2022 Sovereign Outlook

An uneven global recovery amid Covid-19, inflation and monetary tightening challenges sovereign outlook

Sovereign and Public Sector, Scope Ratings GmbH, 7 December 2021

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| Bloomberg: RESP SCOP

Executive summary

An uneven although robust global economy continues next year, with above-trend growth of **4.5%** globally seen over the calendar year 2022, after **5.8%** in 2021 (revised down 0.2pps since June). New variants of Covid-19, elevated inflation and withdrawal of fiscal and monetary support present risks for robustness of the recovery. We summarise projections for major economies in **Figure 1** below, with full forecasts on the **next page**.

Key themes for 2022 include:

Uneven recovery with Covid and rates tightening risk: Although the fastest speed of recovery now lies behind, GDP is likely to continue growing above trend around 3.5% in the US, 4.4% in the euro area, 3.6% in Japan and 4.6% in the UK next year. We expect comparatively slower performance in China (5.2%) with growth edging nearer trend. This assumes continuation entering 2022 of our long-standing baseline of uneven but robust recovery, with modest slowdown over Q4 2021 and Q1 2022 across many economies, if not in cases temporary output contraction – as countries reintroduce generally lighter restrictions on basis of renewed rise of cases, including associated with a new Omicron variant. The economic rebound regains traction by spring of 2022. Full economic normalisation remains vulnerable to renewed introduction of restriction as transmissible virus variants challenge health systems, although the severity of virus risk for economic recovery is seen continuing to moderate with time. Currently, we judge risk to the 2022 global outlook as skewed to the downside.

Higher inflation for longer: Inflationary pressures are expected to remain more elevated over coming years as compared with pre-crisis averages as a result of higher energy and commodity prices and bottlenecks in production chains. While current inflationary pressure may be mainly temporary across advanced economies, moderating by 2022, inflation regimes ought to stay around or above 2% in the US and the UK, testing inflation mandates, although potentially near or under 2% in the euro area and Japan in the long run.

Divergence of global monetary policy and threat from latent financial risk: With divergence of outlooks for inflation, we expect increasing divergence of monetary policy over 2022. While the Bank of England and Federal Reserve take a more hawkish approach, the ECB and Bank of Japan are seen maintaining monetary accommodation over the year – even were some stimulus removed. Withdrawal of monetary stimulus is appropriate but may risk crystallisation of latent debt and financial-bubble risk accrued over past years.

Emerging market vulnerabilities and China's slowdown: Increased threat of risk-reversal in global markets raises risk for developing economies, with countries such as Lebanon, Belarus, Argentina and Turkey among 10 most at risk according to our updated framework under fraught conditions. Slowdown of China's economy impairs growth globally although we see systemic risk from a crisis in China's property sector as containable.

A new EU fiscal architecture: Debate heats up in 2022 around how to improve the EU fiscal framework for a post-crisis era, with potentially far-reaching implications for sovereign risk of EU governmental issuers. The pre-crisis framework remains suspended until end-2022, and fundamental reform balancing preservation of sustainable deficits and debt while making available space for investment is crucial for credit outlooks.

Rating outlook: Sovereign borrowers holding a Stable Outlook in entering 2022 comprise presently more than 90% of Scope's publicly rated sovereign portfolio, indicating a lesser likelihood of ratings change entering 2022 than entering 2021. Nevertheless, economic risks could present upside and downside risk to ratings next year.

ESG's growing impact on ratings: ESG factors present both opportunities and challenges for sovereign ratings. Demographics, especially, will increase downside pressure on European sovereign ratings.

Figure 1: Scope's growth forecasts, summary, as of 7 December 2021

Country/region	Real GDP growth (%)						
		Baseline scenario					Medium-run potential
	2020	2021E	Diff. from Jun.*	2022F	Diff. from Jun.*	2023F	
Euro area	(6.5)	5.0	↑ 0.3	4.4	↑ 0.2	2.1	1.4
Germany	(4.9)	2.4	↓ 1.1	4.4	↓ 0.2	1.8	1.1
France	(8.0)	6.5	↑ 1.5	4.0	-	1.8	1.5-1.75
Italy	(9.0)	6.6	↑ 1.0	4.5	↑ 0.7	2.1	0.8
Spain	(10.8)	4.7	↓ 1.3	6.0	↑ 1.0	2.6	1.5
United Kingdom	(9.7)	6.8	↑ 0.2	4.6	↓ 0.8	2.7	1.5
Russia	(2.4)	4.5	↑ 1.5	2.7	-	2.0	1.5-2.0
Turkey	1.8	10.8	↑ 2.8	2.3	↓ 1.7	2.4	3.9
United States	(3.4)	5.5	↓ 0.7	3.5	↓ 1.3	2.9	2.0
China	2.3	8.0	↓ 1.3	5.2	↓ 0.2	5.0	5.0
Japan	(4.7)	1.5	↓ 1.5	3.6	↑ 1.5	1.6	0.5
World	(3.1)	5.8	↓ 0.2	4.5	↑ 0.1	3.7	3.0

*Changes compared with June 2021's 2021 mid-year Sovereign Outlook forecasts.
Negative growth rates presented in parentheses. Source: Scope Ratings GmbH forecasts, regional and national statistical offices, IMF.

Global macro-economic outlook, 2021-23

Country/region	Real GDP growth (annual average, %)								Policy rates (EOP, %)			
	2020	2021E	Diff. from Jun-21[1]	Diff. from Dec-20[2]	2022F	Diff. from Jun-21[1]	2023F	Medium-run potential	End-2020	End-2021	End-2022	End-2023
Euro area[3]	(6.5)	5.0	↑ 0.3	↓ 0.6	4.4	↑ 0.2	2.1	1.4	(0.5)	(0.5)	(0.5)	(0.4)
Germany	(4.9)	2.4	↓ 1.1	↓ 1.7	4.4	↓ 0.2	1.8	1.1				
France	(8.0)	6.5	↑ 1.5	↓ 0.5	4.0	-	1.8	1.5-1.75				
Italy	(9.0)	6.6	↑ 1.0	↑ 1.0	4.5	↑ 0.7	2.1	0.8				
Spain	(10.8)	4.7	↓ 1.3	↓ 1.3	6.0	↑ 1.0	2.6	1.5				
Netherlands	(3.8)	4.4	↑ 0.4	↑ 1.2	3.0	↓ 0.1	2.0	1.4				
Belgium	(5.7)	5.7	↑ 1.6	↑ 0.2	2.9	↓ 0.6	1.8	1.3				
Austria	(6.8)	4.2	↓ 0.4	↓ 0.4	4.0	↓ 0.2	2.0	1.6				
Ireland	5.8	14.9	↑ 5.9	n/a	6.9	↑ 2.9	4.9	4.0				
Finland	(2.9)	3.4	↑ 0.9	n/a	2.7	↑ 0.2	1.6	1.2				
Portugal	(8.4)	4.6	↑ 0.8	↓ 0.4	5.0	-	2.5	1.8				
Greece	(7.8)	8.9	↑ 2.4	↑ 4.4	4.3	↑ 0.7	2.5	1.0				
Western Europe ex-euro area												
United Kingdom	(9.7)	6.8	↑ 0.2	↑ 0.2	4.6	↓ 0.8	2.7	1.5	0.10	0.10	0.50	1.00
Switzerland	(2.5)	3.5	-	-	2.8	↑ 0.3	1.4	1.3	(0.75)	(0.75)	(0.75)	(0.75)
Sweden	(2.9)	4.0	↑ 1.0	n/a	3.3	↑ 0.6	2.2	1.8	0.00	0.00	0.00	0.00
Norway	(1.3)	3.0	↓ 0.6	n/a	3.9	↑ 0.4	1.7	1.5-2.0	0.00	0.50	1.25	1.50
Denmark	(2.1)	3.9	↑ 1.8	n/a	2.8	↓ 1.0	1.9	1.5	(0.60)	(0.60)	(0.60)	(0.60)
Central and eastern Europe												
Poland	(2.5)	5.5	↑ 0.6	↑ 2.0	4.1	↓ 0.4	3.7	2.5	0.10	1.75	2.50	3.00
Romania	(3.7)	7.2	↑ 2.4	↑ 3.0	5.0	↑ 0.3	5.0	4.0	1.50	1.75	2.75	2.75
Czech Republic	(5.8)	3.0	↓ 0.8	↓ 1.0	4.7	↑ 0.2	4.0	2.5	0.25	3.00	3.75	3.75
Hungary	(4.8)	7.5	↑ 3.0	↑ 2.9	5.4	↓ 0.1	4.0	3.0	0.60	2.10	2.70	2.70
Russia	(2.4)	4.5	↑ 1.5	↑ 2.0	2.7	-	2.0	1.5-2.0	4.25	8.00	7.50	6.50
Turkey	1.8	10.8	↑ 2.8	↑ 4.6	2.3	↓ 1.7	2.4	3.9	17.0	14.5	14.5	17.5
Rest of World												
United States	(3.4)	5.5	↓ 0.7	↑ 1.5	3.5	↓ 1.3	2.9	2.0	0-0.25	0-0.25	0.5-0.75	1-1.25
China[4]	2.3	8.0	↓ 1.3	↓ 1.9	5.2	↓ 0.2	5.0	5.0	3.85	3.85	3.85	3.95
Japan[5]	(4.7)	1.5	↓ 1.5	↓ 1.5	3.6	↑ 1.5	1.6	0.5	(0.1)	(0.1)	(0.1)	(0.1)
World	(3.1)	5.8	↓ 0.2	↑ 0.4	4.5	↑ 0.1	3.7	3.0				

