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FitchSolutions

Q1 2020

Latvia
Country Risk Report
Includes 10-year forecasts to 2028

Contents

Executive Summary 5
Core Views 5
Key Risks 5

Country Risk Summary 6
Economic Risk Index 6
Political Risk Index 6

SWOT 7
Economic – SWOT Analysis 7
Political – SWOT Analysis 8

Economic Outlook 9
Economic Growth Outlook 9
Rapid Employment-Led Growth Coming To An End 9
The Latvian economy will keep growing at a healthy clip, but significantly slower than in the past two years.
GDP By Expenditure Outlook 12
TABLE: GDP GROWTH FORECASTS 12
TABLE: PRIVATE CONSUMPTION FORECASTS 12
TABLE: GOVERNMENT CONSUMPTION FORECASTS 12
TABLE: FIXED INVESTMENT FORECASTS 13
TABLE: NET EXPORTS FORECASTS 13
Outlook On External Position 14
TABLE: CAPITAL AND FINANCIAL ACCOUNT BALANCE 14
TABLE: CURRENT ACCOUNT BALANCE FORECASTS 15
TABLE: IMPORTS 16
TABLE: EXPORTS 16
Monetary Policy 17
Eurozone's Monetary Policy More Accommodative For Longer 17
At Fitch Solutions we now expect the main policy rate to be kept at 0.00% in 2019 and 2020, with further monetary stimulus being delivered over the next quarters through additional cuts to the deposit rate.
Structural Fiscal Position 21
TABLE: MAIN REVENUE AND EXPENDITURE CATEGORIES 21
TABLE: FISCAL AND PUBLIC DEBT FORECASTS 22
Currency Forecast 23
EUR: Retreating On Dollar Strength 23
A strong US dollar, increasingly accommodative European Central Bank monetary policy, prolonged Brexit uncertainty and trade tensions will weigh on the euro over the short term.
TABLE: EUROZONE CURRENCY FORECAST 25

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10-Year Forecast ... 27

The Latvian Economy To 2028 ... 27

Looking For A 'New Normal' ... 27

After three years of growth outperformance following one of the worst recessions in Europe, we think that growth is set to progressively slow over the next 10 years, as the country struggles with competitiveness and demographic challenges.

TABLE: LONG-TERM MACROECONOMIC FORECASTS ... 27

Political Outlook ... 31

Domestic Politics ... 31

2020 Budget To Prove A Hurdle For Governing Coalition ... 31

Latvia's five-party ruling coalition will continue to face difficulties governing and remain at risk of collapse. The coalition is experiencing friction in most policy reform areas.

Long-Term Political Outlook ... 32

Delayed Economic Recovery Accentuates Demographic Issues ... 32

The coming decade for Latvia will be marked by the scars of the global financial crisis of 2008/09. The country's government will struggle to keep growth at pre-crisis levels and will pay the political and social price for this inability to promote growth and ease ethnic tensions.

Operational Risk ... 35

Developed States ... 35

TABLE: LABOUR MARKET RISK INDEX ... 36

TABLE: LOGISTICS RISK INDEX ... 41

TABLE: CRIME AND SECURITY RISK INDEX ... 46

TABLE: TRADE AND INVESTMENT RISK INDEX ... 51

Global Macro Outlook ... 55

Downside Revisions To Stabilise Somewhat, But Policy Risks Remain ... 55

TABLE: GLOBAL MACROECONOMIC FORECASTS (2018-2023) ... 55

TABLE: DEVELOPED MARKETS – REAL GDP GROWTH, % y-o-y ... 56

TABLE: EMERGING MARKETS – REAL GDP GROWTH, % y-o-y ... 57

Index Tables ... 61

TABLE: LATVIA – MACROECONOMIC DATA AND FORECASTS ... 63

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Executive Summary

Core Views

- We forecast a modest growth slowdown over the coming years, with real GDP growth coming in at 2.7% and 2.6% in 2019 and 2020 respectively, from 4.8% in 2018. This still implies considerable growth outperformance relative to the rest of the eurozone due to ongoing business environment improvements and EU fund inflows.

- Rapidly rising wage growth, an external economic shock emanating from the eurozone, or a political shock damaging relations with Russia are the main risks facing the otherwise strong growth outlook.

- After the new government formation in January 2019, we expect policy to follow a similar direction. Further reform to combat money laundering through the offshore banking sector is being implemented, playing out our view. Social policies are likely to highlight the divide between ethnic Latvians and ethnic Russians, with a chance for deeper integration, but also risks of polarisation.

Key Risks

- The main risk on the economic front stems from the continued rise in the minimum wage, which threatens to undermine the country's external competitiveness. Additionally, an economic shock in the eurozone could undermine exports, which make up a large share of Latvia's GDP. Politically, relations with Russia will continue to dominate concerns, despite tensions between NATO and Russia having cooled of late and the US's renewed commitment to the security of the Baltic states.

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Country Risk Summary

Economic Risk Index

The extent of deleveraging required in the domestic banking system, as well as the necessary adjustment to household balance sheets, will ensure that the transition towards strong growth and economic stability will prove a difficult one. In the meantime, the banking sector is likely to remain weak, weighed down by the proliferation of non-performing loans in the aftermath of the credit bubble.

Political Risk Index

A large ethnic Russian population has created concerns that Russia may attempt to mount a destabilising covert operation within its own borders, echoing events in Ukraine over the past few years. Russians are the largest ethnic minority within Latvia, and Latvia possesses a strong Russian media presence, which could help to foment unrest within Latvia's borders.

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SWOT

Economic – SWOT Analysis

Strengths

- Eurozone membership provides Latvian banks with access to European Central Bank liquidity lines.
- Success thus far in implementing fiscal reforms bodes well for the future sustainability of public finances and broader macroeconomic stability.

Weaknesses

- The economy remains heavily dependent on external demand.
- The quality and quantity of the labour force pose significant challenges to long-run economic growth prospects. Labour force growth has ground to a halt as workers across the skills range seek better paid jobs abroad.

Opportunities

- Membership of the eurozone will reduce transaction costs and eliminate foreign exchange risk for inter-bloc trade and investment. This will provide scope for Latvia to expand and diversify its export markets, as well as attract more foreign investment over the longer term.

Threats

- The rapidly shrinking (via mass emigration) and ageing population threatens the long-term trajectory of the Latvian economy and potentially the government's fiscal accounts.

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Political – SWOT Analysis

Strengths

- Despite frequent changes to governing coalitions and the fractious nature of domestic politics, there has been broad consensus in favour of further EU integration, including membership of the eurozone.

Weaknesses

- The risk of government instability is comparatively high and the average life span of coalitions since independence has been around 15 months.
- The administrative and technical capability to formulate and implement policies is weak in places, and corruption remains an obstacle to the proper workings of the state.

Opportunities

- The authorities have made good progress in recent years towards strengthening the judicial system, improving the capacity of the public administration and combating corruption. Further progress can be expected in the coming years as the EU clamps down on the bloc's worst offenders.

Threats

- Given the fragmented nature of Latvian politics, policymaking will remain encumbered by the potential for disagreement between members of the coalition.
- The possibility of Russian aggression remains a key threat.

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Economic Outlook

Economic Growth Outlook

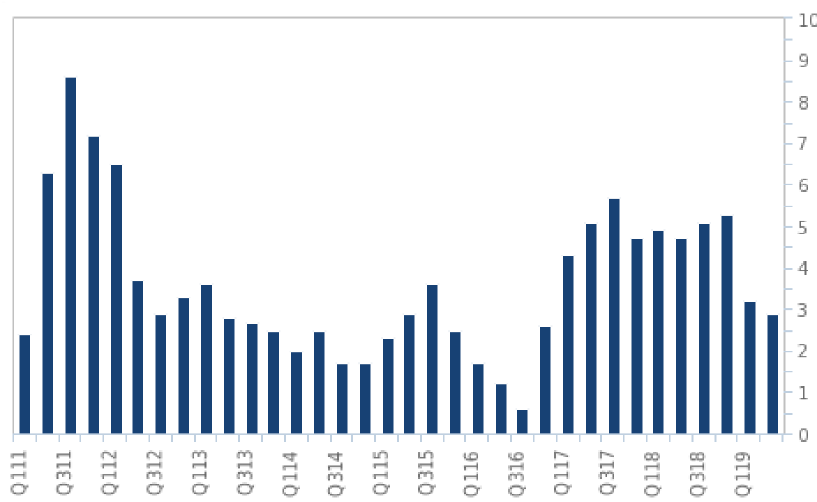
Rapid Employment-Led Growth Coming To An End

Key View

- The Latvian economy will keep growing at a healthy clip, but significantly slower than in the past two years.
- The external environment will remain a headwind, with weak export demand impacting Latvian growth.
- Domestic demand will be the main contributor to growth, but a tight labour market means that there is little scope for rapid consumption growth through employing more workers.
- We at Fitch Solutions forecast the Latvian economy to grow by 2.7% in 2019 and 2.6% in 2020, down from our previous forecasts of 3.8% and 3.6% respectively.

We believe that Latvia's economy will experience robust, but slower growth in the years ahead. Despite a weak Q119, activity rebounded in Q2, in line with our view. Real GDP grew by 0.7% q-o-q, compared to Q1's -0.1% q-o-q. In Q2, private consumption and fixed investment rebounded, while net exports acted as a drag. On the back of a stalled first quarter, we have lowered our growth forecast. We now forecast Latvian real GDP to grow by 2.7% in 2019 and 2.6% in 2020, having previously forecast 3.8% and 3.6% respectively.

Growth To Cool As External Support Wanes
Real GDP, % chg y-o-y



Source: Central Bureau of Statistics of Latvia, Fitch Solutions

External conditions are likely to remain weak over the coming quarters, with net exports weighing on headline growth. Latvia's outperformance compared to eurozone peers remains dependent on strong domestic demand growth against a weak external backdrop in the eurozone. Headwinds to growth in the eurozone due to trade tensions and Brexit-related uncertainty will mean

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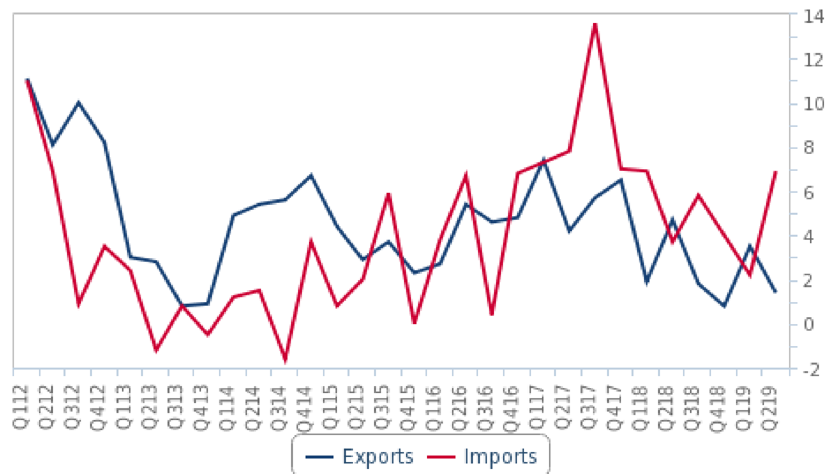
that Latvian exports underperform imports growth, as domestic demand drives the latter. This will ultimately negatively impact Latvia's headline GDP growth.

Imports Outpace Exports As Domestic Demand Remains Robust
Exports & Imports, % chg y-o-y



Source: Central Bureau of Statistics of Latvia, Fitch Solutions

While domestic fundamentals remain strong, tight labour markets will on the one hand support wage growth and consumption, but on the other hand result in slowing output gains. The economy is approaching pre-crisis employment levels, which has led the fall in the unemployment rate to slow considerably (*see chart below*). The economy is running out of slack labour to accommodate extra demand. This is evidenced by labour market data. The rate of unemployment came in at 6.5% in July, and has averaged that same level in the year up to July. Total employment is dipping. Job vacancies are rising, with the job vacancy rate averaging 3.1% in H119, compared to an average of 1.4% in 2014. This has resulted in strong wage growth, averaging 9.1% in H119.

Unemployment Approaching Pre-Crisis Lows
Unemployment Rate, %

Source: Central Bureau of Statistics of Latvia, Fitch Solutions

Fast growth through employment will likely wane and ultimately weigh on output growth. The shortage of labour in Latvia is unlikely to be supplied by previously inactive workers. Despite high wage growth, we believe that there is limited scope for people to return

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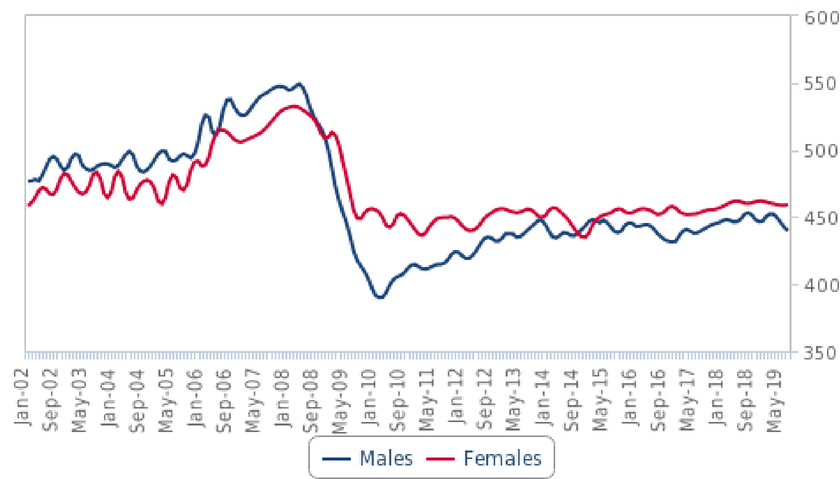
to the active labour force. Female participation rates are very high, with women representing 51.1% of all employees at 459,400 (*see chart below*). The female unemployment rate is also lower than the overall, as it has been since the global financial crisis, at 5.1% (versus 7.8% for males). Therefore, the boost to output activity from labour market gains will stall or even reverse over the coming quarters.

Little Scope To Onboard More Women
Employment By Sex, '000



Source: Central Bureau of Statistics of Latvia, Fitch Solutions

Fixed investment will likely pick up the baton as the prime domestic source of growth over the coming quarters, maintaining our view that Latvia will outperform. As we approach the end of the 2014-2020 EU structural fund financing round, investments are likely to pick up in the country. This is because, especially in the newer members of the EU, institutional capacity bottlenecks lead to a delay in the use of the funds. Most investments are actually made towards the end of the funding cycle. Furthermore, as firms struggle to find workers to expand production, they are likely to invest in capital to boost productivity.

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GDP By Expenditure Outlook

Weak demographics pose significant threats to Latvia's medium-term growth outlook. However, we believe that productivity gains will allow real GDP growth to outstrip its eurozone peers, given the country's relative political stability and friendly business environment.

We have long highlighted the threat that Latvia's demographics pose to the medium-term growth outlook, and see a greater-than-not probability that the country will fall into the middle-income trap. The country suffers from among the worst population projections in the EMEA region, as low birth rates have been compounded by high levels of net migration, primarily from the young, working-age segment of the population seeking employment abroad.

Household Consumption: Latvian households have experienced a challenging time in the post-crisis period, due to a considerable debt overhang which has weighed on consumption. The government has slowly begun to take action to ease this burden, passing a non-recourse mortgage law in 2015 which allows households to hand back houses to banks if they cannot afford to service the mortgage, while protecting borrowers' other assets. As well as helping to reduce the indebtedness of the most leveraged and struggling households, it may also help to strengthen confidence. The process of household deleveraging is drawing to an end. We forecast household consumption to stay static relative to total GDP over the next five years, at around 60%.

Government Consumption: The authorities in Latvia remain committed to fiscal discipline, and we forecast the already small budget deficit to narrow further over the coming years. There is strong cross-party consensus around the need to run minimal

TABLE: GDP GROWTH FORECASTS

	2017	2018	2019f	2020f	2021f	2022f	2023f	2024f	2025f	2026f	2027f	2028f
Nominal GDP, EURbn	27.0	29.5	31.2	32.8	34.7	36.6	38.6	40.7	42.9	45.0	47.3	49.7
Real GDP growth, % y-o-y	4.6	4.8	2.7	2.6	3.2	2.9	2.9	2.8	2.7	2.5	2.5	2.5
GDP per capita, EUR	13,041.6	15,708.8	16,653.6	17,412.4	18,440.1	19,730.0	20,918.0	22,442.0	23,826.5	25,266.2	26,791.7	28,408.6

f = Fitch Solutions forecast. Source: Latvian Central Bureau of Statistics, Fitch Solutions

TABLE: PRIVATE CONSUMPTION FORECASTS

	2017	2018	2019f	2020f	2021f	2022f	2023f	2024f	2025f	2026f	2027f	2028f
Private final consumption, EURbn	16.2	17.3	18.6	19.7	20.9	22.0	23.3	24.5	25.8	27.1	28.5	30.0
Private final consumption, % of GDP	59.7	58.8	59.5	60.0	60.1	60.1	60.2	60.3	60.3	60.3	60.3	60.3
Private final consumption, real growth % y-o-y	4.1	4.5	4.2	3.5	3.3	3.0	3.0	3.0	2.7	2.5	2.5	2.5

f = Fitch Solutions forecast. Source: Latvian Central Bureau of Statistics, Fitch Solutions

TABLE: GOVERNMENT CONSUMPTION FORECASTS

	2017	2018	2019f	2020f	2021f	2022f	2023f	2024f	2025f	2026f	2027f	2028f
Government final consumption, EURbn	4.9	5.2	5.5	5.8	6.1	6.5	6.8	7.1	7.4	7.8	8.1	8.5
Government final consumption, % of GDP	18.0	17.7	17.7	17.7	17.7	17.6	17.6	17.4	17.3	17.2	17.1	17.0
Government final consumption, real growth % y-o-y	4.1	4.0	3.0	2.7	3.0	2.5	2.5	2.0	2.0	2.0	2.0	2.0

f = Fitch Solutions forecast. Source: Latvian Central Bureau of Statistics, Fitch Solutions

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budget deficits, and accordingly a change in government is not likely to result in a major change in fiscal policy. The upshot of this is that while the majority of fiscal retrenchment is now behind us, the government is not likely to become a major contributor to real GDP growth at any point in the foreseeable future. We forecast government consumption relative to GDP to remain stable at around 17% over the next five years, which is among the lowest levels in the EU.

Gross Fixed Capital Formation: After an initial spurt in 2011/12, fixed investment growth tailed off sharply and has failed to make a convincing recovery since for a prolonged period of time. While fixed investment levels in the pre-crisis period were distorted by the real estate and construction bubble, with buildings and dwellings accounting for about 50% of total gross capital formation between 2001 and 2007, fixed investment has had few drivers since late 2012. We expect fixed investment growth to begin to pick up gradually, but do not forecast a significant increase relative to overall GDP.

