1 July 2019 Public Finance

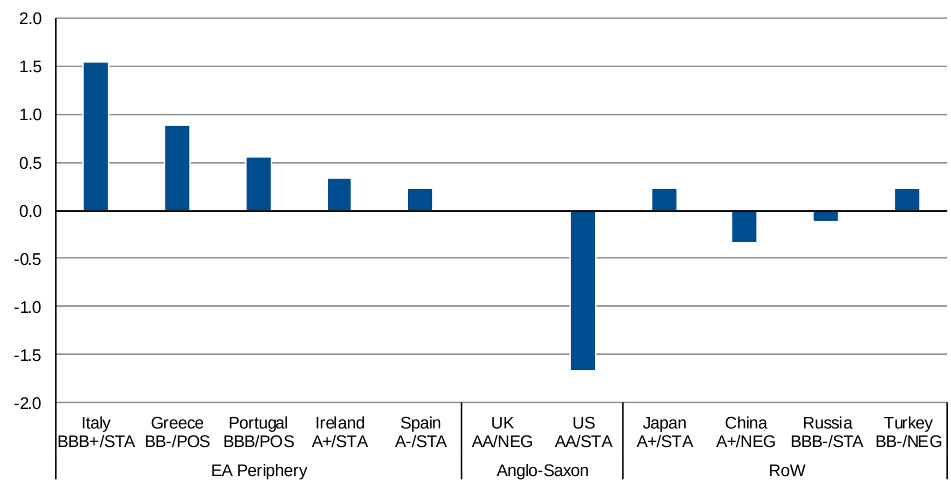
Q3 2019 Sovereign Update: Easing monetary policies and institutional uncertainties

In line with its 2019 Outlook, entering Q3, Scope's economic outlook for this year remains one for slower euro area and global growth, higher financial market volatility and exceptional policy unpredictability. This combination of factors has coincided with Scope's expectation of an interest rate cut in H2 2019 from the Federal Reserve as well as an easing bias from the ECB. In the context of a global slowdown, Scope also highlights upcoming institutional changes in Europe, which will hold important implications for EU sovereign ratings.

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

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

Figure 2: Scope ratings vs US agencies', as of 1 July 2019 (rating notches)



NB: Calculated based on alpha-numeric conversion on a 20-point scale from AAA (20) to D (1). Positive/negative outlooks are treated with a +/-0.33 adjustment. Credit Watch positive/negative with a +/-0.67 adjustment.

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

Date	Sovereign	Rating Action	Rating & Outlook
5-Apr	Portugal	Affirmation/Outlook change	BBB/Positive
	Estonia	Affirmation	A+/Stable
12-Apr	Netherlands	Affirmation	AAA/Stable
3-May	France	Affirmation	AA/Stable
10-May	Greece	Upgrade	BB-/Positive
14-Jun	Turkey	Affirmation	BB-/Negative
21-Jun	Japan	Affirmation	A+/Stable
	Slovenia	Upgrade	A/Stable
28-Jun	Croatia	Upgrade	BBB-/Stable

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Related Research

Public Finance Ratings Calendar
February 2019

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Entering Q3 2019, Scope expects central bank policy easing and fundamental changes in Europe…

- **Global slowdown to ease as central banks shift to more dovish policy in H2 2019**