Country/region	Unemployment rate[6] (annual average, %)				General government balance (% of GDP)				Public debt level (% of GDP)			
	2020	2021E	2022F	2023F	2020	2021E	2022F	2023F	2020	2021E	2022F	2026F
Euro area	7.9	7.7	7.3	7.0	(7.2)	(7.1)	(3.6)	(2.5)	99	99	97	94
Germany	3.9	3.6	3.5	3.3	(4.3)	(6.3)	(1.8)	(0.4)	69	72	70	62
France	8.0	7.9	7.7	7.5	(9.1)	(9.6)	(5.4)	(4.3)	115	116	114	118
Italy	9.3	9.6	8.6	8.0	(9.6)	(7.5)	(5.5)	(3.6)	156	152	149	146
Spain	15.5	15.4	14.8	14.1	(11.0)	(8.0)	(4.8)	(4.2)	120	119	116	116
Netherlands	3.8	3.2	3.3	3.3	(4.2)	(5.9)	(2.4)	(1.5)	54	59	58	52
Belgium	5.6	6.3	6.3	5.9	(9.1)	(8.0)	(4.8)	(4.7)	113	114	114	121
Austria	6.1	6.4	5.8	5.6	(8.3)	(6.4)	(2.8)	(1.8)	83	85	82	74
Ireland	5.8	6.3	5.8	5.6	(4.9)	(5.3)	(2.4)	(1.3)	58	57	55	48
Finland	7.8	7.7	7.2	6.9	(5.5)	(3.9)	(2.7)	(2.0)	70	71	72	76
Portugal	7.1	6.9	6.7	6.3	(5.8)	(4.3)	(3.2)	(2.2)	135	130	125	114
Greece	16.4	14.9	12.5	11.5	(10.1)	(10.2)	(5.2)	(3.6)	206	202	194	181
Western Europe ex-euro area												
United Kingdom	4.7	4.6	4.2	4.0	(12.5)	(11.9)	(5.6)	(2.6)	104	108	107	106
Switzerland	3.1	3.0	2.8	2.7	(2.8)	(2.0)	(0.3)	(0.1)	42	43	42	38
Sweden	8.3	9.0	7.7	7.5	(2.8)	(2.4)	(0.4)	(0.1)	40	39	39	34
Norway	4.6	4.4	3.9	3.7	(6.1)	(5.9)	0.0	2.2	41	43	42	41
Denmark	5.7	5.0	5.1	4.8	(0.2)	(1.9)	0.1	(0.4)	42	39	39	39
Central and eastern Europe												
Poland	3.2	3.6	3.2	3.1	(7.1)	(3.7)	(2.2)	(2.2)	57	55	54	53
Romania	5.0	5.2	4.9	4.7	(9.4)	(7.0)	(6.0)	(5.3)	47	52	54	60
Czech Republic	2.6	2.9	2.6	2.4	(5.6)	(7.5)	(4.7)	(4.0)	38	44	46	50
Hungary	4.1	4.1	3.6	3.2	(8.0)	(7.1)	(5.3)	(3.4)	80	77	76	67
Russia	5.8	4.9	4.7	4.5	(4.0)	(0.5)	0.0	0.0	19	18	19	20
Turkey	13.1	12.3	12.0	12.0	(5.3)	(3.2)	(5.4)	(6.4)	40	36	39	53
Rest of World												
United States	8.1	5.4	4.0	3.6	(14.9)	(11.3)	(8.8)	(7.0)	134	134	135	138
China[7]	5.6	5.1	5.2	5.0	(11.2)	(7.5)	(6.8)	(6.2)	66	69	72	81
Japan	2.8	2.8	2.5	2.4	(10.3)	(9.0)	(8.4)	(5.6)	254	259	259	265
World												

Negative values shown in parentheses
Source: Scope Ratings forecasts, Macrobond, IMF
[1]Changes compared with Scope June 2021's mid-year Sovereign Outlook forecasts
[2]Changes compared with Scope December 2020's 2021 Sovereign Outlook forecasts
("n/a" reflects countries not forecasted as of the December 2020 Sovereign Outlook)
[3]Shown for the euro area policy rate is the ECB deposit facility rate
[4]Shown for China's policy rate is the bank prime loan rate
[5]Shown for Japan's policy rate is the deposit rate on current account balances
[6]Unemployment rate data source is Eurostat for EU member states; national unemployment series otherwise
[7]Unemployment is survey-based urban unemployment rate

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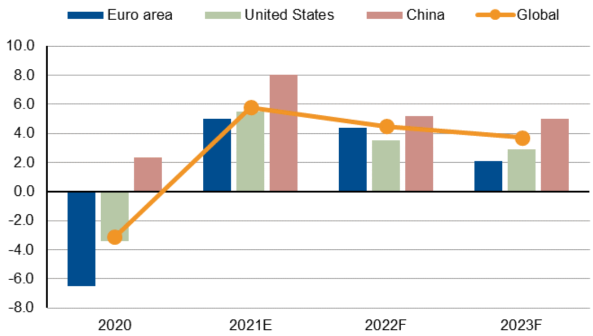
Key themes for 2022

Uneven global recovery with risk from Covid and tightening rates

Although the fastest speed of the recovery now lies behind, global growth over calendar-year 2022 is seen remaining above potential, on aggregate 4.5% over 2022 (**Figure 2**), revised up 0.1pp from a mid-year estimate (global growth potential is estimated around 3%). This 2022 growth forecast represents nevertheless a degree of normalisation in pace after the elevated early recovery expansion of around 5.8% this year (revised down 0.2pps on basis of downside revisions of China and the US), after Scope entered 2021 with an appropriately above-consensus expectation with respect to 2021 growth globally – including as concerns growth of many economies of Europe. In 2023, we pencil in further normalisation of global growth to 3.7%. Unequal vaccine availability means noticeable gaps remain present between sustainability of recoveries of advanced versus those of emerging economies. Even in the advanced world, however, full economic normalisation stays vulnerable to setback as segments of populations stay unvaccinated, while more transmissible virus variants present contingent risks of fresh economic restriction.

Figure 2. Global growth, %, 2020-2023F



Source: Macrobond, Scope Ratings GmbH forecasts

This assumes continuation of a longer-standing baseline for uneven but robust recovery with interruption associated with Covid-19 related undulation, affecting seesaw pivots in the shape of recovery. Temporary modest *slowdown* is seen across many economies over Q4 2021 and Q1 2022 – as countries re-introduce generally lighter economic restrictions linked to renewed increase of cases and risk from a new Omicron variant. In select nations, a quarterly contraction of GDP over these quarters is possible as there is significant diversity in Covid situations and associated national responses. However, impact of Covid on economies is continuing a transition, becoming less severe for output over successive lockdown periods as governments adopt more targeted responses, virus becomes more transmissible but less lethal, and, as importantly, businesses and people adapt ways of doing business.

Similar to expectation of resumption of traction of recovery by spring 2021 after lockdown we anticipated over the 2H-20 through early 2021, we foresee in Europe resumption of traction in recovery by spring of 2022.

Next year, we assume somewhat lesser growth in China – 5.2% in 2022, edging nearer to trend of around 5.0%, after a downward-revised 8.0% in 2021. Conversely, calendar-year growth is seen remaining above trend in 2022 across many advanced economies. The euro area is expected to grow 4.4% in 2022 (revised up 0.2pps), supported by investment spending linked to Next Generation EU (NGEU), after an estimated 5.0% expansion in 2021 (revised up 0.3pps). In 2021, strong euro-area growth has been anchored, as expected entering this year, via strong recovery of economies such as France and Italy. Conversely, growth of Germany has been disappointing. We see Germany as among a more limited set of economies to display faster growth in 2022 than in 2021, however.

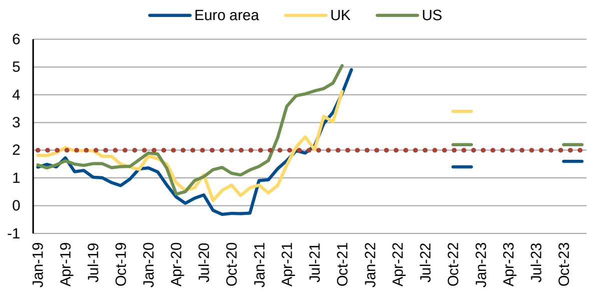
The UK economy is seen recovering 4.6% next year before 2.7% in 2023, after growing 6.8% in 2021 – highest of the G7. Meanwhile, the US economy is seen similarly growing above trend around 3.5% next year (revised down 1.3pps), after 5.5% in 2021 (revised down 0.7pps). Output in the US returns near levels adjusted for pre-crisis trend growth by 2022, while the UK and the EU remain still some distance off in this respect, speaking to disparities in the outstanding output gap. Japan is seen growing an upside-revised 3.6% next year, after 1.5% in 2021 (revised down 1.5pps). As far as emerging economies, Russian growth is seen easing to 2.7% in 2022, after 4.5% this year. Turkish growth is seen easing sharply to 2.3%, from 10.8% in 2021.

Covid-19 risks are intersecting with that associated with currently elevated inflation and responsive policy tightening of central banks. As compared with a balanced skew to risk in entering 2021, we judge risk to the global outlook entering 2022 as being skewed to the downside. Downside risks include should i) virus transmission and variants bring fresh limitations to economic activity; ii) high inflation endure, restricting purchasing power, and tapering of policy support bring crystallisation of latent debt risk; iii) emerging market risks crystallise as G4 central banks taper, China strengthens financial oversight and geopolitics were to worsen; and/or iv) bubbly financial asset markets more significantly correct. Upside risks to growth include were i) significant budget stimulus already in the system to elevate growth more than assumed; ii) forced savings accrued by households and corporates during crisis to be more substantively expended; and/or iii) economic normalisation to be realised faster than anticipated – as economies adapt to endemic Covid.

Higher inflation for longer, with positive and negative sovereign rating implications

Over the course of 2021, price changes in major western economies, such as the US, the UK and the euro area have sped up markedly to rates not seen since the early 1990s in the US and euro area. As of November 2021, headline inflation rose to 4.9% for the euro area, and was 4.1% and 5.0% in the UK and the United States in October.

Figure 3. Inflation, %YoY, 2018-2023F



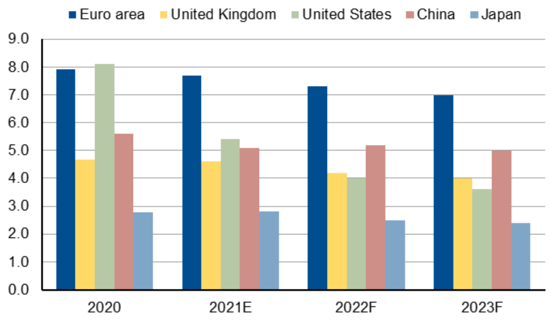
N.B. Inflation forecasts for Q4-2022 and Q4-2023 are from the ECB, Federal Reserve Board and the Bank of England. US inflation refers to the headline personal consumption expenditure (PCE) price index.

Price increases have become broadly based. Core inflation picked up to 3.5% in the UK and 4.1% in the US (core PCE) as of October. In the euro area, core inflation rose to 2.6% in November.

We believe there remains upside risk concerning central bank forward projections of inflation (**Figure 3**). We have held to an opinion since early that there *is* a moderate structural element to current faster price changes, meaning inflation, even after it starts to moderate by next year, ought to remain more elevated over the coming years at least as compared with pre-crisis averages. This means an inflation regime of around or above 2% in the US and the UK, testing 2% price-stability mandates, over the medium run but potentially averaging near or under 2% in the euro area and Japan. This holds implications with respect to divergence of monetary reaction functions.