Net Exports: External trade has been one of the brighter spots in the Latvian post-crisis period. We have written at length about our scepticism about the effectiveness of austerity policies in improving export competitiveness. While real wages fell, the bulk of the wage adjustment took place within the public sector rather than the private sector. Furthermore, the adjustment in labour costs (as measured by real effective exchange rate indices) was actually quite small relative to other countries, and lasted just a couple of years before deteriorating again.

Despite relatively weak external demand from eurozone trading partners, export growth in the post-crisis period has been exceptionally strong, averaging almost 10% between 2010 and 2013. This amounts to a 71% gain in nominal terms since 2009, and 40% in real terms. The main driver of this improvement appears to have been improved competitiveness through job-shedding and non-cost gains, which allowed for a significant improvement in profit margins and allowed exporters to gain market share. Some unrelated factors, such as the economic outperformance of trade partners such as Poland, also likely played a role.

TABLE: FIXED INVESTMENT FORECASTS

	2017	2018	2019f	2020f	2021f	2022f	2023f	2024f	2025f	2026f	2027f	2028f
Fixed capital formation, EURbn	5.7	6.7	7.6	8.1	8.5	9.0	9.5	10.0	10.6	11.2	11.8	12.5
Fixed capital formation, % of GDP	20.9	22.8	24.3	24.6	24.6	24.6	24.6	24.6	24.7	24.8	25.0	25.1
Fixed capital formation, real growth % y-o-y	13.1	16.4	9.5	4.1	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0

f = Fitch Solutions forecast. Source: Latvian Central Bureau of Statistics, Fitch Solutions

TABLE: NET EXPORTS FORECASTS

	2017	2018	2019f	2020f	2021f	2022f	2023f	2024f	2025f	2026f	2027f	2028f
Net exports of goods and services, EURbn	0.0	-0.2	-0.9	-1.2	-1.2	-1.3	-1.4	-1.4	-1.5	-1.5	-1.6	-1.7
Net exports of goods and services, % of GDP	0.1	-0.6	-2.8	-3.6	-3.6	-3.5	-3.5	-3.5	-3.5	-3.4	-3.4	-3.4
Net exports of goods and services, real growth % y-o-y	305.9	101.0	62.4	15.9	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0

f = Fitch Solutions forecast. Source: Latvian Central Bureau of Statistics, Fitch Solutions

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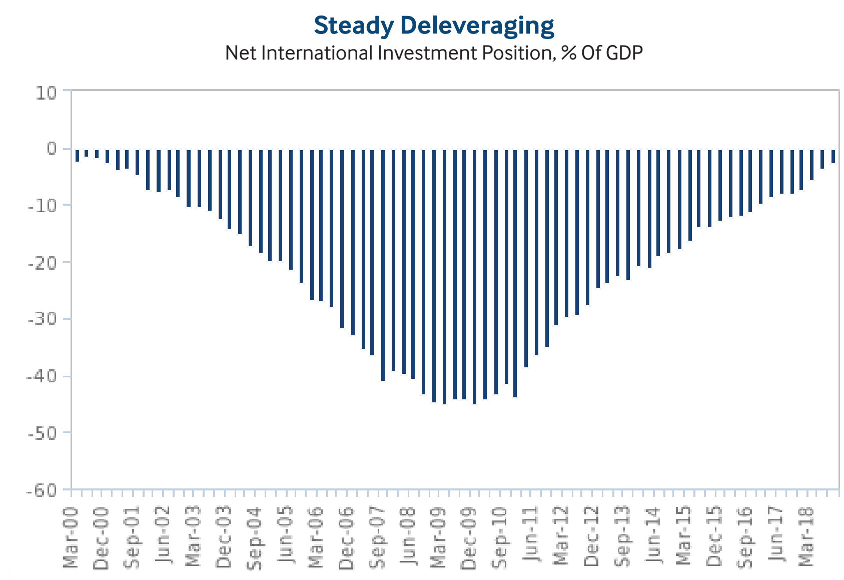
Outlook On External Position

Latvia's structural external position will remain stable in the years ahead. Its net international investment position has significantly improved in recent years, as it now runs small current account deficits.

Steady Deleveraging

Net International Investment Position, % Of GDP



Source: Eurostat, Fitch Solutions

Net International Investment Position: Latvia's external indebtedness has largely recovered to moderate levels, but it was previously large, even by global standards. At the worst point at end 2009, the net international investment position (NIIP) amounted to roughly -45% of GDP, significantly above the -35% threshold used by the EU's macroeconomic imbalance procedure.

Latvia accrued its large external liabilities during the pre-crisis period, in part driven by the entrance of Nordic banks into the local banking system. To this day, the majority of the Latvian banking system is owned by non-residents, although the total level has declined slightly since the global financial crisis.

External borrowing was amplified by the housing bubble experienced across the Baltics between 2000 and 2006, which led households to borrow excessively. The housing bubble was exacerbated by the ready supply of credit from the local subsidiaries of foreign lenders, leading to the development of unsustainable hot money inflows. Between 2003 and 2008, total banking sector assets increased by 300%. The rapid expansion of credit peaked in 2009 after the global financial crisis brought an end to capital inflows, which in turn led to the collapse of the housing bubble as the Latvian economy slumped into recession.

TABLE: CAPITAL AND FINANCIAL ACCOUNT BALANCE

	2013	2014	2015	2016	2017
Capital account, EURbn	0.4	0.6	0.6	0.2	0.2
Financial account, EURbn	0.2	0.5	-0.1	0.4	0.2
Capital and financial account, % of GDP	2.7	4.5	2.0	2.5	1.3
Net FDI inflows per capita, EUR	-136.3	-110.0	-282.5	-2.3	-252.6
Net portfolio investment, EURbn	0.1	0.0	2.4	1.0	1.8
Net other Investment, EURbn	0.2	0.8	-2.0	-0.8	-1.6

Source: Bank of Latvia, Fitch Solutions

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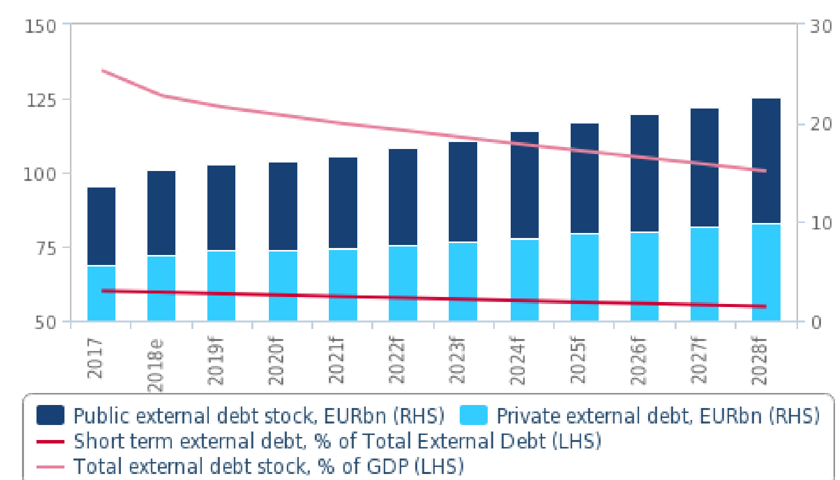
The deep economic contraction which followed left Latvian households with a debt overhang which persists to this day. A lack of non-recourse legislation and bankruptcy legislation meant that Latvian households shouldered the burden rather than foreign-owned banks, further prolonging the deleveraging process.

Despite possessing some of the largest net liabilities in the eurozone, Latvia's NIIP has been declining since 2009. The composition of the NIIP has also slowly changed. The total stock of 'other investment' (predominantly cross-border lending) has been declining as local banks deleverage and repay liabilities to their foreign parent banks. This has been a slow but steady process which has seen net 'other investment' drop from 75% of GDP in 2009 to 57% of GDP in 2017. Latvia's NIIP has also been improved by a growing net positive stock of portfolio investment.

External Debt To Remain Contained

Total External Debt, 2017-2028



e/f = Fitch Solutions estimate/forecast. Source: World Bank QEDS, Fitch Solutions

External Debt: Latvia's total external debt load stood at 124% of GDP at year-end 2017. This marks a significant reduction from a peak of 155% of GDP in 2010. The decline has been driven by an extended period of deleveraging, and by a recovery in real GDP growth rates. The external debt burden is split almost equally between public and publicly guaranteed debt (55% of total) and private non-guaranteed debt (45%). The government remains committed to fiscal discipline and we forecast only small budget deficits

TABLE: CURRENT ACCOUNT BALANCE FORECASTS

	2017	2018e	2019f	2020f	2021f	2022f	2023f	2024f	2025f	2026f	2027f	2028f
Balance of trade in goods, EURbn	-2.4	-2.7	-2.7	-2.7	-2.7	-2.8	-2.8	-2.8	-2.8	-2.9	-2.9	-2.9
Balance of trade in goods, % of GDP	-9.6	-9.1	-8.5	-8.2	-7.9	-7.5	-7.2	-6.9	-6.6	-6.3	-6.1	-5.8
Balance of trade in services, EURbn	2.1	2.4	2.4	2.4	2.5	2.5	2.6	2.7	2.8	2.8	2.9	3.0
Balance of trade in services, % of GDP	8.3	7.8	7.6	7.4	7.2	7.0	6.8	6.6	6.5	6.3	6.1	6.0
Primary income balance, EURbn	-0.4	-0.4	-0.5	-0.5	-0.6	-0.6	-0.6	-0.7	-0.8	-0.8	-0.9	-0.9
Primary income balance, % of GDP	-1.5	-1.5	-1.5	-1.6	-1.6	-1.6	-1.7	-1.7	-1.8	-1.8	-1.8	-1.9
Secondary income balance, EURbn	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.5	0.5	0.5	0.5	0.6
Secondary income balance, % of GDP	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2
Current account balance, EURbn	-0.4	-0.5	-0.4	-0.4	-0.4	-0.4	-0.4	-0.3	-0.3	-0.3	-0.3	-0.3
Current account balance, % of GDP	-1.7	-1.5	-1.3	-1.2	-1.2	-1.0	-1.0	-0.9	-0.8	-0.7	-0.6	-0.5

e/f = Fitch Solutions estimate/forecast. Source: Bank of Latvia, World Bank QEDS, Fitch Solutions

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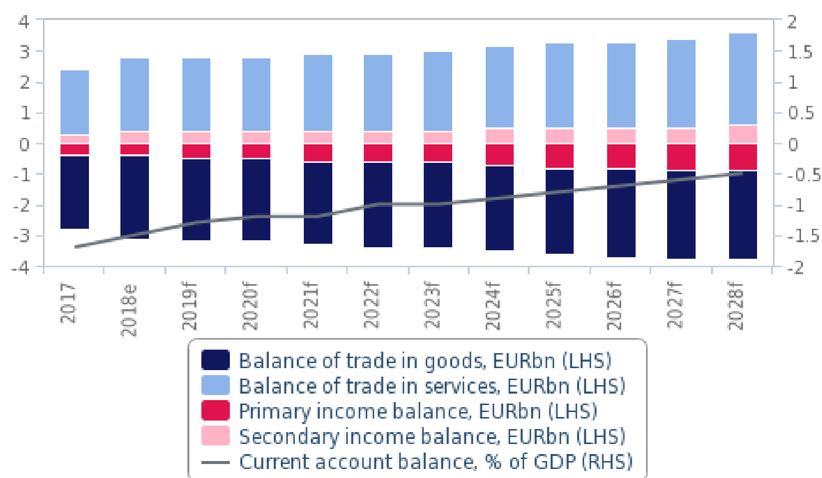
(under 1.5% of GDP) for the foreseeable future, which means that external borrowing will continue to decline. We forecast private external debt to increase relative to GDP over the coming years, but only very slightly.

Current Account Deficit To Narrow
Current Account Balance, 2017-2028



e/f = Fitch Solutions estimate/forecast. Source: Bank of Latvia, Fitch Solutions

Balance Of Payments: Having run vast, unsustainable current account deficits peaking at 16% of GDP in 2006, Latvia's external accounts experienced a sharp correction in the aftermath of the global financial crisis. The current account moved from a deficit of 8.7% of GDP in 2008 to a surplus of 6.1% in 2009 as the rapid contraction in economic activity caused imports to plummet. The current account surplus shrank as the domestic economic recovery took hold, but Latvia has not returned to running large deficits. We forecast the current account deficit to remain under 1.5% of GDP across our 10-year forecast period. Consequently, the current account is not likely to contribute significantly to a larger negative NIIP.

TABLE: IMPORTS

By Country	% Of Total	By Category	% Of Total
Lithuania	18.0	Refined petroleum	12.0
Russia	11.0	Petroleum gas	4.2
Germany	10.0	Packaged medicaments	2.9
Poland	8.7	Cars	2.8
Estonia	6.7	Broadcasting equipment	2.5

Source: Fitch Solutions

TABLE: EXPORTS

By Country	% Of Total	By Category	% Of Total
Lithuania	16.0	Refined petroleum	12.0
Russia	11.0	Sawn wood	4.7
Estonia	7.8	Hard liquor	4.1
Germany	6.4	Packaged medicaments	2.4
UK	5.7	Broadcasting equipment	2.3

Source: Fitch Solutions

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Latvia's unique geographic position on the shore of the Baltic sea makes it a natural candidate for international trade. Latvia's main trading partners are the Baltic states and Russia, which is natural given its geographic proximity. The trade relationship with Russia has been problematic of late due to a) Russian sanctions on EU agricultural products and b) the deteriorating state of the Russian economy, which has had a knock-on effect on economic activity across the region. Accordingly, exports to other Baltic states have also weakened as a result of Russia's economic malaise.

The export base is relatively diversified, although as a major regional shipping hub, trade data is prone to distortion due to the Rotterdam effect, where re-exported goods are counted within the intermediate country's trade data. One of the most significant exports are wood and wood products, as the Latvian forestry industry is a significant part of the economy, and Latvia is one of the most forested EU member states. Latvia also exports higher value-add products, such as medicine and broadcasting equipment.

Monetary Policy

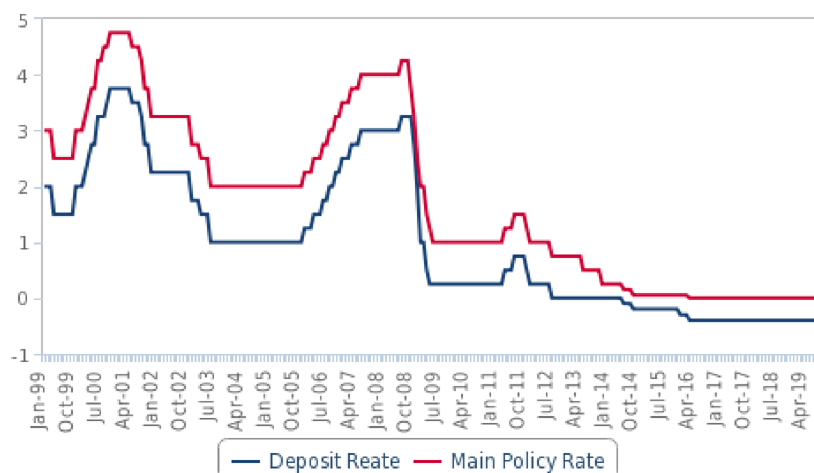
Eurozone's Monetary Policy More Accommodative For Longer

Key View

- At Fitch Solutions we now expect the main policy rate to be kept at 0.00% in 2019 and 2020, with further monetary stimulus being delivered over the next quarters through additional cuts to the deposit rate.
- Lower interest rates for longer also chime with our weaker view on the euro.
- Weakening economic momentum across the globe is leading to a downward convergence of central banks' monetary policies.

More Monetary Stimulus Ahead

ECB – Main Policy Rate & Deposit Rate, %



Source: ECB, Fitch Solutions

Monetary policy will be more accommodative for longer in the eurozone due to persistently subdued inflation against a backdrop of faltering growth momentum. In its September 12 meeting, the European Central Bank (ECB)'s Governing Council kept the key policy

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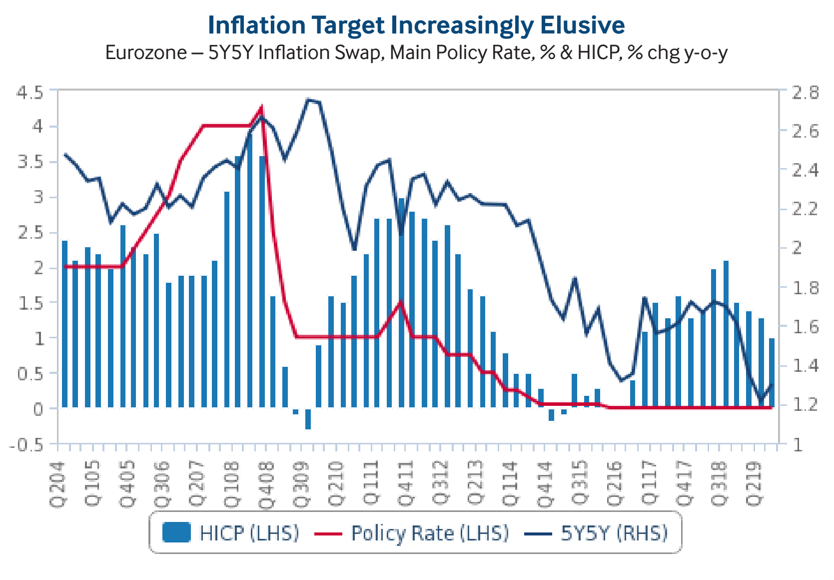
rate unchanged at 0.00%, but cut the deposit rate by 0.1 percentage points to -0.5%. In order to cushion the impact of negative rates on banks, it announced the introduction of a two-tier system, whereby a portion of banks' excess deposits will be exempted from the negative deposit facility rate. Furthermore, the ECB's bond-buying programme (QE) will be re-started from November 1 at a pace of EUR20bn a month until inflation unambiguously converges to target. The rate applied in Targeted Longer-Term Refinancing Operations (TLTROs) will be lowered and maturities lengthened from two to three years.

Inflation Target Increasingly Elusive

Eurozone – 5Y5Y Inflation Swap, Main Policy Rate, % & HICP, % chg y-o-y



Source: Eurostat, Fitch Solutions

The ongoing slide in inflation expectations bears out our view that further monetary easing will be necessary to help re-centre inflation and inflation expectations. Persistently subdued inflation and inflation expectations against a backdrop of weakening growth momentum and still elevated domestic and external uncertainties were key factors that drove the ECB's decision to loosen monetary policy. While we were expecting a 10 basis point cut to the ECB's main policy rate to -0.1% this year, we now believe that the deposit rate will be the ECB's main monetary policy tool going forward. We now expect the main policy rate to be kept at 0.00% in 2019 and 2020, with further monetary stimulus being delivered over the next quarters through additional cuts to the deposit rate. The ECB could also step up its monthly bond-buying in the event of a further moderation of momentum or a further de-anchoring of inflation expectations.

