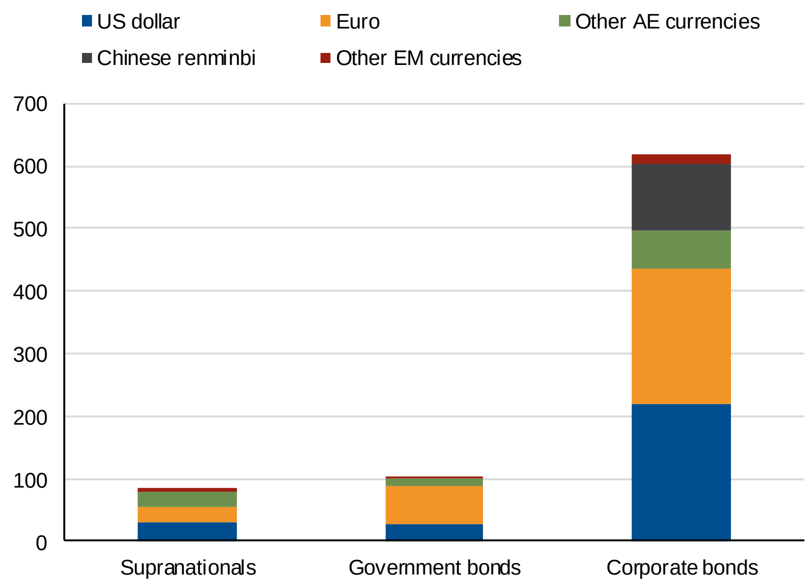
Annual green bond issuance

By country of incorporation, USD bn



Cumulative green bond issuance

By sector and currency, USD bn



Other AEs = Other advanced economies; Other EMEs = Other emerging market economies. *Sept. data. Source: BIS Quarterly Review September 2019, Scope Ratings GmbH.

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➢ Regional views for 2020

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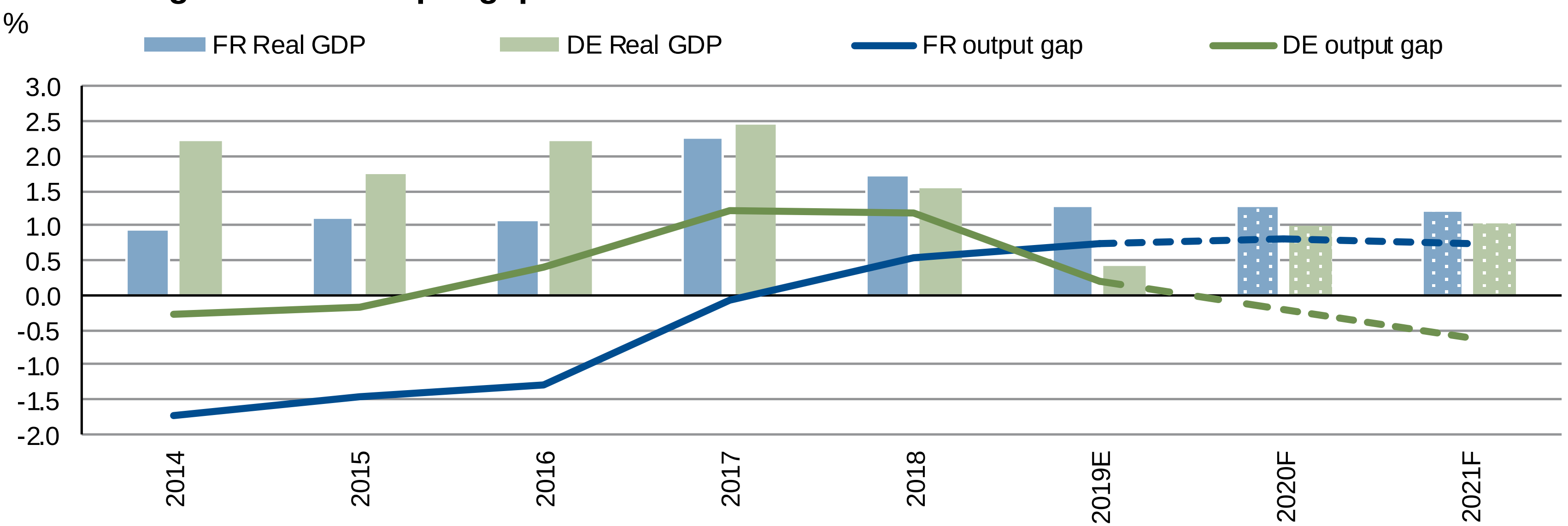
Scope's 2020 Sovereign Outlook