  The global slowdown poses significant challenges. Scope's 2019 global growth forecast is at 3.0%-3.5%, below the 3.6% growth of 2018, and just 1% for the euro area compared to 1.9% last year. Still, despite damaging US-centred trade conflicts, the global and regional slowdown could be cushioned with an expected shift towards monetary easing in H2 2019 via the beginnings of multiple anticipated rate cuts from the US Federal Reserve as well as the launch of TLTRO-III in the euro area. Scope expects at least one Fed rate cut in H2 2019 and two more 25bp cuts by the end of 2020 (to 1.50%-1.75%). Subdued economic and inflationary developments (1.2% YoY headline inflation in June) may also increase pressure on the ECB to consider cuts to its deposit rate (already at an all-time low of -0.4%), with the main refinancing rate moreover on hold at 0% at least through end-2020. Presently, Scope does not anticipate ECB QE to be expanded in 2019 beyond the reinvestments of maturing principal. While easier monetary policies and lower rates will support debt deleveraging efforts via lowering the cost of refinancing large private and public debt stocks, they will also further amplify global financial system vulnerabilities in debt, equity and real estate markets with negative deposit rates in the euro area moreover damaging the profitability of banks. The benefits to debt dynamics from low rates could moreover come at a policy cost, specifically the ongoing complacency over the urgency of needed reforms to sustain fiscal consolidation efforts by highly-indebted sovereigns as well as institutional changes of the euro area.

  European negative yields reduce cost of refinancing public debt but raise risk of reform complacency, June 26

  Sovereign debt refinancing risk: mitigated by safer investor bases despite higher debt-to-GDP ratios, May 31

- **European political and institutional developments: Leadership, EU budget, and Italy**

  Following the European Parliament elections in May, pro-European parties kept a governing, albeit more fragmented, parliamentary majority able to drive the EU integration agenda forward. At the same time, right-wing and Eurosceptic parties did particularly well in France, the UK and Italy. Election results in CEE economies also showed successes for populist parties with anti-EU campaigns. Lega's growing power in Italy raises particular concerns among EU policymakers and investors with risks stemming from the country's weakened budgetary and economic performance. Scope's BBB+/Stable rating on Italy is one to two notches higher than the assessment from US agencies, however, inherently recognising, among other factors, the self-interest and ability of EU institutions in ensuring Italy's debt repayment. The combination of a weak regional economic outlook alongside fundamental institutional changes will challenge the European leadership decisions in coming months. Key EU institutional developments in H2 2019 include: i) leadership appointments for the next European Commission, European Council and ECB; ii) the negotiations over the EU's 2021-27 budget, which will have important rating implications for CEE economies that benefit from structural and cohesion funds; and iii) the intensifying interactions between the UK (around Brexit) as well as Italy and the (exiting/incoming) European leadership.

  Italy: policy worries, fiscal risks remain significant, even amid market rally, June 17

  Italy's fiscal policies after European elections will be critical for the sovereign rating outlook, May 28

  Implications of the 2019 European elections for European public-sector ratings, May 27

  European Parliament elections: Fragmented pro-EU coalition to face bolstered populist opposition, May 22

  Italian regions' autonomy plans weigh on predictability of the country's fiscal framework, April 29

… and Scope's Major Calls and Views on:

- **Brexit: Another extension of Article 50 or a Brexit-in-name-only by 31 October**

  Scope expects in the near-term either: i) a third extension of Article 50 negotiations to be agreed by 31 October, to be negotiated after a Conservative Party leadership contest wraps up later this month, or ii) a Brexit-in-name-only by that date, in which the new Prime Minister manages to ratify a version of the existing Brexit deal, maybe with minor amendments to it, in the UK Parliament – with the UK (AA/Negative) exiting the EU and entering thereafter a transition phase. Either of these near-term scenarios is consistent with Scope's expectation of a long-run endgame of a soft Brexit, with no Brexit at all being the second probable outcome. Scope considers a no-deal Brexit to be unlikely.

  UK mired in costly Brexit uncertainty as Conservative Party chooses new leader, May 29

  Brexit uncertainty weighs on public finance credit outlook, April 8

- **Euro area periphery ex-Italy**

  On 10 May, Scope upgraded Greece to BB-/Positive to account for its high cash reserves and primary surpluses, a recovering economy, a very low interest-payment burden and sustained reforms; the retention of a Positive Outlook reflected an expectation of further fundamental improvements, anchored by post-bailout surveillance reviews. Similarly, the Positive Outlook on Portugal's BBB rating reflects the country's sustained debt reduction and resilient debt structure as well as the gradual unwinding of economic imbalances. Following general, regional and local elections in April and May in Spain (A-/Stable), Scope awaits further clarity on the formation of the next government, though the risk of re-elections is rising.

