SCOPE Scope Ratings

Sovereign Outlook 2023

Sharp economic slowdown, challenging fiscal dynamics, high inflation and rising rates underpin divergence in sovereign ratings

Sovereign and Public Sector, Scope Ratings GmbH, 12 December 2022

Executive summary

The sovereign outlook for 2023 is challenging. This reflects direct and second-round effects of Russia's war in Ukraine, high inflation and significant monetary tightening. We forecast a sharp slowdown in global growth to **2.6%** in 2023 from **around 3.3%** this year. High inflation and challenging fiscal dynamics have led to more sovereign borrowers facing downside rating actions rather than upside since the escalation of the Russia-Ukraine war. We summarise projections for the major economies in **Table 1** below, with full forecasts available in **Tables 2 and 3**.

Key themes for 2023:

A 'new normal' of volatile growth: We anticipate global growth falling below potential next year. This assumes near-stagnation of the euro-area economy (0.7%), slow growth in the United States (1.1%), a contraction in the United Kingdom (-0.6%), and below-potential growth of 4.3% for China. Technical recessions are likely in 2022-23 across multiple economies, even if such recessions are shallow in most such cases. Risks partly reflect potential energy shortages during the winters of 2022/23 and 2023/24 in Europe, as Russia reduces energy supplies. However, we do not expect a severe global or euro-area recession or a global financial crisis in 2023.

Higher inflation for longer even as inflation peaks: We foresee a gradual decline in inflation next year from multi-decade highs, but there remains significant risk for further delays in inflation falling back in line with central-bank targets as price pressures broaden. The result is inflation being higher for longer.

Peak central bank hawkishness but monetary space remains constrained: We expect rate hikes to slow by early 2023, but most central banks will have limited room to ease monetary policy next year. Further upside surprises in inflation could lead to a more drawn-out cycle of rate increases than in our baseline scenario. The high level of private- and public-sector debt as central banks tighten monetary policy increases risks to financial stability.

Higher inflation, rates pose challenging debt-sustainability trade-offs: The combination of constrained monetary policy and challenging fiscal dynamics adds pressure on credit ratings – for emerging as well as for advanced-economy sovereigns. Fast price rises lower the real value of existing debt – credit positive for rated sovereigns -- but the benefits erode as interest payments rise and central-bank room for manoeuvre is curtailed.

A new EU fiscal architecture supports re-adoption of fiscal consolidation: A proposed revision of the EU fiscal framework can help deliver better budgetary outcomes, which will be crucial for European economies as debt-sustainability concerns have risen.

Emerging markets stay susceptible to monetary tightening: Monetary tightening threatens to trigger emerging-market crises. However, a lengthier pause in rate increases could provide much-needed relief for developing countries struggling under the weight of capital outflows and exchange-rate depreciation. This could support ratings in 2023 for some emerging-market sovereigns in an otherwise challenging year. While alternative reserve currencies continue to develop, the dollar will remain the dominant reserve currency for the foreseeable future.

Sovereign rating outlook entering 2023: The sovereign sectoral outlook is Negative entering the new year – indicating comparatively higher likelihood of ratings downgrades next year than ratings upgrades. More than 20% of publicly rated sovereigns have a Negative Outlook compared with 11% with a Positive Outlook.

Global climate-mitigation policies accelerate: While carbon mitigation policies are accelerating, the gap against those needed to limit global warming to 1.5°C remains wide. How countries address such risks will hold lasting implications for economic competitiveness and will affect sovereigns' credit outlooks in 2023 and beyond.

Table 1: Scope's growth forecasts, summary, as of 12 December 2022

Country/region	Real GDP growth (%)						
		Baseline scenario					Medium-run potential
	2021	2022E	Diff. from Jul.*	2023F	Diff. from Jul.*	2024F	
Euro area	5.3	3.4	↑ 0.6	0.7	↓ 1.1	1.8	1.5
Germany	2.6	1.6	-	(0.2)	↓ 1.9	1.5	1.0
France	6.8	2.6	↑ 0.2	0.5	↓ 0.7	1.6	1.3
Italy	6.7	3.7	↑ 0.7	0.5	↓ 1.0	1.5	1.0
Spain	5.5	4.5	↑ 0.4	1.3	↓ 0.7	2.5	1.8
United Kingdom	7.5	4.4	↑ 0.9	(0.6)	↓ 1.6	1.1	1.5
Russia	4.7	(4.0)	↑ 6.5	(4.0)	↓ 5.0	1.0	1.3
Turkey	11.4	5.3	↓ 0.5	3.0	↓ 0.5	3.0	3.9
United States	5.9	2.0	↑ 0.3	1.1	↓ 0.9	1.1	2.0
China	8.1	3.2	↓ 0.4	4.3	↓ 0.8	5.2	5.0
Japan	1.7	1.7	↓ 0.1	2.3	↑ 0.6	1.8	0.4
World	6.0	3.3	↑ 0.2	2.6	↓ 1.0	3.3	2.9

*Changes compared with July 2022's 2022 Sovereign Mid-Year Outlook forecasts. Negative growth rates presented in parentheses.

Source: Scope Ratings forecasts, regional and national statistical offices, IMF.

Table 2. Global economic outlook: growth, inflation and official rates, 2020-2024F

Country/region	Real GDP growth (annual average, %)								Headline inflation[2] (annual average, %)					Policy rates (EOP, %)				
	2020	2021	2022E	Diff. from Jul-22[1]	2023F	Diff. from Jul-22[1]	2024F	Medium-run potential	2020	2021	2022E	2023F	2024F	End-2020	End-2021	End-2022	End-2023	End-2024
Euro area[3]	(6.3)	5.3	3.4	↑ 0.6	0.7	↓ 1.1	1.8	1.5	0.2	2.6	8.5	6.1	2.4	(0.5)	(0.5)	2.0	3.0	2.5
Germany	(4.1)	2.6	1.6	-	(0.2)	↓ 1.9	1.5	1.0	0.3	3.2	9.0	7.5	2.4					
France	(7.8)	6.8	2.6	↑ 0.2	0.5	↓ 0.7	1.6	1.25	0.5	2.1	5.8	4.3	2.1					
Italy	(9.1)	6.7	3.7	↑ 0.7	0.5	↓ 1.0	1.5	1.0	(0.2)	1.9	8.4	5.2	2.0					
Spain	(11.3)	5.5	4.5	↑ 0.4	1.3	↓ 0.7	2.5	1.75	(0.3)	3.0	8.5	5.2	2.2					
Netherlands	(3.9)	4.9	4.2	↑ 1.3	0.7	↓ 1.5	1.1	1.4	1.1	2.8	11.9	9.6	3.0					
Belgium	(5.4)	6.1	2.5	↑ 0.2	0.2	↓ 1.1	1.3	1.2	0.4	3.2	10.5	5.0	3.0					
Austria	(6.6)	4.7	4.5	↑ 0.8	0.6	↓ 1.4	1.5	1.6	1.4	2.8	8.6	6.0	3.2					
Ireland	5.6	13.4	11.9	↑ 5.7	5.3	↑ 0.3	4.2	4.0	(0.5)	2.4	7.9	5.8	2.5					
Finland	(2.2)	3.0	2.3	↑ 0.8	0.2	↓ 0.2	1.4	1.2	0.4	2.1	7.0	4.5	2.0					
Portugal	(8.3)	5.5	6.5	↑ 1.0	1.3	↓ 0.1	2.1	1.8	(0.1)	0.9	8.0	5.8	2.3					
Greece	(9.0)	8.3	6.0	↑ 1.1	1.1	↓ 1.0	1.5	1.0	(1.3)	0.6	9.5	5.8	2.8					
Slovakia	(3.4)	3.0	1.8	↓ 0.4	0.5	↓ 2.9	2.4	2.5	2.0	2.8	12.0	15.0	4.8					
Luxembourg	(0.8)	5.1	2.0	-	2.2	↓ 0.1	2.5	2.5	0.0	3.5	8.4	3.7	2.3					
Lithuania	(0.0)	6.0	2.4	↑ 0.6	0.5	↓ 2.3	3.1	2.5	1.1	4.6	18.5	7.0	2.5					
Slovenia	(4.2)	8.3	5.5	↑ 1.6	1.3	↓ 1.2	2.3	3.5	(0.3)	2.1	9.0	5.8	3.4					
Latvia	(2.2)	4.1	2.4	↓ 0.1	(0.1)	↓ 2.6	3.0	2.5	0.1	3.2	17.0	8.0	2.5					
Estonia	(0.6)	8.0	0.4	↓ 0.8	0.8	↓ 1.9	3.2	2.2	(0.6)	4.5	19.0	7.0	2.5					
Cyprus	(4.4)	6.6	5.5	↑ 3.5	2.2	↓ 1.0	2.5	3.0	(1.1)	2.3	8.1	4.0	2.0					
Malta	(8.2)	10.2	6.2	↑ 1.2	3.3	↓ 1.6	3.6	3.5	0.8	0.7	5.9	4.6	2.6					
Western Europe ex-euro area																		
United Kingdom	(11.0)	7.5	4.4	↑ 0.9	(0.6)	↓ 1.6	1.1	1.5	0.9	2.6	8.9	7.5	3.1	0.1	0.25	3.5	4.0	3.5
Switzerland	(2.5)	4.2	2.0	↓ 0.4	0.6	↓ 1.4	1.9	1.5	(0.7)	0.6	2.9	2.2	1.9	(0.75)	(0.75)	1.25	1.5	1.5
Sweden	(2.3)	4.8	2.7	↑ 0.8	(0.4)	↓ 1.5	1.0	1.8	0.7	2.7	8.4	7.9	2.4	0.0	0.0	2.5	2.5	2.0
Norway	(1.3)	4.0	3.4	-	2.0	↑ 0.7	2.2	1.8	1.3	3.5	5.8	4.2	2.2	0.0	0.5	2.75	2.75	2.5
Denmark	(2.0)	4.9	2.9	↓ 0.4	(0.2)	↓ 1.1	1.4	1.5	0.3	1.9	7.5	4.5	2.0	(0.60)	(0.60)	2.0	2.5	2.0
EU central and eastern Europe ex-euro																		
Poland	(2.0)	6.7	5.7	↑ 0.8	1.5	↓ 1.6	2.9	3.0	3.4	5.1	14.2	12.2	7.0	0.1	1.75	6.75	7.5	6.0
Romania	(3.6)	5.9	4.9	↑ 0.1	2.2	↓ 2.3	4.5	4.0	2.6	5.0	11.8	10.6	6.0	1.5	1.75	6.75	6.75	5.75
Czech Republic	(5.5)	3.5	2.5	↑ 0.9	0.2	↓ 2.5	3.2	2.5	3.2	3.8	14.5	9.1	4.0	0.25	3.75	7.0	6.0	4.5
Hungary	(4.8)	7.1	5.2	↑ 1.2	0.1	↓ 3.3	2.5	2.8	3.3	5.1	14.8	14.5	4.8	0.6	2.4	13.0	11.5	6.5
Bulgaria	(4.0)	4.2	3.2	↑ 1.4	1.0	↓ 2.5	3.0	2.75	1.2	2.8	13.1	7.3	3.5	0.0	0.0	1.3		
Croatia	(7.8)	10.2	6.3	↑ 2.8	1.8	↓ 1.9	2.3	3.0	0.1	2.6	10.6	6.5	3.5	3.0	3.0	3.0	-	-
Non-EU emerging Europe																		
Russia	(2.5)	4.7	(4.0)	↑ 6.5	(4.0)	↓ 5.0	1.0	1.25	3.4	6.7	13.9	7.5	5.0	4.25	8.5	7.5	7.0	6.0
Turkey	1.9	11.4	5.3	↓ 0.5	3.0	↓ 0.5	3.0	3.9	12.3	19.6	73.8	52.6	32.3	17.0	14.0	9.0	7.0	10.0
Ukraine	(4.0)	3.4	(31.0)	-	5.5	↓ 7.0	7.5	2.5	2.7	9.4	20.0	23.0	14.4	6.0	9.0	25.0	25.0	20.0
Serbia	(0.9)	7.4	3.0	↓ 0.0	2.7	↓ 1.3	3.4	4.3	1.6	4.1	11.9	9.4	4.9	1.0	1.0	4.5	5.0	4.0
Georgia	(6.7)	10.4	9.6	↑ 1.6	7.0	↑ 2.0	5.8	5.0	5.2	9.6	11.9	5.8	3.8	8.0	10.5	11.0	9.0	6.5
Rest of World (Advanced)																		
United States	(2.8)	5.9	2.0	↑ 0.3	1.1	↓ 0.9	1.1	2.0	1.2	4.7	8.0	5.1	3.1	0-0.25	0-0.25	4.25-4.5	5-5.25	4.5-4.75
China[4]	2.3	8.1	3.2	↓ 0.4	4.3	↓ 0.8	5.2	5.0	2.4	0.9	2.1	2.3	2.2	3.85	3.8	3.65	3.65	3.65
Japan[5]	(4.7)	1.7	1.7	↓ 0.1	2.3	↑ 0.6	1.8	0.4	(0.0)	(0.2)	2.0	1.4	1.0	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)
Africa																		
South Africa	(6.3)	4.9	1.9	n.a	1.1	n.a	1.7	1.5	3.3	4.6	7.0	6.6	4.8	3.5	3.75	7.0	7.0	6.0
World	(3.0)	6.0	3.3	↑ 0.2	2.6	↓ 1.0	3.3	2.9	3.2	4.7	8.8	6.9	4.5					

Negative values shown in parentheses. Source: Scope Ratings forecasts, Macrobond, IMF.
[1]Changes compared with Scope July 2022's Mid-Year 2022 Sovereign Outlook forecasts ("n.a" reflects countries not forecasted as of the July 2022 Sovereign Outlook). [2]HICP headline inflation for euro-area member states; otherwise, CPI headline inflation.
[3]Shown for the euro-area policy rate is the ECB deposit facility rate. [4]Shown for China's policy rate is the one-year bank prime loan rate. [5]Shown for Japan's policy rate is the deposit rate on current account balances.