Core Europe: inverse policy action needed in Germany & France

➢ Diverging growth prospects, labour market outlook and fiscal policy responses

- France (AA/Stable)'s resilient growth bolstered by consumption, investment and fiscal stimulus
- Political stability in France could lead to advancement of pension and labour market reforms
- Germany (AAA/Stable) is close to stagnation, suffering from weak external demand and a large investment gap of around 5% of GDP, relating to fiscal 'black zero' policies
- Political uncertainty in Germany could risk further delay of reforms

Real GDP growth and output gap

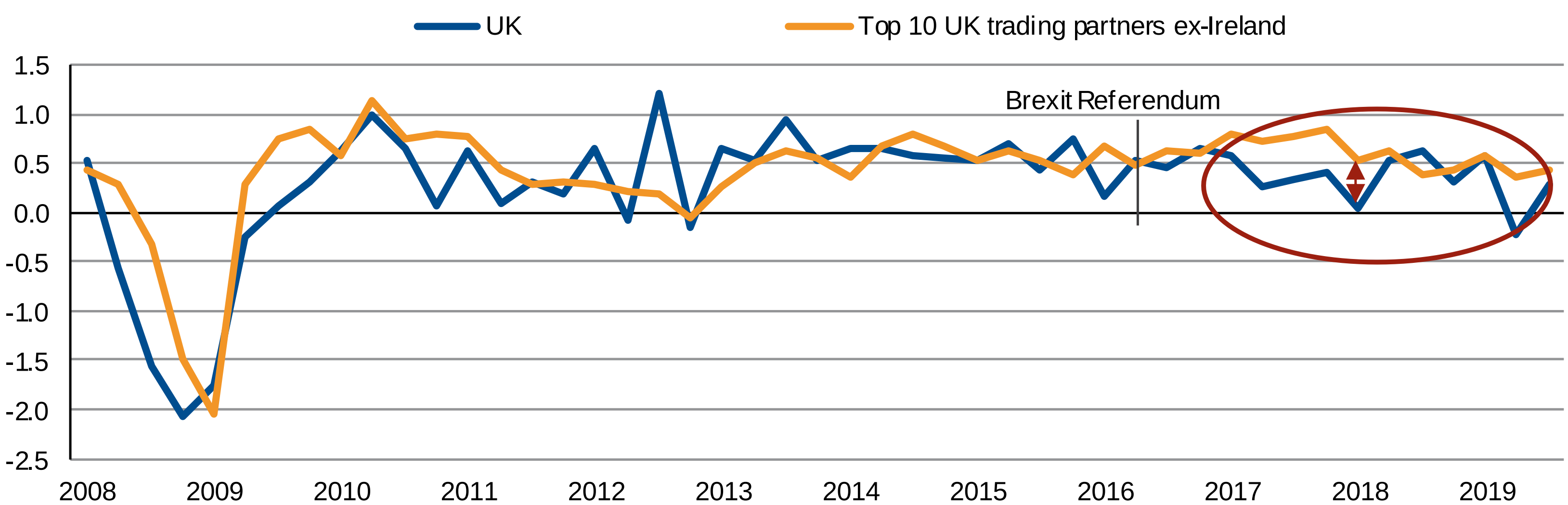


Source: AMECO, Scope Ratings GmbH

Elections could bring a Tory *majority* government, to execute Brexit in 2020

- If so, the UK would enter a standstill transition phase until likely well beyond end-2020
- Conversely, if opposition can at least force a hung parliament, then longer period of uncertainty
- UK to grow only 1.2% in 2020; Brexit uncertainty has already cost the UK well over 1% of GDP
- UK deficit to rise to 2.4% of GDP in 2019-20 (from 1.9%), possibly breaching 2.5% in 2020-21

The cost of Brexit: UK economy versus top 10 trading partners excluding Ireland
% QoQ GDP growth