Markets continue doubting that inflation will rise from current low levels. Market-based measures of inflation expectations have continued to trend downwards, suggesting that markets remain skeptical about the ECB's ability to attain its inflation target of 'just below' 2.0% in the medium term. The five year-five year inflation swap rate was hovering around 1.3% as of mid-September (*see chart above*). This tallies with our view that further monetary easing will be necessary to help re-centre inflation and inflation expectations, which continue to lack any signs of a rebound. A less dynamic outlook for the eurozone economy means that the hitherto weak inflationary trend is unlikely to reverse in the coming months. We forecast inflation of 1.3% and 1.5% in 2019 and 2020 respectively, down from 1.8% in 2018.

Flattening yield curves across the eurozone tally with weakening inflation data, reinforcing our view of subdued inflation ahead. Germany's yield curve, a good proxy for bond market sentiment in the eurozone, has flattened over the past quarters as long-term rates started to level off in anticipation of lower growth and inflation ahead.

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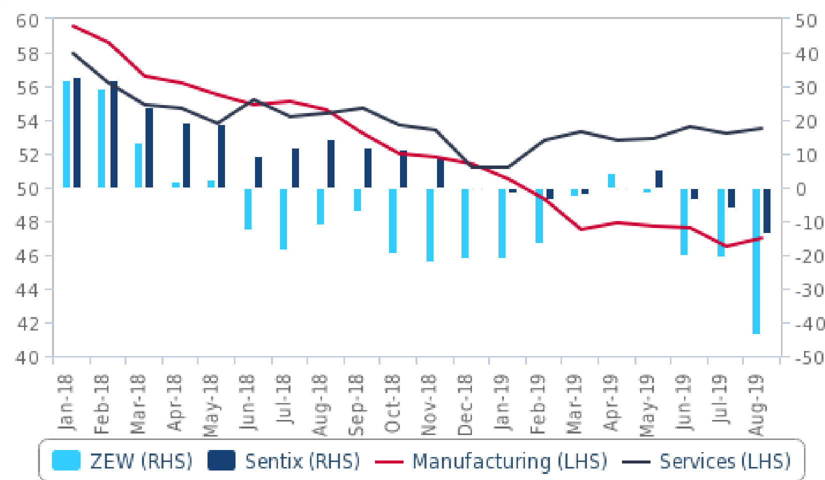
Recent data releases also support our 'more-dovish-for-longer' view. Despite nudging upward in August, the purchasing managers' index (PMI) for the manufacturing sector remains in contractionary territory, as decelerating global trade weighs down orders and confidence. Markit's report shows that PMIs remained at historically low levels, especially in Germany, where operating conditions continue to deteriorate to a considerable extent. Austria, Ireland, Italy and Spain also recorded sub-50.0 PMI readings in August. Furthermore, an ongoing decline in confidence levels points to worsening private sector operating conditions going in the fourth quarter (*see chart below*).

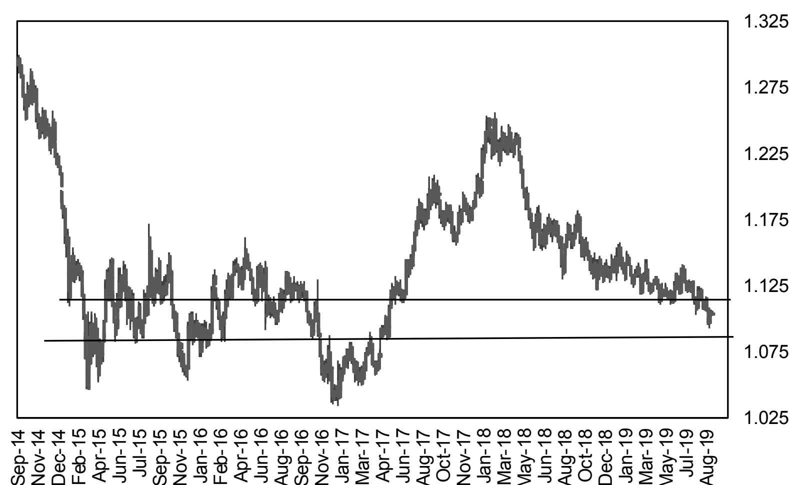
Manufacturing Downturn Shows No Signs Of Rebounding
Eurozone – PMIs & Confidence Indicators



Source: Markit, Zew, Sentix, Fitch Solutions

More accommodative monetary policy in the eurozone, alongside a more bullish view on the US dollar and prolonged Brexit- and trade war-related uncertainty, will weigh on the euro. To reflect this, we recently revised down our forecasts for the euro.

Trading Range To Stand Firm
Exchange Rate, USD/EUR



Source: Bloomberg, Fitch Solutions

We now expect the unit to end 2019 at USD1.09/EUR, down from USD1.15/EUR previously, which takes down our full-year average from USD1.14/EUR to USD1.11/EUR (*see 'EUR: Retreating On Dollar Strength', September 16*). In 2020 we expect the unit to average

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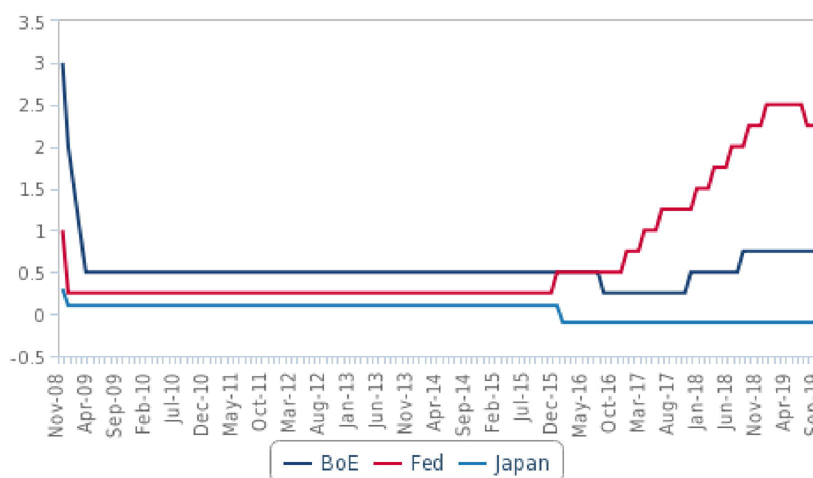
USD1.11/EUR, which means that the unit will likely trade within a range of USD1.05-1.15/EUR. Risks to our forecast remain firmly tilted towards additional weakening of the euro. If the UK were to crash out of the EU without a deal, or if US-China trade tensions were to escalate further, macroeconomic conditions across the currency union would deteriorate significantly and the downside pressures on the euro would intensify.

Weakening economic momentum across the globe is leading to a downward convergence of central banks' monetary policies (*see chart below*). The transition from an early 2019 'patient approach' to rate hikes to outright interest rate cuts currently will continue to unfold against a backdrop of weakening growth momentum amid lingering domestic and external uncertainty. Persistently weak inflation against a backdrop of slower growth momentum were key factors behind the US Federal Reserve's decision to deliver fresh monetary policy stimuli in September (*see 'Quick View: 'Hawkish Cut' By US Fed Suggests Limited Appetite For Further Easing', September 19*).

Central Banks To Press Ahead With Fresh Monetary Stimulus
Main Policy Rate, %



Source: Fed, BoJ, BoE, Fitch Solutions

With a quick solution to Brexit remaining elusive, there is little chance that the ongoing downside pressure on the UK economy will abate any time soon. This prompted the Bank of England to keep its bank rate unchanged at 0.75% during its last monetary policy meeting in September, despite inflation and inflation expectations remaining above target (*see 'Rising Recession Risks To Prompt A Dovish Monetary Policy Response In The UK', September 6*). The Bank of Japan will continue to pursue non-standard policy measures as inflation continues to undershoot expectations and growth remains low (*see 'Bank Of Japan Likely To Face Growing Pressure To Take Action', June 20*).

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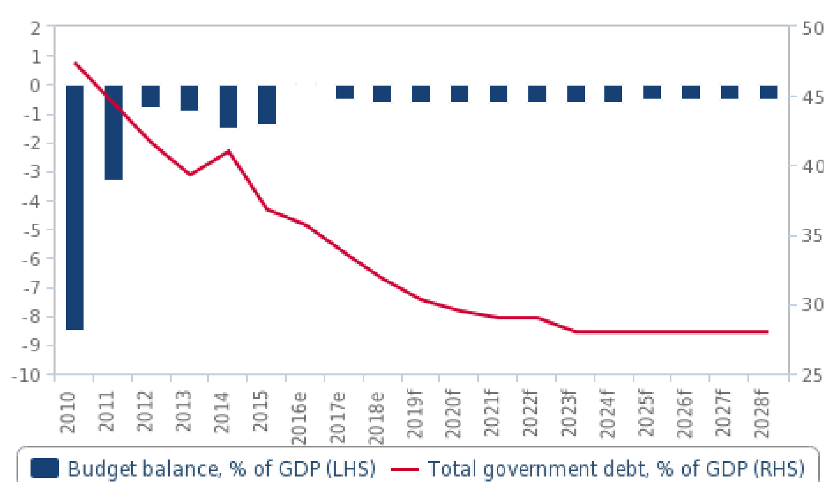
Structural Fiscal Position

While an ageing population will put upside pressure on welfare spending, Latvia will continue to run only minimal fiscal deficits. After enacting among the most stringent fiscal consolidation plans experienced in any country within the EU, Latvia's public finances are finally beginning to reap the benefits, with public debt levels finally starting to fall. We expect a sustained decline in public debt levels across our forecast period, overseen by a government with a strong track record of fiscal consolidation and strong real GDP growth. This will lead to a sustained reduction in government debt ratios over the coming years.

Tight Budget To Allow For Debt Reduction
Gross Debt & Fiscal Balance, 2010-2028



e/f = Fitch Solutions estimate/forecast. Source: Eurostat, Fitch Solutions

Budget Outlook: The government's budget returned to a positive balance in 2016, owing to stronger growth and better tax collections, but returned to a small budget deficit in 2017 and 2018. The budget for 2019 prioritised higher spending in healthcare and infrastructure. The steepest increase was planned for Latvia's health budget, which grew by EUR154mn. Defence spending will stand at the NATO-mandated 2.0% of GDP. For the longer term, we project the government's budget deficit to remain at small and manageable levels.

Overall, despite strong real GDP growth, we do not expect to see a marked deviation from the government's track record of strong fiscal discipline over the coming years. Despite the budget deficit now being below the EU-mandated 3.0% of GDP, fiscal consolida-

TABLE: MAIN REVENUE AND EXPENDITURE CATEGORIES

	Revenues, %		Expenditure, %
Taxes on production and imports	35.1	Social benefits	30.0
Social contributions	24.2	Compensation of employees	26.0
Current taxes on income and wealth	21.8	Intermediate consumption	18.2
Market output, output for own final use & other non-market output payments	9.2	Gross capital formation, acquisitions less disposals of non-fin non-prod assets	12.6
Capital transfers	4.4	Other current transfers	7.2
Other current transfers	3.0	Property income	4.4
Property income	2.3	Subsidies	1.6

Source: Eurostat, Fitch Solutions

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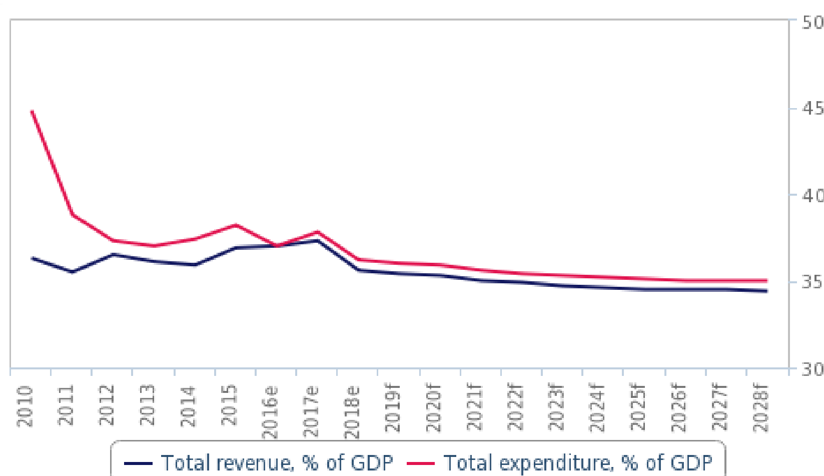
tion will continue for the foreseeable future. There is a broad level of consensus among the government and opposition parties regarding the need to keep spending in check. The government also implements a multi-year stability programme which acts as a strong anchor for budget discipline.

Spending And Revenue To Remain Mostly Stable
Government Spending & Revenue, 2010-2028



e/f = Fitch Solutions estimate/forecast. Source: Eurostat, Fitch Solutions

Public Debt Outlook: Despite climbing sharply during the post-global financial crisis period, Latvia's debt load is extremely low versus other eurozone peers. With the fiscal deficit set to remain below 1.0% of GDP, a combination of steady economic activity and inflation will see the debt-to-GDP ratio decline across our 10-year forecast period, further improving the already strong position of Latvia's public finances. Latvia also benefits from a relatively favourable debt maturity profile, with only 28% of debt due before 2021, and 64% due after 2024. This provides a good level of insulation against liquidity shocks, although given the country's strong credit profile, this is not a major risk factor. FX risk is present but minimal: around 35% of total public debt is issued in US dollars, which will cost more to service as a result of the recent weakness in the euro. However, given that this amounts to around 14% of GDP, the impact on government finances will be modest.

Structural Outlook: We have written at length about the huge challenges that population decline poses to Latvia's growth and debt sustainability. Despite the favourable short-term outlook given the government's strong bias for fiscal consolidation and conservative debt strategy, medium-term risks to Latvia's fiscal and debt dynamics are significant. Predominantly, these risks stem from the

TABLE: FISCAL AND PUBLIC DEBT FORECASTS

	2017e	2018e	2019f	2020f	2021f	2022f	2023f	2024f	2025f	2026f	2027f	2028f
Total revenue, EURbn	10.1	10.5	11.0	11.6	12.2	12.8	13.4	14.1	14.8	15.5	16.3	17.1
Total revenue, EUR, % y-o-y	8.7	4.3	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Total expenditure, EURbn	10.2	10.7	11.2	11.8	12.4	13.0	13.6	14.3	15.0	15.8	16.6	17.4
Total expenditure, EUR, % y-o-y	10.3	4.6	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Budget balance, EURbn	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.3	-0.3
Budget balance, % of GDP	-0.5	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.5	-0.5	-0.5	-0.5
Total government debt, USDbn	10.3	11.1	10.5	10.8	11.3	12.1	12.4	13.2	13.9	14.6	15.4	16.2
Total government debt, % of GDP	33.7	31.8	30.3	29.5	29.0	29.0	28.0	28.0	28.0	28.0	28.0	28.0

e/f = Fitch Solutions estimate/forecast. Source: Eurostat, Fitch Solutions

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huge demographic challenges facing the country, which are the result of high levels of negative net migration and low birth rates. Between 1995 and 2014, Latvia's population declined by 20%. While government debt loads are low, they are de facto secured on the future revenues of taxpayers, and with Latvia's dependency ratio forecast to increase from 49% in 2012 to 59% in 2030, the ratio of government debt to economically active citizens will increase faster than government debt per capita. Over the long term, high levels of emigration and a smaller population will present challenges to the sustainability of public finances, particularly in light of the growing dependency ratio. Nonetheless, given that we expect Latvia to have made good progress in reducing its public debt load over the next 10 years, these risks should become less salient.

Currency Forecast

EUR: Retreating On Dollar Strength

Key View

- A strong US dollar, increasingly accommodative European Central Bank monetary policy, prolonged Brexit uncertainty and trade tensions will weigh on the euro over the short term.
- We have thus revised down the unit's 2019 average from USD1.14/EUR to USD1.11/EUR.
- Over the longer term, the euro also looks weaker than we assumed previously, as a likely expansion of the ECB's bond buying programme in 2020 will cap the unit's recovery from the downturn in 2019.
- Risks to our forecasts are notably tilted towards EUR depreciation, as a hard Brexit or an escalation in global trade tensions could send the unit towards parity against the dollar.

Short-Term Outlook (three-to-six months)

We at Fitch Solutions have revised down our forecasts for the euro. We now expect the unit to end 2019 at USD1.09/EUR, down from USD1.15/EUR previously, which takes down our full-year average from USD1.14/EUR to USD1.11/EUR. This revision is based on three key factors:

- USD strength
- More accommodative European Central Bank monetary policy
- Prolonged Brexit & trade war uncertainty

1. USD strength. While we previously held a neutral view on the dollar, we now believe that the unit is poised for appreciation, although in the absence of significant risk, dollar strength should be limited (*see 'US Dollar View: From Neutral To Bullish', September 9*). We base this assumption on our conviction that futures markets are currently overpricing the extent of US Federal Reserve cuts. While markets are currently pricing in about 50 basis points (bps) worth of cuts by the end of 2019 and another 50bps by the end of

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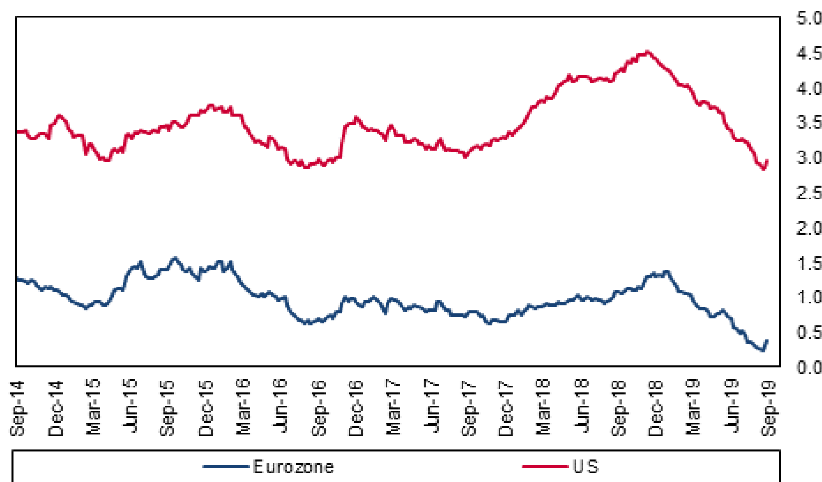
2020, we only expect one more 25bps cut this year and none throughout 2020. Fewer cuts than markets currently expect should keep the USD on the front foot, limiting the extent of any appreciation of the euro against the greenback.

