Fitch Ratings 2020 Outlook: Global Sovereigns

Policy Easing Ahead

Fitch's Sector Outlook: Stable

Global sovereigns enter 2020 with the world economy slowing and policymakers debating what to do about it. Most countries are exposed to the trade dispute between China and the US, making it more difficult to calibrate domestic policy settings given the international uncertainties. Fitch Ratings expects widespread monetary easing in 2H19 to be followed by varying degrees of fiscal easing in 2020. Fiscal space and the degree to which growth is lifted by stimulus will be important considerations in determining what, if any, rating implications might follow policy changes.

Rating Outlook: Stable

About 75% of sovereigns are on Stable Outlook, in line with the long-term average. However, there are notable differences by region, with Latin America accounting for a disproportionate share of those on Negative Outlook and Emerging Asia having none on Negative. Emerging Europe's upward rating momentum of recent years is likely to slow, while the Middle East and Africa has more Negative than Positive Outlooks, but by a smaller margin than at any time since 2014. Outlooks in developed markets are about evenly split between Positive and Negative.

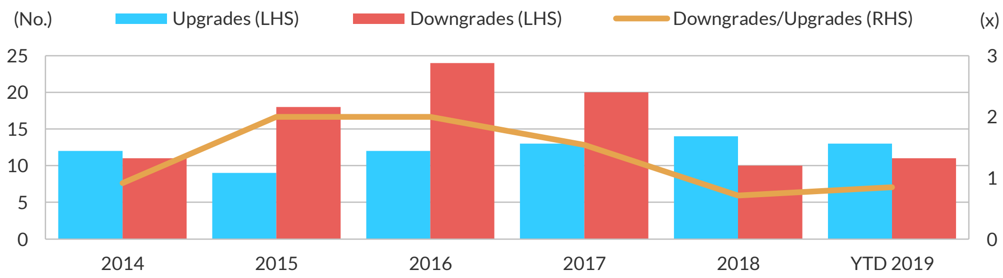
Rating Distribution Weighting: 'B' Category the Biggest, but 'AAA' May Expand

Two factors have led to the growth of the 'B' category, neither of which will be reversed in 2020. Many of the sovereigns downgraded from the 'BB' category during and after the correction in commodity prices in 2014 have yet to establish a path to a stronger credit profile consistent with a rating upgrade. New rating mandates continue to be at the lower end of the rating scale as first-time capital market borrowers take advantage of low interest rates and investor appetite for higher yields. The 'AAA' category is likely to expand next year for the first time since 2011, as Austria (AA+) and Finland (AA+) have both been on Positive Outlook since 2018. They would be the first Fitch-rated sovereigns to regain their 'AAA' ratings.

James McCormack, Managing Director & Head of Sovereigns

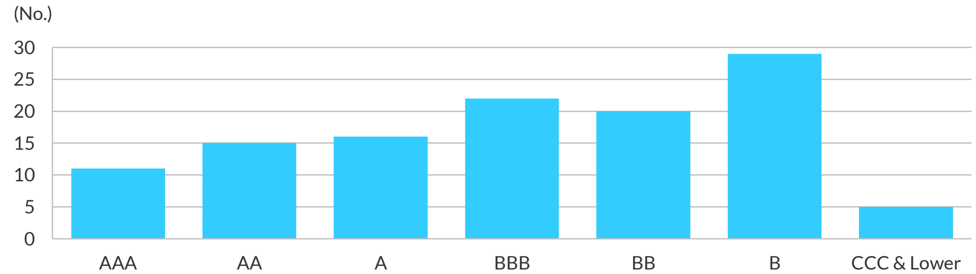
Fitch believes there will be a tendency toward fiscal easing in 2020 due to trade uncertainties hanging over the global economy, and expectations of slower growth and continued low interest rates. Greater demand for income inequalities to be addressed along with more spending on environmental and other social issues may also have public finance implications.

Global Sovereign - Rating Changes



Source: Fitch Ratings

Global Sovereign - Rating Distribution



Source: Fitch Ratings

What to Watch

- An accommodative macro policy backdrop in developed markets will be growth-supportive, but unable to fully offset the global effects of uncertainties around trade policy.
- Increased government borrowing to take advantage of low interest rates and provide stimulus may contribute to deteriorating debt dynamics if growth fails to materialise.
- Global capital flows are following global trade lower; a continued decline in foreign direct investment would leave external borrowers in emerging markets reliant on more volatile flows.
- Political risks will affect ratings in 2020, as several regional conflicts persist, and public discontent centred on economic issues is rising. There will be pressure for policy change.