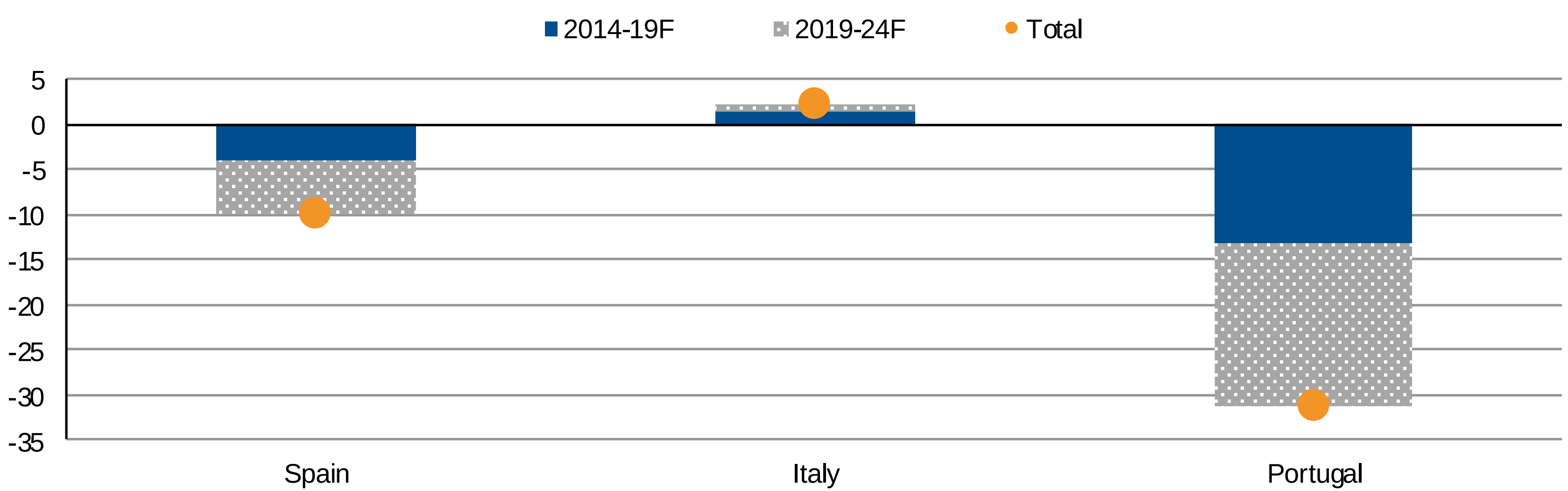


Source: Haver Analytics, Scope Ratings GmbH

Diverging political stability amidst still-too-high public debt levels

- Italy (BBB+/Stable): debt sustainability remains prime rating constraint, as 2020 budget targeting 2.2% of GDP deficit fails to comply with EU fiscal rules
- Spain (A-/Stable): political stalemate to result in either a weak government or another election
- Portugal (BBB/Positive): political stability likely to ensure continued debt reduction

Debt reduction projections
Change, as a % of GDP



Source: IMFWEO, Scope Ratings GmbH

Scope's 2020 Sovereign Outlook

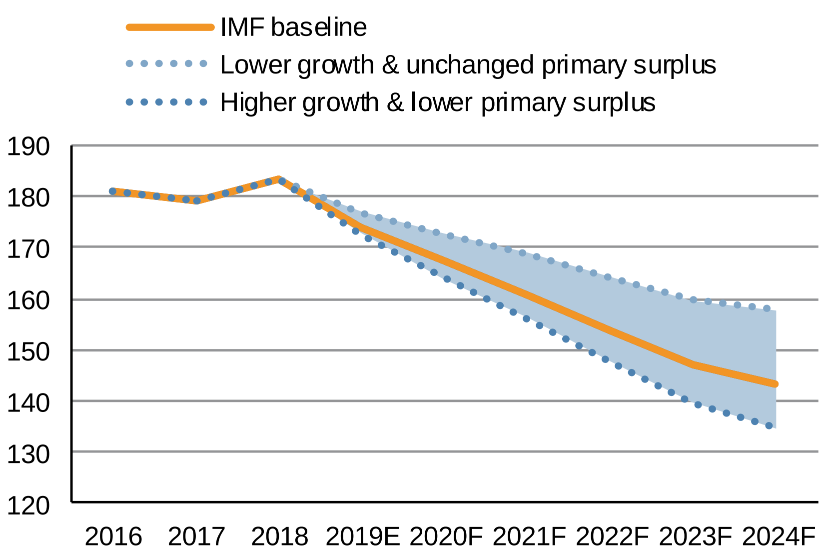
Greece & Cyprus: continued debt and NPL reduction

➢ Potential upside for Greece and Cyprus given above-average growth

- Greece (BB/Positive): growth will remain resilient next year, driven by higher investments as a result of continued implementation of business-friendly reform
- We expect a gradual building of consensus with Greece's European lenders around a lower primary balance target from 2021 on – supporting growth and debt sustainability
- Cyprus (BBB-/Stable)'s strong growth and prudent fiscal policy ensure debt reduction