Inflation jumps of the second half of 2021 in entering 2022 have been pushed up by rises of energy and commodity prices plus expense of pent-up demand as economies re-opened, with resulting supply-demand mismatches as materials and labour-market shortages may be further stressed as some economies re-enter partial lockdown over coming months. In the medium run, expectations for somewhat higher structural inflation considers effects of comparatively looser fiscal and monetary policies moving ahead, as compared with the disinflationary deleveraging, rates tightening and austerity policies of the last decade. It also considers acceleration of wage growth. An adoption of symmetrical central-bank price-stability objectives alongside increased attention on maximum employment of central banks also support more elevated price changes moving ahead. Unemployment rates being trimmed (**Figure 4**) boosts price pressures as output gaps diminish.

Figure 4. Unemployment rate, %, 2020-2023F



Source: Macrobond, Scope Ratings GmbH forecasts

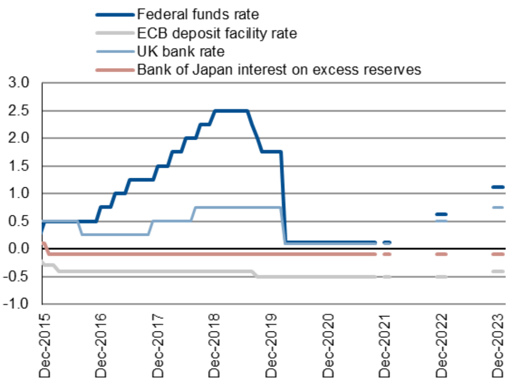
However, we do not presently consider a scenario of "runaway inflation" or a prolonged phase of stagflation as baseline. Inflation expectations, while having risen several tenths, remain anchored near 2% under prime market-based and survey-based measurements. There remain, furthermore, multiple factors that hinder sustained elevated price rises, such as the forces of globalisation, technological innovation and automation, even social dynamics such as disinflationary consequences of ageing populations and rising income and wealth inequality. As budget stimulus is pulled back, inflation surges during initial recovery of demand drop out of YoY inflation and supply-chain bottlenecks owing to the pandemic moderate with time, price increases should comparatively attenuate.

Current higher and more persistent inflation holds both positive and negative credit implications for sovereign credit ratings. On the one hand, somewhat higher trend inflation supports higher nominal economic growth, abetting reduction of debt-to-GDP ratios – and supporting easing of heightened deflation danger experienced in the past in the euro area and Japan. On the other hand, higher inflation causes higher inflation volatility, increasing economic uncertainty and impairing business conditions. In addition, higher bond yields and associated rises of costs of the public debt portfolio, alongside devaluation of exchange rates of emerging markets, might stress public-debt trajectories should inflation prove durable. As central-bank support has been a critical cushion for sovereign ratings since this crisis, a persistent inflation scenario in which central banks were compromised in their monetary space to intervene represents a core risk to credit outlooks, curtailing, under such scenarios, capacity of central banks to impede market sell-off – possibly risking crystallisation of debt risk presently latent.

Divergence of global monetary policy & threat of crystallisation of debt risk

The 2020 Covid crisis shock resulted in *convergence* of monetary policy across jurisdictions in low rates, liquidity provision and extraordinary bond purchases. As some economies re-enter lockdown-lite and economies deal with inflation risk to varying degrees, we expect, however, increasing *divergence* of monetary policy over 2022 as we slowly exit this crisis.

Figure 5. Policy rates, %, with forecasts



Source: Central banks, Scope Ratings GmbH forecasts.

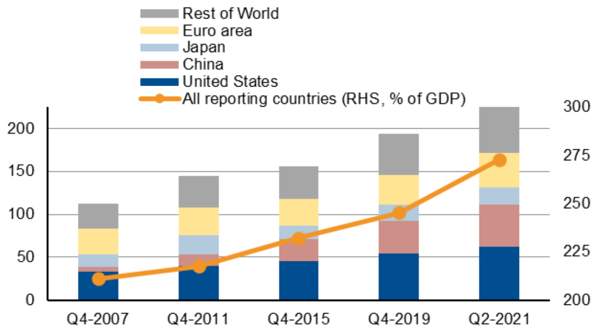
While the Bank of England and Federal Reserve are likely to take a more hawkish approach, we expect the ECB and Bank of Japan to maintain comparatively accommodative policy over a next year. The Bank of England is likely to be a first major central bank to raise interest rates in the coming months, whilst also becoming the first major central bank to start curtailing the size of its balance sheet. The Federal Reserve started tapering of net asset purchases last month with net purchases expected to be concluded by the middle of 2022 if not prior. We expect the Federal Reserve to raise rates before end-2022 (**Figure 5**). Meanwhile, the ECB is seen halting the Pandemic Emergency Purchase Programme (PEPP) next year, but we believe PEPP and/or other asset-purchases facilities will be adjusted to retain room for manoeuvre and smoothen transition in markets – with the ECB balance sheet continuing to expand but at a more moderate pace. This is expected to ensure continuation of support in debt capital markets with policy rates only starting to increase after 2022. Finally, the Bank of Japan is unlikely to shift from accommodative monetary policy given tepid inflation (0.1% in October) after a new government confirmed commitment to 2% inflation.

Inflationary pressure presents challenges for central bank mandates, even after authorities adjusted price stability objectives in support of enhanced tolerance for temporarily overshooting 2%. As many central banks tighten monetary policy amid policy divergence, peer central banks that might otherwise prefer looser financial conditions may see themselves compelled to likewise remove some accommodation, otherwise risking currency depreciation adding to underlying inflation undercurrents. In this respect, 2022 may be a year during which the bounds of central banks to set aside "unlimited" monetary accommodation is tested. At the same time, with governments dealing with record levels of debt and central banks owning large shares of this debt, "fiscal dominance" might coerce some moderation in speed of policy normalisation – such as to avoid financial instability short run but with any such delay adding to longer-run inflation risk.

The pandemic has demonstrated how large-scale monetary and budgetary balance-sheet expansion could mitigate market sell-off from amplifying a severe economic crisis. Even as stimulus is withdrawn, lessons derived from coordinated countercyclical policy responses during heights of this crisis hold resonance for reaction functions over future crises. Innovation such as a flexibility of ECB asset purchases across jurisdiction, time and asset classes is likely to be credit relevant were it re-introduced in future crises – supporting especially sovereigns with lower credit ratings, and partially redressing weaknesses in ECB lender of last resort functions within monetary union.

Withdrawal of monetary stimulus may, however, risk crystallisation of latent risk associated with debt and deficits accrued over recent years. The latest statistics of the Bank for International Settlements display fresh highs in non-financial-sector debt of reporting countries of USD 225trn in Q2 2021, or 273% of GDP (**Figure 6**).

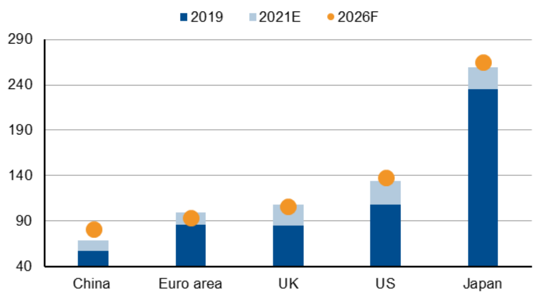
Figure 6. Global non-financial sector debt (reporting countries), USD trn



Source: Bank for International Settlements, Scope Ratings GmbH

While low or negative interest rates, forbearance and emergency liquidity programmes anchored private-sector finances over this crisis, non-performing loans and bankruptcies may rise as such extraordinary liquidity is tapered and interest rates increase. Similarly, growing dependence upon central banks for sustaining high public debt (**Figure 7**) increases contingent risk. Such vulnerabilities, moreover, also interact with those from asset price inflation since the global financial crisis – not only concerning fixed-income markets but also equity and housing, accentuating risk for correction relevant as regards financial stability longer term.

Figure 7. General government debt, % of GDP



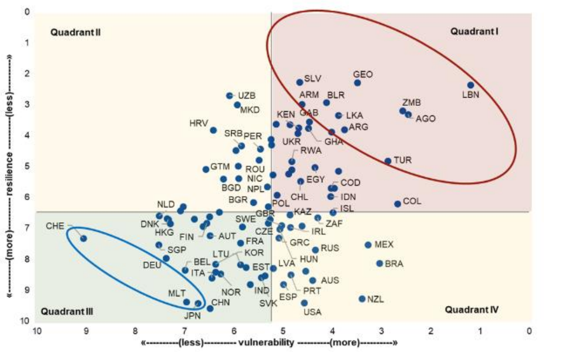
Source: Macrobond, IMF, Scope Ratings GmbH

Emerging market vulnerabilities amid G4 tapering, geopolitics and China's tightening financial supervision

Amid uneven recovery, increasing inflation and turning interest-rate cycles, increased threat of risk-reversal in global markets increases likelihood for crystallisation of external vulnerabilities of developing countries. Sovereign credit defaults reached a record last year: Argentina defaulted twice; Zambia and Lebanon defaulted in 2020. Two sovereign credit events already occurred this year (Suriname and Belize). The risk for further credit events is high as vulnerable nations face repayment difficulty under testy market conditions. It is less likely defaults in 2022 exceed 2020 records but, nevertheless, there are borrowers from Argentina to Ethiopia to Sri Lanka on the brink. Moreover, geopolitical risk and possibility of conflict is a central risk for nations such as Russia and Ukraine.

Under Scope's 2021 external risk rankings[1], Lebanon, Belarus, Argentina and Turkey rank among a top 10 of most at risk economies globally (the group circled in red under **Figure 8**) of 95 countries we evaluated under conditions of rates tightening and fraught external-sector conditions. These economies share characteristics such as high foreign-currency exposure, historical volatility of currencies, current-account deficits and exposures to phases of intensive capital outflow. Of these ten riskiest, Scope rates two currently: Georgia (BB/Stable) and Turkey (B/Negative).

Figure 8. External vulnerability and resilience two-axis grid: 2021



More details, including with respect to definitions of the grid's four quadrants, summarised within Scope's 2021 external risk report.