  Spain: regional party politics complicate formation of Spain's next government, June 19

  Spain's general, regional and local elections: Nothing is agreed until everything is agreed, May 24

Greece's sovereign rating improvements explained, May 16

Portugal's debt reduction and unwinding of economic unbalances underpin positive credit outlook, April 11

- **Germany, France and core Europe**

Germany has an unstable government with little scope for longer-term-oriented policymaking. By contrast, the French government under President Emmanuel Macron has combined a growth-enhancing structural reform programme with concessions to *gilets jaunes* protesters. Scope expects snap elections in Germany to become more likely next year if weak polls for the coalition parties turn into losses in three upcoming regional elections in September and October. In Belgium, national elections in May have led to gridlock, as none of the major parties have found a comfortable parliamentary majority.

France's residency tax reform poses fiscal risks at the local and national level, June 13

France's labour reforms support growth, constrained by elevated public debt and unemployment, May 13

Netherlands' widening wealth gap and household debt pose medium-term challenges to healthy economy, April 16

- **Turkey and EM**

On 14 June, Scope affirmed Turkey at BB- and maintained a Negative Outlook, highlighting risks from weak reserve levels and significant deterioration in the policy and institutional frameworks. At the same time, Scope's rating level acknowledges Turkey's credit strengths including low public debt and a flexible lira exchange rate. Scope named Turkey to its "Risky-3" of economies most exposed to external risks, along with Georgia and Ukraine, in a 13 December study and ranking.

Turkey faces potential foreign-currency debt repayment problem unless it rebuilds reserves, June 18

- **Central & Eastern Europe**

Scope upgraded Croatia to investment-grade (BBB-/Stable) in June, driven by the improving fiscal framework and strengthening external buffers, which support progress towards entry into ERM II. Similarly, already in February, Scope upgraded Bulgaria to BBB+/Stable (now 1-2 notches above the ratings assigned to Bulgaria by US agencies). Scope also upgraded Slovenia's long-term ratings to A from A- in June, driven by its sustained public debt reduction, prudent fiscal framework and increases in its potential growth to around 3%. Conversely, Scope downgraded Romania's ratings to BBB- with a Negative Outlook last October, signalling risks to its IG rating. Money-laundering scandals in the Baltic states have created unexpected uncertainty about their financial stability outlooks, though these risks do not necessarily challenge the countries' sovereign ratings. Scope upgraded Russia to BBB-/Stable in 2017, ahead of similar upgrades by S&P and Moody's, given the country's robust external economic and public finance risk profiles, despite the drag of sanctions on structurally-weak growth. Poland (A+/Stable) and Hungary (BBB/Positive) maintain solid growth as Scope expects both to benefit from strong domestic consumption and infrastructure spending.

Hungary's growth covers up underlying weaknesses and pro-cyclical fiscal policy, May 23

Nordic bank scandals: Five questions answered on the implications for Baltic sovereign risk, April 10

- **United States**

The economic outlook for the United States is subject to downside risks, as evidenced by the Federal Reserve's pause of rate hikes, and in fact, the now widely expected first rate cut in H2 2019. The peak US growth rate has already been reached this cycle, the push from fiscal policy is fading, asset prices are overvalued, and corporate debt levels are at an all-time high. In addition, major uncertainties remain regarding the direction of President Trump's shifting trade policy agenda, particularly vis-à-vis China. A divided and polarised Congress is unlikely to address the underlying structural challenges. Scope maintains a AA/Stable rating on the US – challenging the consensus of US Treasuries as the risk-free asset.