Table 3. Global economic outlook: unemployment, fiscal metrics, 2020-24F

Country/region	Unemployment rate[6] (annual average, %)					General government balance[7] (% of GDP)					Public debt level (% of GDP)					
	2020	2021	2022E	2023F	2024F	2020	2021	2022E	2023F	2024F	2020	2021	2022E	2023F	2024F	2027F
Euro area	7.9	7.7	6.7	7.0	6.9	(7.0)	(5.1)	(3.8)	(3.6)	(3.2)	97	95	93	92	91	89
Germany	3.7	3.6	3.0	3.2	3.2	(4.3)	(3.7)	(3.3)	(2.1)	(2.0)	68	69	71	68	66	61
France	8.0	7.9	7.7	8.1	8.0	(9.0)	(6.5)	(5.1)	(5.6)	(5.0)	115	113	112	112	113	116
Italy	9.3	9.5	8.2	8.5	8.5	(9.5)	(7.2)	(5.2)	(4.8)	(4.3)	155	150	146	145	145	142
Spain	15.5	14.8	12.7	12.9	12.5	(10.1)	(6.9)	(4.5)	(4.3)	(3.5)	120	118	113	112	109	107
Netherlands	4.9	4.2	3.5	4.0	4.1	(3.7)	(2.6)	(0.5)	(2.7)	(2.4)	55	53	48	48	48	52
Belgium	5.8	6.3	5.7	5.9	5.8	(9.0)	(5.6)	(5.2)	(5.8)	(5.1)	112	109	104	107	109	117
Austria	6.1	6.2	4.8	5.1	5.2	(8.0)	(5.9)	(3.6)	(2.7)	(1.7)	83	83	79	78	77	74
Ireland	5.9	6.2	4.5	5.3	5.0	(5.0)	(1.7)	0.4	(0.0)	0.2	58	55	46	42	38	30
Finland	7.8	7.6	7.0	7.5	7.0	(5.5)	(2.7)	(1.6)	(2.0)	(1.7)	75	72	71	73	74	75
Portugal	7.1	6.6	6.0	5.8	5.7	(5.8)	(2.9)	(1.9)	(1.3)	(0.9)	135	126	114	110	106	97
Greece	17.6	14.9	12.4	12.1	12.0	(9.9)	(7.5)	(3.5)	(2.7)	(2.4)	206	193	169	160	154	147
Slovakia	6.6	6.8	6.2	6.2	6.0	(5.4)	(5.5)	(4.9)	(6.4)	(4.4)	59	62	61	61	60	59
Luxembourg	6.7	5.4	5.0	5.0	5.0	(3.4)	0.8	(0.4)	(2.2)	(1.1)	25	25	25	27	28	29
Lithuania	8.5	7.1	5.7	6.5	6.5	(7.0)	(1.0)	(2.0)	(4.5)	(2.0)	46	44	39	40	40	38
Slovenia	5.0	4.8	4.3	4.3	4.1	(7.7)	(4.7)	(4.0)	(5.2)	(3.1)	80	75	69	69	68	63
Latvia	8.1	7.6	6.8	7.5	7.5	(4.3)	(7.0)	(6.1)	(4.1)	(2.0)	42	44	43	45	44	41
Estonia	6.9	6.2	6.0	6.5	6.5	(5.5)	(2.4)	(2.0)	(3.5)	(2.7)	19	18	17	20	22	26
Cyprus	7.6	7.5	7.4	7.2	7.0	(5.8)	(1.7)	1.2	1.5	1.8	114	101	91	86	78	63
Malta	4.4	3.4	3.2	3.3	3.4	(9.4)	(7.8)	(5.8)	(5.5)	(4.2)	53	56	57	59	61	60
Western Europe ex-euro area																
United Kingdom	4.7	4.6	3.8	4.2	4.5	(12.8)	(8.0)	(5.7)	(6.6)	(4.5)	103	95	95	98	100	100
Switzerland	3.2	3.0	2.2	2.7	2.9	(3.0)	(0.7)	0.0	(0.0)	0.1	43	42	40	39	37	33
Sweden	8.5	8.8	7.5	7.9	8.2	(2.8)	(0.1)	0.1	(1.4)	(0.8)	40	36	33	32	32	29
Norway	4.8	4.4	3.2	3.4	3.3	(2.8)	9.1	21.3	18.7	16.9	47	43	39	38	37	35
Denmark	5.6	5.1	4.4	5.0	4.9	0.2	2.6	1.1	0.6	0.5	42	37	32	33	32	32
EU central and eastern Europe ex-euro																
Poland	3.2	3.4	2.9	3.2	3.2	(6.9)	(1.8)	(3.9)	(3.9)	(3.5)	57	54	49	47	48	50
Romania	6.3	5.7	5.5	5.9	5.6	(9.2)	(7.5)	(6.0)	(5.4)	(4.6)	47	49	49	51	53	56
Czech Republic	2.6	2.8	2.4	2.9	2.9	(5.8)	(5.1)	(4.5)	(3.9)	(2.9)	38	42	43	44	45	44
Hungary	4.1	4.0	3.5	4.1	4.1	(7.5)	(7.1)	(6.0)	(4.7)	(3.5)	79	77	76	77	74	64
Bulgaria	6.1	5.3	4.6	5.2	5.2	(3.8)	(3.9)	(3.9)	(3.7)	(3.1)	25	24	23	26	27	30
Croatia	7.7	7.6	6.3	6.2	6.0	(7.3)	(2.6)	(1.4)	(2.5)	(2.9)	87	80	70	66	65	60
Non-EU emerging Europe																
Russia	5.8	4.8	4.5	5.0	5.2	(4.0)	0.8	(1.5)	(3.5)	(2.9)	19	17	17	21	23	27
Turkey	13.1	12.0	11.0	11.5	11.5	(3.4)	(2.7)	(3.8)	(4.5)	(4.4)	40	42	38	39	41	45
Ukraine	9.5	10.3				(5.3)	(3.4)	(13.5)	(13.0)	(12.5)	61	48	82	81	77	84
Serbia	10.1	11.4	10.0	10.5	10.0	(8.0)	(4.1)	(3.0)	(2.0)	(1.5)	59	58	55	52	50	46
Georgia	18.5	20.6	17.1	14.5	14.2	(9.3)	(6.0)	(3.0)	(2.5)	(2.2)	60	49	39	41	41	41
Rest of World (Advanced)																
United States	8.1	5.4	3.7	4.1	4.7	(14.5)	(10.9)	(4.4)	(5.4)	(6.4)	135	128	122	122	124	132
China[8]	5.6	5.1	5.6	5.4	5.3	(9.7)	(6.1)	(8.9)	(7.2)	(7.5)	68	71	77	84	89	102
Japan	2.8	2.8	2.6	2.4	2.4	(9.0)	(6.7)	(8.4)	(6.5)	(4.8)	259	262	265	263	263	268
Africa																
South Africa	29.2	34.3	33.6	33.5	33.0	(9.7)	(6.0)	(4.8)	(5.2)	(6.2)	69	69	68	71	73	83
World																

Negative values shown in parentheses. Source: Scope Ratings forecasts, Macrobond, IMF.

[6]Unemployment rate data source is Eurostat for EU member states; national unemployment series otherwise. [7]Turkey and Ukraine fiscal-balance figures are for the central-government budget balance.

[8]Unemployment is survey-based urban unemployment rate.

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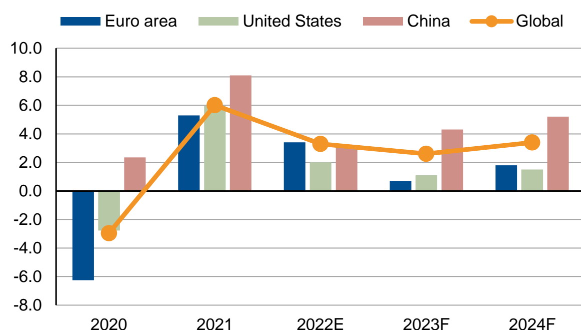
Key themes for 2023

A 'new normal' of volatile growth amid sharp slowdown but no severe global recession

We project marked slowdown of annual growth for 2023, especially in Europe. Impediments to economic growth reflect an ongoing cost-of-living crisis, weakened economic sentiment, and tightening of global rates. We revise down our forecast of global economic growth for 2023 to 2.6% (**Figure 1**), from 3.6% as of our July 2022 projections. Global growth for next year thus falls *below* its potential rate (estimated at 2.9%). Meanwhile, economic growth during 2022 – of an estimate of 3.3% globally, raised 0.2pps from our July estimate, has been in line with our expectation entering this year of robust, defined as above-potential, but uneven, global growth with a downside skew of macroeconomic risks. Identified risks to our baseline entering the year ranging from higher inflation and aggressive central-banking tightening, further escalation of Russia's war in Ukraine and emerging-market vulnerabilities as global central banks taper, to unwinding of asset-market bubbles have crystallised – precipitating slowdown as the year has advanced.

Figure 1. Global growth %, 2020-24F



Source: Eurostat, national statistical agencies, Scope Ratings forecasts

Rate hikes are assumed to slow by early 2023 although risk remains of more significant monetary tightening than anticipated by market participants. Inflation is expected to remain higher for longer even as it begins to gradually recede, threatening a new normal of continued uneven economic growth over forthcoming years and further market instability.

We foresee shallow technical recessions (defined as two consecutive quarters of output contraction) over 2022-23 in multiple economies. This partly reflects stresses during the winters of 2022/23 as well as 2023/24 amid the European energy crisis – though widespread gas supply shortages this winter are unlikely. Russia may further halt energy flows. China will support growth via gradual relaxation of its zero-Covid policies. Our baseline does not assume severe global or euro-area recession nor a global financial crisis during 2023 although rapid rate rises and an inverted yield curve represent risks for 2023 and beyond – threatening an early end of the global post-Covid recovery.

There are downside and upside risks for our baseline of sharp slowdown next year. Downside risks reflect: i) more persistent inflation surprises, provoking more aggressive central-bank responses; ii) global financial and real-estate markets correcting significantly; iii) Russia's war in Ukraine or economic warfare between the West and Russia further escalating; and iv) an emerging-market crisis gaining traction or China maintaining its zero-Covid policy, presenting adverse economic consequences.

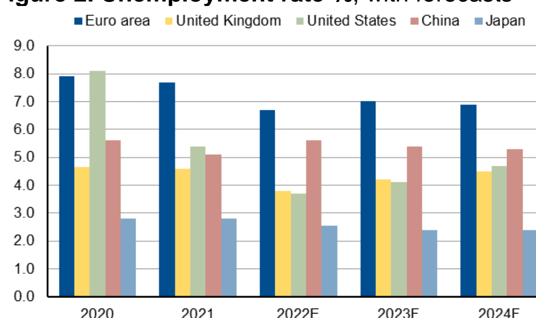
Upside risks reflect: i) more resilient demand than expected as Covid-19 supply-side bottlenecks relax, wages rise and unemployment remains very low; ii) fiscal support, such as EU funding, anchoring recovery; iii) inflation declining faster or energy crisis is less severe than expected; and/or iv) China managing to exit from its zero-Covid policy by the summer.

For 2023, we assume near stagnation of the euro-area economy – 0.7% growth for the calendar year (comparatively stronger than consensus forecasts), following above-potential economic growth of 3.4% estimated this year. This reflects a modest 2023 annual recession in the German economy (-0.2% growth), alongside slowdown in France (0.5%), Italy (0.5%) and Spain (1.3%).

We see the UK economy contracting 0.6% next year, after 4.4% growth this year. Growth in the United States ought to slow to 1.1% for 2023 (cut in half from 2% expected as of July) after 2% growth this year. Our growth forecast of Japan is 2.3% for next year after 1.7% in 2022. As for emerging economies, China should grow by 4.3%, after 3.2% this year. The Russian economy is expected to contract 4% this year, before contracting a further 4% next year. Turkey ought to grow by 3% in 2023, after 5.3% this year.

The slowdown is increasing labour-market slack, as intended, although unemployment next year (**Figure 2**) remains near multi-decadal lows and will continue to exert price pressures.