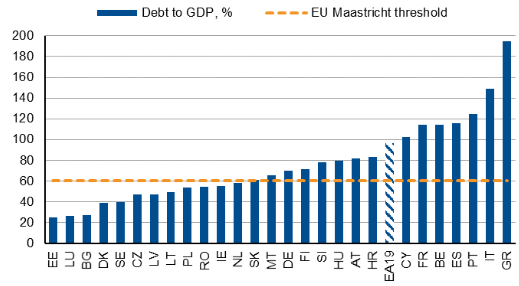
Risk concerning emerging markets and global recovery also relate to meaningful spill-over from slowdown of China's economy as authorities rein in credit to highly indebted firms. In our view, systemic risk stemming from a crisis at the Evergrande Group is containable, however, and Chinese authorities may compel managed restructuring of the Group. Nevertheless, given rise of off-balance sheet lending and interlinkages within China's banking system and with China's non-bank financial sector, contagion risks are significant.

China's economic growth will stay the single largest driver of global growth in 2022, accounting for around 20% of global economic growth next year. As a result, instability in China's property sector, and resulting implications for the economy's growth outlook, is still a core constraint upon global recovery. A challenge for authorities over 2022 will be striking the right balance between facilitating necessary reappraisal in Chinese markets of the fundamentals of borrowers, curtailing excess loan growth and spreading out a process of managed default, but without causing the very "hard landing" they are seeking to avoid longer term.

European Union's fiscal rules: from shock response to a new architecture?

The need for large-scale fiscal support in face of the Covid-19 crisis has opened up to fresh debate around the European Union's fiscal framework. Confronted by enormous economic and budgetary costs of the crisis and increasing government debt, global policy makers departed from fiscal restraints and existing norms around fiscal rules.

Figure 9. Public debt ratios, end-2022 (F)



Source: Scope Ratings GmbH forecasts

The European Commission's economic governance review, launched in February of 2020, has provided a platform for debate around how to improve the European Union's Stability and Growth Pact (SGP), with potentially far-reaching implications for sovereign credit risk concerning the region's 27 member states. Presently, the SGP remains suspended through end-2022, with most EU member states unlikely to be compliant with deficit and especially the 60% debt rule even well after end of the suspension phase (**Figure 9**). SGP reform suggestions have included abandonment of fiscal rules in favour of fiscal standards[2], adoption of an expenditure rule[3], or softening limits that restrict debt at 60% and/or the required speed of transitional debt reduction in cases in which the debt limit is violated. Instead of specifying debt and deficit objectives, other approaches of framing a future of EU fiscal policy have

[1] See Scope Ratings. "2021 External Vulnerability and Resilience rankings: Risks for emerging economies amid rising inflation, rates", 8 November 2021.

[2] Blanchard, O., Á. Leandro & J. Zettelmeyer. (2021) "Redesigning EU fiscal rules: From rules to standards", Peterson Institute for International Economics.

[3] European Stability Mechanism. (2021) "EU fiscal rules: reform considerations", Discussion Paper 17.

included a more sophisticated long-run spending rule indexed to underlying drivers such as, as example, increasing life expectancy to commit governments to budgetary decisions sustainable over longer horizons. However, given complexity of such far-reaching schemes, such approaches hold little chance of going in force as they require reopening of EU treaties.

Sizeable countercyclical stimulus has facilitated euro area economies' recoveries to pre-crisis levels of output, anticipated being reached by 2022 for the euro area-19 (half the time it required for recovery to pre-crisis output after the global financial crisis). Still, the depth and duration of this shock and size of budget responses have resulted in significant deterioration and increasing divergence in fiscal positions of euro area member states. Next year, budget balances are set to improve, as emergency support is phased out and economies resume recovery: we see an aggregate euro-area deficit of 3.6% of GDP before declining under 3% by 2023, after 7.1% in 2021 and 7.2% in 2020.

However, euro area governments are confronting an historic challenge in correcting fiscal balances whilst preserving robustness of recovery. The EU's NGEU funds support this process – sustaining or enhancing national public investment, and thereby growth outlooks, absent weighing directly upon national public finances.

Besides recovering from this pandemic crisis, countries need to rebuild fiscal space to confront structural challenges over the medium run, from rising ageing-related expenditure to the climate crisis, likely to call upon significant budgetary resources over the decades. Defining an EU fiscal framework addressing high and diverging public debt ratios among member states while balancing need for budgetary space to invest is critical for credit outlooks of EU member states after this crisis.

Sovereign ratings: mostly Stable Outlooks entering 2022

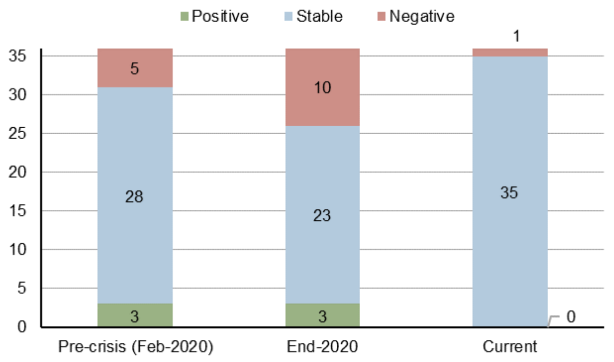
An uneven but robust recovery in global growth amid undulations of the pandemic and associated supply-chain disruption, elevated inflation and risk reversal as central banks normalise as well as transition of international fiscal policies as governments seek more elevated deficits after this crisis set a stage for sovereign credit risk in entering 2022.

As of the end of 2020, Scope held 10 sovereign borrowers on Negative Outlook with three on Positive Outlook (of 36 countries rated publicly). As recoveries gathered traction, and as scale of impairment of fiscal balance sheets became more transparent over the course of 2021 with debt trajectories stabilising, most Outlooks were "*resolved*" over the course of the year. In the majority of such cases, Negative Outlooks were revised to Stable acknowledging fundamental deterioration since the crisis but commensurate institutional support, including central bank intervention, supporting resilience of borrowers' credit standings at outstanding credit rating levels. The sovereigns that observed such Outlook revisions to Stable during 2021 to date: China (A+), the United Kingdom (AA), Spain (A-), Italy (BBB+), Romania (BBB-), Georgia (BB) and Slovakia (A+).

Meanwhile, longer-standing improvement of macroeconomic resilience has supported credit-rating upgrades of three credits that entered the crisis on Positive Outlook: Greece (BB+), Ireland (AA-) and Lithuania (A); Russia (BBB+) was, furthermore, upgraded in 2021. However, material and lasting effects of this crisis on long-run debt sustainability contributed to downgrades of Japan (A) and Belgium (AA-) this year. Currently, 33 of Scope's 36 publicly rated sovereigns are investment-grade rated with three rated sub-investment-grade. **Annex I** presents a summary of ratings and rating actions to date in 2021.

Sovereign borrowers holding a Stable Outlook entering 2022 make up presently more than 90% of the publicly rated portfolio (**Figure 10**), indicating comparatively lesser likelihood of ratings changes next year versus the circumstance in entering 2021. Nevertheless, upside and downside risk to the economic outlook may place ratings Outlooks to the test over 2022. The only sovereign currently on Negative Outlook: Turkey (B).

Figure 10. Scope sovereign rating Outlooks



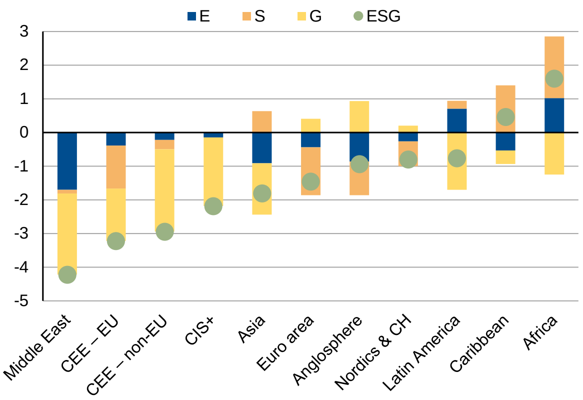
Source: Scope Ratings GmbH

ESG risks increasingly relevant for sovereign ratings

Since October 2020, Scope's sovereign rating methodology systematically accounts for environmental, social and governance (ESG) risk as part of an independent ESG rating pillar. We recognise that: i) environmental risks are likely to have longer-term demand- and supply-side economic implications and may result in significant disruption to economic and financial systems; ii) social risks hold fundamental effects on growth, government finances and political developments; and iii) institutional quality, political stability and exposure to geopolitical conflict affect a sovereign's capacity and willingness to service debt. We thus assign a significant 20% weighting to this ESG pillar in our methodology, providing for a transparent and forward-looking assessment of ESG metrics informing our sovereign credit ratings.

ESG factors relate mostly to structural, long-run drivers that can have an impact on a sovereign's economic growth and sustainability of government finances. Our analysis of potential long-run implications from these factors for 11 country groups revealed significant and multi-notch disparities (**Figure 11**). Overall, Middle Eastern nations faced the highest potential adverse credit implications from ESG risk over the long run, driven by environmental and governance-related factors. African sovereigns, on the other hand, could benefit from a meaningful potential uplift to ratings compared with current indicative credit assessments based upon demographic and environmental opportunities. Finally, adverse demographics and ageing populations are a drag upon long-run credit outlooks in the euro area, the Anglosphere as well as central and eastern Europe (CEE).

Figure 11. Potential challenges and opportunities from ESG trends, rating notches



Source: Scope report on sovereign ratings vs ESG drivers.

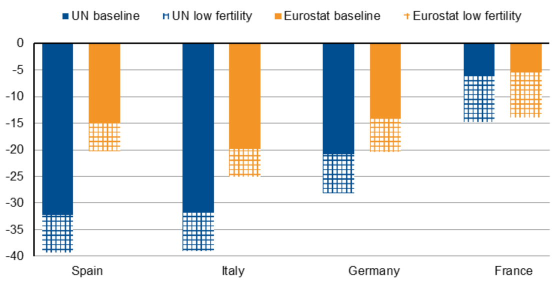
Looking at environmental factors in more detail, we note that extreme climate events constitute an important environmental risk for European governments. Our recent research demonstrates that the cost of extreme weather events has held marginal macroeconomic impact in Europe thus far but will become increasingly material for sovereign risk as their frequency and severity rise. They are also likely to increasingly interact with other risk areas as climate risk spills over to economic and fiscal spheres as well as impacts financial stability. Southern European and CEE countries are most exposed to developments concerning extreme climate. The pervasiveness of these risks could result in greater credit ratings divergences among European sovereigns with countries that are the most exposed tending to be those already the lowest rated.