Greece debt sustainability analysis

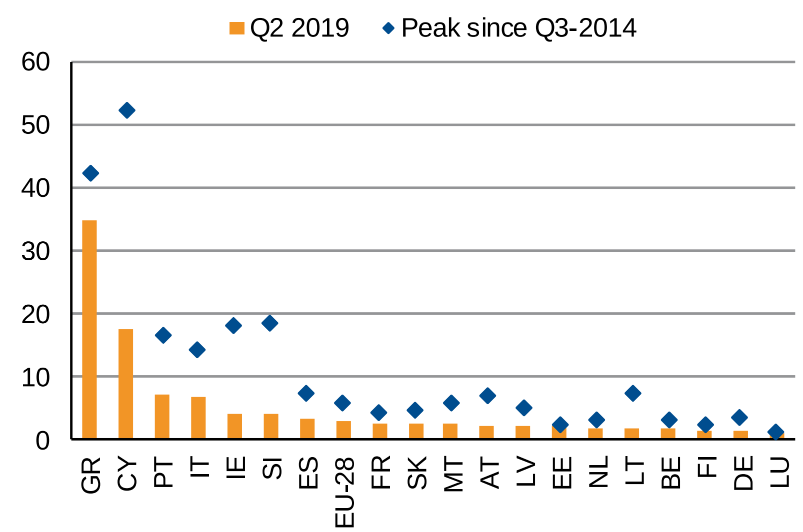
% of GDP



Source: IMF, Scope Ratings GmbH

Continued NPL reduction

% of total loans



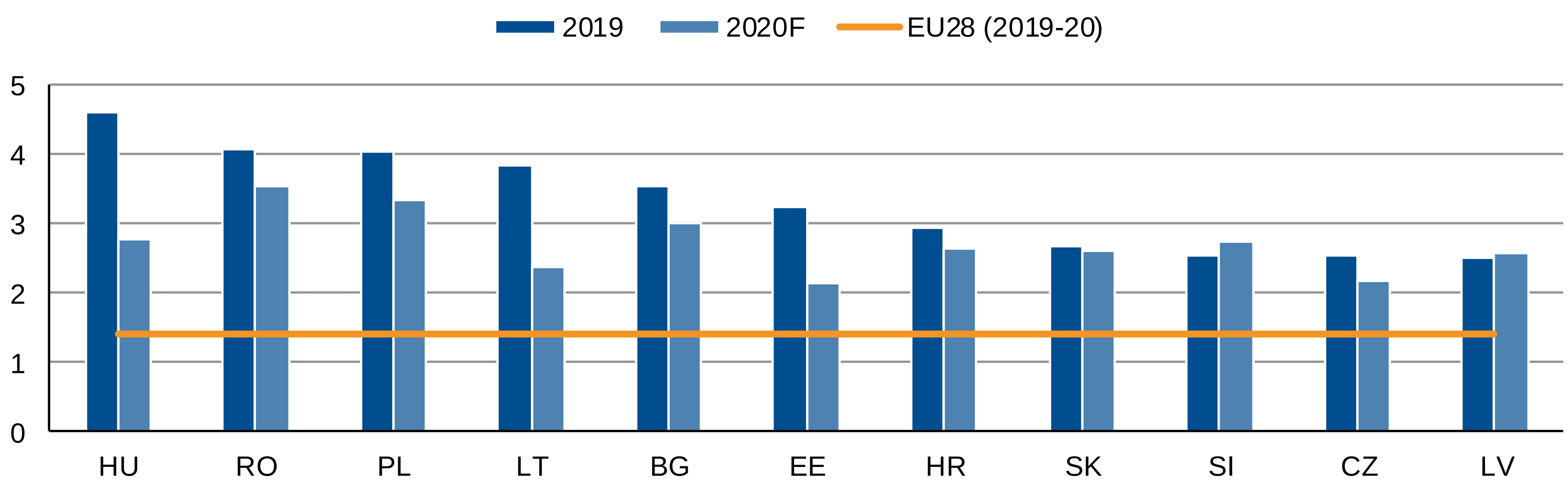
Source: European Banking Authority, Scope Ratings GmbH

➢ EU central and eastern European economies (CEE 11) outlook:

- Resilient average growth rate of 3.3% in 2019 with several countries growing above potential
- In 2020, CEE economies will grow on average 0.5-0.7pps less than in 2019
- Scope expects final 2021-27 EU budget to be more favourable for CEE than original EC draft
- Despite EC 'Rule of Law' procedures, Poland and Hungary to remain resilient economically