Figure 2. Unemployment rate %, with forecasts



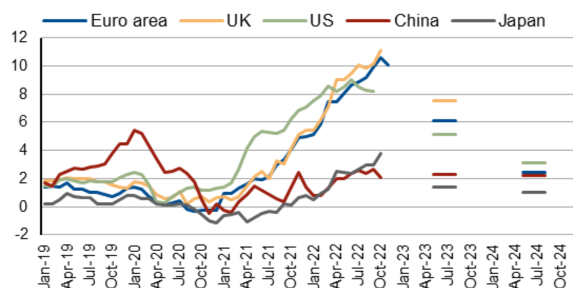
Source: Eurostat, national statistics, Scope Ratings forecasts

Higher inflation for longer even as inflation peaks

Higher-for-longer inflation appears likely. Inflation should stay well above central-bank objectives for most forecasted economies through 2023. However, recent declines of inflation rates in some major economies – led by that in the United States, supported by the strong greenback, are expected to continue gradually next year (**Figure 3**). For major economies, we only anticipate annual average inflation for 2023 coming close to or falling below inflation objectives in Switzerland (2.2%), Japan (1.4%) and China (2.3%). Annual inflation will start to approach price-stability goals for most economies only by 2024.

Still, inflation could persist beyond expectations with price pressures broadening even as energy prices receded recently. Western economies are particularly exposed, with levels of price rises not seen during the past 40 years, as an acute phase of the Covid-19 global pandemic crisis – and related inflationary fiscal and monetary accommodations – was immediately followed by energy and food crises triggered by Russia's full-scale invasion of Ukraine.

Figure 3. Headline inflation, %YoY, 2019-2024F

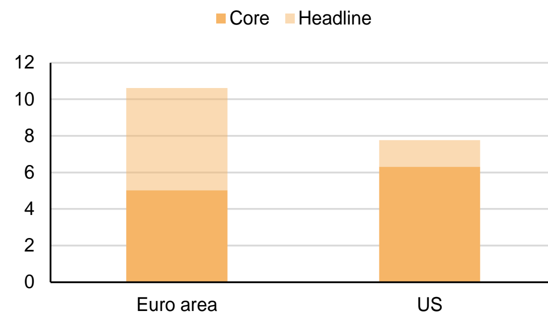


Source: National/regional statistics bodies, Scope Ratings forecasts

Euro-area harmonised index of consumer prices (HICP) inflation should average 6.1% next year before 2.4% in 2024, after 8.5% this year – about in line with consensus forecasts. In the United Kingdom, we see inflation of 7.5% next year and 3.1% in 2024, after an average of 8.9% for this year. United States consumer price index (CPI) inflation of 5.1% is assumed for 2023 before 3.1% for 2024, after 8.0% this year. Conversely, in Japan, 2023 and 2024 inflation rates will remain below the Bank of Japan's 2% target, after 2.0% inflation for this year.

How long elevated inflation persists hinges on a range of factors. The Russia-Ukraine war has spurred fresh supply-side constraints though energy and non-energy commodity price increases have partly reversed. At the same time, demand surged after Covid-19 re-openings, supported by release of pent-up demand, large-scale government spending, and declining unemployment, raising demand-pull inflation. Core inflation is rising due to robust wage gains and second-round inflation of goods and services as companies furthermore try to rebuild profit margins by passing on price hikes, risking entrenching inflation. Conversely, severe supply-chain bottlenecks from the Covid-19 crisis are gradually correcting, caps on energy prices and sharp slowdown across many economies are helping to ease price rises. Finally, any further dollar depreciation could help countries import disinflation via their currency channels.

Figure 4. Core vs headline inflation, %, October 2022

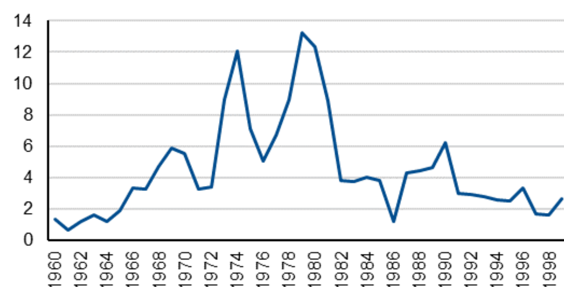


Source: Eurostat, US Bureau of Labor Statistics (BLS), Scope Ratings

The mix of drivers of inflation also differs geographically. For instance, this is reflected in the dominance of energy-associated factors for euro-area inflation, against demand-driven price pressures of the United States (**Figure 4**).

Like the supply-side inflationary crises of the 1970s, inflation is probable to stay higher for longer even as it recedes from peaks (**Figure 5**). Amid late central-bank responses, the duration of current high inflation since 2021 has already endured for long enough for further price hikes to be partially self-sustaining.

Figure 5. Headline inflation, United States, 1960-99

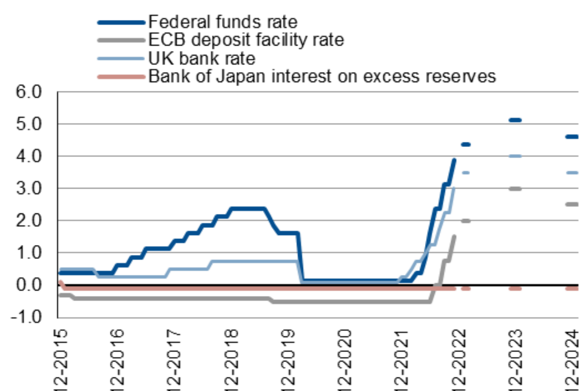


Source: BLS, Scope Ratings

Peak central bank hawkishness but monetary space to stay constrained

Sharply rising inflation since 2021 has resulted in one of the fastest monetary-policy tightening cycles of the post-war age. The Federal Reserve has hiked the Federal Funds Rate by 375bps entering December 2022 while the Bank of England's Bank Rate has risen 290bps, reflecting the steepest rises since the 1980s. The ECB began to raise its key rates comparatively late by July of this year but has since increased official rates 200bps each, the quickest rise since the ECB's founding (in 1998). Japan is an outlier with comparatively lower inflation while the Bank of Japan retains ultra-loose policies, such as unlimited government bond purchases (**Figure 6, next page**).

Figure 6. Policy rates, %, with forecasts



Source: Central banks, Scope Ratings forecasts

Despite expectation of headline inflation easing gradually by 2023, core inflation remains at or near its peak. Many central banks – most importantly, the Federal Reserve – may have reached "peak hawkishness". We see the speed of rate rises slowing going forward after front-loaded hikes from Covid-19 record lows. Still, there appears to be limited scope of any monetary-policy *easing* next year for most central banks even if terminal rates were reached 1H 2023.

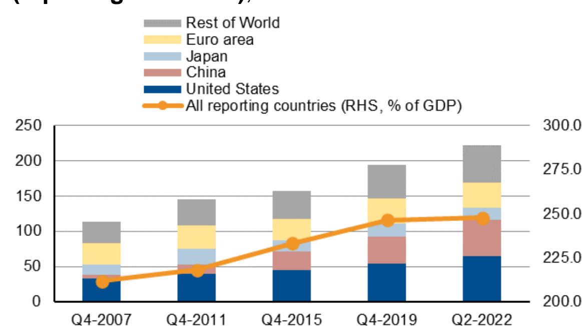
Central banks will be compelled by markets to retain tight monetary stances as inflation stays elevated. Otherwise, they risk currency devaluation and/or hikes of bond yields endangering price- and/or financial-stability objectives. Further upside surprises of inflation could furthermore compel more drawn-out rate-rise cycles than current baselines. This is especially the case for global policy rates should the Federal Reserve and/or European Central Bank be forced to accept lengthier rate-hike cycles not concluding by the spring of next year – given knock-on effects for actions of other monetary authorities.

Furthermore, quantitative tightening will accelerate as central banks gradually unwind asset purchases programmes to raise long-end rates. The Federal Reserve and Bank of England have started to reduce sizes of their balance sheets. After initiating wind-down of Targeted Longer-Term Refinancing Operations in 2022, the ECB will gradually shrink its Asset Purchase Programme holdings beginning next year vis-à-vis ceasing reinvestment of proceeds from maturing securities.

The combination of constrained monetary policy and reduced fiscal space after unprecedented support during the pandemic crisis place pressure on credit ratings – for emerging as well as for advanced-economy sovereigns. More limited capacity of public sectors to support their economies and address market failure raises risk during phases of market sell-off.

In this respect, risks associated with debt accrued in recent years might crystalise. The latest statistics of the Bank for International Settlements (BIS) display fresh highs for non-financial-sector debt of reporting countries of USD 222trn in Q2 2022, or 261% of GDP (**Figure 7**).

Figure 7. Global non-financial sector debt (reporting countries), USD trn



Source: BIS, Scope Ratings

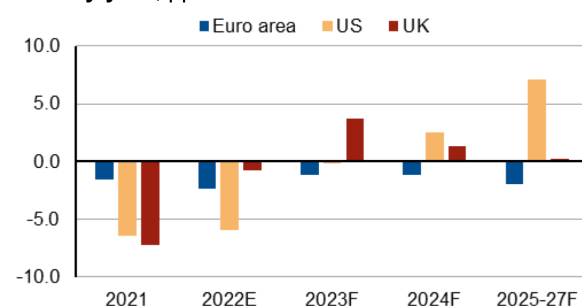
High levels of private- and public-sector debt during current monetary tightening elevates financial-stability risk. This can be exacerbated by corrections of housing markets or possibility for rising corporate insolvency bringing higher non-performing loans (NPLs).

Under current conditions, limitations of markets' capacity and willingness to continue funding rising debt – even for so-called reserve-currency sovereigns – was exemplified during the United Kingdom's attempt during September to introduce large unfunded tax cuts, which were due to be financed by raised borrowing. In the aftermath of the budget announcement, the Bank of England found itself in an uncomfortable position of having to step in as market-maker of last resort for pension funds following liability-driven investment strategies.

Higher inflation, rates pose challenging debt sustainability trade-offs

During 2022, rated sovereigns benefitted from a favourable boon of high inflation for balance sheets, due to very strong nominal growth and associated gains for government revenue. This anchored declining budget deficits and debt-to-GDP ratios. Indeed, public-debt ratios are expected to decline for most advanced economies this year (**Figure 8**).

Figure 8. Changes in general government debt-to-GDP by year, pps of GDP



Source: IMF World Economic Outlook (WEO), Eurostat, Scope Ratings forecasts

However, the end of the low-rates environment presents substantive *medium-run* debt travails. Sovereigns' funding costs have increased and are due to remain higher, marking an end of a decade of record-low borrowing costs. As such, the average interest costs of outstanding debt will pick up while countries' debt levels are higher after the Covid-19 pandemic. For example, for the United States, even as debt ratios rise again only gradually starting 2024, interest payments are seen doubling to 12.1% of general government revenue by 2025, from 6.0% in 2022. So, first-order favourable effects of high inflation for credit quality begin to erode as rates stay higher such as to bridle inflation. Higher interest payments result in more constrained fiscal space, less favourable debt dynamics and thus weakened overall debt sustainability.

In addition, the expected winding down of central bank asset purchases programmes will shift ownership of public-debt securities from the public sector to private hands, albeit gradually at this stage. As sovereign ratings are assigned on debt due to be paid to the private sector, a rising portfolio of rateable securities held by the private sector is credit negative.

Elevated inflation also restricts central bank's room for manoeuvre the longer it endures. Advanced economies have increasingly relied on strong and credible central banks for creating meaningful fiscal space and significant tolerance for higher debt levels. However, western central banks are unable to supply unlimited liquidity during phases of above-target inflation. This in the end curtails fiscal space and can precipitate currency and debt crises.

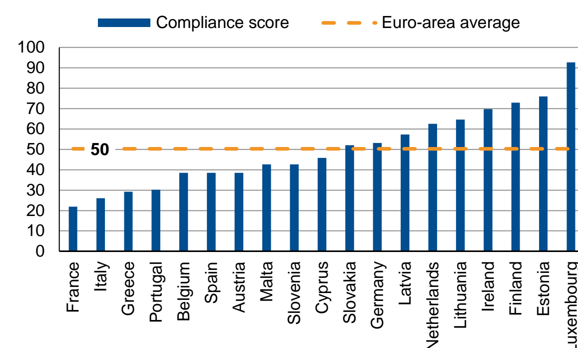
Such a present higher inflation-interest rate environment manifests a substantive paradigm shift for debt sustainability, reversing years during which high and rising debt stocks did not present near-term fiscal-sustainability risks for sovereigns because of the role of central banks – such was the case during heights of the Covid-19 crisis. Latent risk from rises in debt stocks and/or more-elevated deficits is today crystallising as rates rise and central banks are comparatively restricted as far as capacities to intervene. So, we see short-run benefits of price hikes inflating away debt for a given sovereign turning to a greater challenge for creditworthiness as the structure and ownership of debt weakens.

EU: fiscal-governance reforms and return of market discipline reintroduce fiscal consolidation

The EU fiscal framework has suffered from shortcomings since it was last reformed nearly a decade ago. The need for large-scale fiscal support in wake of the Covid-19 crisis and the long-run fiscal challenges of addressing climate change and delivering on sustainable economic growth opened fresh debate around European Union governance frameworks. EU fiscal rules were suspended in 2020, during the height of the Covid-19 pandemic.

Existing rules have helped avoid unbridled fiscal slippage, but they have not prevented build-up of fiscal vulnerabilities or pro-cyclical fiscal policies of many member states. Compliance has been especially poor. On average, compliance with EU rules was only 54% during 1998-21 (**Figure 9**), with significant cross-country disparities.