Policies could mitigate some of these risks, bolstering institutional capacity to assess risks from climate change and address them effectively. In 2021, the EU adopted the European Green Deal and a new EU Strategy on Adaptation to Climate Change to facilitate transition in direction of a carbon-neutral, climate-resilient and resource-efficient economic model. EU leaders have agreed to earmark at least 37% of EU funding under the Recovery and Resilience Facility while the European Commission has proposed at least 25% of the EU's multiannual budget be geared towards climate action over 2021-27. Monetary authorities are also taking action to greening central-banking mandates although there is no consensus on an optimal approach at this stage. The ECB's actions include incorporating climate considerations in macroeconomic modelling, conducting climate stress tests, and introducing climate disclosure requirements.

In social risk, our research around demographics speaks to shrinking working-age populaces and ageing dynamics as among core challenges European economies are facing over the coming years. We were surprised to observe such large disparity in projections among official institutions associated with European population dynamics and major question marks over underlying assumptions, particularly as regards migration and fertility rates. In our view, outstanding assumptions are quite optimistic.

A key finding is that absent 1m of net migration yearly until 2060 (the European Commission's baseline assumption), the EU's working-age population could decrease by 30% and the old-age dependency ratio rise to 70%. Including such migration, the working-age population nevertheless drops 16% and the old-age dependency ratio rises to 60%. While all countries face challenges to a degree related to ageing, Italy, Spain and Germany are comparatively more exposed to these dynamics than the US, UK and France (**Figure 12**).

Figure 12. Change working-age population (20-64): 2060 vs 2020, pps



N.B. UN low fertility scenario assumes 0.5 lower fertility rate than baseline; Eurostat low fertility scenario assumes 20% lower fertility rate than baseline. Source: UN, European Commission, Scope Ratings.

Regional views for 2022

Core Europe: Divergence in fiscal trajectories longer term

For **Germany** (AAA/Stable) – in 2022, we anticipate strong growth of 4.4% as supply-side constraints start subsiding, allowing output to return to pre-pandemic levels by 1H-22. We have simultaneously lowered an expectation of growth for 2021 to around 2.4% (revised down 1.1pps since June) due to supply-chain disruption and a new wave of Covid-19 during recent months.

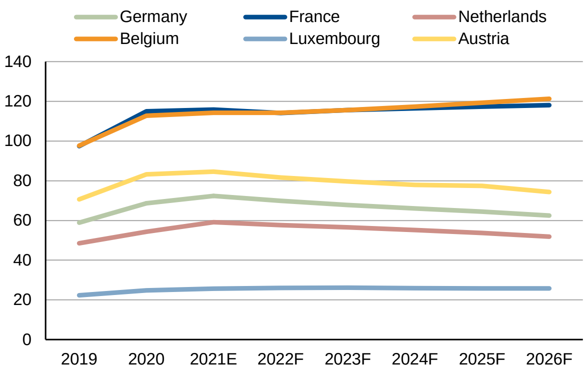
In 2020, a general escape clause of Germany's debt brake was triggered as response to the pandemic crisis. The European Commission estimates crisis-related temporary emergency measures increased from 2.7% of GDP in 2020 to 4.3% in 2021 before expected to decrease to 0.3% in 2022. This is reflected in sharp increase of government debt – we see debt reaching 72.4% of GDP by end of this year. The debt brake will remain suspended until 2023, with a 2022 budget deficit of 1.8% of GDP according to the government draft federal budget. However, a combination of stronger growth and borrowing restraint in line with the debt brake is expected to return government debt on a declining trajectory, reaching 62.5% of GDP by end of 2026. The new coalition agreement is unlikely to change this declining debt trajectory meaningfully.

Two months after September federal elections, coalition groups presented their draft agreement. Spending priorities outlined via the coalition agreement cannot be met solely via re-shuffling the budget. Since the debt brake is anchored in the Constitution, fundamental change requires two-thirds majorities under both houses of parliament – unlikely near term. However, we also do not expect the government to return to a pre-pandemic 'Black Zero' policy, which linked with persistent budget surpluses. Some budgetary flexibility is available as Germany was running structural surpluses averaging 1% of potential output during years before the pandemic and tax revenue has exceeded expectations thanks to robust recovery.

The new coalition is planning a range of policies in raising public spending. We believe that while these measures may help tackle an investment gap, further private-sector incentives to raise investment are crucial.

France (AA/Stable) faces presidential and parliamentary elections in April and June 2022. The ability of the next government to sustain reform momentum and raise the country's growth potential will prove crucial as meaningful public expenditure reductions are unlikely. While the French government has announced two large-scale stimulus programmes to support recovery – the EUR 100bn (4% of GDP) *France Relance* recovery and the EUR 30bn (1% of GDP) France 2030 investment plan – their implementation, accompanied with reforms, is critical. However, increased fragmentation of the political landscape may make it harder to form a clear parliamentary majority in implementation. This would be credit negative given France's poor track record of budget consolidation, with the last primary surplus recorded in 2001. We estimate the debt-to-GDP ratio hovering around 115%-120% over the coming years, as the budget deficit is unlikely to decline under 3% of GDP until after 2026 – a trajectory that contrasts with that of most euro area peers (**Figure 13**), raising possibility of future excessive deficit procedures.

Figure 13. General government debt, % of GDP



Source: Eurostat, Scope Ratings GmbH forecasts

Netherlands (AAA/Stable) will record growth of around 3% next year, even as lockdown restrictions are tightened ending this year, after growth of an estimated 4.4% over 2021. The public debt ratio is seen reaching a peak of 59% of GDP this year, and reversing starting 2022, reaching 52% by 2026 – still higher than pre-crisis. Entering 2022, Netherlands' outlook is weighed down by the longest government formation talks on record after 2021 elections.

Belgium (AA-/Stable) is seen presenting growth of around 2.9% in 2022, after 5.7% this year. Recent deterioration in the public-health situation and associated tightening of virus restriction are expected to weigh moderately on recovery, especially in Q1 2022. After 2022, we expect gradual growth convergence in direction of a weak potential growth rate of 1.3%. Public indebtedness is expected to remain on an increasing trajectory longer term, with debt-to-GDP reaching 121% by 2026, from 98% in 2019. Policy making at national level to address structural fiscal pressure remains hindered by polarisation and a fragile seven-party governing coalition. In May 2021, Scope downgraded Belgium's credit rating to AA-, from AA.

Luxembourg (AAA/Stable) has demonstrated resilience over this crisis to date, with only mild recession of 1.8% in 2020, thanks to strong performance in the information and communication technologies sector, a large financial system and large-scale fiscal and monetary policy responses. We see output growing a robust 3.6% in 2022, after 5.9% in 2021, although medium-run growth will be lower than pre-pandemic trend rates. Public debt is expected to stabilise around 26% of GDP over 2022-23.

In **Austria** (AAA/Stable), we see real growth in 2021 of 4.2%, with baseline expectation of 2.5% QoQ decline of output in Q4. Austria was the first in Europe to re-impose full lockdown – negatively impacting private consumption as well as tourism exports over this crucial winter season. With restrictions easing by Q1, we anticipate growth of around 4% in 2022. Renewed restrictions also come with fresh budget support, raising the fiscal deficit to an estimated 6.4% of GDP for the year. We see the public debt ratio gradually declining from a 2021 peak of 85% of GDP from 2022, reaching 74% in 2026, still above a 2019 level of 71%.

UK resilient to Brexit & Covid crises; manageable impact of global tax change on Irish public finances

In the **United Kingdom** (AA/Stable), we expect recovery of 4.6% in 2022 (revised down 0.8pps), after 6.8% growth during 2021 (revised up only 0.2pps since an above-consensus December 2020 estimate). Our forecast assumes temporary slowdown of growth towards the end of 2021 and early 2022 due to continued concern around new Covid-19 variants.

We affirmed the UK's credit ratings at AA and revised the Outlook from Negative to Stable in June 2021. The entering into force of the Trade and Cooperation Agreement with the European Union in May 2021 mostly eliminated cliff-edge-related Brexit risk and associated significant economic, fiscal, external-sector and institutional repercussions for the ratings. In addition, resilience of the economy, government debt profile and reserve-currency status demonstrated over Brexit and Covid-19 crises support the ratings outlook.

In 2022, the UK's budget balance is seen improving to -5.6% of GDP, after -11.9% in 2021 and -12.5% in 2020. Public debt will have risen to around 108% of GDP this year (from 85% in 2019). Longer run, we expect proposed fiscal targets to support debt remaining comparatively stable, ending a forecast period at 106% of GDP by 2026. However, just slightly slower growth or stronger borrowing assumptions could place government debt ratios on an increasing trajectory.

Inflation has picked up sharply and the Office for Budget Responsibility estimates CPI inflation to peak at 4.4% in Q2 2022. We have expected the Bank of England to raise rates by Q1 2022, becoming the first major central bank to raise rates. Governor Andrew Bailey has indicated that Bank Rate would rise to 0.5% before the Bank intends to reduce the stock of purchased assets by ceasing to reinvest maturing UK government bonds. Asset purchases to date have helped to hold 10-year gilt yields low around 0.8% and have shifted around 33% of all gilt holdings to the central bank balance sheet (as of Q2 2021), from 23% previous to the pandemic.

The UK's challenges entering 2022 include high government debt, wide fiscal and current account deficits, and Brexit. These are partially offset by still comparatively moderate gross debt ratios relative to some peers, a long average maturity of gilts of 14.8 years, significant ownership of government debt by the central bank, and sterling's reserve currency status with an independent monetary policy.

Ireland (AA-/Stable)'s growth turned out to be significantly stronger than initially expected and we have revised up estimates for 2021 from around 5%, estimated in May 2021, to 14.9%, with continued strong growth in 2022 of 6.9%. Enhanced growth expectations are largely due to activities with limited domestic linkage including exports of multinational enterprises with large intellectual property, particularly in foreign-owned high-tech sectors such as pharmaceuticals and information technology. If these were excluded, we expect significantly lower growth in the underlying economy of around 5% in 2021 and 6.6% in 2022.

Ireland's favourable corporate tax regime has been a crucial driver for firms' relocations of operations to Ireland. Such multinational corporates are critical for tax revenue. Particularly the strength of corporate and income tax revenue helped to sustain government finances over this crisis. The global corporate tax reform agreed in October may somewhat temper Ireland's strong growth over the coming years, but the aggregate impact of global tax changes on Irish tax revenue is seen being manageable. In May 2021, Scope upgraded Ireland's credit ratings to AA-, from A+.