CEE 11 real GDP growth rates

%



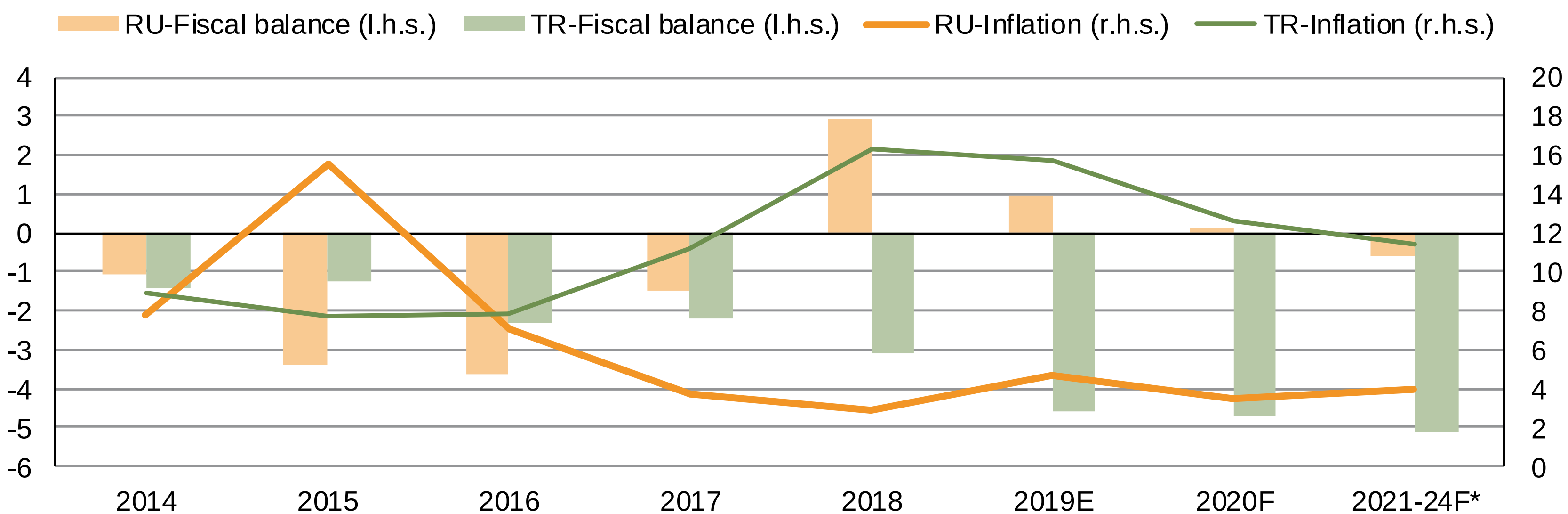
Source: European Commission, Scope Ratings GmbH

➢ Turkey's ratings trajectory in the balance, while Russia has a Positive Outlook

- Turkey (BB-/Negative): improvements in inflation, current account balance and reserves vs institutional degradation, aggressive rate cuts, *structural* imbalances and geopolitical risk
- Russia (BBB-/Positive): robust budgetary position results from fiscal policy being focused on rebuilding buffers, which has improved the country's capacity to cope with shocks

Turkey and Russia's fiscal balances and inflation developments

% of GDP (l.h.s.); % (r.h.s.)