Figure 9. EU fiscal rule compliance scores, 1998-21, % of years and rules complied with



Source: European Fiscal Board, Scope Ratings

In November 2022, the European Commission published its communiqué on orientations for a reform of the EU economic governance framework. The proposal is an important step towards building more credible rules that account for disparities across member states while promoting economic stabilisation and investment to support green and digital transitions, though challenges remain.

An important improvement reflects simplification of rules to focus on a single observable variable over which governments have control: net primary expenditure (spending net of interest, discretionary revenue measures and cyclical unemployment costs). This addresses one of the core critiques of the current system, which relies on unobserved potential GDP-based variables challenged by measurement and revision issues.

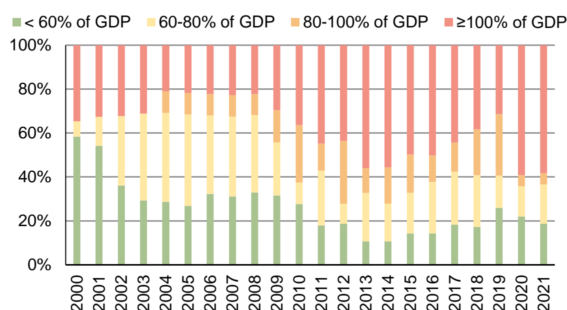
The European Commission would advance reference multi-year adjustment paths based on member states' respective fiscal positions, underpinned by debt sustainability analyses. Countries could thereafter present multi-annual fiscal and economic adjustment plans, which could be lengthened by up to three years if underpinned by reforms and investments supporting debt sustainability and addressing EU policy priorities such as climate change.

There remain uncertainties. Enforcement mechanisms have been strengthened, through introduction of reputational costs, more operational financial sanctions and via EU funding conditionality. But their effectiveness is untested and might be challenged by significant discretion introduced to the system by abandoning specific and common targets, in favour of country-specific multi-annual plans. Risks of

interjurisdictional conflicts between national governments and Brussels also remain, as the European Commission would retain a primary role in steering euro-area fiscal policies.

Through 2023, reintroduction of fiscal discipline is crucial for sovereign-rating stability as the EU framework is scheduled to be reintroduced only in 2024. EU governments are facing a meaningful challenge next year in consolidating their public finances amid economic slowdown and higher rates, which structurally push up current expenditure, while the green and digital investment gaps will grow as private-sector propensity to invest might be lower in forthcoming years.

Figure 10. Elevated share of euro-area countries with high debt ratios, % of total



Source: Eurostat, Scope Ratings forecasts

The European Commission hopes to reach consensus with its member states around suggested reforms by 2024. Despite uncertainties, the proposed framework should deliver better budgetary outcomes, which will be crucial as debt-sustainability risks have risen, further compounded by present higher rates (**Figure 10**).

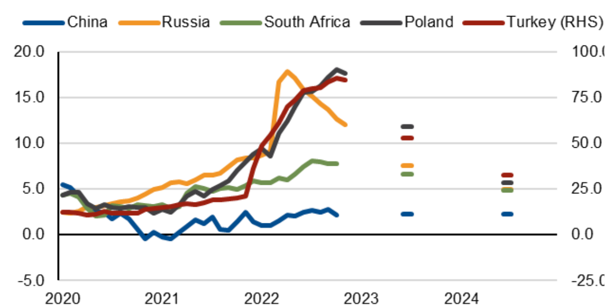
In the meanwhile, the return of market discipline helps prevent excessive fiscal loosening amid monetary normalisation and higher rates in the euro area. With the ECB reducing the size of its balance sheet, governments with weak fiscal positions will be increasingly pressured by financial markets to concentrate on growth, fiscal prudence and reform.

The crisis caused by Russia's war in the Ukraine challenges governments to strike the correct balance between supporting economic growth and ensuring fiscal sustainability. This underscores a need for a modernised EU fiscal framework – one effective in ensuring countercyclical fiscal policies alongside adequate fiscal space available to counteract shocks.

Emerging markets stay exposed to monetary tightening while alternative reserve currencies develop

In emerging markets, central banks face a significant challenge. On the one hand, they have advanced rapid tightening to manage medium-run inflationary expectations (**Figure 11**) to discourage capital flight and pressures on their currencies. On the other hand, there is little monetary policy can do to contain price pressures from bottlenecks in global supply chains.

Figure 11. Headline inflation, %YoY, 2020-2024F



Source: Macrobond, Scope Ratings forecasts

Some emerging-market central banks seem to have concluded monetary tightening by Q4 2022 given evidence of slowdown of their economies and inflation peaking. Meanwhile, central banks such as that of Russia and Turkey, have eased policy. However, further tightening of monetary policy might be made compulsory during H1 2023, especially for central banks where real rates are deeply negative.

Shortcomings of monetary frameworks as well as of transmission of monetary policy of many emerging countries may force central banks to hold rates higher for longer. Nevertheless, global official rates reaching peaks by 2023 might present a much-needed degree of relief for developing countries struggling under the collective weight of capital outflows and exchange-rate depreciation. This could support ratings during 2023 for some emerging-market sovereigns during an otherwise challenging year.

In the longer run, emerging markets are likely to increasingly promote alternative reserve currencies to curtail reliance on US monetary policy and diversify emerging markets' financing mix. This has been illustrated by issuance of non-dollar denominated debt securities such as Sukuk bonds in Malaysian ringgit, Saudi riyal, Indonesian rupiah, as well as panda bonds in Chinese renminbi. Large emerging markets such as China and Russia are growingly contesting US dollar hegemony for strategic and geopolitical reasons, seeking to carve out regional spheres centred around their domestic economies and financial systems amid a slow deglobalisation of the post-war multilateral order.

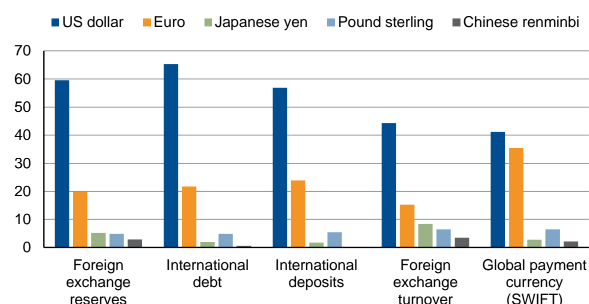
The growing competition between West and East is intensifying after the Covid-19 pandemic disrupted trading relations, while severe Western sanctions this year significantly restrained Russian access to the global financial architecture as well as to reserves held in the West. Such crises speed up American and Chinese policy agendas for reducing financial and commercial interdependence.

China is seen developing further its non-dollar-centred financial infrastructure, via increased trade settlements in domestic currency and via plurilateral agreements. This could underpin greater renminbi adoption among the BRICS, such as via the New Development Bank, the Asian Infrastructure Investment Bank, among other entities that could present alternative financing options.

China-led economic alliances – such as the Shanghai Cooperation Organisation – will probably enlarge its economic, financial, and political clout over the forthcoming decades. Commercial and financial transactions between China and other nations of the Global South might anchor the rise of renminbi-denominated assets, with renminbi accounting for 2.9% of global allocated foreign-exchange reserves by Q2 2022, nearly tripling from 1.1% as of Q3 2017. Should gains continue long run, greater use of the yuan in cross-border monetary, finance and trading operations could support upside for China's sovereign rating – similar to strong reserve-currency statuses anchoring ratings of the United States, euro-area member states, Japan and the United Kingdom.

However, the dollar – anchored by the United States' historical safe-haven status – is expected to remain the dominant reserve currency over the foreseeable future (**Figure 12**), with the euro a distant second.

Figure 12. Currency composition of the international monetary system, %



Source: ECB, BIS, IMF, SWIFT, Scope Ratings

Sovereign ratings: Negative skew of risk entering 2023

A crucial legacy of the Covid-19 crisis has been higher government debt stocks. High inflation can be credit positive near term via trimming of debt ratios. However, persistent inflation derails output growth, results in structurally-higher interest rates, and constrains central banks' room for monetary manoeuvre. Because of this, more *persistent* inflation leans credit negative. This is reflected in our ratings actions. Since Russia's full-scale invasion of Ukraine in February, we have downgraded three countries' ratings (Russia, Ukraine, Turkey), changed five countries' Outlooks to Negative (Japan, China, Czech Republic, Hungary, Slovakia) with only five sovereigns' ratings or Outlooks revised up due to structural improvements in credit fundamentals: ratings of Croatia, Cyprus and Ukraine (the latter after its debt restructuring) were upgraded; Portugal, Cyprus, Greece have seen revisions of Outlooks to Positive.

Downgrades have to date concentrated around emerging economies directly connected to the war (Russia, Ukraine) as well as those presenting longer-standing macro-economic and governance impairments (Turkey). High-income economies have seen more favourable ratings migration. The upgrade of Croatia was specific to forthcoming accession to the euro area. Southern European sovereigns have seen favourable credit-rating actions due to declining debt, long average maturities of debt after past debt relief – reducing sensitivity to rate rises, alongside strengthened EU institutional support.

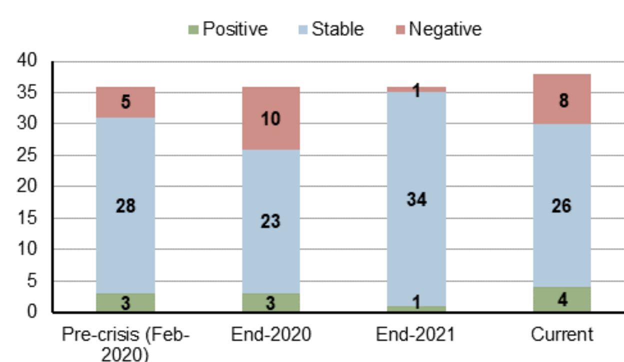
During 2022, Scope Ratings introduced first-time sovereign ratings for three governments (Ukraine in January 2022 (published at B/Negative as the only credit rating agency to evaluate Ukraine on Negative Outlook ahead of the full-scale invasion), Serbia in June (BB+/Stable) and South Africa in October (BB+/Stable)) while withdrawing ratings of one sovereign – becoming the first agency to withdraw ratings of Russia (during March) after an EU ban of ratings services for Russian entities.

Eight sovereign borrowers are presently rated on Negative Outlook and four sovereigns on Positive Outlook (see **Annex I**). Russia defaulted shortly after Scope Ratings withdrew its ratings while Ukraine restructured foreign debt in August.

Entering 2023, the sovereign sectoral outlook is Negative, with above 20% of publicly rated sovereigns presently evaluated on Negative Outlook, indicating higher likelihood for ratings downgrades next year than ratings upgrades. This compares with a single sovereign state (Turkey) on Negative Outlook and above 90% of sovereign borrowers on Stable Outlook at year-end 2021 (**Figure 13**).

Currently, 32 of Scope's 38 publicly rated sovereigns are investment-grade rated with six rated sub-investment-grade. **Annex I** presents a summary of ratings and rating actions to date in 2022.

Figure 13. Scope sovereign rating Outlooks, number of sovereigns



Source: Scope Ratings

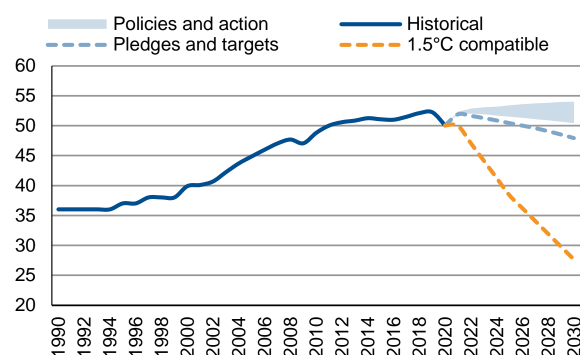
Global climate-mitigation policies accelerate, EU still has far to go to demonstrate leadership

As the impact of climate change becomes more apparent than ever and the Russia-Ukraine war disrupts global energy markets, climate mitigation has become growingly salient for our sovereign-rating

outlooks. Early and proactive climate policies are crucial to bolstering long-term economic resilience and placing growth on a sustainable path. The economic, fiscal and social costs of inaction could prove severe for economies, with estimates of economic attrition reaching up to 18% of global GDP by 2050.

Scope captures such climate risks explicitly and systematically via an independent environment, social and governance (ESG) pillar under its Sovereign Rating Methodology, with environment holding a 5% weighting in its quantitative model, the Core Variable Scorecard.

Figure 14. Global emissions trajectories, $GtCO_2e$



Source: Climate Action Tracker, Scope Ratings

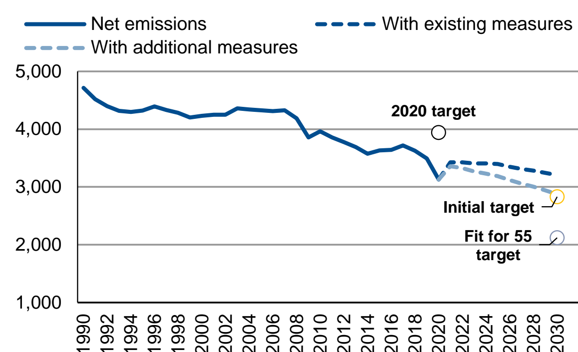
Climate-mitigation policies are accelerating. The US has reversed setbacks to its climate policies and passed the Inflation Reduction Act, one of the most ambitious and potentially impactful climate policy packages of its history while China has ramped up clean-energy policies. Likewise, the EU's July 2021 'Fit for 55' package raised greenhouse gas (GHG) emissions reduction objectives to at least 55% by 2030 against 1990 levels, from a previous 40% target.