Italy, Spain and Portugal: robust recoveries support Stable Outlooks

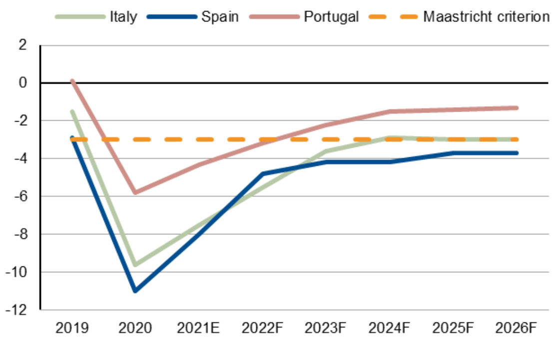
We expect growth next year in **Italy** (BBB+/Stable) of 4.5% (revised up 0.7pps), after 2021 growth of an estimated 6.6% – revised up (a moderate) 1pp from an above-consensus December 2020 estimate. Recovery has been supported by vaccination although recent rise of cases has brought fresh restrictions for unvaccinated with wider economic restrictions likely on the horizon.

Prime Minister Mario Draghi enjoys a strong parliamentary majority, underpinning expectation for further reform advancement. We do not expect Draghi to stand for the Italian Presidency in 2022, serving out a current term as premier to 2023. Nevertheless, uncertainty is heightened with respect to the economic reform agenda after 2023 elections, after which a right-wing government remains a possible outcome according to opinion polling.

An expansionary fiscal policy translates to higher growth and wider budget deficits. Nevertheless, Italy's deficit is seen concluding this year meaningfully under expectations – around 7.5% of GDP, before declining further to 5.5% in 2022. Public debt edges lower from 156% in 2020 to 149% by end-2022 and 146% by 2026, but Italy's high debt stock still represents a crucial ratings constraint as we expect the debt ratio to remain on a structurally increasing trajectory in the long run.

Extraordinary support vis-à-vis ECB asset purchases has anchored funding and the public debt profile. Over 25% of Italian general government debt will have been transitioned to the joint Eurosystem balance sheet by end-2021, from 17% pre-crisis, resulting in less Italian debt held on private-sector balance sheets by end-2021 than pre-crisis. However, as the ECB tapers asset purchases, questions around Italian debt present risk under scenario of repricing of debt risks in sovereign markets. These factors were considered in a decision to revise the Outlook to Stable, from Negative, of Italy's BBB+ ratings in August 2021.

Figure 14. General government balance, % of GDP



Source: Eurostat, Scope Ratings GmbH forecasts

We revise up expectations as regards **Spain** (A-/Stable)'s recovery in 2022 to 6% (revised up 1pp), returning output to pre-pandemic levels next year, after downward-revised 2021 growth of 4.7% (-1.3pps). 2022 growth is anchored by high carry-over from 2021, anticipated rejuvenation of the tourism sector as well as high public- and private-sector investment. Growth is seen after 2022 converging on medium-run potential of around 1.5%. The Spanish government's temporary job retention scheme (ERTEs) was successful in cushioning impact of the pandemic on employment, and we see unemployment declining, to 15.4% in 2021, 14.8% in 2022 and 14.1% in 2023. Despite recent strong labour market outcomes, with the number of persons employed exceeding 20m, very high structural unemployment (averaging over 20% over 2010-2019 pre-crisis) and adverse demographics in form of a declining workforce are constraints on growth potential.

We expect the recovery to allow for gradual improvement of public finances. Our baseline sees gradual improvement in the budgetary situation, with the deficit, nevertheless, remaining above an EU 3% of GDP reference value over a forecast horizon to 2026. After increase of the debt-to-GDP ratio to 120% in 2020, we expect this ratio to gradually decline, stabilising around 115.5% of GDP by 2026, well above levels pre-crisis. This high level of public debt remains a risk. An ageing population represents a longer-term challenge.

Stable governance supporting efficient implementation of structural reform and public investment is crucial for Spain's credit outlook in 2022. After a period of recurrent parliamentary deadlock, the coalition government's budget bill was approved by the lower chamber of Congress. This development, alongside improving dialogue with pro-independence party Republican Left of Catalonia, ease medium-run political risk. We revised Spain's Outlook to Stable in July.

We expect **Portugal** (BBB+/Stable)'s output to return to near pre-pandemic levels by the end of this year, with growth of 4.6% in 2021. This growth is seen accelerating to 5% in 2022 before gradually converging towards 1.5% medium run. The importance of tourism for the Portuguese economy (17.1% of output in 2019) exposes it to a prospect of subdued recovery.

The recent breakdown of a minority government led the President to call snap elections scheduled for January 2022. Snap elections come at a sensitive juncture and a delayed budget will hold adverse repercussions as concerns rise over the post-pandemic recovery plan. There is risk to authorities' established track records of prudent fiscal policy and commitment to fiscal consolidation after elections, which might hinder unwinding of structural imbalances, including reduction of elevated structural unemployment.

Assuming Portugal is able to maintain fiscal discipline of recent years, Scope expects the public debt ratio to maintain a declining trend from 2021 on despite primary deficits of around 2% of GDP in 2021 and 1% in 2022. Low funding rates and robust growth, underpinned by a EUR 17bn recovery and resilience programme, pave way for post-crisis public debt reduction. The economic rebound will allow the budget balance to improve, to -4.3% of GDP this year and -3.2% in 2022 – displaying stronger performance than Italy and Spain (**Figure 14**). We expect return to modest primary surpluses by 2024. Accordingly, the debt ratio ought to return under 2019 levels by 2026, reaching 114.4% of GDP.

Greek outlook contingent on EU framework, reform progress; Cyprus set for post-crisis debt reduction; Malta's grey listing a recovery risk

Greece has displayed strong recovery from this severe Covid-19 crisis. We expect the Greek economy to grow 4.3% during 2022, acknowledging expectation of further tightening of economic restriction due to elevated Covid cases, after 8.9% growth in 2021 (revised up 0.3pps compared with a September estimate) – the latter significantly above the 2021 growth estimate for the euro-area aggregate (5.0%). Medium run, we see the Greek economy expanding an above-potential rate of around 1.8% a year over 2023-26, anchored by EU- and nationally-funded investment – which, on aggregate, easily exceeds *cumulative* Greek public investment of the past five years. Nevertheless, we estimate longer-run growth potential of Greece of a more modest 1% a year. Spending action to address economic and public-health consequences of this crisis and raise medium-run growth have corresponded with an estimated budget deficit of 10.2% of GDP this year, after 2020's 10.1%. This deficit is projected to ease in 2022 to 5.2% before edging under a 3% Maastricht ceiling by 2024.

Greece's general government debt ought to moderate to 194.5% in 2022, from a 206.3% peak in 2020, but remain significantly above a 180.5% pre-crisis level. The high stock of Greek debt leaves the government vulnerable to pull-backs in international markets as the ECB scales down emergency support introduced during crisis. On this basis, another key as regards the credit outlook rests upon forthcoming decisions of the central bank in transitioning quantitative easing policies for a post-Covid phase, including how the central bank opts to tackle a question of support on behalf of Greece after halt in PEPP net asset purchases and waivers that have allowed Greek instruments' eligibilities under purchases and ECB collateral regulations. Should the ECB preserve flexibility in balance-sheet management and communicate continued support for instruments of Greece – this supports sustainability of Greek debt.

In September 2021, we upgraded ratings of Greece one notch to BB+ with a Stable Outlook, becoming the first rating agency to return Greece to a credit standing one notch under investment grade. Our evaluation of Greece's credit ratings moving ahead will be premised around factors such as the post-crisis EU policy framework, Greece's fiscal consolidation and debt trajectory, medium-run growth potential and reforms anchoring macroeconomic sustainability, alongside resolution of banking-system fragilities.

We see **Cyprus** (BBB-/Stable)'s economy strongly growing 4% in 2022, after a 5.1% recovery this year, followed by gradual convergence in direction of a robust medium-run potential of 2.6%. A rapid return towards fiscal surpluses is seen by 2024, supported by growth and commitment to fiscal discipline. These factors, combined with Cyprus's good track record of fiscal consolidation, underpin our view that it will achieve a significant decline in its public debt ratio from 115% of GDP in 2020 to 82% by 2026.

Malta (A+/Stable)'s economy is seen growing 6.1% in 2022, after 5% in 2021. We expect strong growth supporting decline of Malta's public debt ratio starting in 2024. Still, large uncertainties remain with respect to the medium-run growth outlook given decision by the Financial Action Task Force to add Malta to its grey list. While we do not see immediate pressure on the ratings, prolonged placement on this grey list could hamper recovery and lead to weaker fiscal outcomes, highlighting need for swift and effective action.

Monetary policy divergence in the Nordics; robust growth of Swiss economy

Norway, **Sweden**, **Denmark** (all rated AAA/Stable) and **Finland** (AA+/Stable) share wealthy and competitive economies, strong economic and fiscal governance frameworks, low-to-modest public debt ratios, and sound external and financial sectors. The region experienced comparatively shallow economic contractions during pandemic peaks as compared with depth of recessions of other European economies.

Financial stability remains a concern across the region with high private sector debt and rapidly increasing housing prices. However, highly capitalised banking systems, robust public-sector balance sheets (most notably, Norway's with a sovereign wealth fund of USD 1.37trn, or 389% of mainland GDP), external sector cushions and strengthened regulatory requirements ensure economies' comparative resiliency to macro-financial risk, including under scenarios of severe economic downturn.

Monetary policy approaches are diverging across the region. Norway was the first economy of the G10 to start raising rates and has already started tightening macroprudential measures such as the countercyclical capital buffer as it aims for normalisation of central-bank policies with an economy back on pre-pandemic trend. By contrast, Sweden has committed to maintaining accommodative monetary policy due to inflation expected to be on target longer term and concerns policy tightening may result in affordability challenges in mortgage lending. Finland sees accommodative monetary conditions through euro membership while Denmark aligns closely with ECB policy given its long-standing fixed exchange rate against the euro.

As regards **Switzerland** (AAA/Stable), we foresee real growth of 2.8% in 2022 and maintain an estimate of 3.5% growth this year. However, we also note increase of downside economic risk pertaining to increase of Covid-19 infections and coming restrictions over the winter period. Headline budget deficits for 2021 will be roughly comparable to levels in 2020 of around CHF 15bn, or 2% of GDP in 2021. Switzerland's debt to GDP ratio is forecast to gradually recede from a 2021 peak of around 42.6% moving ahead. Downside risks include stronger than expected franc appreciation and/or a correction in elevated real estate prices.