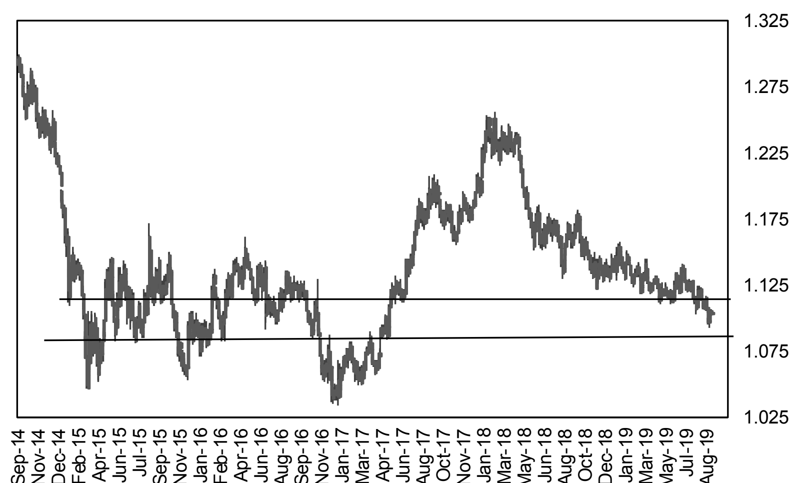
EUR Assets Remain Unattractive
Corporate Investment Grade Yields, %



Source: Bloomberg, Fitch Solutions

2. More accommodative European Central Bank monetary policy. On September 12 the European Central Bank (ECB) finally backed up its increasingly dovish rhetoric, delivering a 10bps cut to the deposit rate (now -0.5%), and announcing that it will restart its bond-buying programme (QE) at a monthly pace of USD20.0bn as of November 1 (*see 'Quick View: ECB Delivers Fresh Monetary Stimulus And More Likely To Come', September 12*). This will in turn continue to pin down eurozone bond yields, which remain substantially lower than their counterparts in the US (*see chart above*). As a result, the currency union's assets will remain relatively unappealing for yield-hunting investors.

Trading Range To Stand Firm
Exchange Rate, USD/EUR



Source: Bloomberg, Fitch Solutions

3. Prolonged Brexit and trade war uncertainty. Our previous euro forecasts were predicated on the assumption that Brexit- and trade war-related growth risks for the eurozone would gradually subside, yet the opposite now appears to be unfolding. The risk of

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a 'hard' Brexit has substantially increased since our last update on the euro, in which we envisioned that the UK would eventually go down a 'soft' Brexit route. Instead, the chances of no deal are now on par with the chances of a Brexit deal (*see 'Brexit: Three Scenarios – No Deal Probability At Parity With Deal', September 2*), and we do not expect the current deadlock to be resolved before late October. At the same time, the risk of higher tariffs in the US-China trade war has also increased (*see 'USD-China Trade War: Increasing Risk Of Still Higher Tariffs', August 27*), which will continue to weigh on foreign demand for global exports.

Bearish Positioning Still Contained

Net EUR Future Contracts

Note: Net future positioning = difference between long and short euro contracts. Reading above 0 = long & below 0 = short. Source: Bloomberg, Fitch Solutions

From a technical perspective, the aforementioned headwinds imply that the euro will continue to trade in a weak range of USD1.08-1.12/EUR. However, if the unit were to break through technical support at USD1.08/EUR, a move towards resistance near USD1.05/EUR could be on the cards, which we do not expect for the time being, as USD/EUR speculative positioning currently does not appear to be stretched.

Long-Term Outlook (six-to-24 months)

We have also revised down our longer-term forecasts for the euro. Compared to USD1.17/EUR in 2020, we now expect the unit to average USD1.11/EUR for the year as a whole, which means that the unit will likely trade within a range of USD1.05-1.15/EUR. On the one hand, the ECB's dovish monetary policies will continue to keep a lid on the EUR. In fact, we believe that the ECB could ramp up its bond-buying programme (it is currently set at EUR20bn per month, which is far from EUR80bn when it ran in full steam in 2016) in the event of a further moderation of economic momentum or a further de-anchoring of inflation expectations, which still remain well below the bank's official 2.0% target. On the other hand, the whole-year average suggests that the currency could be somewhat resilient, primarily on the back of the two following factors. First, we still expect that real GDP growth in the eurozone will stabilise

TABLE: EUROZONE CURRENCY FORECAST

	SPOT	2019	2020
USD/EUR, ave	1.11	1.11	1.11
USD/EUR, eop	1.11	1.09	1.11
ECB Main Refinancing Rate, %	0.00	0.00	0.00

Note: Last updated on September 11. Source: Bloomberg, Fitch Solutions

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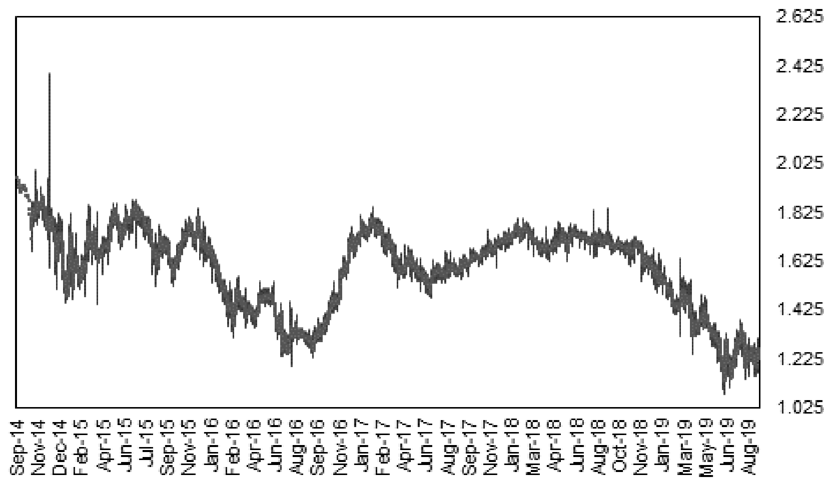
at an average of 1.3% in 2020-2021, after falling from 1.9% in 2018 to an estimated 1.2% in 2019. Second, the euro appears to be fairly valued, while the US dollar is currently overvalued by around 10%, which opens up some space for EUR gains against the USD.

Inflation Target Remains Elusive
Eurozone – 5Y5Y Inflation Swap, %



Source: Bloomberg, Fitch Solutions

Risk To Outlook

Risks to our forecast remain firmly tilted towards a weakening of the euro. If the UK were to crash out of the EU without a deal, or if US-China trade tensions were to escalate further, macroeconomic conditions across the currency union would deteriorate significantly and the downside pressures on the euro would intensify.

Downside Scenario Would Push Euro Towards Parity
Exchange Rate, USD/EUR (daily)

Source: Bloomberg, Fitch Solutions

In such a scenario, a move below support near USD1.05/EUR (*see chart above*) would appear likely, with longer-term EUR/USD parity remaining a real possibility. However, if a marked friendly Brexit deal were to be passed in October, the unit would receive some tailwinds over the short term.

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10-Year Forecast

The Latvian Economy To 2028

Looking For A 'New Normal'

Key View: *After three years of growth outperformance following one of the worst recessions in Europe, we think that growth is set to progressively slow over the next 10 years, as the country struggles with competitiveness and demographic challenges.*

While considerable attention is often paid to Latvia's pre-crisis trend growth, often in the context of anti-austerity arguments to dismiss the strength of the economy's post-crisis growth, extrapolations of pre-crisis growth seem inaccurate. Latvia's growth rates in the 2005-2007 period must be understood within the context of an economy that was overheating as a result of a foreign-capital driven investment boom, which pushed growth well above trend. IMF estimates indicate that the economy was probably operating around 5-10% above potential before the crisis, although this figure could be substantially higher just before the end of the boom. It is therefore not of major significance, in our opinion, that real GDP is likely to remain below the 2005-2007 trend over the next decade.

Using a period of more modest economic growth, such as 1995-2005 trend GDP, suggests that after several years of catch up, Latvia is close to pre-crisis trend growth. The structure of the labour market has changed significantly over the last five years due to heavy emigration. The country is nearing pre-crisis unemployment levels owing to an increasingly tight labour market. While this appears large, it is consistent with the unemployment rate having been historically high in Latvia: the average unemployment rate between 1996 and 2011 was above 13%.

Based on this assessment of Latvia's output gap, expectations for the recent period of high growth to continue indefinitely should be moderated, given that we expect the economy to settle on a lower growth path over the long term. Nonetheless, our forecast for real GDP growth of 2.7% on average over the next decade is not unimpressive, and places Latvia firmly in the middle of our emerging market economies. However, with the days of raging credit-fuelled consumption now likely to have passed, we expect to see more stable current account dynamics out to 2028. Given the emergence of a substantial current account surplus since 2009, and with domestic demand (and imports) likely to remain weaker over the medium-to-long term, we expect the current account to post manageable deficits going forward.

Eurozone Accession Is No Magic Bullet

In line with our long-held expectations, Latvia finally joined the eurozone in January 2014. However, we think that the upside potential created by euro membership will be rather limited, even over a long-term horizon. From a structural perspective, eurozone

TABLE: LONG-TERM MACROECONOMIC FORECASTS

	2019f	2020f	2021f	2022f	2023f	2024f	2025f	2026f	2027f	2028f
Nominal GDP, EURbn	31.2	32.8	34.7	36.6	38.6	40.7	42.9	45.0	47.3	49.7
Real GDP growth, % y-o-y	2.7	2.6	3.2	2.9	2.9	2.8	2.7	2.5	2.5	2.5
Population, mn	1.91	1.89	1.87	1.85	1.83	1.82	1.80	1.78	1.77	1.75
GDP per capita, EUR	16,353	17,412	18,604	19,816	21,099	22,442	23,826	25,266	26,791	28,408
Consumer price inflation, % y-o-y, ave	2.7	2.6	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Current account balance, % of GDP	-1.3	-1.2	-1.2	-1.0	-1.0	-0.9	-0.8	-0.7	-0.6	-0.5
Exchange rate EUR/USD, ave	0.90	0.90	0.89	0.88	0.87	0.86	0.86	0.86	0.86	0.86

f = Fitch Solutions forecast. Source: National sources, Fitch Solutions

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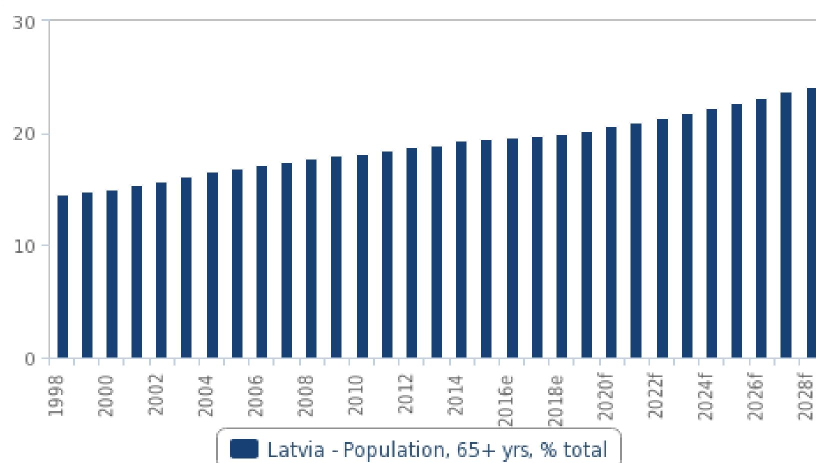
membership carries benefits as well as downside risks. In theory, Latvia will stand to benefit from a reduction in exchange rate risks, which may help to promote foreign investment, as well as improvements in trade dynamics due to the use of a common currency. In reality, foreign exchange risk has been minimal anyway – the lat has been pegged throughout its entire existence, and to the euro since 2005. While speculation mounted that the lat's stability was at risk after the 2008 financial crisis, the government instead opted to pursue painful internal devaluation in order to stay in ERM-II and on course for eventual eurozone entry.

Improvements to its overall sovereign creditworthiness are unlikely to be anywhere near as drastic as those experienced by countries such as Greece. Latvia's fiscal and debt dynamics already place it among the strongest of its eurozone peers, and this is reflected in its sovereign borrowing costs, where it pays a spread of around 100 basis points over comparable German bonds. Furthermore, Latvia's central bank retains a level of credibility that is among the highest in emerging Europe. Both these factors suggest that eurozone membership is unlikely to mean any major benefits for its sovereign creditworthiness.

From a banking sector perspective, euro membership will remove the FX imbalances in the banking sector, although as the economy is partially dollarised, the risk from FX mismatch is reasonably low anyway. Banks will benefit from improved access to European Central Bank liquidity facilities, mitigating some of the external liquidity risk. However, overall liquidity in the domestic banking sector is reasonably strong anyway, and most of the domestic client-facing banks are self-funded, while banks catering to non-resident clients are subject to more stringent liquidity requirements

A Rapidly Ageing Society
Pensionable Population, % Of Total



e/f = Fitch Solutions estimate/forecast. Source: National sources, Fitch Solutions

Demographics Are A Major Long-Term Challenge

Over the long term, Latvia's demographics are among the worst in Europe. The country has suffered high levels of emigration since 1992, peaking after the 2008 financial crisis pushed unemployment up to 20% as the economy suffered one of the worst recessions of the crisis. Our forecasts predict average annual population contraction of 0.5% a year. The majority of migrants are under 30 years of age, increasing the likelihood of a 'top heavy' ageing population by 2030. In addition to high levels of emigration from Latvians seeking employment prospects abroad, the low birth rate is also exacerbating the population decline. This is likely also due to women of child-bearing age emigrating, in addition to the uncertain economic outlook.

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While the government has become more proactive in tackling Latvia's demographic challenges, it will not be easy. Surveys suggest that after three years, the number of emigrants planning to return to Latvia in the short run drops from 10% to just 3%. The economic cost of emigration will be severe: Latvia is losing a large chunk of its most skilled and able workforce, and the aged dependency ratio is set to increase substantially, placing the social security net under strain. While near-term growth prospects are solid, Latvia's demographic outlook remains a major impediment to long-term prosperity.

Our long-term macroeconomic forecasts are based on a variety of quantitative and qualitative factors. Our 10-year forecasts assume in most cases that growth eventually converges to a long-term trend, with economic potential being determined by factors such as capital investment, demographics and productivity growth. Because quantitative frameworks often fail to capture key dynamics behind long-term growth determinants, our forecasts also reflect analysts' in-depth knowledge of subjective factors such as institutional strength and political stability. We assess trends in the composition of the economy on a GDP by expenditure basis in order to determine the degree to which private and government consumption, fixed investment and the export sector will drive growth in the future. Taken together, these factors feed into our projections for exchange rates, external account balances and interest rates.

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Political Outlook

Domestic Politics

2020 Budget To Prove A Hurdle For Governing Coalition

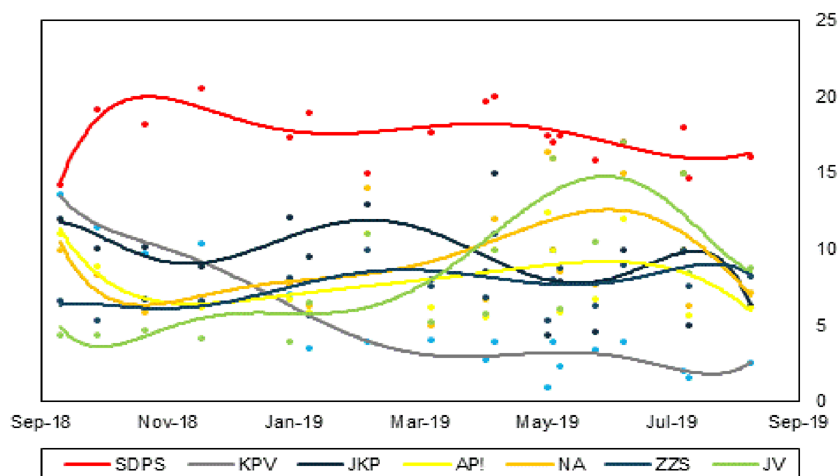
Key View

- Latvia's five-party ruling coalition will continue to face difficulties governing and remain at risk of collapse. The coalition is experiencing friction in most policy reform areas.
- We at Fitch Solutions believe that this lack of reform momentum is resulting in voters shifting support back to established parties, reversing the trend that favoured newer parties in the last parliamentary election.
- Progress in eradicating money laundering will continue, as it remains a key priority on which parties are largely aligned.

Latvia's five-party government will continue seeing intra-coalition friction. As we have highlighted in the past, the fractious coalition is very well aligned on reform to crack down on money laundering, but it will likely run into trouble agreeing on other policies. The coalition is composed of the centre-right reformist New Conservative Party (JKP), liberal 'Development/For?' (AP?), established conservative party New Unity (JV), nationalist National Alliance (NA) and 11 of 16 MPs from the anti-establishment 'Who Owns The State?' (KPV). The government is headed by Prime Minister Krišjānis Kariņš of New Unity. The presence of five sets of demands for governance means that reform momentum will remain slow, except for issues on which all parties align, such as anti-money laundering regulation. Our view remains that this coalition is at significant risk of collapse, as if any party bar JV defects, the coalition would lose its 61-seat majority in the 100-member parliament. In the event of a collapse of the coalition, talks would still be possible with the Union of Greens and Farmers (ZZS), but if they were to fail, snap elections would likely be called.

Anti-Establishment KPV Losing Support

Opinion Polls, %



Source: Various polling agencies, Fitch Solutions

The 2020 budget will be a key issue that the parties will have to agree on over the coming months. Thanks to robust economic growth, expenditure will grow without leading to a significant widening of the fiscal deficit in the coming years. While there is a gen-

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eral consensus for a slight increase in defence spending, the parties disagree on the allocation of the rest of the extra funds. Some of the main potential uses cited for these funds have been the healthcare sector or higher wages for some government workers. Despite these differences, all parties have signaled resolve to agree on the 2020 budget, so we do not believe that this will lead to a political deadlock.

The slow pace of general reform will likely lead to dwindling support for the newer parties. The October 2018 parliamentary election was marked by a widespread shift of support from older parties to newer parties. We attribute this shift to a perception of widespread corruption in the political and business environment, with many voters punishing established parties and turning to newer parties. This trend has reversed in the year since the election, due in part to perceived under-delivery of reform by such a fragile coalition. This is particularly the case for the anti-establishment KPV, which received the second-highest number of votes with around 14.3% in the general election, but has been polling below 5.0% since early 2019.

Anti-Money Laundering Reforms Going Ahead As Expected

A key area where reforms are well underway is Anti-Money Laundering (AML) regulation. Over the 2000s Latvia gained a reputation as an international money-laundering hub, given its specialised sector of boutique banks serving foreign clients. In 2018 the US authorities named **ABLV Bank** a money-laundering institution, leading to a subsequent scandal and the channeling of political will towards improving Latvia's reputation. This was a key point on which many candidate parties agreed leading up to the October 2018 parliamentary election. In August 2018 MONEYVAL, the Council of Europe's AML and terrorism financing evaluation committee, issued a report highlighting Latvia's importance as a financing centre for clients mostly in the Russia & CIS region. In late August 2019 the Latvian ministry of finance submitted a report showing tangible progress in most key AML policy areas recommended by MONEYVAL, underlining Latvia's political commitment to fighting money laundering.

Long-Term Political Outlook

Delayed Economic Recovery Accentuates Demographic Issues

Key View: *The coming decade for Latvia will be marked by the scars of the global financial crisis of 2008/09. The country's government will struggle to keep growth at pre-crisis levels and will pay the political and social price for this inability to promote growth and ease ethnic tensions.*

The global financial crisis of 2008/09 had a particularly severe impact on Latvia economically and socially. We expect the next decade to be marked by stagnant economic growth, latent ethnic tensions and continued efforts to reduce energy dependence on neighbouring Russia. We previously highlighted our expectation for tensions in the Baltic region to remain high against the backdrop of an increasingly confrontational Russian state. We expect this theme to dominate Latvia's long-term political outlook as it has the country's past. Latvia scores fairly high in our proprietary Long-Term Political Risk Index, coming in at 77.3 out of 100. However, we caution that there are a number of risks to the country's longer-term stability.