Still, a large gap (23-27 $GtCO_2e$, or around half of 2020 global emissions) remains between anticipated emissions under current policies and planning and those consistent with limiting global warming to 1.5°C (**Figure 14**). COP27 last month yielded only mixed results on the way ahead. Establishment of a "Loss and Damage" Fund is a positive step towards compensating countries that are most vulnerable to climate change. But there was no meaningful strengthening of climate commitments from governments and no agreement around phase-out of fossil fuels. Furthermore, the current energy crisis has resulted in an explosion of new liquified natural gas distribution projects, which risks locking in fossil fuels, while coal-fired plants have been re-opened across multiple economies.

In this context, the EU is uniquely positioned to demonstrate that sustainable development is possible and inspire similar actions among global partners. It has set increasingly ambitious climate targets over recent years and is revising its climate legislations including the Emissions Trading System (ETS) and Effort Sharing Regulation (ESR), reflecting changes to nationally-binding emissions targets under the ESR.

This increased ambition is welcome, but the EU will miss objectives absent tougher climate policies and ramped-up investment – at regional and national levels. Even if current climate plans were implemented, the EU is seen missing its target by 753$MtCO_2e$ (15% of 1990 emissions, **Figure 15**).

Figure 15. EU-27 net emissions targets and trajectories, $MtCO_2e$



Source: European Environment Agency, Scope Ratings

Some countries such as Germany have put forth more ambitious climate plans since projections presented above were made, which will help move emissions closer to EU ESR objectives. Still, an important risk to ESR emissions reduction is national governments failing to implement required policies to achieve objectives. Lack of broad political consensus and willingness to act on climate issues, fragmented parliaments, the rise of climate-antagonistic right-wing populist groups and popular pushback weigh on reform momentum.

In this context, EU instruments should support green policies of its member states. Setting more ambitious parameters in the ETS and ESR as well as addressing lingering imperfections disincentivising forceful and timely climate action are crucial. Consideration of further usage of EU common resources to fund national climate initiatives could also be broached. The Next Generation EU (NGEU) programme has exemplified the capacity of Brussels to mobilise climate action at national level. Similarly, investments via the EUR 100bn Horizon Europe and EUR 375bn InvestEU programmes will drive climate innovation via increased R&D, enhanced infrastructure, and better skills.

Whether or not EU countries are up to the task will hold lasting implications for economic competitiveness and capacities to respond to climate-related environmental hazards long run – affecting sovereigns' credit outlooks in 2023 and beyond.

Regional views for 2023

Core Europe: Stable rating Outlooks but sharp economic slowdowns

Entering 2023, our credit outlook of **Germany** (rated AAA) remains Stable despite deterioration of economic growth. Fallout from the Russia-Ukraine war, such as high inflation, a sharp rise of financing costs and supply-chain disruption, has halted Germany's recovery from the pandemic crisis. While we do not foresee rationing of gas this winter, economic output is nevertheless expected to decrease 0.2% next year from slower economic growth among core trading partners and tightening monetary policy. This comes after growth of 1.6% in 2022, less than half our expectation for growth this year of 4.4% before escalation of the war in Ukraine – contributing to a weaker 3.4% growth for the euro-area aggregate this year (compared with 4.4% foreseen entering 2022).

Despite slower growth, the German government retains significant room for budgetary manoeuvre. Our expectation is for decline of medium-run debt-to-GDP from 71% in 2022 to 61% by 2027. However, financing flexibility of the federal government is constitutionally constrained by the debt brake. Increased use of special funds, which are excluded from debt-brake rules, will help finance energy-price support measures as well as green transition and higher military expenditure, but they weaken Germany's earlier record of fiscal transparency and risks weakening the national fiscal framework. Downside risks remain to baseline expectations. Notably, risk of a more severe global economic slowdown or escalation of geopolitical risks resulting in unexpected gas rationing in parts of the industrial base could cause deeper recession next year.

France (AA/Stable) is expected to see slowdown in economic momentum, with output growth slowing to 0.5% in 2023 (after an estimated 2.6% in 2022) as inflation takes its toll on real disposable incomes and household consumption, while higher financing costs and heightened uncertainty dampen investment. Still, France's growth prospects for 2023 benefit from structural improvements after pre-Covid-19 reforms, which helped raise employment. Furthermore, continued recovery of tourism-services exports, as well as significantly more benign inflation dynamics than elsewhere in the region, support economic conditions.

The general government primary deficit is seen staying elevated medium run, at around 3% of GDP on average as potential delays in withdrawal of counter-cyclical measures combine with low fiscal-reform momentum after this year's elections. Public debt is seen edging up from 111.6% of GDP in 2022 to 115.6% of GDP by 2027 because of sustained primary deficits, a rising interest burden, and only modest real economic growth. In our view, ability to bring public debt back on a firmly declining path has weakened since recent crises. France has a debt trajectory that has fallen short of multi-year objectives, contributing to divergence with the declining debt path of the euro-area aggregate.

The **Netherlands** (AAA/Stable) is seen slowing to 0.7% growth next year before 1.1% growth in 2024, after growth this year of an upside-revised 4.2% (despite our expectation of shallow technical recession in the 2H). After declining to 48.4% in 2022 (-6.3pps from a 2021 cyclical peak), the general government debt-to-GDP ratio is seen edging sideways, to 48.2% in 2023 – remaining around 2019 lows – before edging along a gradual upside trajectory over years thereafter, ending a forecast horizon at around 51.6% by 2027. The fiscal deficit is seen rising to around 2.7% of GDP next year from policies implemented under context of the energy crisis, after having declined to 0.5% of GDP this year. The agreement between government coalition partners has represented a marked shift of fiscal-policy orientation. We recently affirmed Netherlands' ratings.

Belgium (AA-/Stable) stands to be adversely impacted by the Russia-Ukraine war, with growth foreseen of just 0.2% next year before growth gradually converges on medium-run potential of around 1.2% by 2025. However, the economy is seen registering robust growth of 2.5% this year despite significant headwinds from the war. High household net wealth, a sound household debt structure, and automatic wage indexation to inflation ought to support household demand during the energy crisis. The public debt trajectory is expected to remain on a rising trend longer run, reaching 117% of GDP by 2027, challenged by ageing-related costs. This rising debt reflects an important ratings challenge.

Meanwhile, **Luxembourg** (AAA/Stable) has demonstrated resilience during recent crises, helped by large and multi-pronged budgetary support packages, and a favourable economic structure. Rising inflationary pressure and supply-side bottlenecks weigh on recovery, however. Growth is set to pick up modestly to 2.2% in 2023 and 2.5% by 2024, after slowing to 2.0% during 2022. Luxembourg maintains ample fiscal cushions to face future crises.

For **Austria** (rated AAA/Stable), we expect real growth of 0.6% during 2023, after 4.5% this year. Headwinds have reflected the economy's high dependence on Russian gas (which accounted for 80% of gas imports and 18% of energy consumption before Russia's full-scale invasion) and energy-intensive industry. The country's gas storage capacity is 95% full, representing around a year of consumption, the second-highest storage-to-consumption ratio of the EU. This alleviates gas-shortage concerns over coming months, although refilling storage next year with further-reduced or even fully-stopped Russian gas flows would present a challenge. We expect the budget to remain in deficit, at 2.7% of GDP next year, after a 3.6% deficit this year. Austria's debt-to-GDP ratio of 79% of GDP is seen

trending lower over coming years but the ratio remains the highest among AAA-rated sovereigns.

Italy and Spain: Sturdy economies this year; Portugal's declining debt supports Positive Outlook

Italy (BBB+/Stable)'s economic resilience has been demonstrated this year. Nevertheless, ramifications of the war in Ukraine will be taxing over coming months, given significant exposure of the economy to trade and energy-price shocks. We see economic growth slowing to 0.5% next year, after 3.7% growth this year (against 4.5% expected for 2022 entering the year), rebounding to 1.5% in 2024. Inflation would average 8.4% this year and average above 5% next year, before converging on an ECB 2% target. Over the medium run, the Italian economy continues to face structural challenges of anaemic productivity growth on top of weak demographics. As a core beneficiary of NGEU funding, the country has, however, an opportunity to boost growth potential.

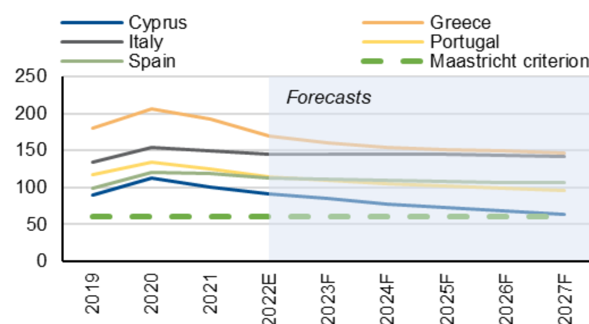
We see the incumbent government of Prime Minister Giorgia Meloni sticking to prudent fiscal policies, carefully balancing need to cushion the economy from the energy crisis with that of maintaining fiscal rectitude before investors. This was reflected in the 2023 draft budget and underpins our expectation of institutional and market constraints preventing a shift towards unorthodox policies. This informed Scope's affirmation of Italy's ratings. Still, higher rates amid elevated government debt challenge an outlook for debt sustainability in the absence of a rapid return to primary surpluses. We expect only gradual reduction of the general government deficit from around 5.2% of GDP this year to 4.8% next year and 3.2% by 2027. Debt-to-GDP would slightly drop to 142% by 2027, from 146% this year – remaining a challenge for the ratings.

Spain (A-/Stable) is seen slowing to 1.3% growth in 2023, before picking up to 2.5% in 2024. This follows comparatively strong output growth of 4.5% for this year (nearly unchanged against 4.1% under our July forecasts). Economic growth was strong during 2022 H1: 6.7% year-on-year, driven by a rebound in tourism-services receipts and household demand, and helped by more limited direct economic exposures to the Ukraine conflict. Labour-market dynamics have so far remained resilient, with the unemployment rate well below pre-pandemic averages, at 12.7% this year. At the same time, economic output remained 2pps under end-2019 levels as of Q3 2022. Economic growth is slowing rapidly but no so fast as to reverse a post-pandemic decline in the public debt ratio.

CPI inflation has moderated during recent months, albeit remaining at historically elevated levels, at 6.8% as of November, with adverse effects for household consumption. We see the headline government deficit remaining elevated next year, at 4.3% of GDP, partly from expected extension of energy support measures and weaker revenue growth. This follows the government deficit having moderated to about 4.5% of GDP this year, below a 5.3% estimate in our mid-year outlook, but public finances are vulnerable to sluggish growth, higher interest payments and increased welfare expenditure absent a stronger fiscal framework. The debt-to-GDP ratio is seen receding somewhat, to around 112% by end-2023, although remaining well above pre-pandemic levels (+13.5pps).

Portugal's (BBB+/Positive) ratings are supported by steady improvements of public finances, despite headwinds associated with global economic slowdown. Real growth is forecast slowing to 1.3% (-0.1pp from our July forecast) next year, due to impact of weaker external demand and elevated CPI inflation (9.9% YoY in November) weighing on household consumption. This comes following strong economic growth of 2022, at 6.5% (versus 5.5% under our mid-year outlook), reflecting strong performance during the first half of this year bolstered by rebound of international tourism receipts. We estimate the general government deficit to recede to a modest 1.9% this year and 1.3% next year, which, combined with still-robust nominal growth, will allow for decline of the debt-to-GDP ratio to about 110% by end-2023 – below end-2019 levels. We revised Portugal's rating Outlook to Positive in May.

Figure 16. Southern Europe: debt-to-GDP, %



Source: IMF WEO, Scope Ratings forecasts

Greece and Cyprus: Positive ratings decisions entering 2023; Malta's resilience after FATF grey listing

On 2 December, Scope became the first credit rating agency to assign Positive Outlooks to **Greece**'s BB+ ratings – indicating at minimum a one-in-three likelihood of an upgrade to investment grade. This came one year after becoming an initial credit rating agency to upgrade Greece's credit rating to BB+, one level below investment grade. Strengthened European institutional support for Greece – a development Scope expects to endure beyond current crises – may argue for BBB-ratings if said institutional support for Greece is maintained beyond next year's elections and beyond the Covid-19 crisis. Specifically, we assume monetary and fiscal policy innovations since the Covid-19 pandemic crisis are available for reintroduction during future crises if required, anchoring debt sustainability of vulnerable euro-area borrowers such as Greece. So long as Greece *stays* compliant with EU rules, Scope

views the ECB as likely to support Greek markets in the future under adverse market scenarios – providing a much-needed financial backstop.

An emphasis on EU institutional support reflects a core disparity of our credit-ratings approach to evaluating Greece and other euro-area sovereign borrowers.