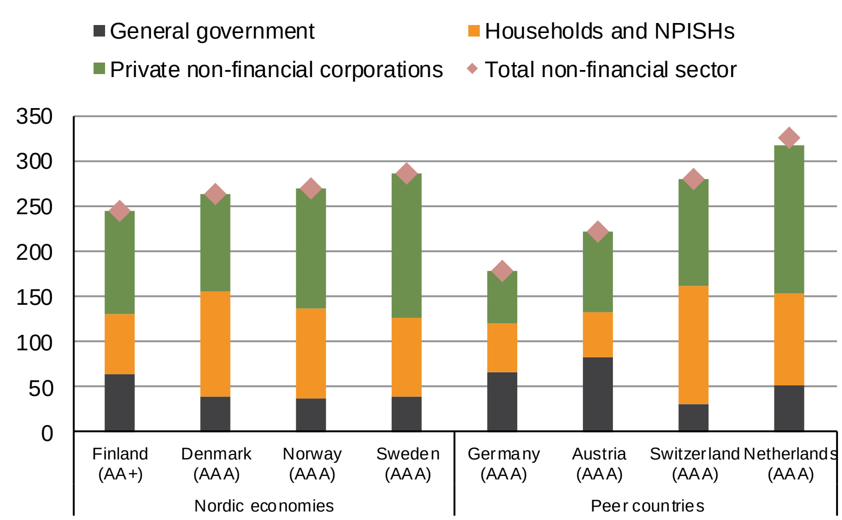


Source: IMFWEO, Scope Ratings GmbH

Nordics & Switzerland: highly-rated credits with some financial stability risks

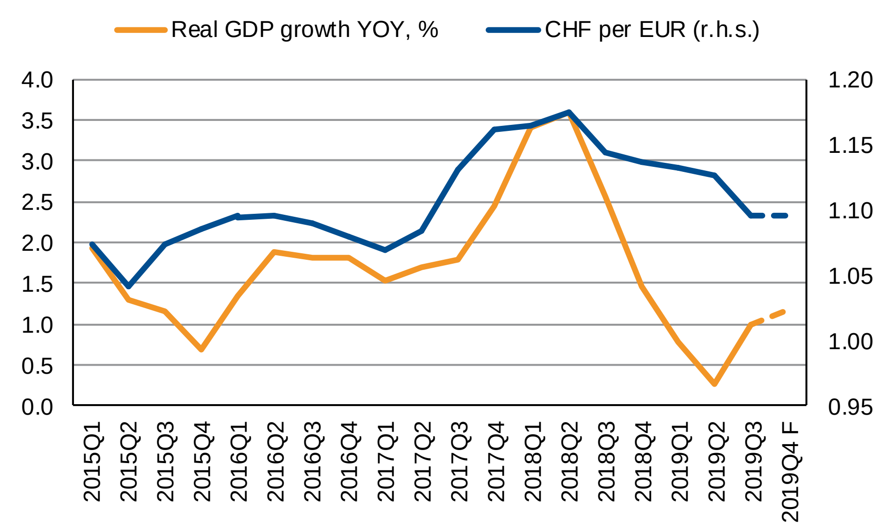
- Moderate 2020 growth: 2.5% in Norway, 1.6% in Denmark, 1.5% in Sweden, 1.2% in Finland
- Well-known financial stability risks in Nordic region, counter-balanced by regulatory tightening
- Moderate recovery in Swiss growth in 2020 assuming a small appreciation of franc
- Scope expects new framework deal to be agreed between CH & EU – but after Brexit happens

Total non-financial sector debt, by country
% of GDP, as of Q1 2019



Source: Bank for International Settlements

Swiss growth and exchange rate developments
%YoY (l.h.s.); CHF/EUR (r.h.s.)



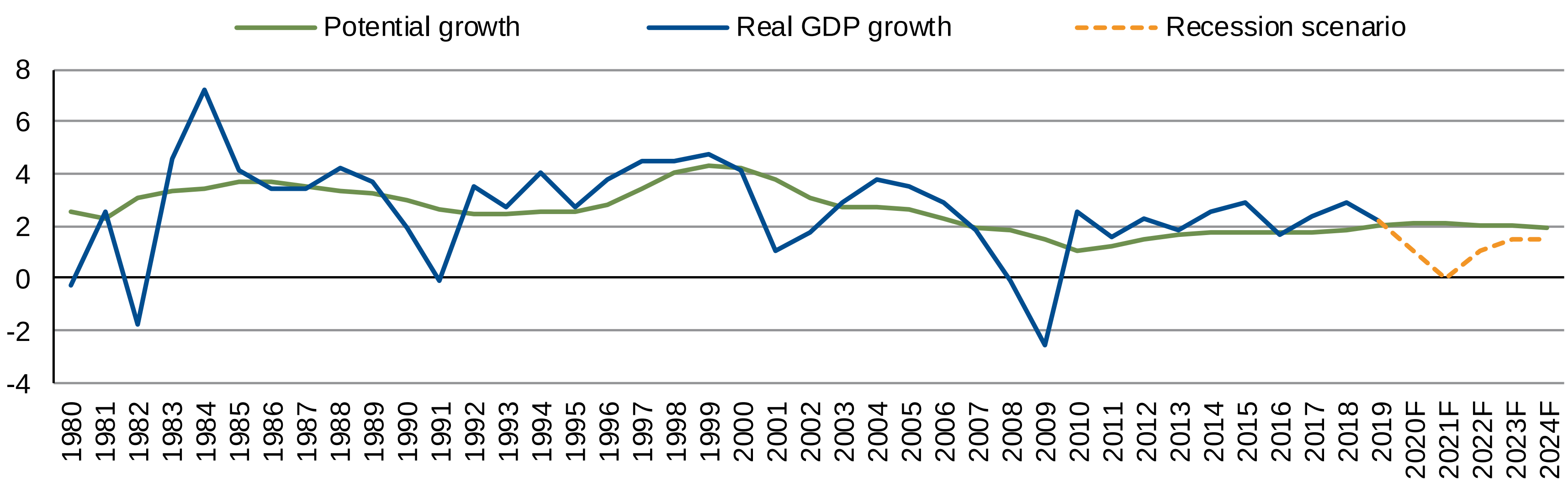
Source: Swiss National Bank, Swiss State Secretariat for Economic Affairs, Scope Ratings GmbH

US economic outlook subject to significant downside risks over next two years

- Re-escalation of trade conflicts at some stage in 2020 is more rather than less likely
- Deteriorating sentiment and wage-induced pressures on corporate profits will reduce investment
- Boost from administration's fiscal policies is expected to phase out by the end of 2019
- Decline in US productivity due to low rates, reduced competition, troubling social outcomes