Challenges And Threats

Slower Economic Growth: Economic stagnation threatens to severely undermine the country's long-term political risk profile. Latvia was the hardest hit European country in the global downturn, with the collapse of **Parex Bank** in 2008 forcing the government to seek IMF aid and eventually agreeing to a three-year EUR7.5bn loan from the lender. The ensuing aggressive fiscal austerity

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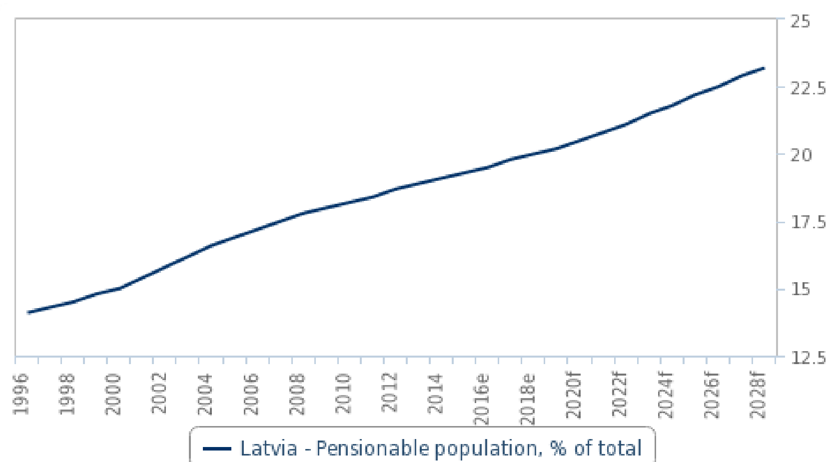
measures compounded the international credit crunch and slowdown in trade and Latvia was plunged into three consecutive years of recession. Real GDP fell by 17.7% in 2009 alone, one of the biggest collapses of any EMEA economy.

We forecast real GDP growth to average around 2.9% over 2019-2023 and then to remain around 2.6% over the period 2024-2028, compared to the average 8.3% real GDP recorded in the period 2000-2006. This is predicated on our expectation that the economic rebalancing to correct a number of imbalances racked up during the pre-crisis boom years will take at least a decade to unwind. We do not expect household consumption to return to pre-crisis highs of 21.4% growth seen in 2006, rather forecasting 3.0% average annual growth over 2019-2028. This will have important repercussions for social and political stability as future governments attempt to improve economic growth and employment prospects for future generations. Further lending credence to our view for economic stagnation are the demographics of Latvia.

Rapidly Dwindling Population: Owing to the lack of job prospects in the country as the government forced a fierce internal devaluation to rebalance the economy, many Latvians simply chose to leave and look for job opportunities elsewhere. While we do not expect to see net migration continue at this pace in the coming years, given that the population has already fallen some 13% since 1999, we do expect the population to continue its general decline due to emigration and natural population controls. This will have serious repercussions for the long-term economic outlook of the country, given the rapidly rising dependency ratio. The ongoing fall in the productive population (a problem across emerging Europe) will put pressure on the government's ability to maintain social safety nets amid falling income tax revenues.

Falling Population A Key Threat
Latvia – Pensionable Population, % Of Total



e/f = Fitch Solutions estimate/forecast. Source: UN, Fitch Solutions

Ethnic Tensions: These are likely to remain a dominant theme in Latvian politics over the coming decade. Ethnic Russian and Russian-speaking minorities make up 33.3% of the population against 59.5% ethnically Latvian. There have been repeated calls from the Russian government and minority rights groups for Latvia to improve its treatment of Russian speaking minorities. The government maintains the policy of non-citizen status (whereby 'stateless' citizens of the former USSR are granted limited rights in Latvia) for many Russian speaking residents, and most official documents are not translated into Russian despite a large portion of the citizenry using Russian as its primary language.

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The implications of ongoing ethnic tensions are potentially huge. In the election held in October 2014 the Russian party Harmony Centre gained the largest share of the vote and the most seats in parliament, but was left out of coalition building, mirroring the events of the previous election. The continued rejection of Russian interest parties in mainstream politics could have the damaging impact of radicalising more right-leaning elements among the Russian-speaking electorate. This would also be lent momentum by the similar nationalist process already underway in Russia, led by the resurgence of the 'Russia for Russians' movement. The impact on domestic politics and social cohesion in Latvia would be highly damaging, as the two electorates and their orientations (towards NATO/EU on the one hand and Russia on the other) move further away from each other.

Scenarios For Political Change

Best-Case Scenario: Our best-case scenario for Latvia over the next 10 years sees the political parties that represent ethnic Russians (mainly Harmony) and Latvians working together to increase social harmony and mend past grievances. This would also have the knock-on effect of creating stronger, more sustainable coalitions, in turn improving the policy continuity and enforcement environment. Improved relations between ethnic groups would have the added benefit of improving relations with neighbouring Russia and could give Latvia a more prominent position in the region's foreign policy dynamics.

We view this best-case scenario as only second most likely, given the deep-seated distrust between Latvians and ethnic Russians based on the perception of Russia as occupiers rather than liberators following WWII.

Intermediate Scenario: The status quo remains. This would entail weak coalition governments over the course of the forecast period, given the main parties' refusal to include Harmony in coalition building, thereby essentially ignoring the interests of a quarter of the population. The political landscape will likely be littered with collapsed coalitions as political parties struggle to address the challenges listed above and attempt to counter domestic minority interest in closer ties with Russia by continuing to push for Western integration.

We view this scenario as the most likely for the coming decade.

Worst-Case Scenario: Our worst-case scenario for Latvia sees a complete denigration of ties with Russia, which would likely be sparked by an event involving the mistreatment of the ethnic Russian and Russian speaking minority. In this eventuality, given the high uncertainty regarding the NATO guarantee to the region over the coming decade (*see 'NATO Relevancy Questioned, But Viable Alternatives Lacking', June 27 2016*), the benefits of all-out conflict, or even diplomatic spats, would fall to Russia due to the asymmetrical relationship between the Baltic country and its goliath neighbour.

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Operational Risk

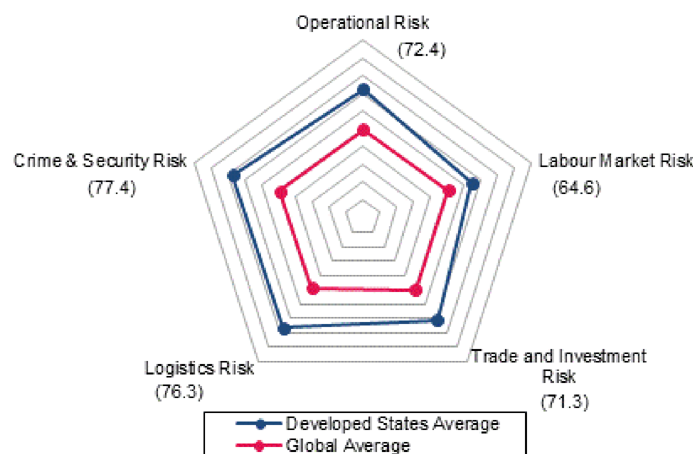
Developed States

Our Operational Risk report series provides a comprehensive overview of potential risks facing investors operating in a country, as well as a cross-country regional evaluation of threats and advantages. The Operational Risk service evaluates Logistics Risk, Trade And Investment Risk, Labour Market Risk and Crime And Security Risk. Below are sections from these reports.

Businesses in developed states benefit strongly from the availability of reliable, high-quality utilities and transport infrastructure, generally open and more predictable trade and investment policies, deep and sophisticated capital markets and highly skilled workforces. This gives them a distinct advantage over those operating in emerging and frontier markets, particularly in the areas of logistics and trade and investment risks. Additionally, while developed states are at the forefront of surging populism, crime and security risks, instances of violent social protest and political change that would endanger business activities are lower mainly because of their mature democracies and more civilised societies compared to those of emerging markets.

Superior Performance Across The Board Boosts Attractiveness

Developed States – Operational Risk Scores



Note: 100 = Lowest risk; 0 = highest risk. Source: Fitch Solutions Operational Risk Index

Nevertheless, ageing populations underpinned by stagnating fertility rates and upward wage pressure across all sectors are key long-term risks for labour-intensive businesses in developed states. Furthermore, the strong competition in largely saturated developed markets necessitates considerable investment in technological upgrades, cybersecurity and skills development, which raises costs for businesses. Finally, the US's assertive foreign policy under President Trump seeking to put US interests first has significantly contributed towards increasing global tensions, particularly with Iran, China, Venezuela and North Korea. This is elevating business exposure to various forms of interstate conflict risks, such as cyberwarfare, trade protectionism and military confrontations, denting broad-based trade and investment opportunities, particularly in sectors such as manufacturing and ICT.

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Labour Market Risk

Weak demographic trends in developed markets, underscored by low birth rates and ageing populations, will significantly tighten recruitment options for firms and potentially drive up labour costs over the medium term, particularly for manufacturers that generally require a steady and large supply of workers. In addition, stringent regulations regarding the protection of workers' rights, onerous social security contributions and tax obligations as well as hefty severance pay requirements drive up labour costs for businesses operating in developed states. For most developed states, the Labour Cost component is their worst performing component in the Labour Market Risk Index, with Italy being the least competitive in this regard with a score of 25.5 out of 100. This is largely due to having one of the highest minimum wages (USD1,898.4), generous labour tax contributions (34.8% of commercial profits) and annual paid leave of 26 days. Finland, Belgium, France and Portugal are other worst performing markets while the US has the highest (most competitive) score with regard to labour costs among all the developed states. While businesses face high remuneration costs for labour, they are compensated for this by the availability of highly skilled workers due to the strong educational systems

TABLE: LABOUR MARKET RISK INDEX

Country	Education	Availability Of Labour	Labour Costs	Labour Market Risk
US	91.5	71.3	81.0	81.3
Switzerland	82.3	68.0	74.8	75.0
Denmark	83.3	63.0	78.0	74.8
Canada	89.4	70.0	63.7	74.3
New Zealand	78.9	71.0	71.2	73.7
Japan	86.6	63.4	67.3	72.4
UK	86.5	70.4	57.4	71.4
Israel	83.8	72.9	57.4	71.4
Isle of Man	82.5	54.6	70.2	69.1
Australia	87.5	73.1	42.8	67.8
Sweden	85.5	70.4	47.3	67.7
Ireland	80.7	63.9	55.7	66.8
Netherlands	82.4	68.9	46.5	65.9
Germany	89.5	68.0	39.0	65.5
Norway	82.2	68.8	40.9	64.0
Estonia	79.0	57.6	51.9	62.9
Austria	82.9	61.2	38.2	60.8
Latvia	77.9	51.3	52.9	60.7
Iceland	70.2	68.4	43.3	60.6
Lithuania	79.8	49.6	51.4	60.2
France	81.2	67.7	31.3	60.1
Liechtenstein	62.2	58.3	59.1	59.8
Spain	77.9	63.3	37.1	59.4
Belgium	78.7	64.8	31.2	58.2
Finland	76.0	61.4	30.0	55.8
Malta	55.1	52.7	56.8	54.9
Italy	76.9	61.2	25.5	54.5
Luxembourg	62.8	57.7	42.1	54.2
Greece	71.6	52.2	38.7	54.2
Portugal	67.7	53.8	33.6	51.7

Note: 100 = Lowest risk; 0 = highest risk. Source: Fitch Solutions Labour Market Risk Index

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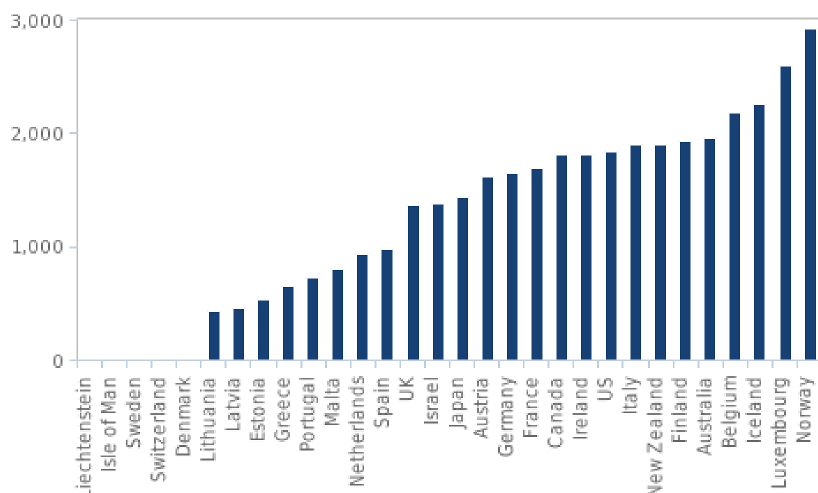
and attainment levels across developed markets. This together with strong investment in research and development boost worker productivity and give businesses access to advanced and highly efficient production systems.

According to the World Bank, the average labour tax and contributions in developed states was equal to 21.1% of commercial profits in 2018 (latest available data). This is substantially higher than the global average labour taxation and contributions rate of 15.1% of commercial profits and therefore poses significant cost risks to businesses considering entering these countries. In particular, we highlight France and Belgium as having the highest labour taxation and contributions rates of 49.7% and 46.2% respectively. Therefore, these countries expose businesses to the most significant risks in this regard. Spain, Sweden, Italy and Austria all have labour tax rates above 33% of total profits. In some of these countries, such as Belgium, Italy, Sweden and Austria, the high taxation rate is partly mitigated by the lack of legally required severance pay for redundancy dismissals. In Spain, however, high labour taxes are further accompanied by exorbitant severance pay requirements of 15.2 salary weeks in case of redundancy dismissal, which is far above the regional average of 5.1 salary weeks.

Certain developed states, however, have extremely competitive labour tax rates, offering advantages to those businesses keen to establish themselves in a developed state with the benefits of good physical infrastructure, a well-educated labour force and a well-developed bureaucratic environment. These lower-risk countries include the UK and the US, with labour tax rates of 10.8% and 9.8% respectively, as well as New Zealand at only 2.8%, which is one of the lowest labour tax rates in our Operational Risk Index among those countries that have labour tax and contributions in terms of statutes. In addition to low labour tax rates, businesses looking to enter these three markets will further benefit from low or a lack of severance pay requirements, with only the UK requiring mandatory severance pay (at 4.0 salary weeks).

High Minimum Wages Partially Compensated For By Strong Productivity Levels

Developed States – Minimum Wages (USD/month), 2018



Note: As applicable to the worker assumed in the case study. Source: World Bank 'Doing Business'

Additional costs to employers stem from the relatively high minimum wages seen in developed states. At USD1,260.0 per month on average, minimum wages in developed states are substantially higher than the majority of emerging markets and significantly higher than the global average of USD377.2 per month in 2018. This is largely due to the more established legislation protecting the workforce and the stronger unionisation seen in many of these countries. The highest minimum monthly wages are found in

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Norway, at USD2,923.3 per month and Luxembourg, at USD2,603.0 per month. In contrast, for those states in the region that have legislated minimum wages, Lithuania, Latvia, Estonia and Greece have some of the lower monthly minimum wage requirements at USD424.8, USD461.3, USD530.7 and USD652.5 respectively. However, even in these latter markets actual wages are highly likely to be well above the minimum wage due to the high competition for labour and the fact that workers in developed states have good educational attainment levels that will push wages higher.

Five countries (Denmark, Switzerland, Liechtenstein, the Isle of Man and Sweden) have no legislated minimum wage, offering a substantial reduction in labour costs for incoming businesses. Nevertheless, we note that average wages in these countries remain among the highest globally and most businesses will face elevated wage bills even when employing relatively low-skilled workers. Furthermore, due to tightening demographic trends, underscored by ageing populations, particularly in countries such as Italy (among others in Western Europe) and Japan, wages relative to productivity may become increasingly uncompetitive while recruitment options are likely to tighten as the relative proportion of working-age population to total population in developed states decline over the medium-to-long term.

Although wages are generally high in developed states, the redundancy requirements for the majority of these countries are relatively low, or even non-existent. Half of the countries included in the developed states rankings have no legal requirement for severance pay, including the US, Norway, Finland, Denmark, Japan, the Netherlands, Malta and New Zealand. However, on the other end of the spectrum, Spain (with requirements of 15.2 weeks of severance pay for redundancy dismissal), Greece, Israel and Germany pose significant cost risks, as businesses are obligated to provide more than 15.9 weeks, 23.1 weeks and 11.6 weeks of severance pay to dismissed workers respectively.

Other key operational considerations that businesses must take into account include labour market vectors such as the size, composition and skill set of the workforces in developed states (however, these are comparatively minimal compared with less developed peers). This is largely due to the fact that developed states have good urbanisation levels (Belgium, Malta, Iceland, Israel, Netherlands, Luxembourg and Japan have urbanisation rates of above 90%), which reduces the risk of additional costs or delays for businesses reliant on workers travelling large distances. In addition, it increases the ease of employment if large pools of skilled and unskilled labour are easily available in centralised locations. We note that the average urbanisation rate in developed states stands at 77.3%, far above the global average of 57.6%. The lowest levels of urbanisation are found in Liechtenstein (at 14.3%, though we highlight the small size of the country in terms of both land mass and population size), Isle of Man (52.5%), Austria (58.1%) and Ireland (63.0%).

Developed states offer highly skilled labour on the back of well-established education systems. This is reflected in the high primary school enrolment rates found in these countries. The predominantly high quality of primary education systems and compulsory school attendance (with an average mean of more than 11.2 years of schooling) has resulted in large, well-educated workforces – the majority of whom are literate and numerate. The high levels of basic skills are accompanied by large shares of the labour force with tertiary education; the regional average here stands at 32.6%, which compares favourably with the global average of 19.0%. We highlight Canada, Israel, Australia and the US in particular, where the proportion of degree holders stands at more than 41.0% of the population, indicating especially high levels of qualifications among the labour force in these countries that benefit employers seeking highly skilled employees such as in the ICT, manufacturing, services and power sectors. The US is a significant bright spot in terms of tertiary educational attainment levels, producing almost 4mn tertiary level graduates annually.