EU CEE: EU investment funding represents opportunity; Poland and Hungary: rising governance risks

Broad-based, if uneven, economic rebound from the pandemic crisis support improvements of sovereign credit fundamentals of the EU's central and eastern European markets (CEE-11). Expansion has been anchored by investment and export recovery, alongside consumption via expenditure of forced savings accrued in crisis alongside rising wages and employment. However, pace of growth varies, affected by disparity in underlying economic structures and in degree of exposure to supply shocks. While capacity utilisation of manufacturing has returned to pre-pandemic levels, services sectors have not bounced back as fully.

Central banks of the region have responded to rising inflation by increasing rates, sometimes belatedly – given outstanding negative real rates, such rate hikes are seen continuing over 2022: to 2.5% by end-2022 in Poland, 3.75% in the Czech Republic, 2.7% in Hungary.

Despite outstanding headwinds, we project the CEE-11 aggregate to grow a robust 4.6% next year and 4.1% in 2023, after 5.6% in 2021 (**Figure 15**) – accounting for gradual easing of outstanding supply-side bottlenecks. Our growth estimates for CEE-11: Poland: 5.5% (2021), 4.1% (2022); Czech Republic: 3%, 4.7%; Hungary: 7.5%, 5.4%; Slovakia: 3.7%, 5.3%; Romania: 7.2%, 5%; Bulgaria: 3%, 4.8%; Croatia: 8.8%, 4.8%; Slovenia: 6.4%, 4.5%; Lithuania: 4.7%, 4.3%; Latvia: 4.6%, 5%; and Estonia: 9%, 4.3%.

A key constraint for credit ratings outlooks remains elevated budget deficits preventing reduction of government debt and exposing CEE sovereigns to scenarios of tightening global financial conditions.

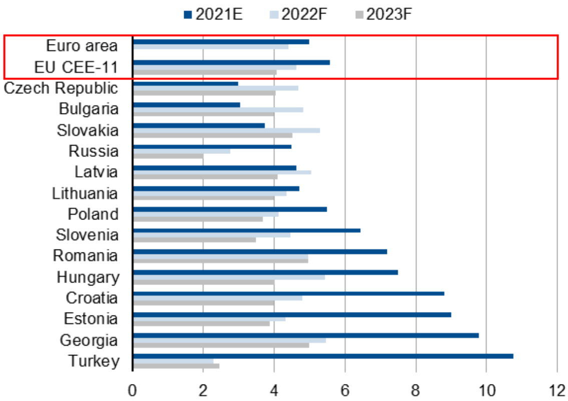
We see general government deficits remaining elevated around 5.5% of GDP on aggregate for CEE-11 in 2021, as governments have allocated discretionary budget support for recovery. As a result, debt ratios are expected to further increase this year, but start gradually declining from 2022 on as recovery and withdrawal of emergency support abet health of budget balances. We project a CEE-11 budget deficit of 3.8% of GDP in 2022 before 3.1% of GDP in 2023.

Elevated public debt accrued in crisis has increased longer-run fiscal vulnerabilities and represents a risk to ratings, including for non-euro-area CEE-11 governments, which do not benefit from access to the ECB and instead face tangible risk from outstanding foreign-currency-denominated debt. This situation demands resumed commitment to fiscal consolidation as this crisis gradually eases, especially in nations with unstable governments or forthcoming elections, such as Romania, Hungary, Slovakia and Poland. Authorities' capacities to consolidate public finances will prove important to their trajectories of ratings.

Polarised political conditions in Poland and Hungary, challenges to the independence of the judiciary and the media, weakening of independent institutions and rule of law, and confrontational positions with the EU represent ratings challenges for these two borrowers entering 2022. Aside from monetary penalties faced via European Court of Justice decisions and an escalating row with the EU adversely impacting currency sell-off and foreign direct investment, the risk is the current disputes bring more significant and prolonged suspension of EU financing. This could impede growth and public-finance outlooks. In Romania, credibility of the new government's fiscal consolidation agenda is a key driver concerning its credit outlook. For Croatia and Bulgaria, 2022 will prove a year during which consolidation of reforms required for meeting euro-area convergence criteria, sought by 1 January 2023 in case of Croatia and 1 January 2024 regarding Bulgaria, is crucial; in Bulgaria's case, after a third elections in November possibly bring a reform-minded centrist government.

CEE-11's access to significant inflow of EU investment funding over the coming years represents a crucial opportunity to facilitate not only near-term economic recovery but also raising of longer-run potential growth vis-à-vis effective public infrastructure investment. Our outlook for the CEE region will be discussed in more colour in our forthcoming 2022 central and eastern Europe sovereign outlook.

Figure 15. CEE growth forecasts, %



Source: Scope Ratings GmbH

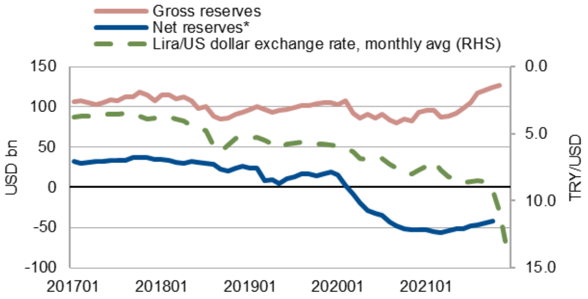
2022 may prove a flash-point year for Turkey; sanctions risk for Russia counterbalanced by better resilience

We downgraded **Turkey** (B/Negative) in late 2020 (with foreign-currency ratings lowered one notch to B). The Turkish central bank's policies are likely only to deepen Turkey's economic difficulties and increases likelihood of full balance of payment crisis. In addition, rate cuts raise the possibility of another sudden reversal of monetary policy if the lira continues to decline in value. We have seen that in the past, as in 2018 and late 2020: if a lira crisis gets "bad enough", rates are raised in the end. The question is how much further lira would need to fall before we reach such a watershed moment. The currency has lost nearly half its value since February.

However, high political stakes involved in Turkey's interest-rate setting next year ahead of elections due in 2023 makes such a short-run pivot of monetary policy harder to foresee. Turkish President Recep Tayyip Erdoğan and his AKP have fallen behind in opinion polling over the run of 2021. As for prospects that higher growth helped by lowered rates might engineer Erdoğan's sought electoral comeback, recent evidence suggests there is less correlation between growth and the president's political fortunes than might meet the eye. We estimate growth of a very high 10.8% over 2021 (before moderating sharply to 2.3% in 2022 and 2.4% in 2023), yet voters appear preoccupied with more pressing economic crises such as loss of purchasing power and rising poverty. The government's attention on raising economic growth via easing rates, including possibility of further rate cuts, is damaging the country and economic stability – impairing the ratings outlook.

As lira devalues, it is crucial entering 2022 to monitor the degree to which government falls back on tightening of capital controls, engaging in swap arrangements and using FX reserves in defence of the currency – to allow loose monetary policy while slowing down losses of the exchange rate. The problem with this policy combination is its cost: of over USD 100bn of reserves during 2018-20: net reserves ex-swaps stood at negative USD 42.3bn as of October (**Figure 16**).

Figure 16. Turkey net reserves, lira exchange rate



*Central bank net foreign assets minus short-term swap liabilities. Lira-USD monthly average exchange rate as of December 2021; source: Macrobond, Turkish central bank, Scope Ratings GmbH.

Should Erdoğan refuse to change course ahead of the elections and faces defeat, 2022 and 2023 may prove flash-point years for Turkey in the case the president seeks alternative avenues to remain in power, with an opposition otherwise in pole position to oust him.

We upgraded **Russia**'s credit ratings to BBB+/Stable in October 2021 reflecting strengthened macroeconomic stability and higher budgetary and economic resilience to external shock, anchored around effective fiscal, monetary and exchange-rate management. Russia is seen growing an above-potential 2.7% in 2022, after 4.5% in 2021 – supported by expenditure from the National Wealth Fund on local infrastructure and higher commodity exports. After 2022, we see Russian growth returning to a more subdued potential rate of around 1.5-2% from 2023.

The economy's structural reliance upon energy exports and lack of far-reaching reform to date to diversify the export base – which is politically challenging to do – expose longer-run growth and public-finance outlooks to risk from global policies aimed at trimming carbon emissions. Russia's exports to the EU may be materially affected by a proposed EU carbon levy, as one example. Assessment of potential costs from such a levy for the Russian economy are around EUR 5.5-6bn a year (roughly 0.5% of 2020 GDP). This impact is still modest but might increase should the EU expand the mechanism to include oil and gas.

We believe sanctions risks remain elevated. Geopolitical risk tied to potential escalation in a Ukraine conflict and threat of more punitive sanctions – such as impacting banks and rouble convertibility – weigh on the outlook for economic stability. However, we do not expect wide-ranging sanctions on Russia's energy sector after completion of the Nord Stream 2 gas pipeline, or a ban on Russian banks from doing business in US dollar.

As regards **Georgia** (BB/Stable), we estimate growth of 5-5.5% in 2022 and 2023, after a revised-up 9.8% growth in 2021. Vulnerabilities to FX volatility, due to dependence on foreign-currency borrowing, and reliance on tourism have been key risks over this crisis. However, Georgia's strong ties with the IMF and international financial institutions represent a continued credit strength, even after conclusion earlier this year of an IMF Extended Fund Facility. Prolonged political instability is a downside risk. Scope revised the Outlook of Georgia's ratings to Stable in September 2021.

Robust growth in the US but risk from inflation, monetary tightening, debt

In the **United States** (AA/Stable), we estimate 3.5% growth in 2022, after strong growth of output this year, trailed by 2.9% growth in 2023, gradually converging thereafter in direction of an estimated rate of potential growth of 2%. The latter estimate of growth potential has been raised from a previous estimate of potential of 1.9% and compares favourably against potential growth of peers such as that of the United Kingdom, France and Belgium. The Joseph R. Biden government signed into law in March the American Rescue Plan, an initial component of a three-pillar recovery programme, with spending of 8.1% of 2021 GDP. The second part of the recovery plan was approved in November: the American Jobs Plan, an infrastructure investment programme embedding around USD 550bn of fresh expenditure over five years (2.0% of average 2022-26 GDP). And the concluding element (under review in Congress) reflects an ambitious USD 1.75trn social safety net and climate bill expended over 10 years.

The recovery plan reflects a large-scale lift as regards public investment, addressing longer-standing weaknesses in the US infrastructure and social system, and bolstering an outlook as regards productivity growth, alongside lifting short-run recovery. At the same time, recovery plan measures combine with recurrent budgetary measures in contributing to expectation of continued sizeable fiscal deficits over the forthcoming years. We expect a headline general government deficit of 8.8% of GDP in 2022, remaining elevated after a 11.3% deficit in 2021. Over years after 2022, net borrowing is expected to remain elevated, above 5% of GDP annually through a forecast horizon to 2026. After increasing over 25pps in 2020, reaching 133.9% of GDP last year, the US government debt-to-GDP ratio is projected remaining initially comparatively unchanged through 2026, ending a forecast horizon at just above 138% – aided by assumed above-potential growth of an average of 2.5% over 2022-26 and above-average inflation. However, Scope assumes the US' debt ratio remains on an increasing structural trajectory in the long run, including expected significant discrete jumps in this debt ratio during future downturns.