Trade Policy Uncertainties Contribute to Macro Policy Easing

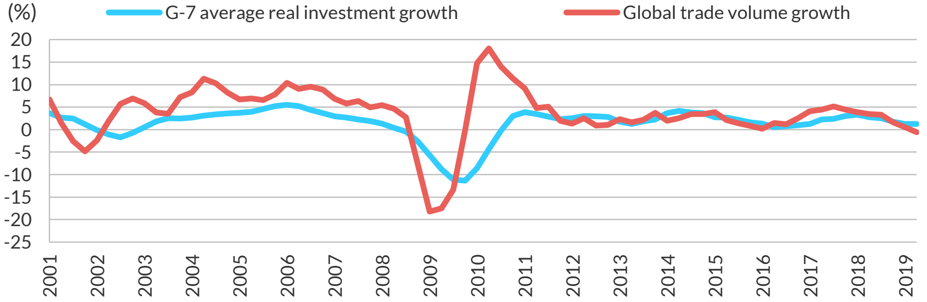
There are a number of reasons for sovereigns to ease fiscal policy in 2020. Most important is the fact that the China-US trade dispute remains unsettled, and the global growth outlook is therefore surrounded by higher-than-usual uncertainty. Private-sector investment spending is inversely influenced by uncertainties related to economic policies and prospects, prompting fiscal and monetary policymakers to take action.

Countercyclical macro policies need not affect credit ratings, which are intended to be resilient to cyclical developments. Even so, the easing expected in 2020 is not primarily to counter a cycle, but to offset another set of policies, the duration of which is unknown. This will make it much more difficult for policymakers to judge the success of their efforts and to gauge the appropriate time for stimulus withdrawal. Fitch does not believe fiscal or monetary stimulus will be able to fully counter the negative effects of trade disruptions on growth, raising the risk that policy is eased further to seek additional impact.

Assuming global interest rates remain relatively low, government debt dynamics will be driven more by primary balances and economic growth, so the effectiveness of fiscal stimulus in supporting growth will be critical to whether debt ratios rise or fall. In addition to directional changes in debt, ratings could be affected by the degree to which sovereigns have – and draw upon – fiscal space.

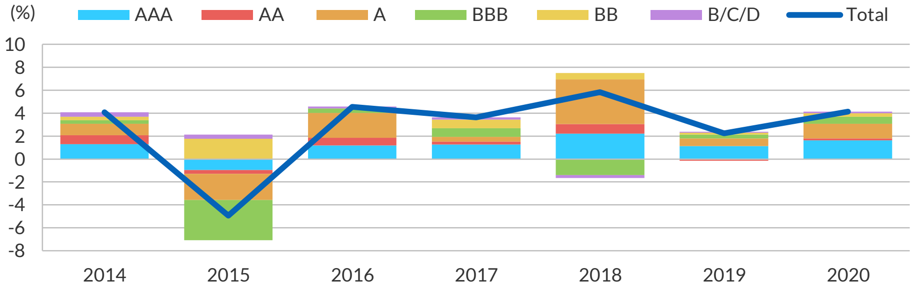
In this context, fiscal space should be understood as being determined largely by peer comparisons of a combined assessment of the fiscal variables in the Fitch Sovereign Rating model, which include the fiscal balance, government debt, government interest payments relative to revenue and the foreign-currency share of government debt. Sovereigns that perform less well on these metrics and whose overall model score is nearing the lower end of their predicted rating category could face downward rating pressures if fiscal performance slips further. It is not necessarily the case that sovereigns with higher ratings have more fiscal space, as government debt ratios, for example, are not correlated with ratings.

Investment and Trade



Source: Fitch Ratings, Haver Analytics

Growth of Government Debt in US Dollar Terms, at Market Exchange Rates



Source: Fitch Ratings

Commodity Price Risks Remain a Consideration

Changes in commodity prices can alter sovereign credit profiles quickly, having implications for public and external finances, economic growth and structural reform initiatives. This can be the case for both commodity exporters and importers. A lesson from the 2019 attack on Saudi Arabia's infrastructure might be that the sensitivity of prices to supply interruptions has diminished, at least for the oil market, and that smoother, more predictable prices should be expected. We consider this conclusion overly sanguine. The Saudi authorities minimised the disruption to world oil markets, but other jurisdictions that host different parts of the global oil supply chain, or are critical suppliers of other commodities, might not be as effective in mitigating the price impact of event risks. Commodity price volatility is unlikely to have been relegated to the past.