- **China and Japan**

Scope revised its Outlook on China's A+ sovereign rating to Negative from Stable last September – a non-consensus rating decision at the time, with DBRS in March 2019 following with the same action. China's rising debt levels are a major systemic risk, with Scope expecting an economic deceleration to 6.3% growth in 2019, supporting the call for a global slowdown this year. Japan's A+/Stable rating recognises the government's efforts to revive the economy and enhance the labour supply as well as the Bank of Japan's credibility and resolve to keep an ultra-accommodative monetary policy, easing debt sustainability concerns.

US-China trade war increases systemic economic risks, but China more vulnerable than US, May 15

- **Nordics and Switzerland**

Scope identifies imbalances in the housing and commercial real estate markets as core challenges for Nordic sovereigns. Despite some uncertainties, Scope expects a new framework arrangement to be agreed between Switzerland and the EU.

- **ESG & sovereign risk**

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

Annex I: Macro-economic Outlook

Macro-economic overview, 2018-20

Region	Real GDP growth (%)				Inflation (%)				Policy Rates (%)		
	2018E	2019F	2020F	Medium-run potential	Target	2018E (AVG)	2019F (AVG)	2020F (AVG)	Current	End-2019	End-2020
Euro area	1.9	1.0	1.2	1.2	2.0	1.8	1.3	1.6	0.00	0.00	0.00
Germany	1.4	1.0	1.3	1.3	2.0	1.9	1.3	1.7			
France	1.7	1.3	1.5	1.5	2.0	2.1	1.3	1.5			
Italy	0.9	0.2	0.6	0.75	2.0	1.2	0.8	1.2			
Spain	2.6	2.1	1.8	1.7	2.0	1.7	1.2	1.6			
United Kingdom	1.4	1.4	1.3	1.5	2.0	2.3	1.8	2.0	0.75	0.75	1.00
Russia	2.3	1.6	1.7		4.0	2.9	5.0	4.5			
Turkey	2.6	-1.9	3.0	3.9	5.0	16.3	17.5	14.1			
United States[1]	2.9	2.0	1.5	<2.0	2.0	1.9	2.0	2.0	2.25-2.50	2.00-2.25	1.50-1.75
China	6.6	6.3	6.1	5.0	3.0	1.9	2.3	2.5			
Japan	0.8	1.0	0.5	<1.0	2.0	1.0	1.1	1.5			
World	3.6	3.0-3.5			-	-	-	-			

Region	Unemployment rate			General government balance (% of GDP)			Public debt level (% of GDP)		Current account (% of GDP)		
	2018E	2019F	2020F	2018E	2019F	2020F	2018E	2024F	2018E	2019F	2020F
Euro area	8.2	8.0	7.7	-0.6	-1.0	-0.9	85.0	75.7	3.0	2.9	2.8
Germany	3.4	3.4	3.3	1.7	1.1	1.1	59.8	43.7	7.4	7.1	6.8
France	9.1	8.8	8.4	-2.6	-3.2	-2.4	98.6	96.2	-0.7	-0.4	0.0
Italy	10.6	10.7	10.5	-2.1	-2.6	-2.6	132.2	133.2[2]	2.6	2.9	2.6
Spain	15.3	14.2	14.1	-2.7	-2.5	-2.2	97.0	92.3	0.8	0.8	0.8
United Kingdom	4.1	4.2	4.4	-1.4	-1.3	-1.2	86.9	80.3	-3.9	-4.2	-4.0
Russia	4.8	4.8	4.7	2.8	1.0	0.8	14.0	16.9	7.0	5.7	5.1
Turkey	11.0	12.7	11.4	-3.6	-3.25	-3.5	29.1	26.7	-3.6	-1.0	
United States	3.9	3.8	3.7	-4.3	-4.6	-4.4	105.8	110.3	-2.3	-2.4	-2.6
China	3.8	3.8	3.8	-4.8	-6.1	-5.5	50.5	72.4	0.4	0.4	0.3
Japan	2.4	2.4	2.4	-3.2	-2.8	-2.1	237.1	238.3	3.5	3.5	3.6
World	-	-	-	-	-	-	-	-	-	-	-

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

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

[2] By 2021

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