US potential and real GDP growth

%

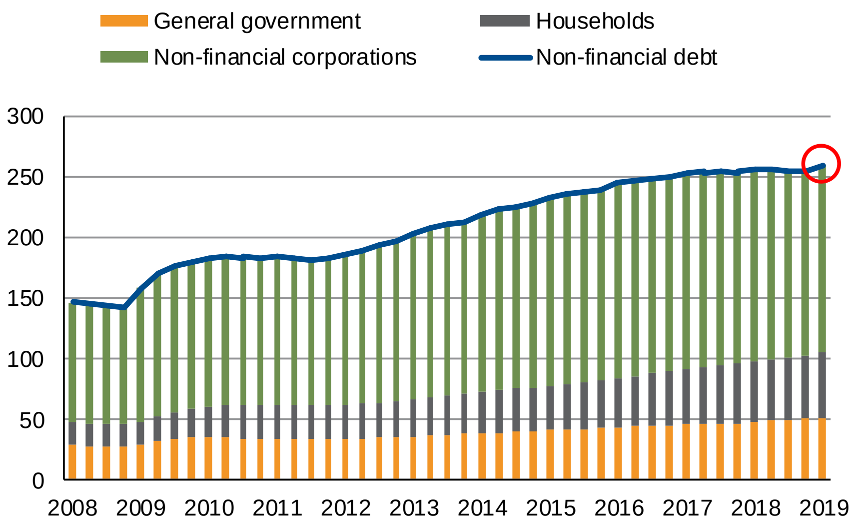


Source: Congressional Budget Office, Scope Ratings GmbH

➢ Fiscal and financial stability risks are rising in China and Japan

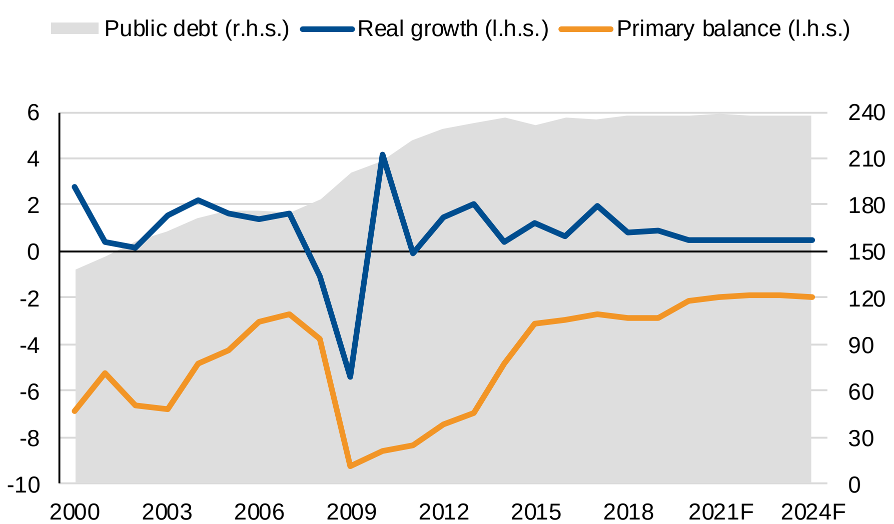
- China to slow to 5.8% growth in 2020, after an estimated 6.1% this year
- Renewed increase in Chinese debt stocks spells risks for domestic and global economies
- Japan's demographic headwinds are weighing on growth and hampering debt reduction efforts
- BoJ's ultra-loose monetary policy is leading to risk-taking behaviour and shortage of safe-assets

Total non-financial sector debt in China
% of GDP



Source: Bank for International Settlements

Japan's growth, primary balance and public debt
% or % of GDP (l.h.s.); % of GDP (r.h.s.)



Source: IMFWEO, Scope Ratings GmbH

Scope's 2020 Sovereign Outlook

Annex: Scope's sovereign ratings

➢ Scope's sovereign ratings, as of 2 December 2019

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

✓ **Coverage of 36 sovereigns** ✓ **Covering 100% of EU issuers**

Scope's 2020 Sovereign Outlook

Annex: Scope's macro-economic outlook 2018-20F

Region/country	Real GDP growth (%)				Inflation (%)				Policy Rates (%)		
	2018	2019E	2020F	Medium-run potential	Target	2018 (avg.)	2019E (avg.)	2020F (avg.)	End-2018	End-2019	End-2020
Euro area	1.9	1.2	1.1	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		1.9	1.4	1.3			
France	1.7	1.3	1.2	1.5		2.1	1.2	1.3			
Italy	0.9	0.2	0.6	0.7		1.2	0.8	1.0			
Spain	2.4	2.0	1.7	1.7		1.7	1.0	1.2			
United Kingdom	1.4	1.2	1.2	1.5	2.0	2.3	1.8	1.9	0.75	0.75	0.75
Russia	2.3	1.0	1.5	1.0-1.5	4.0	2.9	4.0	3.7	7.75	6.0	5.0
Turkey	2.8	0.2	3.0	3.9	5.0	16.3	15.7	12.6			
United States[1]	2.9	2.2	1.5	<2.0	2.0	2.0	1.8	1.9	2.25-2.50	1.50-1.75	1.00-1.25
China	6.6	6.1	5.8	5.0	3.0	1.9	2.3	2.4			
Japan	0.8	0.9	0.5	<1.0	2.0	1.0	1.0	1.3			
World	3.6	3.0	~3.0		-	-	-	-			