Developed states also offer very high life expectancy, at an estimated 81.7 years on average, due to the well-developed healthcare systems that help to boost worker productivity. The well-being of the labour forces in these countries is further highlighted by the

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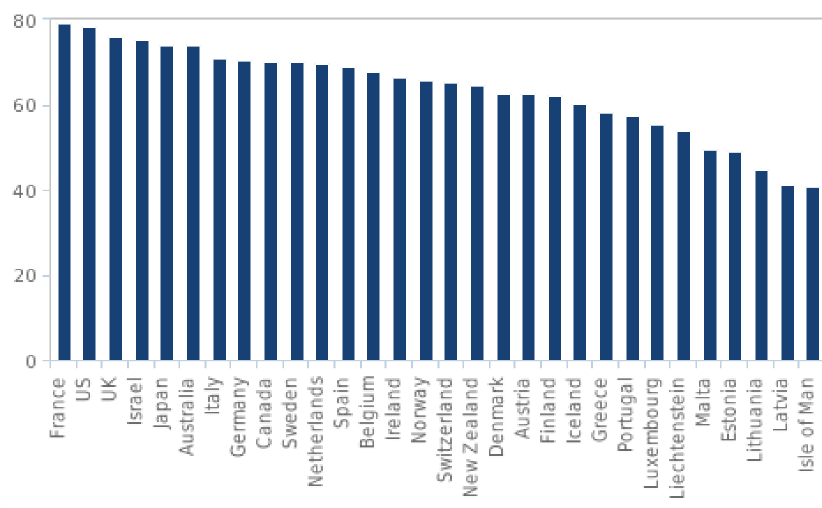
high level of healthcare expenditure per capita, which stands at around USD4,389.9 on average in the region – which is around four times higher the global average of USD1,087.1 per capita. Countries that spend over USD5,000 on healthcare include the US (with the highest at USD10,630.6 per capita), Switzerland, Norway, Luxembourg, Denmark, Australia, Austria and Iceland. Australia is among the countries with the highest life expectancy (83.4 years), ranking fifth in the region, marginally behind Japan (84.2 years), Italy (83.5 years), Switzerland (83.8 years), Spain (83.6 years) and Iceland (83.2 years). We note that Australian businesses further benefit from good urbanisation and employment rates as well as very good education systems, resulting in a large, skilled labour pool. Consequently, Australia is an outperformer with regard to Availability Of Labour in our Labour Market Risk Index, with a score of 73.1 out of 100, ranking slightly above Israel, the US, Canada and New Zealand.

Ample Recruitment Options In Developed Markets

Developed States – Size Of Labour Force



Note: 100 = Lowest risk; 0 = highest risk. Source: Fitch Solutions Labour Market Risk Index

Nonetheless, over the medium-to-long term, overall labour risks remain skewed to the downside in many developed states. In particular, we highlight that many of these countries continue to have limited female labour participation rates (the majority resting around the mid-50% range), representing a large untapped pool of workers. In addition, the percentage of the working-age population in employment also remains somewhat subdued, with only 10 out of 30 developed states having over 60% for this indicator. In descending order these states are Iceland, Liechtenstein, New Zealand, Switzerland, Israel, Norway, Canada, Australia, Netherlands and Sweden. Meanwhile, Greece, Italy, Spain, Belgium and France are all regional underperformers, with below 51% of their working-age populations in employment. Greece, Italy, Spain and Belgium are the worst performers here, with just 41.5%, 43.3% and 49.1% and 49.6% of the working-age population in formal employment respectively. Moreover, many of the countries still suffer from historically poor healthcare and education, resulting in a poorly educated workforce in the 50+ age bracket, many with health conditions resulting in high levels of absenteeism and lost productivity.

Furthermore, labour market performance in various developed states is being increasingly challenged by demographic shifts. In particular, ageing populations and low birth rates compounded by low labour force participation rates will have negative ramifications on productivity in the medium-to-long term. For example, the labour markets in Italy, Portugal and Greece are at comparatively high risk, due to factors such as an extremely low level of the working-age population in employment and low female labour force participation rates and growing population clusters of people over 65 years. In Greece, the population group of over 65 years constitutes 20.6% of the total population in 2018, while the proportions of this age group in Italy, Portugal and Japan stand at 23.3%, 21.9% and 27.5% respectively (against a global average of 8.9%). Meanwhile, over the next decade (barring significant shifts in global

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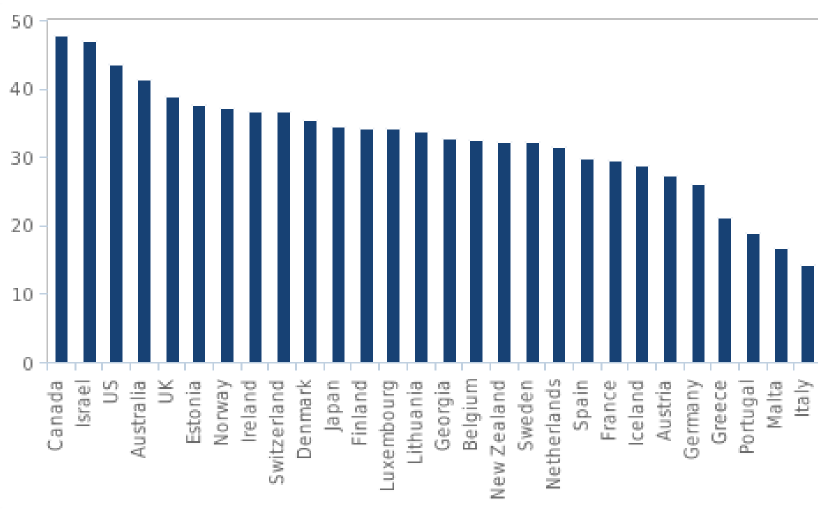
migration), many developed states will struggle to replenish their working-age populations given the fact that in 2018 those aged between 0-15 years constituted around 15% or less of the population, particularly in Japan (13.7%), Greece (15.1%), Italy (14.4%) and Portugal (also 14.4%). These concerning demographic trends have direct structural implications for labour markets through three primary channels: labour supply, labour productivity and labour demand (largely due to shifts in the structure of aggregate demand).

High Levels Of Educational Attainment Boost Productivity

Developed States – Labour Force With Tertiary Education, %



Source: World Bank, Fitch Solutions

We see the education systems in developed states as offering the fewest risks and the best advantages to businesses with regard to Labour Market Risk. This is due to the fact that the quality of the education received is extremely good, as is the education infrastructure, due to substantial government spending on the sector and technological advances. Developed states on average allocate 12.8% of total government spending on education. In addition, the majority of the countries covered here have high attendance levels at both secondary and tertiary levels, good female participation levels and large numbers of graduates in key science, mathematics, engineering and manufacturing subjects, offering a large pool of highly trained skilled labour. France, Japan, the UK and the US have some of the best education systems among the developed states based on our metrics, with high education spending levels, very strong secondary and tertiary enrolment levels and some of the largest numbers of science and engineering graduates in the countries covered in our Operational Risk Index.

Logistics Risk

The superior availability of basic utilities, more sophisticated transport infrastructure and smoother customs and border compliance procedures in developed states over their emerging market peers are reflected in their far better scores for the Logistics Risk Pillar of our Operational Risk Index. The developed states regional average score for this pillar stands at 76.3 out of 100, compared to the global average score of 49.0 out of 100.

The top five scoring developed states for Logistics Risk include the Netherlands, Denmark, Sweden, Finland and France. The five regional underperformers for this pillar include Greece, Australia, Liechtenstein, Malta and the Isle of Man.

Greece's weakest point is its score for the Utilities Network segment. Greece's electricity and fuel costs are higher than the developed states averages for these. Greece also loses an estimated 8.24% of national power generated in the transmission and distribution

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phases, indicating weaknesses in the national grid infrastructure, as this is the fifth highest percentage loss rate during these phases out of the 25 developed states for which data is available for this indicator.

Australia's weakest point is also its utilities network, where the country's reliance on crude and refined fuel imports have caused some concerns, as well as its water availability. Australia's net crude imports stood at an estimated 150,300 barrels per day in 2018, with our Oil & Gas team forecasting that its dependence on crude oil imports will deepen over the coming years. This will be due to continued output declines largely from mature offshore fields. In April and May 2018, local media outlets in Australia reported concerns of nationwide fuel shortages occurring due to shortages of supply with US airstrikes in Syria. It was reported that Australia only had around 43 days' worth of fuel supply at this time. While nationwide fuel shortages did not come to pass in Australia, we emphasise that the country is the largest refined fuel net importer out of all the developed states. Additionally, while the country has water infrastructure of excellent quality and high levels of water availability (an estimated 20,971cu m per capita), its agricultural sector remains highly water intensive (accounting for around 60% of total water withdrawals). This makes Australia's agricultural output highly vulnerable to droughts. In October 2018 parts of New South Wales is Australia had been declared '100% in drought', as rainfall levels over the course of 2018 in this region of Australia have been declared as the lowest seen for an extended period.

TABLE: LOGISTICS RISK INDEX

Country	Utilities Network	Transport Network	Trade Procedures And Governance	Logistics Risk
Netherlands	70.7	96.9	98.3	88.6
Denmark	78.0	91.8	95.0	88.3
Sweden	78.0	88.4	96.2	87.5
Finland	78.0	84.9	87.2	83.4
France	64.9	91.3	93.4	83.2
Belgium	62.8	90.8	96.0	83.2
US	67.5	92.5	88.7	82.9
Germany	61.3	93.2	89.2	81.2
Spain	59.6	91.9	91.2	80.9
Portugal	65.9	87.4	89.4	80.9
Norway	80.4	76.2	85.7	80.8
Austria	71.2	75.0	95.3	80.5
Luxembourg	64.6	78.1	97.4	80.0
UK	56.0	90.8	88.7	78.5
Japan	61.9	91.9	79.8	77.9
Canada	62.1	83.4	84.6	76.7
Italy	58.4	79.8	90.3	76.2
Switzerland	58.0	81.3	86.1	75.1
New Zealand	58.9	82.3	75.2	72.1
Ireland	56.0	82.2	77.8	72.0
Israel	57.7	83.2	72.5	71.1
Iceland	76.9	67.7	64.2	69.6
Greece	56.2	76.7	73.7	68.9
Australia	61.6	76.0	67.4	68.3
Liechtenstein	54.2	66.0	64.4	61.5
Malta	42.7	71.0	68.7	60.8
Isle of Man	38.9	54.6	54.3	49.3

Note: 100 = Lowest risk; 0 = highest risk. Source: Fitch Solutions Logistics Risk Index

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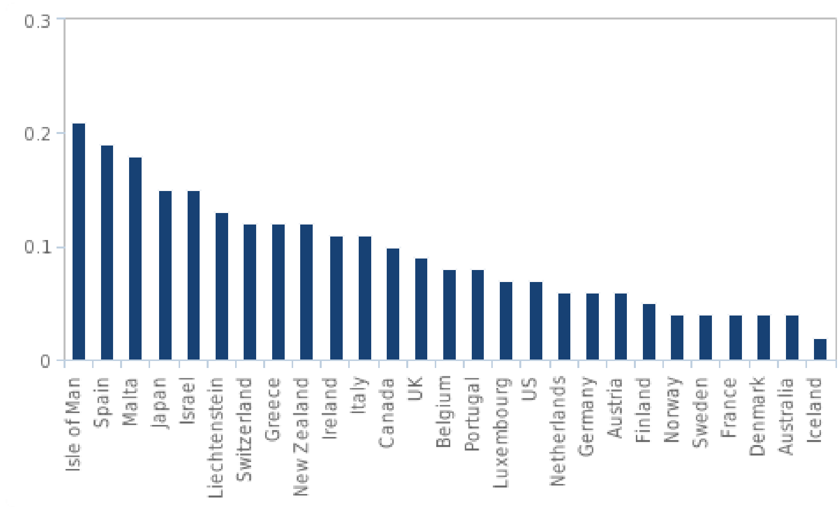
Consequently, in December 2018 Australia lowered its wheat production forecast by 11% (the lowest forecast in around a decade). In response to these risks, we note that Australia is a major market for the construction of desalination facilities, currently having the seventh largest capacity globally.

The third lowest scoring developed state for Logistics Risk is Liechtenstein. Liechtenstein's most salient area of weakness is its utilities network, with its comparatively higher utility costs weighing down its score. For example, in terms of the average electricity costs in the country these come in at around USD0.13/KWh, which is the sixth highest electricity cost out of the 27 developed states. Furthermore, fuel costs in Liechtenstein average at around USD1.59 per diesel litre. This stands just above the developed states regional average fuel cost of USD1.57 per diesel litre.

Malta ranks second from last in terms of its logistics environment out of the 27 developed states. Its weakest point is its utilities network, with the reliability of the electricity, fuel and water supplies being the most pertinent concerns. Malta's electricity supply is not perceived as being highly stable, given that several major electricity outages have been reported as occurring on the island over the course of 2018. Most of these electricity outages lasted several hours and were caused by technical difficulties, storms and problems with the grid-interconnector from Cyprus. The country is also a refined fuel net importer, which increases its vulnerability to fuel shortages caused by supply chain delays. From a water availability perspective, Malta is one of the only two developed states (along with Israel), within which its natural, renewable water resources available per capita are exceeded by its water consumption levels per capita. The European Environmental Agency (the EU's environmental wing), noted in a report dated December 2018 that ground water levels in Malta are drying up at a rapid rate. The World Research Institute has also noted that Malta is one of the most water-stressed countries in the world, and is increasingly relying energy-intensive desalination methods to meet the local population's water consumption demands.

High Tariffs Add To Operating Costs

Developed States – Electricity Costs, USD per KWh



Source: National sources, Fitch Solutions

The Isle of Man is the lowest ranking developed state in terms of its logistics environment. This is largely because its utilities network is the lowest scoring out of the 27 developed states. Utility costs are the Isle of Man's particular weak point, as demonstrated by the fact that at USD0.21/KWh, the island has the highest electricity costs out of all the developed states. The Isle of Man also scores well below the regional average scores for the Transport Network and Trade Procedures And Governance segments.

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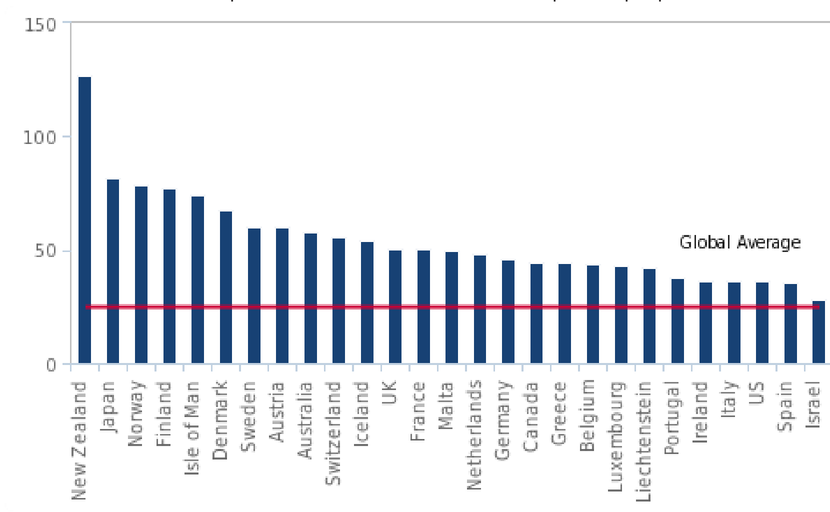
Although the supply of electricity is reliable and readily available in the majority of these countries, costs are on average much higher than in emerging markets and developed states have some of the highest electricity costs globally. This is due to the fact that many developed countries, such as Germany and Japan, are engaged in expanding their renewable electricity generation capacity. This is a costly and protracted process and the outlays made by utilities to implement renewable developments are being passed onto the customers in many cases. In addition, a number of countries import thermal fuels from abroad, further driving up costs and undermining the reliability of the supply. For example, Western European countries are reliant on Russian gas and to a lesser extent US coal, while Japan imports a great deal of costly liquefied natural gas following the closure of its nuclear facilities.

The cost of fuel is also extremely high in many of these countries due to a combination of high taxation on the end user via various means and the high import requirement. The average price of fuel in developed states is USD1.57 per diesel litre, and prices in a number of countries are substantially higher than that. In particular, businesses reliant on road-based supply chains face substantial cost risks in countries including Norway, the UK, Sweden and Iceland.

However, it is worth highlighting that although utilities costs remain a substantial burden in many countries, most developed states benefit from increased reliability of supply and do not face the risk of major shortages or restrictions. In addition, some countries boast domestic natural resources which confer advantages in terms of lower costs. For example, in Australia and the US both fuel and electricity prices remain relatively low by global standards. Electricity costs currently stand at an estimated USD0.07/kWh in the US and USD0.04/kWh in Australia, while a litre of fuel costs around USD0.84 in the US and USD1.12 in Australia. In terms of electricity costs, we note that Iceland is the regional outperformer, with costs of only USD0.02/kWh, significantly below the regional average of USD0.09/kWh.

Good High-Speed Internet Availability A Boon For Business Operation

Developed States – Broadband Subscribers (per 100 people)



Source: Fitch Solutions

In terms of utilities risk, we note that businesses looking to enter developed states will benefit from high internet penetration rates and a generally high proportion of secure internet servers. In terms of broadband penetration rates, New Zealand is the regional outperformer in this regard, with over 100 broadband subscribers per 100 people, indicating a high level of internet connectivity. Conversely, the lowest penetration rates can be found in Israel, with just 27.9 broadband subscribers per 100 people.

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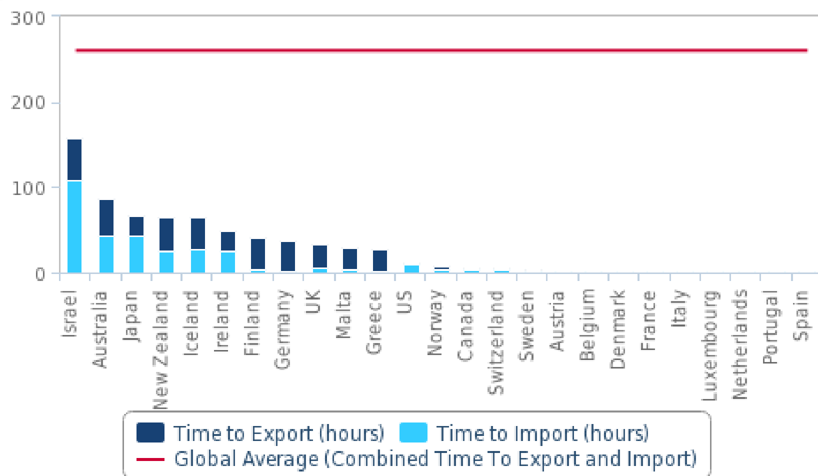
Developed states also perform extremely well in terms of the number of secure internet servers, especially important for businesses reliant on cybersecurity. On average, developed states offer 1,729.2 secure servers per 1mn people. This is far above the global average of 361.4 servers per 1mn people. However, we note that a handful of countries sit below the global average.