Growth of the Greek economy is assumed to slow to 1.1% next year (cut 1pp since July forecasts) but rebound to an above-potential 1.5% by 2024 and 1.4% over 2025-27. This comes after robust economic recovery since spring of 2020 (8.3% growth in 2021 and a further 6% growth estimated for 2022). While inflation is seen remaining higher for longer – reinforcing a cost-of-living crisis, we see HICP inflation easing from 9.5% YoY in 2022 to a still-high 5.8% in 2023.

The outlook for Greece is aided by decline of public debt. A return to primary budgetary surpluses by next year appears probable. Presently, our baseline debt-sustainability analysis (**Figure 16, previous page**) envisions debt-to-GDP reaching 169.3% this year (roughly unchanged from 172% in our July forecasts), 160% in 2023 (157%) and 147% by 2027 (148%), reflecting a meaningful decline from 206.4% all-time peaks of 2020, and converging on debt levels of other highly-indebted euro-area sovereigns.

However, Greece's rating outlook for next year remains constrained by a number of factors, such as i) elevated government debt; ii) banking-system fragilities even though NPLs have declined; iii) structural economic weaknesses; as well as iv) uncertainties around 2023 elections as any post-election pivot of economic policy could raise financial risk.

We upgraded the ratings of **Cyprus** to BBB this month, after having revised Outlooks to Positive earlier in the year. The economy has outperformed expectations despite substantive direct tourism linkages to Russia and Ukraine. We forecast Cyprus to grow 2.2% next year before 2.5% in 2024, after 5.5% growth in 2022 (revised up 3.5pps since our July outlook). This, combined with strong fiscal performance, will support one of the fastest declines of public debt-to-GDP among euro-area member states.

Malta (A+/Stable)'s economic recovery has been stronger than anticipated. However, we expect slowdown to 3.3% next year after 6.2% growth in 2022. We held Malta's ratings unchanged last year after it was placed on the Financial Action Task Force (FATF)'s grey list – and Malta was removed from this list by June 2022, reflecting strengthened oversight of its financial system and enforcement of anti-money laundering and counter-terrorism financing frameworks.

UK: Stable Outlook through recent crisis; Ireland's robust growth

After strong growth during 2022, we expect sharp slowdown of the **United Kingdom** (AA/Stable) economy next year with output contracting 0.6% (cut 1.6pps from our July forecasts). After one of the sharpest contractions among advanced economies during the Covid-19 crisis (-11%), output rebounded 7.5% in 2021 and a further 4.4% this year. A worsening cost-of-living crisis, including sharp reductions of real disposable income, rising taxes and higher interest expenses align with substantively slower household consumption over the coming quarters.

After political turmoil of recent months, the UK's institutional strengths proved crucial in ensuring smooth transition of power and easing tensions in financial markets. The new government's commitment to budgetary discipline, an appropriate policy response from the Bank of England and a more orthodox economic policy of the new government has helped reverse a crisis triggered by rapid and unfunded fiscal expansion announced via a 'mini-budget' of the previous government. The current government's Autumn Statement perorated a mix of direct and indirect tax increases and sharp reductions of public spending, returning the UK on a path of fiscal discipline. While spending cuts have been largely back loaded to after 2025, tax rises will start to take effect more immediately. Unlike peer credit rating agencies, Scope affirmed the United Kingdom's ratings and held its Outlook at Stable through the recent short crisis – seeking to ensure a longer-run view.

Given an exceptionally challenging economic backdrop, the government has, however, announced amendments of its fiscal framework, which could weaken future fiscal discipline.

Scope affirmed **Ireland**'s sovereign credit ratings (AA-/Stable) in April. Output has recovered strongly since the pandemic crisis, and we expect robust (GDP) growth of 5.3% in 2023 after 11.9% for this year. Strong growth in the multinational enterprise sector, including in pharmaceuticals and IT sectors, continues to anchor output growth. The underlying economy is expected to grow around 2.5% next year, after about 6% growth this year – despite rising inflationary pressure affecting households and businesses.

Strong economic performance is expected to maintain public-debt ratios on a declining path, supporting the credit outlook. The debt-to-GNI ratio stood at around 101% as of end-2021 (55% of GDP) and is expected to fall to 85% (46% of GDP) by end-2022. Debt levels are seen reaching about 30% of GDP by 2027. Ireland is among countries that could see curtailed competitiveness from changes of global corporate tax policy, although the aggregate impact remains unclear.

Financial-stability concerns in Nordics; Switzerland's strong franc

Denmark, **Norway**, **Sweden** (all rated AAA/Stable) and **Finland** (AA+/Stable) share wealthy and competitive economies, robust economic and fiscal governance frameworks, low-to-moderate public debt ratios and sound external and financial sectors. The region has

seen slowdown of growth due to strong inflationary pressure caused by escalation of the Russia-Ukraine war, which has curbed private consumption and investment.

All Nordic economies have, however, demonstrated significant resilience, helped by effective support from their strong fiscal frameworks, accompanied by comparative energy independence due to only marginal dependence on Russian gas and an elevated share of renewables in energy consumption. Robust public-sector balance sheets (most notably Norway's with a sovereign wealth fund of above USD 1trn, and expected to benefit further from higher oil and gas revenues) have enabled adoption of appropriate fiscal-support measures and higher defence spending, such as for Finland and Sweden. In addition, external-sector cushions and strengthened regulatory requirements ensure economies' comparative resilience to macro-financial risks under scenarios of severe downturn.

In the face of higher energy prices and high core inflation, regional central banks have tightened policy and raised key rates (Norges Bank and Riksbank each hiked policy rates to 2.5% last month). Households' sensitivities to higher rates given elevated debt and a correction in housing markets – most significantly in Sweden's – have raised financial-stability concerns. However, strongly capitalised banking systems and ample household financial assets help mitigate such risks and prevent spill-over across the region's highly-interconnected financial systems.

Economic growth is expected to remain robust this year, but slow significantly next year with Nordic economies next year seeing contraction of 0.4% for Sweden, contraction of 0.2% (Denmark), growth of 0.2% (Finland) and growth of 2.0% in Norway.

As regards **Switzerland** (AAA/Stable), we anticipate slowdown to 0.6% growth next year (revised down 1.4pps in our mid-year forecast), after growth of 2% for 2022 (revised down 0.4pps). Withdrawal from negotiations around an institutional framework agreement with the EU weigh on relations with its largest trading partner and complicates establishing future trading arrangements. We expect Switzerland's debt-to-GDP ratio to be around 39% alongside a balanced budget next year.

The Swiss National Bank (SNB) has accelerated monetary tightening, hiking its policy rate a cumulative 125bps this year to 0.5%. This strengthened the franc and currency appreciation is helping hold inflation at comparatively moderate levels. At the same time, the SNB recorded record-high losses of CHF 142bn up to Q3 2022, due to valuation changes of its foreign-exchange reserves. This will likely present consequences for federal and cantonal budgets, which during past years have benefitted from sizeable dividend payments from SNB net profits. Finally, the country's second largest bank, Credit Suisse AG, is in the middle of a strategic overhaul resulting in high restructuring costs. We see limited risk of crystallisation of contingent risks for the Swiss sovereign, in view of high loss absorption capacity and a comprehensive resolution framework.

EU CEE: significant slowdown entering 2023; Hungary and Poland face EU funding risks

Average growth in the 11 EU central and eastern European economies (CEE-11) will slow to 1.2% next year (**Figure 17, next page**), from the 3.3% we had forecast as of July, with less rapid growth anticipated across all 11 countries. This follows growth of CEE-11 of an estimate of 4.6% this year, revised up from 3.8% as of our July forecast.

Given a euro-area economy seeing steep slowdown as high inflation hits private demand, temporary contraction of output across many economies of CEE-11 during this current winter appears probable. Risk of stagflation has increased in areas of the region, especially for countries reliant upon global value chains such as the **Czech Republic** (AA/Negative) and **Hungary** (BBB+/Negative).

Our growth estimates for CEE-11 economies: **Poland** (A+/Negative): 5.7% (2022), 1.5% (2023); Czech Republic: 2.5%, 0.2%; Hungary: 5.2%, 0.1%; **Slovakia** (A+/Negative): 1.8%, 0.5%; **Romania** (BBB-/Stable): 4.9%, 2.2%; **Bulgaria** (BBB+/Stable): 3.2%, 1.0%; **Croatia** (BBB+/Stable): 6.3%, 1.8%; **Slovenia** (A/Stable): 5.5%, 1.3%; **Lithuania** (A/Positive): 2.4%, 0.5%; **Latvia** (A-/Positive): 2.4%, -0.1%; and **Estonia** (AA-/Stable): 0.4%, 0.8%.

Inflation of the region will peak around Q4 2022 or Q1 2023 but remain above central-bank objectives. High energy prices as governments seek permanent, if frequently costly, alternatives to dependence on Russian energy exports will hold inflation high. Most CEE-11 economies reached a 1 November objective to fill natural-gas storage levels to 80% of capacity ahead of the winter, with Poland, Romania and Czech Republic at nearly full. Sufficient storage (with current levels covering around 25-30% of annual gas consumption) have contributed to recent declines of gas prices – helping CEE-11 avoid harsh energy-rationing crisis this winter. However, Europe might easily see a deeper gas shortfall by the following winter in the absence of Russian gas and should Chinese demand for imports of liquefied natural gas recover.

Most regional central banks are seen tentatively concluding monetary tightening by Q4 2022 given evidence of weakening economies. Central banks of the Czech Republic and Hungary have already indicated that rate hikes are coming to an end, while the National Bank of Poland surprised markets in October via *prematurely* pausing interest-rate rises ahead of 2023 elections. The National Bank of Romania might continue tightening at a slower pace through Q1 2023. However, further upside surprises of inflation data

and/or rise of pressure on currencies or bond markets might compel official rates to rise further in 2023.

Yields for 10-year local-currency sovereign bonds have risen twofold for CEE-11 governments compared with where they were as of end-2021. Borrowing costs will stay elevated and volatile across the region next year.

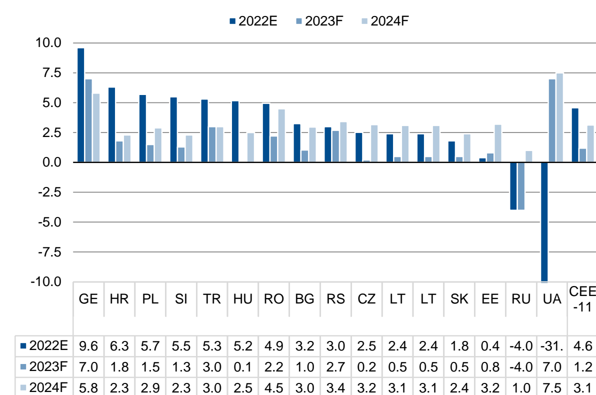
We see general government deficits next year of between 2.5% of GDP for Croatia to a high of 6.4% of GDP for Slovakia. Deficits of the CEE-11 region will average 4.3% of GDP in 2023, after 4.4% this year.

Here, CEE-11 countries benefit from moderate government debt stocks (**Figure 18**). As an example, for the Baltic states, resilience of fiscal metrics and solid medium-run growth potential represent crucial elements of resilience against elevated exposures to high inflation and security risk.

Croatia represents an outlier of the region, as reflected in our ratings upgrade from BBB- to BBB+ in July. This reflected formalisation of entrance to the euro area from 1 January 2023, reflecting clear credit-positive aspects such as elimination of foreign-currency risks of Croatia's euroised economy and private- and public-debt stocks. Accelerating a pathway for adoption of euro is similarly crucial for further ratings upside for Bulgaria, as euro adoption would give Bulgaria reserve-currency status and access to the Eurosystem. However, Bulgaria risks another early election during H1 2023. This would further extend political instability, hindering passage of reforms and risking delay of euro adoption beyond a planned 1 January 2024.

Meanwhile, the European Commission has recommended freezing Hungary's EU Budget funding under rule-of-law conditionality while making reception of EU Recovery and Resilience Facility monies conditional on meeting 27 so-called 'super-milestones'. Poland similarly must meet milestones to receive its first tranche of EU recovery funds while the EU withholds EUR 76.5bn in cohesion funding from Poland. The withholding of EU funds presents downside risk for Hungary and Poland's ratings.

Figure 17. 2022E-24F real growth (CEE), %



	GE	HR	PL	SI	TR	HU	RO	BG	RS	CZ	LT	LT	SK	EE	RU	UA	CEE-11
2022E	9.6	6.3	5.7	5.5	5.3	5.2	4.9	3.2	3.0	2.5	2.4	2.4	1.8	0.4	-4.0	-31.	4.6
2023F	7.0	1.8	1.5	1.3	3.0	0.1	2.2	1.0	2.7	0.2	0.5	0.5	0.5	0.8	-4.0	7.0	1.2
2024F	5.8	2.3	2.9	2.3	3.0	2.5	4.5	3.0	3.4	3.2	3.1	3.1	2.4	3.2	1.0	7.5	3.1

Diagram sorted by 2022 growth rates. Source: Scope Ratings forecasts.