Politics and Discontent

Perceptions around income inequality and broader economic unfairness will continue into 2020, shaping the political agenda in a growing number of countries. It is too simplistic to suggest the upshot is a larger public sector or weaker public finances, but this is certainly a risk. Similarly, increased government spending on environmental and social issues, which many feel have been overlooked for too long, could have fiscal and rating implications, at least in the short term. Tax policies might also be focused on these issues, intended to curb behaviours or the use of certain products, with less clear fiscal and rating implications.

It is evident that a debate has begun as to how economic policy can be more substantially reoriented to take account of the view that recent settings have, in fact, perpetuated income inequalities. Proponents will seek to further the idea that fiscal and monetary policies need to be not just coordinated in countercyclical undertakings, but that monetary policy should be drawn closer to fiscal initiatives that specifically address socioeconomic priorities. Fitch believes a high degree of caution is warranted in applying monetary tools to support fiscal objectives, no matter how appealing those objectives may be, although we recognise that negative consequences such as higher inflation or exchange rate instability may take time to materialise.

Meanwhile, the risk of social unrest with political consequences remains high. The widespread nature of such unrest in 2019 and its rapid development confirms the difficulty in predicting where it might arise in 2020.

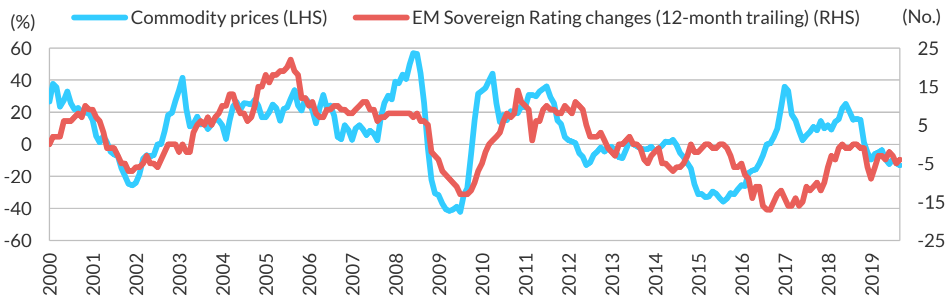
Trade Flows Down, Capital Flows Too

The rise of trade protectionism has been accompanied by a distinct slowing of global capital flows as a less high-profile but equally important corollary. For emerging markets, trade is the most reliable way to close the income gap with wealthier countries. Capital inflows, particularly foreign direct investment (FDI), are often required to facilitate subsequent trade flows, and are critical for technology transfers.

Fitch expects the trend that began in 2019 of declining foreign investment outflows from the largest developed countries will continue into 2020. When companies are investing less at home due to economic uncertainty, investing abroad can be even less compelling. This is especially the case if the economic uncertainty is derived from trade protectionism, so that investment assets abroad could be trapped behind tariff barriers that diminish their value.

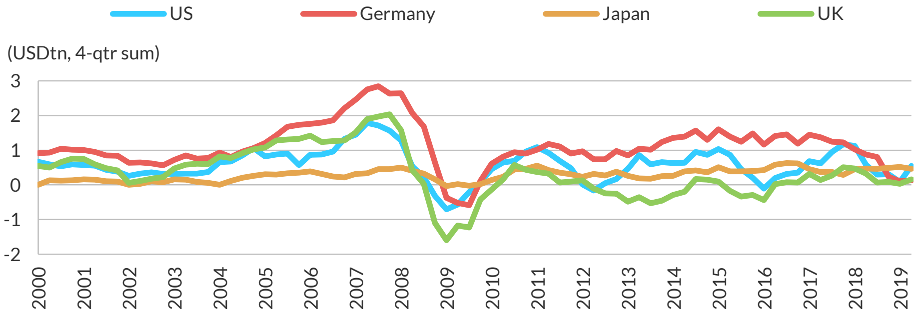
This is a negative development for emerging markets due to the impact on growth, and also the subsequent reliance on less desirable types of capital inflows to finance current account deficits. Portfolio flows and international bank lending are more volatile than FDI; if they decline quickly, there would need to be a corresponding current account adjustment or a reduction in international reserves, along with currency depreciation pressures. Some sovereign ratings may be vulnerable depending on the fragility of countries' external finances.

Commodities and Ratings



Source: Fitch Ratings, Haver Analytics

Capital Outflows



Source: Fitch Ratings, Haver Analytics

Outlooks and Related Research

2020 Outlooks
Global Economic Outlook (September 2019)

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