Limited Trade Barriers Between Major Economies Ease Economic Activity

Developed States – Time To Export & Import (hours)

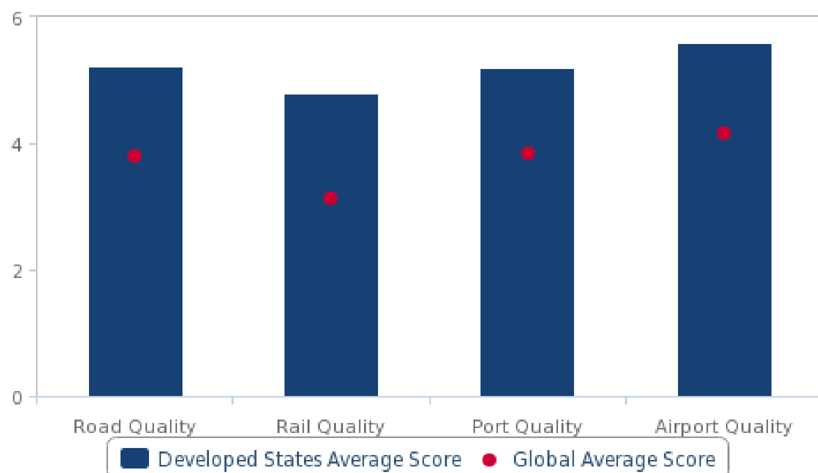


Source: World Bank 'Doing Business'

Businesses reliant on secure internet connections must be aware of increased risk of cybercrime in Greece (with only 146.5 servers per 1mn people), Italy (253.5), Israel (255.8) and Portugal (261.6). In contrast, Liechtenstein provides by far the most secure online environment, not only among the developed states but also on a global scale, with more than 9,837.8 servers per 1mn people, followed by Iceland and Switzerland.

Superior Quality Of Transport Infrastructure Eases Logistical Risks

Developed States & Global – Average Infrastructure Quality



Note: 7 = highest score, 1 = lowest score. Source: World Economic Forum's Global Competitiveness Index, 2018-2019

Trade procedures and governance risks are minimal for incoming businesses and investors. Advantages include the investor-friendly, trade-focused nature of the majority of the developed states, in conjunction with good connectivity and a large number of trade

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agreements. Most developed states boast wide-ranging free trade agreements with major trade partners, with those countries in the EU benefiting from particularly low trade barriers and negligible costs due to the absence of non-tariff barriers and free movement of goods. These factors contribute to the limited bureaucratic requirements for importing and exporting goods. This, in conjunction with the strong internal transport infrastructure seen in most of these countries, results in rapid turnaround times and shorter lead times for deliveries.

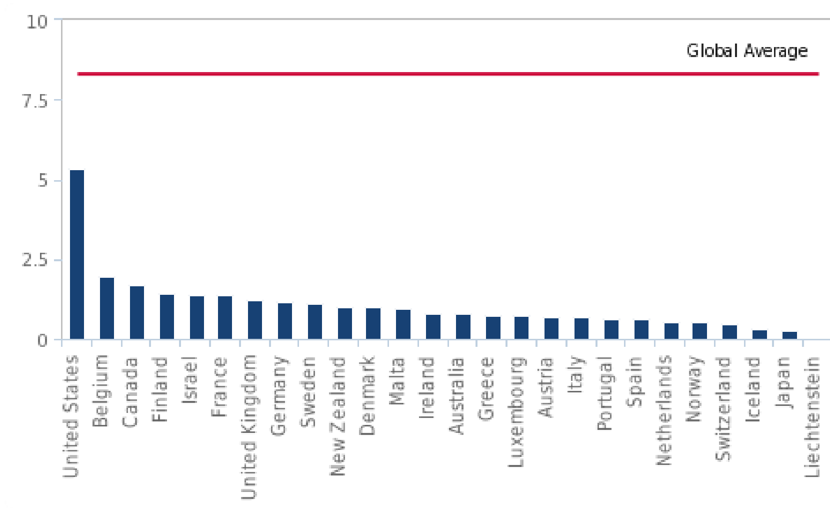
As noted, the good connectivity seen in these countries is due to their well-developed transport networks. Good physical infrastructure is one of the main advantages that developed states offer, with more extensive, better quality and more efficient road and rail networks, and more numerous ports and airports, with higher capacities, than their emerging market peers. In particular, we emphasise the strength of the developed Western European states, which offer particularly extensive domestic transportation options, accounting for 14 of the top 20 countries globally for road density and 16 of the top 20 for rail density. This is highlighted in our Operational Risk Index, where the nine highest-scoring countries for the Transport Network component are developed states, with scores above 80.0 out of 100.

Crime And Security Risk

Overall, businesses operating in developed states benefit from stable political and economic systems, higher average household incomes, strong armed forces, good bilateral relations and well-funded military and police forces, all of which serve to reduce risks of domestic social unrest and international conflicts. This gives businesses that operate in developed states a distinct advantage over those in emerging markets who will face higher operational costs underlined by significant security risks. The top five scoring developed states on the Crime And Security Risk component of our Operational Risk Index are New Zealand, Iceland, Norway, Finland and Liechtenstein. The five regional underperformers for this pillar are Greece, Israel, Italy, the US and Belgium.

Low Homicide Rates Indicate Secure Environment

Developed States – Homicide Rates (per 100,000 population)



Source: UNODC

The US's weakest points are its high violent crime rates compared to other developed states and its comparatively higher levels of organised crime. According to the latest UNODC statistics, the US has the highest homicide rate out of the 27 developed states currently standing at 5.35 homicides per 100,000 people. While this is still well below the global average homicide rate, it stands at slightly above five times the regional average homicide rate of 1.05. Several recent and high-profile events such as the mass high

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school shooting which occurred in Parkland, Florida, in February 2018 have now refocused the spotlight on the dangers posed by widespread gun ownership in the country and reignited the national debate on gun control. According to the Gun Violence Archive, a not for profit Us corporation, there have been 304 mass shootings in the US in 2019 as of mid September 2019. While there has been little political appetite to introduce wide-ranging gun controls in the past, this incident has put renewed pressure on the US government to pass more stringent gun control laws. Regarding financial crime, the US Department of State's own 2018 International Narcotics Strategy Report identifies the US as a 'major money laundering jurisdiction', with its proximity to South America also making it a prime destination country for many illicit narcotics.

The third lowest scorer for Crime And Security Risk out of the developed states is Italy. This is largely as a result of the high levels of perceived corruption and entrenched organised crime, which still remain huge problems in the country. The IMF estimates that its shadow economy had an average size of around 25% of GDP between 1991 and 2015. According to Transparency International's 2017 Global Corruption Barometer, around 40% of Italians surveyed rated 'most' or 'all' government officials as being involved in corruption, compared to the 22% developed states average. The US Department of State's 2018 International Narcotics Strategy Report identifies Italy as an important transit country and final market for illicit narcotics, mostly from Asia and South America. The

TABLE: CRIME AND SECURITY RISK INDEX

Country	Conflict Risk	Crime Vulnerability	Business Crime	Crime And Security Risk
New Zealand	81.8	92.2	91.0	88.3
Iceland	83.0	96.7	84.5	88.1
Norway	80.5	93.8	89.3	87.9
Finland	73.9	93.6	83.5	83.7
Liechtenstein	77.8	95.4	76.5	83.2
Switzerland	85.0	91.8	72.8	83.2
Isle of Man	76.5	91.0	79.8	82.4
Denmark	74.9	85.2	86.7	82.3
Canada	74.8	83.5	86.4	81.6
Austria	75.8	90.3	78.5	81.5
Netherlands	77.8	88.4	75.8	80.7
Australia	73.3	88.1	78.2	79.9
Luxembourg	77.3	90.4	70.1	79.3
Ireland	66.6	84.0	86.4	79.0
Sweden	67.3	81.4	87.1	78.6
Portugal	82.8	84.8	67.6	78.4
UK	63.5	82.5	88.7	78.2
Spain	61.8	85.3	80.8	76.0
Malta	63.2	81.1	76.8	73.7
Germany	71.3	78.1	71.3	73.6
France	61.0	74.1	83.2	72.8
Japan	68.9	80.7	64.9	71.5
Belgium	62.3	73.5	77.7	71.1
US	56.3	71.2	80.5	69.3
Italy	70.5	56.1	66.2	64.3
Israel	33.9	70.5	83.7	62.7
Greece	53.3	61.3	64.2	59.6

Note: 100 = Lowest risk; 0 = highest risk. Source: Fitch Solutions Crime And Security Risk Index

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US Department of State also classifies Italy as a 'major money laundering jurisdiction', largely due to high levels of domestic organised crime such as tax evasion, tax fraud, smuggling, drug trafficking and extortion.

Greece ranks in the last position in terms of its crime and security environment out of the 27 developed states. Its weakest point is the Conflict Risk section of our Crime And Security Risk Index, for which it scores a low 53.3 out of 100. This is largely because of higher security risks posed to business operation by terrorism and political violence threats in Greece than in many other developed states. These have primarily been caused by the activities of insurgent organisations on the far left. These include the November 17 Revolutionary Organisation and the Revolutionary Struggle. In November 2013, a new group called The Fighting People's Revolutionary Powers shot dead two members of the neo-Nazi Golden Dawn political party outside the organisation's headquarters in Athens. These events highlight the risk of ongoing political violence in the country, which have been exacerbated by the country being involved in economic bailout programmes for the past nine years. Greece's other weak points include its high levels of corruption, and that its organised crime problem has worsened with its economic crisis. Its strategic geographic location makes it a popular thoroughfare for the trafficking of illicit narcotics, goods and people from the Middle East and Asia to Western Europe.

Israel is the second lowest ranking developed state in terms of its crime and security environment. This is because Israel suffers from multiple internal and external security threats such as unstable relationships with most of its peers in the MENA region, which pose significant risks to business operations. Since its establishment in 1948, the state of Israel has been involved in numerous conflicts with its neighbours and its relations with most Arab countries remain hostile. Furthermore, the inability to find a lasting settlement to the intractable Israeli-Palestinian conflict has spawned a number of terrorist organisations which target Israeli interests.

The major crime and security themes which have caused security risks for businesses operating in all developed states globally have been in relation to the continued risk of terrorist attacks from extremist Islamic groups, cybercrime and cyberattacks and the ramifications of US President Donald Trump's trade policies and style of international diplomacy. Political events with security implications mainly impacting businesses operating in the UK and EU member developed states include the ongoing Brexit debacle and the rise of populist, right-wing political movements across various EU states.

A significant spike in the number of terrorist attacks in 2017 have occurred in developed states globally with more of these attacks than in previous years being perpetrated by lone-wolf actors with alleged ties to jihadist Islamic groups such as Islamic State (IS) or for which IS has claimed responsibility. According to the EU's 2018 'Terrorism Situation and Trend' report, for 2017 there were 205 terrorist attacks (failed, foiled and completed) reported by nine EU member states (the UK, France, Spain, Italy, Greece, Belgium, Finland and Sweden). This was a 45% increase in the number of terrorist attacks reported by EU states in 2016, with the number of jihadist-related attacks increasing from 13 in 2016 to 33 in 2017. In 2017 both the US (in New York) and Canada (in Alberta) witnessed their first terrorist attacks by lone-wolf perpetrators using a vehicle as a weapon to target pedestrians. This type of risk remains highest in Australia and New Zealand as Japan has yet to be the target of jihadist-related terrorist plots. We note, however, that the risk of such attacks occurring in Japan are not completely unlikely, as 2017 and 2018 have seen a significant spike in jihadist-related activity in the East and South East Asian region. On March 15 2019, New Zealand experienced its first major attack by a gunman targeting two mosques, killing 51 people in Christchurch. Media reports suggest that the attack has been linked to the extremist, alternative right wing movement that is believed to be against immigration.

In terms of interstate conflict risks impacting developed states, the US is directly involved in a number of disputes and is indirectly at risk of conflict via defence agreements with countries such as Japan, South Korea and Israel. Tensions between the US and Iran remain very high and the two countries were increasingly pushed towards the possibility of armed conflict following Iran's shoot-

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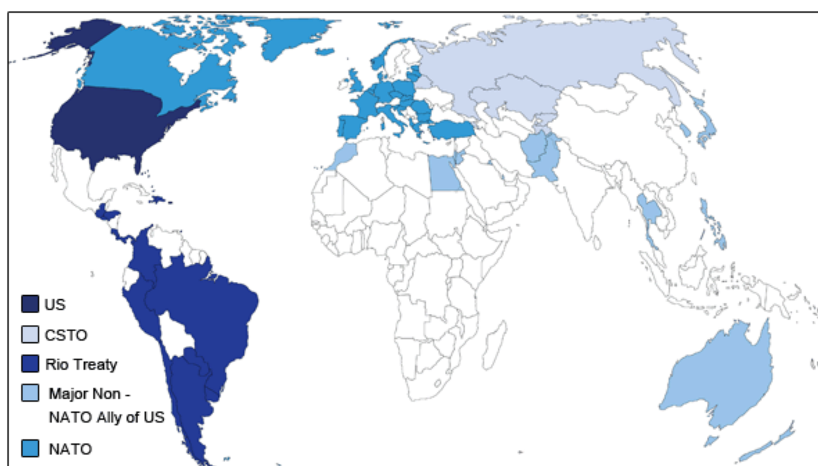
down of a US drone in the Gulf on June 20 2019. The New York Times reported on June 21 2019 that Trump allegedly ordered a military strike on Iran but then changed his mind. According to several news sources, Trump later that day expressed his belief that a 'loose and stupid' individual in Iran, such as a 'general or somebody who made a mistake', was behind the incident. This language suggests that Trump regards the incident as a one-off, and does not wish to escalate the matter. On September 10 2019, Trump also announced the dismissal of US National Security Advisor John Bolton, saying that he and other members of his administration had 'disagreed strongly' with 'many suggestions' coming from Bolton. Bolton is a foreign policy hawk known to favour an uncompromising stance against Tehran, as well as Pyongyang, Moscow and Taliban. Bolton's departure probably makes an all-out military conflict between the US and Iran less likely. However, the likelihood of an inward incursion into the US is greatly reduced by the fact that the country retains the world's most highly sophisticated armed forces. Furthermore, the army, air force, navy, marine corps and coast guard are among the largest in the world. Since the end of the Second World War, they have accrued significant combat experience across the entire spectrum of military operations.

Japan's risk of international conflict is reduced by the fact that it enjoys the support of the US armed forces in the event of an external attack, which boosts its overall military capabilities. However, there are a number of flashpoints facing the country with regard to potential interstate conflicts and these pose significant risks to incoming businesses and their workers. The foremost risk is the threat from North Korea, which flew two missiles over Japanese territory in 2017 and carried out a number of further missile and nuclear weapons tests, which resulted in significantly heightened tensions in the region. While these tension have abated substantially since 2018 due to ongoing diplomacy efforts between the US, South Korea and North Korea, they still remain a long-term security concern.

Global Defence Agreements



Note: The US is a member of the Rio Treaty and NATO. Kuwait and Bahrain are also major non-NATO allies of the US. Source: d-maps.com, Fitch Solutions

Furthermore, relations between Japan and South Korea have been undermined by their ongoing tech exports and historical disputes, which could cause tensions to increases in the near term. Although bilateral relations have long been subject to periodic strains, the latest uptick in tensions began at the end of June 2019 when Japan tightened restrictions on the export of advanced materials used to make semiconductors to South Korea. Japan cited national security concerns in its decision, implying that the materials could end up in North Korea – a suggestion that the South has flatly rejected. This could be problematic for South Korea's economy because semiconductors make up around 20% of the country's total exports. Meanwhile, public anger in South Korea over the tech restrictions has prompted calls from some circles to boycott Japanese goods. On August 22 2019, South Korea decided not to renew a military intelligence sharing pact with Japan ahead of the annual August 24 2019 deadline, suggesting that the trade

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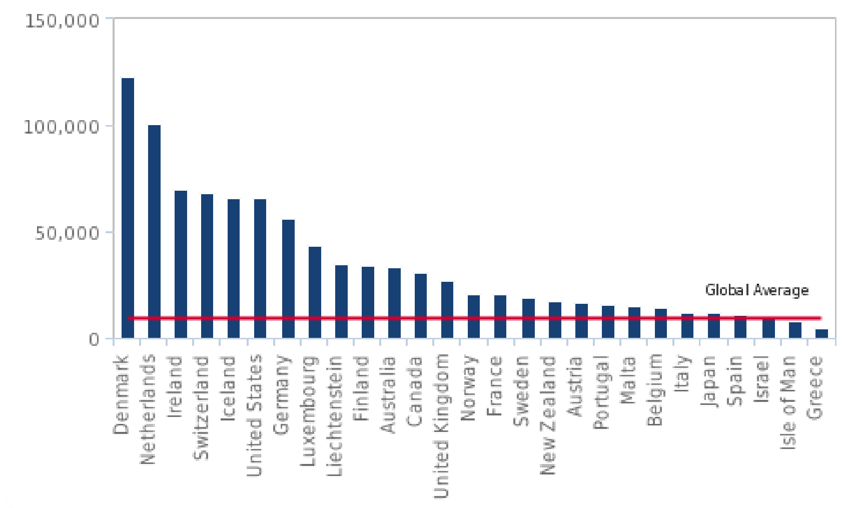
dispute between the two countries will be prolonged. The dispute is ultimately rooted in South Korean perceptions that Japan has not apologised sufficiently or sincerely enough for its occupation of the Korean Peninsula in 1910-1945, and perceptions in Japan that it has apologised enough and resolved all compensation claims in the 1965 treaty that normalised relations between the two countries. Despite the lapse of the intelligence pact, Seoul and Tokyo are likely to continue discussions to ultimately resolve the dispute and it is very unlikely that the two countries will be involved in any armed conflict as this would harm relations with the US and the EU. Overall, Japan's Interstate Conflict Risk score of 67.0 out of 100 is the fifth lowest from the bottom among developed states.

Risks of cyberattacks impacting developed states also spiked significantly over the past few years, particularly in 2017, with the 'Wannacry' attacks in May 2017 which targeted over 150 states globally. The impacted developed states included the UK, the US, Canada, Portugal, Spain, Greece and Germany. The attacks targeted the information systems of healthcare providers and hospitals such as the UK's National Health Service, car companies such as **Renault** and **Nissan**, telecommunications and courier companies, schools and universities and railway operators. We emphasise that the most vulnerable developed states to cyberattacks and cybercrime are Spain, Portugal, Italy, Israel and Greece. All of these states have a secure internet server headcount per 1mn people which is just equal to the global average of around 9,152.4 secure internet servers per 1mn people but significantly lower than the developed sates average of 35,250.4. This indicates that these states have the weakest national cybersecurity capabilities in the region.

Some Developed States Still Have To Boost Their National Cybersecurity Capabilities

Developed States – Secure Internet Servers (per mn people)



Source: World Bank, Fitch Solutions

We have also seen the rise of right-wing, nationalistic and/or populist political parties across various EU developed states such as Austria, France, Germany, Italy and Sweden in 2017 and 2018. This indicates growing domestic support for such movements and could potentially result in an uptick in attacks on minority groups by extremist right-wing or nationalist groups in these countries. Nevertheless, the chance of creating a significant security threat for business operation in these states remains unlikely. Rather, the direct implications for businesses will be more policy based, such as an increase in euroscepticism and more stringent anti-immigration and nationalistic policies being enforced in these states. We maintain, however, that the UK's expected departure from the EU in 2019 will not be the catalyst for other countries to leave the bloc over the next five to 10 years (*see 'The Gradual Emergence Of A 'Two-Tier' EU', August 23 2018*). As for the Brexit debacle, we expect this to continue to create navigational difficulties for businesses headquartered in the UK for their EU-based operations over the years to come due to the uncertainty regarding the ultimate resolution of the situation.