Figure 18. 2019-27F general government debt, CEE, % of GDP

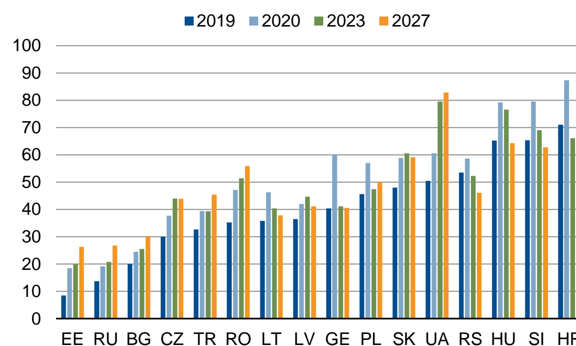


Diagram sorted by 2019 general government debt levels. Source: Eurostat, national statistics agencies, IMF WEO, Scope Ratings forecasts.

Non-EU Emerging Europe: Exceptional risks from protracted Russia-Ukraine war; Turkey's historic elections

We foresee **Russia** (WD)'s economy being around 8% smaller at end-2023 compared with where it was in 2021, whereas before the full-scale war, we expected Russia's economy to grow around 5% over 2022-23. So, the Russian economy would have been around 14% larger by 2023 were it not for escalation of the war.

The war and an acceleration of labour outflows from Russia – with estimates of several hundreds of thousands of persons leaving since 24 February, most of them educated and highly-skilled – further worsen demographic decline, reducing output and productivity growth – underpinning our estimate of reduced potential growth (1%-1.5% annually) medium run.

We see Russia seeking to further economic integration and expansion of the BRICS group to try replacing trade and investment lost from Western sanctions. From Russia's perspective, there is much to gain from strengthening trade and economic ties and plenty of pressure to do so. However, we do not anticipate Russia compensating for the lost technology, export markets, and access to global financial systems via BRICS+.

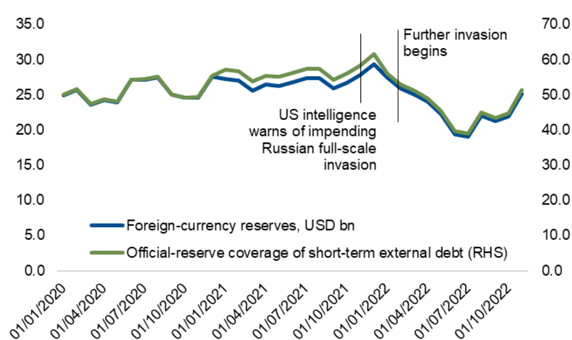
Russia's foreign debt default in June of this year after selective default for rouble debt in the second half of March hold limited near-term financial implications as high energy revenue helps the State finance itself. Russia's access to foreign markets is mostly closed anyway. In the longer run, foreign default will restrict Russia's financing flexibility and damages investor confidence, likely to further discourage foreign investment Russia badly requires. The foreign default has complicated debt payment and borrowings of the private sector, whose external debt is around four times that of the State. After Russia's full-scale invasion of Ukraine, Scope became the first EU rating agency to withdraw Russia's credit ratings after an EU ban of ratings services for Russian entities.

On 22 August, Scope Ratings upgraded foreign-currency long-term ratings of **Ukraine** to CC after completion of an anticipated foreign debt-service suspension, while assigning a Negative Outlook on basis of probability for further debt relief being presented over forthcoming years, possibly requiring additional private-sector involvement, in ensuring Ukraine's debt sustainability as well as adequate liquidity during war and reconstruction. Based upon this year's debt restructuring, around USD 6bn of foreign-currency debt service has been deferred two years, with the first Eurobond maturity after a suspension phase coming due on 1 September 2024. Scope was the only credit rating agency to assign Ukraine a Negative Outlook ahead of the 24 February full-scale invasion, and assess significant likelihood of such military steps being taken by Russia. Domestic-currency ratings are one step above foreign-currency, rated CCC/Negative.

In our July 2022 mid-year outlook, we revised up expectations for Ukraine's economy for this year to a contraction of 31%. For 2023, recovery of 5.5% (revised down from 12.5%) is foreseen, with output remaining next year over 25% under 2021 levels. Our forecasts assume protracted conflict with Russia. Inflation is seen averaging 23% in 2023 and 14.4% in 2024, after 20% this year, with the National Bank of Ukraine (NBU) expecting its current level of the policy rate (25%) to be maintained until at least Q2 2024.

The severe 2022 drop of economic output has placed substantive pressures on debt sustainability: Ukraine's debt-to-GDP ratio is expected to gain from 47.6% of GDP as of end-2021 to 81.8% of GDP in 2022, dropping to 80.6% during 2023 recovery, before concluding a forecast horizon to 2027 around 84% of GDP – held up by significant costs of long-run reconstruction.

Figure 19. Ukraine reserves and reserve coverage



Source: National Bank of Ukraine, IMF, Scope Ratings

Foreign-currency reserves rose to USD 25.2bn in November 2022, from USD 19.1bn in July (**Figure 19**). Official reserve (including gold) coverage of short-term external debt (by remaining maturity) has risen, reaching 51.3% in November, although still well under a 62% level as of end-2021. Expectation of further reduction of NBU monetary financing and continued receipt of international financial assistance support reserve levels.

Ahead of elections due by June 2023, we expect the government of **Turkey** (foreign-currency debt rated B-/Negative) to continue prioritising near-term growth via increasingly loose monetary and fiscal policies. The government might use capital controls more freely should lira depreciation intensify again. This unorthodox economic policy framework raises risk to external and public finances, while failing to restore long-run currency stability or rebuild foreign-exchange cushions.

At this stage, we do not see any likelihood for a reset of monetary policy, at least before the elections. This will keep the Turkish currency under constant pressure. The lira has lost nearly 30% of its value against dollar this year.

We estimate Turkey running a current-account deficit of around USD 40bn, or 4.5% of GDP, over the next 12 months, up from a deficit of USD 7.3bn (0.9% of GDP) last year. Turkey is one of the largest energy importers of CEE. Net energy imports may reach 10% of GDP this year, up from 5.2% of GDP last year. Alongside capital controls, Turkey is likely to use potential USD-denominated Islamic bond issuance, currency swap agreements with aligned central banks and closer cooperation with Russia – all of which involve varying degrees of geopolitical, economic and financial trade-offs – to help address widening external funding gaps.

We have revised down growth of the Turkish economy to 3% from 3.5% for 2023, after 5.3% growth (revised from 5.8%) for 2022. Despite ultra-loose monetary policy contrasting sharply with tightening of other G-20 central banks, aggregate supply in Turkey has been well behind aggregate demand. The negative contribution of inventories to growth reached around -10pps in Q2 2022. This results in high inflation and risks disorderly adjustment of aggregate demand. We see headline inflation averaging around 50% next year, after 74% this year.

Pressure on lira may ease if economic policies were to change course following scheduled elections to centre around price stability and addressing macroeconomic imbalances. This would support Turkey's credit ratings. Conversely, in addition to widening economic imbalances, possible political unrest related to elections, heightened sanctions risks from the United States over Turkey's deepening cooperation with Russia, engagement in conflicts in Syria and Libya, as well as tensions around gas exploration in the eastern Mediterranean pose risks to the ratings.

Georgia (BB/Stable) is expected to grow 7% next year, after 9.6% growth this year, boosted by elevated tourism and remittances revenues associated with a significant inflow of Russian businesses and migrants upon escalation of Russia's war in Ukraine. Rising current-account inflows have supported appreciation of lari by 15% YTD against dollar and an increase in official reserves of more than USD 600mn since February to USD 4.6bn by November. This will act as a cushion against wide current-account deficits. Lari

appreciation has cut inflationary pressure from imported energy and food prices (CPI was 10.4% YoY as of November, down from 13.9% in January) and has enabled the central bank to maintain rates unchanged at 11% since March.

While Ukraine and Moldova were granted candidate status for EU accession in June, Georgia was granted a "European perspective" – candidacy only upon meeting specified institutional and governance objectives. We consider Georgia to be exposed to geopolitical risk – related to unresolved conflicts in South Ossetia and Abkhazia with Russia. However, we do not foresee a material escalation of conflict over the foreseeable future, given Georgia's nuanced approach to participation in sanctions against Russia and current economic relations between Russia and Georgia.

Scope assigned first-time BB+/Stable ratings for **Serbia** this June. We have revised down growth expectations for Serbia for next year to 2.7%, from 4%. This comes after 3% growth this year (unchanged from our mid-year forecasts). For the first time since 2015, foreign direct investment might not entirely cover the current-account deficit, with the latter projected to widen to around 9% of GDP for this and next year, from 4.4% of GDP in 2021, due to high costs of energy imports.

Serbia is seen using upcoming IMF financing and a low-interest loan received from the UAE to cover high external financing needs over the next two years. The expected adoption of a new fiscal rule next year and oversight from the IMF ought to help rebuild fiscal cushions and keep the budget deficit contained around 2% of GDP next year.

Serbia will probably maintain its balancing act around Russia's war in Ukraine. Given that Serbia, to date, has not aligned itself with EU measures against Russia, this might further complicate separate EU accession negotiations. We therefore expect an accession target year of 2025 to be delayed considerably.

Post-election risks in the United States as higher rates challenge economy

After mid-term elections last month, heightened policy gridlock is anticipated for the **United States** (rated a below-consensus AA/Stable) after Democrats lost control of the House of Representatives although retaining control of the Senate. This nevertheless raises probability of political brinkmanship and impediments of government capacity to address medium-run economic and fiscal challenges, although a more divided government after elections might also place a straight-jacket on expansionary budget policy – supporting restraint of budget and current-account deficits as well as of inflation to a degree. Furthermore, former President Donald J. Trump continues to exert significant influence on positioning of the Republican party, presenting risk for the institutional outlook as he seeks re-election in 2024 elections.

In 2023, the US credit outlook is further challenged by longer-run risk associated with misuse of the debt ceiling. Unless Democrats are able to pre-emptively raise the debt ceiling during the lame-duck session of Congress to year-end, debt-ceiling risks rise by next year. Experiences of 2011 and 2013 debt-ceiling crises demonstrate that debt-ceiling risks were near peaks when a Democrat President faced a divided or Republican-led Congress – and was absent recourse to a party-line congressional vote to raise (the ceiling) such as during last year's debt-limit crises. Heightened political polarisation and attenuated capacity to locate bipartisan compromise increase risk around such crises compared with the past. Furthermore, federal deficits are elevated over forthcoming years – curtailing a space of time the US Treasury has for emergency actions in meeting spending obligations.

The US economy exited a foreseen H1-22 technical recession by Q3 of 2022, with growth of an annualised 2.6% QoQ. While economic conditions remain exceptionally challenging, we assume growth of 1.1% for 2023 (revised down from 2%) after 2% for 2022 (revised up from 1.7% under July 2022 forecasts) – reflecting comparative resilience of the economy to this stage. However, downside risks are meaningful should more significant rate hikes be needed to bring inflation down. Labour-market conditions have remained tight and we see unemployment averaging 3.7% this year before rising to 4.1% in 2023 and 4.7% by 2024.

Headline CPI inflation eased to 7.7% this October, after a 9.1% June peak; core CPI inflation eased to 6.3%. We see CPI inflation averaging 5.1% next year and 3.1% in 2024, after 8.0% this year. As a response to inflation, the Federal Reserve has raised rates 375bps since March and concluded net asset purchases by early March. It doubled the pace of quantitative tightening by September, and we expect rate hikes to 4.25-4.5% by end-2022 and 5-5.25% by 1H-2023.

Headline general government deficits are seen returning to more elevated levels, averaging 6.6% of GDP over 2023-27, as roll-out of significant spending policies weighs on primary deficits as interest payments furthermore rise. This follows reduction of the general government deficit to 4.4% of GDP by 2022, from 14.5% in 2020 and 10.9% in 2021. We see the general government debt ratio further moderating to 122.1% of GDP this year (from 134.5% peaks as of 2020) before this trajectory reverses more significantly by 2024, with debt ending a forecast horizon to 2027 at 132% of GDP.

Upside revisions of debt inform Negative Outlook for China; Japan's monetary easing faces challenges

We affirmed A+ sovereign credit ratings of **China** in June 2022 but revised the Outlook to Negative. This Outlook revision reflected significant structural public-sector deficits and steepening of an upside general government debt trajectory compared with our December 2021 forecasts. Budget stimulus as a

response to the pandemic crisis raised general government debt to 72% of GDP in 2021 and we expect debt to reach 102% of GDP by 2027 as continued fiscal support is required given a sharp property-market correction. Under the IMF's broader debt definition, which includes debts of local government financing vehicles and other off-balance-sheet entities, the government's 'augmented debt' ratio stood at 102% of GDP as of 2021 and is seen reaching 129% by 2026, significantly above debt ratios of sovereign peers with similar wealth levels.

The Outlook revision also reflected the challenge and associated risks of achieving sustainable economic growth absent exacerbating large financial imbalances – e.g., avoiding a 'hard landing'. In the second half of 2022, debt levels of households and non-financial corporates stood at 220% of GDP, far higher than those of the United States (155%), euro area (167%) and Japan (188%). Chinese authorities have introduced appropriate policies to addressing financial imbalances and curtailing leverage across crucial economic sectors, such as real estate. Such structural reforms, in combination with the zero-Covid policy, have contributed to economic slowdown, however – with growth of 4.3% expected next year as the economy gradually re-opens. The weak economic outlook has put pressure on public finances, while causing slowdown of reform momentum. Partially to support credit growth, the central bank and banking regulator introduced a series of 16 measures last month with an objective of stabilising the property sector and reducing liquidity and debt-repayment pressures.