Outstanding risk to the economic outlook is presented via supply chain disruption, increasing inflation and elevated Covid-19 cases. Core personal consumption expenditure inflation rose to 4.1% YoY in October, with the Federal Reserve expecting this preferred gauge of inflation to average 3.7% over 2021 but recede to 2.3% by 2022 and 2.2% in 2023. Scope considers there to be upside risk to the Federal Reserve's inflation projections. An adjustment to a "flexible average inflation targeting" central-banking approach alongside broadened definition of a Fed maximum employment objective likewise support higher inflation. In response to inflation, the Federal Reserve appropriately opted to start taper of asset purchases, fully phasing out bond purchases by mid-next year if not prior. Scope expects an initial rate hike this cycle before end-2022. As the US tightens monetary policy, there is risk of crystallisation of vulnerabilities, however, in bubbly financial-asset markets as well as in the corporate debt market.

The debt ceiling remains a relevant risk entering 2022. The Bipartisan Policy Center estimates that, given capacity to deploy extraordinary measures after borrowing limitations are reached, a new "X-date" on which Treasury faces either delaying payments for activities or default on debt obligations lies between mid-December and early February 2022. Even if the US government raises or suspends the debt ceiling over the coming month(s) as expected, debt-ceiling risks may increase after November 2022 mid-term elections, if Democrats lose control of Congress.

China's focus on reining in debt risk supports outlook; Japan risks return to "revolving-door" political age

We continue to forecast strong calendar-year growth in **China** (A+/Stable) of 8.0% in 2021 (revised down 1.3pps since June) and 5.2% (revised down 0.2pps) in 2022. While the government has controlled Covid-19 spread via its zero-Covid policy, the growth outlook has dampened moderately over the course of the year due to a slowing real estate sector and energy disruptions.

Authorities aim to manage gradual correction in credit markets. This includes introduction of the three-red-lines policy of 2020 – a macroprudential framework imposed upon real estate developers restricting their access to credit based on size of their liabilities, debt levels and cash holdings. Similar approaches are being used to rein in local government spending for infrastructure projects through off-balance sheet financing. Evergrande Group, with total liabilities of nearly 2% of China's 2020 GDP, was the most prominent real estate developer to face repayment difficulties as a result. We believe that some form of managed default remains the most likely outcome for Evergrande although authorities will need to carefully balance risk to avoid more severe spill-over of risk across China's large real estate sector.

The challenge in engineering a desired 'soft landing' in China is significant. Non-financial sector debt is high, around 270% of GDP at end-2020. This is expected to rise to around 300% of GDP by 2025. Non-augmented general government deficits will remain wide around 7.5% of GDP in 2021 and 6.8% in 2022, with public debt seen increasing to 81% of GDP by end-2026 (from 57% in 2019 and only 27% as of 2008).

The nation's 14th five-year plan, covering 2021-2025, and China's Vision 2035 were approved by the National People's Congress in March 2021. Prudently, no explicit growth target was set for 2021-25 but only implicitly referenced under Vision 2035, which established an objective to doubling the size of the economy by 2035. This implies more sustainable average growth requirements of just under 5% per annum between 2022-35, assuming growth of 8% in 2021. Shift towards more flexible economic growth objectives and increased attention on linking urban and rural development are credit positive. Ongoing transition of the financial system supported revision of the sovereign Outlook to Stable, from Negative, in July.

Japan (A/Stable)'s economic recovery has lagged that of other advanced economies due to adverse effects of supply-side constraints on exports and production, sustained downward pressure from the Covid-19 crisis on consumption and less rapid release of pent-up demand. Newly elected Prime Minister Fumio Kishida recently announced a huge JPY 55.7trn (10% of GDP) stimulus, which will bolster the economy although efficacy of some measures remains under question. We forecast growth of 3.6% in 2022, and 1.6% in 2023, after a downward-revised 1.5% in 2021.

Longer-standing challenges tie to low growth, deflation risk and poor fiscal performance, which have been exacerbated by this Covid-19 crisis and face further pressure owing to demographics. It is crucial that the Japanese government designs and implements an appropriate economic policy and sets a foundation for credible post-crisis budget consolidation. While the government has renewed a commitment to reflating the economy and placing public finances on a sustainable footing, it remains unclear which policies the government will push under a "new form of capitalism".

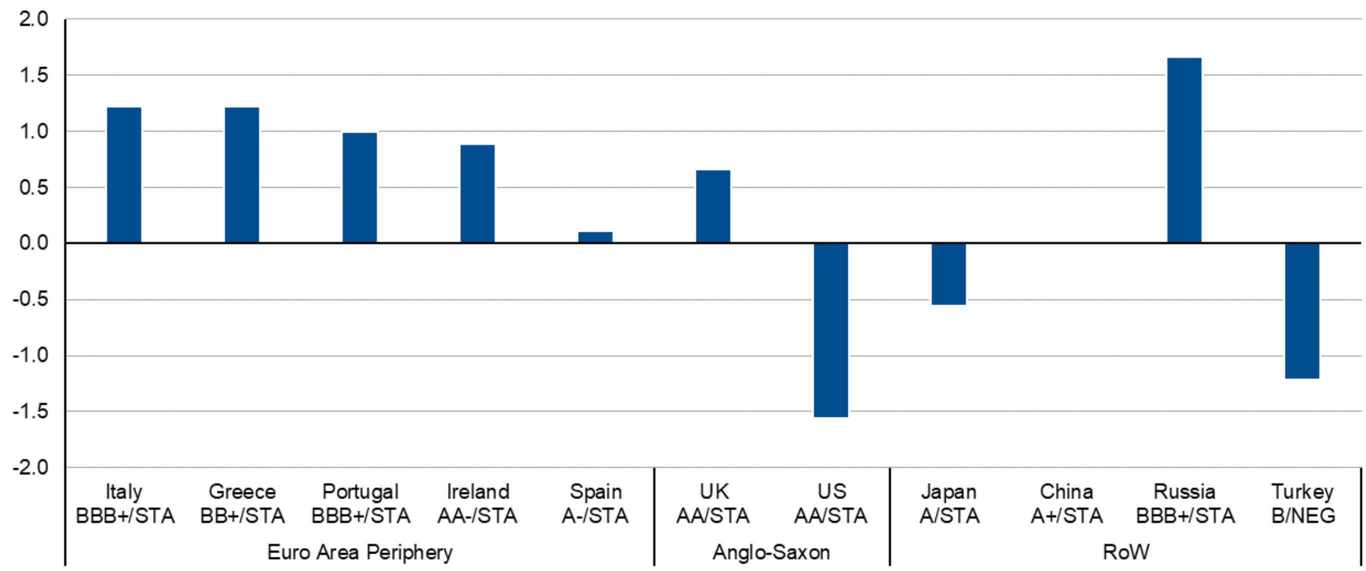
In addition, re-emergence of political volatility after Yoshihide Suga's resignation after years of stability under Shinzo Abe is a challenge. The return to a "revolving door" era in which prime ministers face short-lived tenures could weigh on the government's ability to respond to structural weaknesses. In June, we downgraded Japan's ratings to A with Stable Outlook.

Annex I: Scope's sovereign ratings and recent rating actions

Scope's publicly-issued long-term foreign-currency sovereign credit ratings, as of 7 December 2021

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

Scope sovereign rating levels versus the US agency average* (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. RoW = Rest of the world. *Foreign-currency long-term issuer ratings vs average of Moody's, S&P and Fitch Ratings. As of 7 December 2021.

Scope's sovereign rating actions, 2021 YTD

Date		Sovereign	Rating action	Rating & Outlook
Jan	29 January	Lithuania	Upgrade/ Outlook change	A/Stable
Apr	23 April	Malta	Affirmation	A+/Stable
May	14 May	Romania	Outlook change	BBB-/Stable
	21 May	Ireland	Upgrade/ Outlook change	AA-/Stable
	28 May	Belgium	Downgrade/ Outlook change	AA-/Stable
Jun	18 June	Bulgaria	Affirmation	BBB+/Stable
	18 June	Japan	Downgrade/ Outlook change	A/Stable
	25 June	United Kingdom	Outlook change	AA/Stable
Jul	09 July	China	Outlook change	A+/Stable
	16 July	Spain	Outlook change	A-/Stable
Aug	20 August	Italy	Outlook change	BBB+/Stable
Sep	3 September	Austria	Affirmation	AAA/Stable
	3 September	Georgia	Outlook change	BB/Stable
	10 September	Greece	Upgrade/ Outlook change	BB+/Stable
Oct	29 October	Russia	Upgrade	BBB+/Stable
Nov	5 November	Finland	Affirmation	AA+/Stable
	5 November	Sweden	Affirmation	AAA/Stable
	12 November	Norway	Affirmation	AAA/Stable
	12 November	Denmark	Affirmation	AAA/Stable
	26 November	United States	Affirmation	AA/Stable
Dec	3 December	Slovakia	Outlook change	A+/Stable
	3 December	Germany	Affirmation	AAA/Stable

Annex II: Related research

Central and Eastern European Sovereign Outlook: GDP to fully recover crisis losses by 2022
(30 June 2021)

Sovereign Outlook: global GDP to rise 6% in 2021, 4.4% in 2022 amid debt, variant & inflation risks
(17 June 2021)

CEE 2021 Sovereign Outlook: region set for uneven 2021 rebound amid higher debt, external risks
(17 December 2020)

Sovereign Outlook 2021: global growth recovers amid high debt; changing fiscal, monetary frameworks
(9 December 2020)

Central & Eastern Europe Q4 Sovereign Update: full economic recovery to be gradual and uneven
(19 October 2020)

Sovereign Outlook Q4 Update: gradual, uneven recovery faces new virus-containment challenge in Q4
(12 October 2020)

Central & Eastern Europe Sovereign Update: rebound has begun but full recovery only after 2021
(15 July 2020)

Sovereign Outlook Q3 Update: gradual, uneven global recovery; meaningful risks remain on the horizon
(8 July 2020)

Sovereign Outlook 2020: slow growth, political uncertainty, rising debt add pressure on policymakers
(2 December 2019)

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