Region/country	Unemployment rate (%)			General government balance (% of GDP)			Public debt level (% of GDP)		Current account (% of GDP)		
	2018	2019E	2020F	2018	2019E	2020F	2018	2024F	2018	2019E	2020F
Euro area	8.2	7.7	7.5	-0.5	-0.9	-0.9	85.4	76.1	2.9	2.8	2.7
Germany	3.4	3.2	3.3	1.9	1.1	1.0	61.7	45.6	7.3	7.0	6.6
France	9.1	8.6	8.4	-2.5	-3.3	-2.5	98.4	97.8	-0.6	-0.5	-0.4
Italy	10.6	9.9	9.6	-2.2	-2.2	-2.2	134.8	~138[2]	2.5	2.9	2.9
Spain	15.3	13.9	13.2	-2.5	-2.2	-1.9	97.1	90.5	0.9	0.9	1.0
United Kingdom[4]	4.1	3.8	3.8	-1.9	-2.4	<-2.5	86.8	~85	-4.3	-5.0	
Russia	4.8	4.8	4.7	2.9	1.3	1.0	14.6	16.9	6.8	5.7	5.1
Turkey	11.0	13.8	13.7	-3.1	-4.6	-4.7	30.2	35.2	-3.5	0.4	-1.0
United States	3.9	3.7	3.5	-5.7	-5.6	-5.5	104.3	115.8	-2.4	-2.5	-2.6
China[3]	3.8	3.8	3.8	-4.8	-6.0	-6.0	50.6	76.6	0.4	1.2	1.0
Japan	2.4	2.4	2.4	-3.2	-3.0	-2.2	237.1	237.6	3.5	3.3	3.3
World	-	-	-	-	-	-	-	-	-	-	-

Source: Scope Ratings GmbH, IMF, European Commission and Federal Reserve forecasts, Haver

[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]UK's budget figures refer to public sector net borrowing for a specific fiscal year (e.g. 2019F = forecast for 2019-20 fiscal year)

Additional research

- ✓ Sovereign Outlook 2020 (Full Report)
- ✓ Scope's Public Finance Ratings Group: How We Are Different
- ✓ Sovereign methodology
- ✓ Supranational methodology
- ✓ Sub-sovereign methodology
- ✓ Government related entities methodology

Scope's 2020 Sovereign Outlook

Annex: Team

Dr Giacomo Barisone
Managing Director

Scope Ratings GmbH
Location: Frankfurt

English, Italian

Head of Public Finance Ratings

With Scope since 2017

20+ years experience including at:
- DBRS
- UBS Investment Bank
- Moody's
- The Economist Intelligence Unit

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English, German, Spanish

Deputy Head of Public Finance Ratings

Coverage:
- USA, Japan, Austria, Spain, Portugal, Cyprus, Catalonia, EU, EIB

With Scope since 2017

8+ years experience including at:
- ESM and ECB
- Moody's

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Director

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Coverage:
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- Alliance Bernstein

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Location: Frankfurt

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Coverage:
- Russia, Poland, Greece, German States, Spanish Regions, GREs

With Scope since 2017

10+ years experience including at:
- Eurohypo
- Commerzbank

Scope's Public Finance Ratings Group

Annex: Team

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Location: Frankfurt

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Coverage:
– Germany, France, Netherlands, Belgium, Malta, Czech Republic, Hungary, Slovenia, Romania, Supranationals

With Scope since 2018

7+ years experience in academia in addition to:
- Deutsche Bank

Levon Kameryan
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Location: Frankfurt

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With Scope since 2016

4+ years experience including at:
- Central Bank of Armenia
- Deutsche Bank

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Associate Analyst

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Location: Frankfurt

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Coverage:
– Spain, Portugal, Italy, France, Austria Hungary, sub-sovereigns

With Scope since 2018

1+ years experience including at:
- European Commission
- Provincia Autonoma di Trento

Thibault Vasse
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Location: Frankfurt

English, French

Coverage:
– France, US, Japan, Cyprus, Netherlands, sub-sovereigns

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- OECD
- Société Général

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