In May, we revised the Outlook for **Japan**'s A ratings from Stable to Negative. The economic recovery has been uneven and lagged that of other main advanced economies although growth of 2.3% is expected for 2023, after 1.7% for 2021 and 2022. There has been significant budgetary support, including the recent JPY 29trn (5.3% of GDP) stimulus package announced in October. Most of the package is geared towards current expenditure, seeking to mitigate rising prices and support sectors hard hit by the pandemic crisis. Some investments are foreseen supporting strategic sectors, to raise fertility and enhance human capital (JPY 6trn).

Still, we see structural pressures due to an ageing population weighing on medium-run fiscal and economic performance, with limited potential for meaningful budget consolidation. Effects of weak economic growth and wide fiscal deficits will maintain Japan's very high public debt ratio on an upside trajectory, reaching 268% of GDP by 2027.

Deterioration of public finances means the government is increasingly dependent on the Bank of Japan's accommodative monetary policies. However, Japanese monetary policies are growingly facing challenges under a context of tightening global financial conditions elsewhere with pressures on yen and the Bank's yield-curve-control policy. This has prompted record levels of foreign-exchange interventions and government bond purchases. This comes on top of longer-run financial-stability concerns. A persistent ecosystem of negative policy rates, forceful monetary-policy interventions and any renewed yen devaluation could give rise to credibility concerns for the central bank and threaten to erode yen's reserve-currency status.

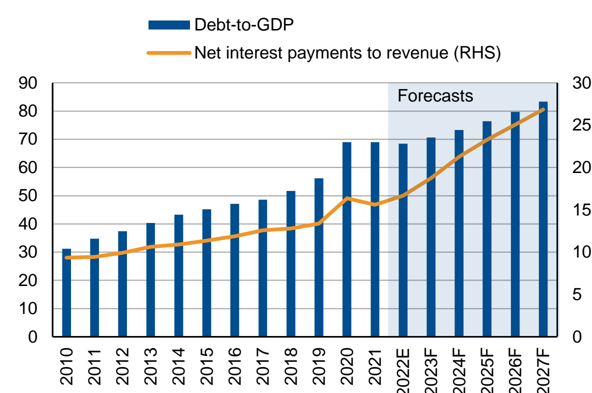
South Africa ratings challenged by a rising debt burden

Scope assigned BB+/Stable first-time ratings for **South Africa** on 28 October 2022 – its first public sovereign credit rating in Africa.

We see economic growth of 1.1% for 2023, following a post Covid-19 crisis rebound (of 4.9% growth in 2021, and 1.9% in 2022). We see 1.7% growth during 2024. Inflation is seen staying above its 3%-6% target range until Q3 2023 (averaging 7.0% in 2022, 6.6% in 2023 before 4.8% in 2024) and to reach a mid-point of the target range by circa mid-2024 – roughly in line with current central-bank expectations.

South Africa's fiscal deficit is expected to be a better-than-anticipated 4.75% of GDP for FY2022/23 (compared with an earlier government target of 6% of GDP) although we expect this deficit to rise to 5.2% in FY2023/24 and see it climbing during future years because of the rise in interest payments amid higher rates. Contrary to government expectations, we see government debt rising to 73.3% of GDP by 2024, before continuing to rise medium run (**Figure 20**). Meanwhile, net interest payments are expected to average around 18% of government revenue over 2022-23, before rising to above 20% by 2024.

Figure 20. South Africa debt metrics, %, 2010-27F



Source: IMF WEO, Scope Ratings forecasts

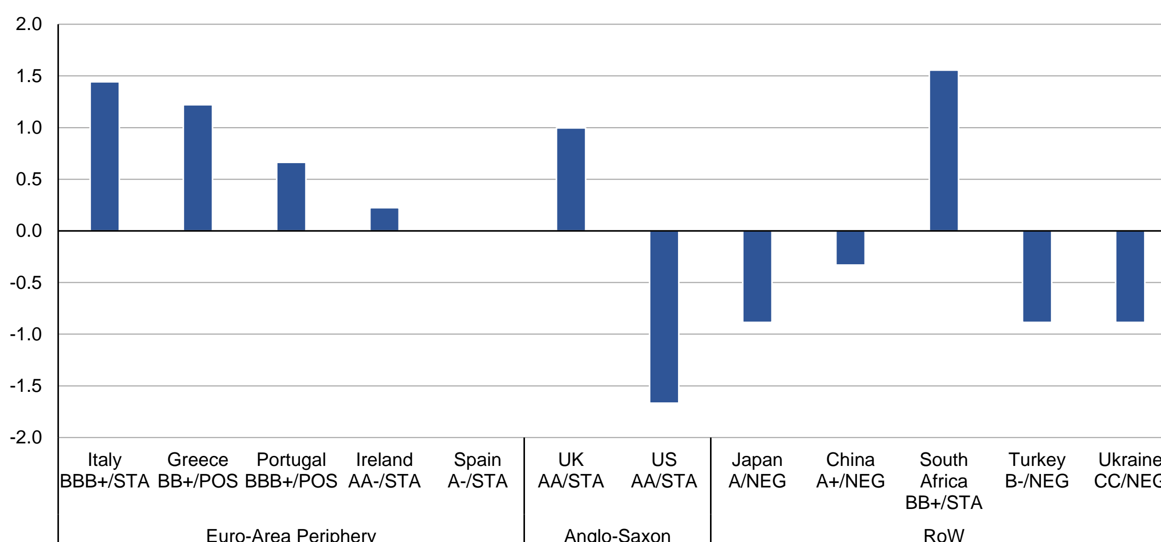
Political uncertainty has risen after calls for the resignation of President Cyril Ramaphosa, elevating risk for the reform agenda. Longer-run fiscal risk and moderate economic growth potential are constraints for any consideration of an investment-grade rating for South Africa.

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

Figure 21. Scope's publicly-issued long-term foreign-currency sovereign credit ratings, as of 12 December 2022

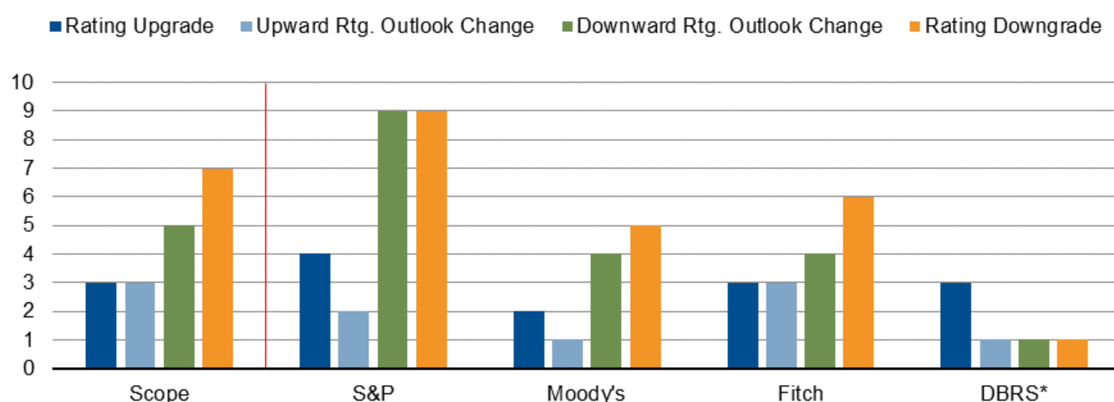
Europe						Other Countries	
EU				EFTA			
Euro area		Non-euro area					
Austria	AAA/Stable	Bulgaria	BBB+/Stable	Norway	AAA/Stable	China	A+/Negative
Belgium	AA-/Stable	Croatia	BBB+/Stable	Switzerland	AAA/Stable	Georgia	BB/Stable
Cyprus	BBB/Stable	Czech R.	AA/Negative			Japan	A/Negative
Estonia	AA-/Stable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

Figure 22. Scope sovereign rating levels versus the US agency average* (rating notches), as of 12 December 2022



NB: Calculated based on alpha-numeric conversion on a 20-point scale from AAA (20) to D (1) with US agency ratings adjusted to the Scope rating scale. Positive/Negative Outlooks are treated with a +/-0.33 adjustment. Credit Watch positive/negative with a +/-0.67 adjustment. RoW = Rest of the world. Calculated based on foreign-currency long-term issuer ratings.

Figure 23. Number of rating revisions since 24 February 2022 (since Russia's escalation of Ukraine war)



NB. Rating revisions since 24 February 2022 for the 39 countries that Scope has rated publicly since 24 February 2022 (including revisions for Russia until ratings of Russia were withdrawn on 17 March 2022 and including Serbia since Scope started rating Serbia on 3 June 2022 and South Africa since Scope started rating South Africa on 28 October 2022). *Among countries that Scope has rated, DBRS has not rated Bulgaria, Croatia, Hungary, Romania, Russia, Serbia, South Africa, Turkey and Ukraine (as such, the above is from a sample of 30 rated countries in the case of DBRS).

Figure 24. Scope's sovereign rating actions, 2022 YTD

Month 2022	Date	Sovereign	Rating action	Rating & Outlook*
Jan	14 January	Latvia	Outlook change	A-/Positive
	14 January	Poland	Outlook change	A+/Negative
	14 January	Cyprus	Affirmation	BBB-/Stable
	21 January	Czech Republic	Affirmation	AA/Stable
	28 January	Croatia	Outlook change	BBB-/Positive
	28 January	Ukraine	First-time rating assignment	B/Negative
Feb	18 February	Switzerland	Affirmation	AAA/Stable
Russia further incursion in the Ukraine began on 24 February 2022.				
Mar	1 March	Russia	Downgrade/ Under review	BB+/Review for dng
	1 March	Ukraine	Downgrade/ Under review	CCC/Developing
	4 March	Russia	Downgrade/ Under review	CCC/Review for dng
	10 March	Russia	Downgrade/ Under review	C/Developing
	11 March	Turkey	Downgrade	B-/Negative
	17 March	Russia	Ratings withdrawn	Ratings withdrawn
	18 March	Luxembourg	Affirmation	AAA/Stable
Apr	22 April	Ireland	Affirmation	AA-/Stable
May	6 May	Japan	Outlook change	A/Negative
	13 May	Portugal	Outlook change	BBB+/Positive
	27 May	Spain	Affirmation	A-/Stable
Jun	3 June	China	Outlook change	A+/Negative
	3 June	Serbia	First-time rating assignment	BB+/Stable
	3 June	United Kingdom	Affirmation	AA/Stable
	17 June	Ukraine	Confirmation/ Outlook assigned	CCC/Negative
	24 June	Cyprus	Outlook change	BBB-/Positive
Jul	8 July	Czech Republic	Outlook change	AA/Negative
	15 July	Croatia	Upgrade/ Outlook change	BBB+/Stable
	22 July	Ukraine	Downgrade/ Under review	C/Developing
	29 July	Italy	Affirmation	BBB+/Stable
August	12 August	Austria	Affirmation	AAA/Stable
	16 August	Ukraine	Downgrade	SD
	19 August	Slovenia	Affirmation	A/Stable

	22 August	Ukraine	Upgrade/ Outlook assigned	CC/Negative
September	5 September	Hungary	Outlook change	BBB+/Negative
	23 September	Malta	Affirmation	A+/Stable
October	7 October	Sweden	Affirmation	AAA/Stable
	14 October	Finland	Affirmation	AA+/Stable
	14 October	Belgium	Affirmation	AA-/Stable
	21 October	Denmark	Affirmation	AAA/Stable
	21 October	Norway	Affirmation	AAA/Stable
	28 October	Slovakia	Outlook change	A+/ Negative
	28 October	South Africa	First-time rating assignment	BB+/Stable
November	11 November	United States	Affirmation	AA/Stable
	11 November	Spain	Affirmation	A-/Stable
	11 November	Germany	Affirmation	AAA/Stable
	25 November	Estonia	Affirmation	AA-/Stable
	25 November	United Kingdom	Affirmation	AA/Stable
	25 November	Netherlands	Affirmation	AAA/Stable
December	2 December	Greece	Outlook change	BB+/Positive
	2 December	France	Affirmation	AA/Stable
	9 December	Cyprus	Upgrade/ Outlook change	BBB/Stable

Annex II: Related research

Central and Eastern Europe: Russia's war in Ukraine defines mounting credit risks this year and next
(26 July 2022)

Sovereign mid-year outlook: slowdown, inflation, rising rates create divergent ratings trajectories
(18 July 2022)

2022 Central & Eastern Europe Outlook: sound growth, but deficits, governance, geopolitics are risks
(14 December 2021)

Sovereign Outlook 2022: Covid-19, structural inflation, monetary tightening challenge global outlook
(7 December 2021)

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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This is an amended version of the original report published 23 January 2023 correcting data for China's and Bulgaria's policy rates in Table 2, correcting Luxembourg's general government balance for 2020-21 in Table 3 and S&P's rating revisions in Figure 23.