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On a global scale, businesses in developed states are expected to continue to face the additional operational headwinds that have come with President Trump's term in office, especially as we expect his assertive foreign policy stance to continue (*see 'Trump Administration To Retain Assertive Foreign Policy Beyond Mid-Terms', September 26 2018*). Governments of these developed states are currently maintaining a balancing act of not openly endorsing Trump's particular brand of economic nationalism, but also of not openly opposing it either. Strong criticism of this could compromise trade relations with the US or cause the loss of US military support, factors which remain especially critical for developed states such as the UK, Japan and Australia. The residual overflow of the US-China trade war, increased US sanctions on Iran and Russia and Trump's style of international diplomacy will also continue to impact businesses in developed states through higher input costs in relation to raw materials, heightened inflation and rising global crude prices.

Trade And Investment Risk

The developed states offer substantial rewards to businesses and investors with regard to trade and investment. They also present minimal risks, with investors benefiting from large established economies open to foreign investment, developed financial markets, strong trade flows, numerous trade agreements and solid reliable intellectual property protection and well-regulated legal systems. Nevertheless, increasing trade protectionism and the risk of further adoption of populist policies over the medium term will heighten risks for investors with global supply chains and encourage localisation at the expense of foreign investment and free trade.

Among the best performers for Economic Openness are the Netherlands, Luxembourg and Belgium with scores of 92.8, 91.4 and 90.2 out of 100 respectively. In 2017 (latest data available), developed markets received 192.5% more foreign direct investment (FDI), as a bloc, than in 2016 and disproportionately approximately half of all FDI globally (according to UNCTAD and in-house data). Trade estimates demonstrate similar trends, as data for 2018 indicate that 52% of total global trade can be attributed to 27 developed markets, with exports slightly outpacing imports (51.9% and 48.1% respectively). According to Fitch Solutions forecasts, developed states will predominantly remain net exporters of goods over the medium term. Trade from developed markets as a percentage of total global trade will, however, gradually shrink over the medium term, but is poised to provide the lion's share of trade activity nonetheless (at an expected 50.8% of global trade in 2023). The US, Israel and Iceland will all remain net importers over the medium term, with Canada, Portugal, Austria and New Zealand joining the group over the period out to 2023.

Eurozone real GDP growth is expected to slow in 2019, which suggests that the region's growth outlook will slip further behind comparable developed markets, such as the US. A confluence of factors looks set to dampen growth across the bloc. The external trading environment will be less accommodating, due to slowing eurozone domestic demand and the EU-US trade dispute. Businesses will further be faced with a combination of political uncertainty and a lack of clarity on the UK's future trading agreement with the EU, which will continue deterring investment throughout the bloc.The short-to-medium term growth outlook for the US economy remains constructive due to a tightening labour market, a continued recovery in private investment and expansionary fiscal policy. Wider budget deficits and a higher debt-to-GDP ratio are on the cards in the years ahead, as tax cuts lower revenue, but are not accompanied by offsetting reductions in spending. Although the US is significantly dependent on foreign countries for imports, this is broadly sustainable, given the US's relative wealth and the comparative advantage of producing certain goods and services.

In October 2018, Canada, the US and Mexico reached an agreement on a new and modern trade agreement called the United States-Mexico-Canada Agreement (USMCA). This modernised agreement maintains the tariff-free market access from the original NAFTA, and includes updates and new chapters to address modern-day trade challenges and opportunities. The original NAFTA eliminated virtually all tariffs between the three countries, with very few exceptions. The USMCA maintains these benefits and ensures that the vast majority of USMCA trade will continue to be duty-free. Additionally, a new Customs Administration and Trade Facilitation

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Chapter standardises and modernises customs procedures throughout North America to facilitate the free-flow of goods. There are also important improvements to disciplines on technical barriers to trade that will make it easier for businesses to export goods within the USMCA region. The USMCA comprises 34 chapters, 3 schedules, 18 annexes and 12 side letters. One of the chapters (on Rules of Origin) is 234 pages in length.

The USMCA has made a key change to the autos rules of origin. The revised automotive rules of origin require higher levels of North American content in order to incentivise production and sourcing in North America. The agreement specifies that 40.0% of vehicles sold in the region must come from a market with wages of USD16/hour or more. This wage provision was brought into place in order to attempt to level the playing field between Mexican and US workers and reduce the incentives for companies to outsource manufacturing jobs. However, the USMCA will face a difficult ratification process in the US, as a divided Congress digs in for a protracted debate. In October 2018, the US, Mexico and Canada agreed to a new iteration of the 25-year old North American Free Trade Agreement (NAFTA), with its replacement, USMCA, now requiring ratification by each country's legislature in order to go into effect.

TABLE: TRADE AND INVESTMENT RISK INDEX

Country	Economic Openness	Government Intervention	Legal	Trade And Investment Risk
UK	76.0	70.6	89.9	78.8
Netherlands	92.8	57.9	84.1	78.3
Liechtenstein	66.6	83.5	84.4	78.2
Sweden	77.7	65.1	91.3	78.0
Ireland	85.8	66.0	81.9	77.9
Luxembourg	91.4	61.4	79.9	77.6
Switzerland	83.9	66.8	82.0	77.5
Estonia	75.6	64.5	89.1	76.4
Denmark	75.0	60.9	93.0	76.3
Canada	69.7	73.4	83.6	75.6
New Zealand	59.5	71.1	95.4	75.4
US	66.2	72.1	87.8	75.3
Finland	69.0	64.2	89.5	74.2
Belgium	90.2	49.7	78.4	72.8
Norway	60.1	62.8	93.7	72.2
Austria	77.2	55.7	82.5	71.8
Lithuania	69.5	62.3	82.5	71.5
France	66.4	63.0	84.2	71.2
Germany	74.4	52.4	80.4	69.1
Malta	81.4	64.0	61.6	69.0
Spain	72.0	61.9	73.0	69.0
Latvia	67.8	56.1	78.6	67.5
Iceland	57.6	60.9	83.5	67.3
Portugal	71.8	47.8	80.3	66.6
Japan	54.3	61.3	80.9	65.5
Israel	60.5	58.0	74.8	64.4
Isle of Man	43.6	73.3	70.4	62.4
Italy	69.0	44.4	66.2	59.9
Greece	46.0	44.9	57.0	49.3

Note: 100 = Lowest risk; 0 = highest risk. Source: Fitch Solutions Trade And Investment Risk Index

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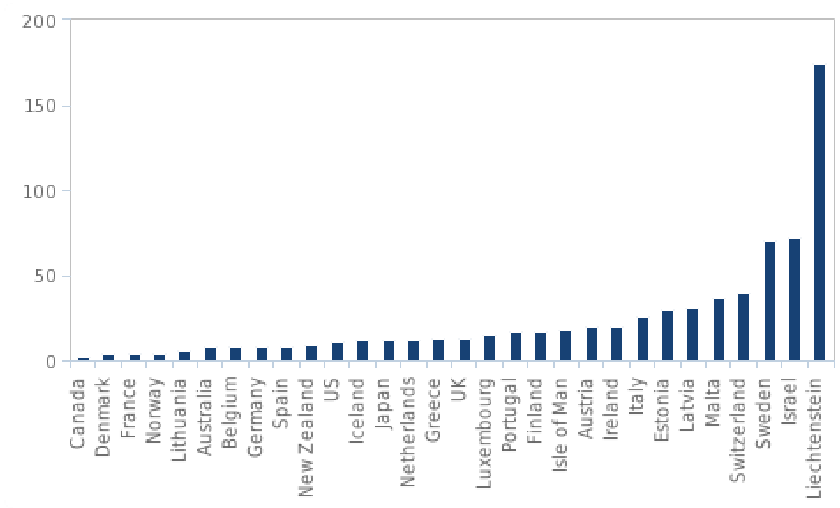
The process is expected to be fairly straightforward in Mexico and Canada, but is likely to face substantial hurdles in the US, especially as the opposition Democratic Party regained control of the lower house in Congress in November 2018 mid-term elections.

The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) comprising Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore and Vietnam came into effect in 2019. The agreement was ratified in Q418, with the deal representing 13.4% of global GDP, making it the third-largest trade agreement after the proposed USMCA and the EU. The agreement aims to cut tariffs, improve access to markets and set common ground on labour and environmental standards and intellectual property protections, which will be a boon to the trade and investment environments for Japan, Canada and Australia.

In July 2018, the EU and Japan signed a trade deal that promises to eliminate 99% of tariffs that cost businesses in the EU and Japan nearly EUR1.0bn annually. According to the European Commission, the EU-Japan Economic Partnership Agreement (EPA) will create a trade zone covering 600mn people and nearly a third of global GDP. The result of four years of negotiation, the EPA was finalised in late 2017 and came into force on February 1 2019 after the EU parliament ratified the agreement in December 2018. The total trade volume of goods and services between the EU and Japan is an estimated EUR86.0bn. The key parts of the agreement will cut duties on a wide range of agricultural products and it seeks to open up services markets, particularly financial services, e-commerce, telecommunications and transport. Japan is the EU's second biggest trading partner in Asia after mainland China. EU exports to Japan are dominated by motor vehicles, machinery, pharmaceuticals, optical and medical instruments and electrical machinery.

Generally Efficient Bureaucratic Procedures Encourage Investment

Developed States – Time To Open A Business (days)



Source: World Bank 'Doing Business'

Interventionist governments can pose a risk to incoming businesses and although developed states have historically offered relatively low risks here, an increasing turn towards protectionism threatens this. Taxation is comparatively businesses-orientated, with established e-governance platforms and clearly delineated regulations facilitating the swift payment of taxes. On average it takes just 139.6 hours a year to pay taxes in the developed states, contrasting positively with the global average of just over 240 hours. Moreover, many countries require less than 100 hours a year, such as Estonia, Finland, Luxembourg, Switzerland, Ireland and Norway.

We note that Israel, Italy and Portugal underperform, with the longest times taken to pay taxes in the region at 238, 239 and 243 hours respectively, placing a heavy burden on businesses operating in these countries. These risks are exacerbated by relatively high levels of taxation and high numbers of annual tax payments. In both Italy and Japan, for instance, businesses face corporate

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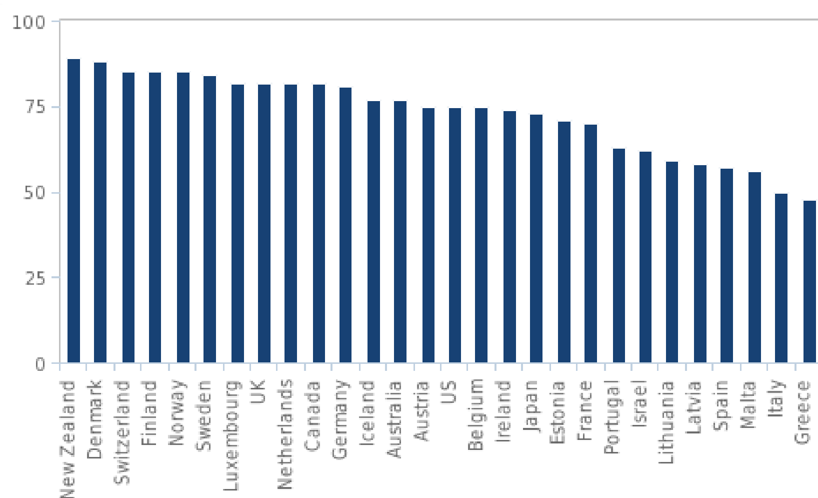
tax rates and numbers of annual tax payments that are above the regional average. Corporate income tax is relatively competitive in most developed states, however, with Liechtenstein and Ireland offering the lowest cost risk in this regard, with corporate income taxed at 12.5%, which is among the lowest rates globally.

It is in the bureaucratic environment field where the developed states excel the most over their emerging market peers, with the majority offering rapid turnarounds for the opening and closing of businesses, limited delays with regard to property registration and comparatively low construction permit costs. The majority of developed states perform well relative to the regional average in terms of the efficiency of bureaucratic procedures, requiring an average of just 23.9 days to open a business, 1.6 years to resolve insolvency proceedings and 20.5 days to register a property purchase. We do, however, note that a few countries still exhibit lengthy delays and additional costs for incoming businesses: Austria, Germany, France and Malta, in terms of the World Bank's latest Ease of Doing Business report. In Austria, it takes 21 days to open a business – ranking only ahead of Luxembourg in the regional comparison, where it takes 16.5 days. New Zealand is a particular outperformer for all the ease of doing business indicators and it ranks first globally out of 190 states surveyed. New Zealand scores 95.4 out of 100 for the Legal Risk component of the Trade And Investment Index.

Transparent Operating Environments Enhance Appeal

Developed States – Transparency International Corruption Perceptions Index 2017



Source: Transparency International

The developed states offer additional advantages, including low corruption risks (barring Italy and Greece, where corruption is fairly endemic in certain sectors), efficient and effective legal systems, reliable contract enforcement for businesses and strong intellectual property rights protection (though again, Greece and Italy perform poorly here). Overall, the poor bureaucratic environment in Spain, as well as corruption and weakness of the rule of law in Greece and Italy, pose the greatest dangers with regard to trade and investment risk among the developed states. These issues are factored into the countries' scores in the Trade And Investment Risk Index, with Greece sitting in last place with a score of 49.3 out of 100, just below Italy, Isle of Man and Israel with scores of 59.9, 62.4 and 64.4 out of 100 respectively. The UK, however, is the outperformer, leading the rankings with a score of 78.8 out of 100, ahead of the Netherlands with a score of 78.3.

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Global Macro Outlook

Downside Revisions To Stabilise Somewhat, But Policy Risks Remain

At Fitch Solutions, we have kept our aggregate global growth forecast for 2019 unchanged at 2.7%, but we have cut our 2020 forecast by 0.1 percentage points (pp) to 2.8% as softening forward-looking indicators hint at weaker global growth momentum. Unchanged 2019 forecasts mask some revisions to individual markets. The most important are our downward revisions to Germany in 2019 (0.2pp to 0.7%), the UK (0.3pp to 1.2%), Australia (0.3pp to 2.0%), Hong Kong (1.0pp to 1.0%), Russia (0.2pp to 1.2%), India (0.4pp to 6.4%) and Argentina (1.3pp to -2.6%), which in large part reflect the negative impact of the ongoing US-China trade war on the global trade and manufacturing sectors, as well as rising political and geopolitical risks – although Argentina is a case on its own.

Some of these downward revisions were partially offset by upward revisions to growth in countries such as Turkey (0.8pp to -1.1%) and Malaysia (0.4pp to 4.6%), as well as a 0.1pp increase to Canada and the Czech Republic to 1.4% and 2.6% respectively. While we continue to see some downside pressures on global growth – largely due to US-China trade tensions and Brexit risks – we believe that, from a cyclical perspective, pressures may start to ease slightly, given seasonal dynamics and base effects, and some data are starting to surprise to the upside again, according to the Citi Surprise Index. The trajectory of the global economy will remain dependent on trade and Brexit risks, which seem to have eased slightly recently, but as we have seen on numerous occasions, negotiations remain unpredictable.

TABLE: GLOBAL MACROECONOMIC FORECASTS (2018-2023)

		2018	2019f	2020f	2021f	2022f	2023f
Real GDP Growth (%)							
	US	2.9	2.2	2.0	1.8	1.8	1.8
	Eurozone	1.9	1.2	1.3	1.4	1.4	1.5
	Japan	0.8	0.5	0.5	0.5	0.4	0.4
	China	6.6	6.3	6.1	5.7	5.4	5.4
	World	3.2	2.7	2.8	2.9	2.9	3.0
Consumer Inflation (ave)							
	US	2.4	2.1	2.2	2.2	2.1	2.1
	Eurozone	1.8	1.3	1.5	1.7	1.9	1.9
	Japan	1.0	1.6	1.6	1.2	1.0	1.0
	China	2.1	2.7	2.7	2.2	2.3	2.3
	World	2.9	3.0	2.9	2.7	2.7	2.7
Interest Rates (eop)							
	Fed funds rate	2.25	1.75	1.75	1.75	1.75	1.75
	ECB refinancing rate	0.00	0.00	0.00	0.00	0.50	1.00
	Japan overnight call rate	-0.10	-0.10	-0.10	0.00	0.00	0.10
Exchange Rates (ave)							
	USD/EUR	1.18	1.14	1.17	1.22	1.25	1.27
	JPY/USD	110.50	110.00	109.00	108.00	107.50	107.00
	CNY/USD	6.62	6.95	7.30	7.30	6.98	6.65
Oil Prices (ave)							
	OPEC basket (USD/bbl)	69.78	61.00	59.00	55.00	56.00	58.00
	Brent crude (USD/bbl)	71.76	64.00	62.00	58.00	59.00	61.00

f = forecast. Source: Fitch Solutions

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We made two other significant revisions this month, both related to the US economy. The first relates to interest rates; we expect another interest rate cut by the US Federal Reserve (Fed) by the end of 2019 to 1.75-2.00%, from 2.00-2.25% currently, and then a hold over 2020, although we note downside risks to this view. We have also changed our view for the US dollar from neutral – a view we held since December 2018 – to bullish, to trade within a slight uptrend. We believe that central banks around the world are easing at a quicker pace than the Fed will, and an increase in volatility should keep the greenback bid.

We saw this following the European Central Bank (ECB)'s September meeting, which saw the euro weaken immediately after the ECB announced additional easing measures. That said, we do not expect a strong rally similar to what occurred in 2018, as the US dollar is about 10% overvalued compared with its long-term average and US President Donald Trump will aim to limit too much strength.

TABLE: DEVELOPED MARKETS – REAL GDP GROWTH, % y-o-y

	2018	2019f	2020f	2021f
Developed Markets Aggregate Growth	**2.3**	**1.7**	**1.6**	**1.7**
G7	2.1	1.6	1.6	1.5
Eurozone	1.9	1.2	1.3	1.4
EU-27	2.0	1.5	1.5	1.6
Selected Developed States				
Australia	2.7	2.0	2.3	2.4
Austria	2.7	1.6	1.6	1.6
Belgium	1.4	1.2	1.2	1.3
Canada	1.9	1.4	1.4	1.7
Czech Republic	2.9	2.6	2.3	2.5
Denmark	1.4	1.7	1.7	1.4
Finland	2.3	1.7	1.4	1.6
France	1.7	1.4	1.4	1.5
Germany	1.4	0.7	1.1	1.7
Hong Kong	3.0	1.0	2.3	2.5
Ireland	6.7	4.1	3.1	3.0
Italy	0.9	-0.1	0.3	0.4
Japan	0.8	0.5	0.5	0.5
Netherlands	2.5	1.6	1.5	1.4
Norway	1.4	2.4	1.9	1.7
Portugal	2.1	1.7	1.6	1.5
Singapore	3.0	0.9	1.7	2.6
South Korea	2.7	2.1	2.3	2.7
Spain	2.6	2.3	2.0	1.6
Sweden	2.7	1.9	1.6	2.1
Switzerland	2.5	1.5	1.7	1.5
Taiwan	2.6	2.1	2.2	2.5
UK	1.4	1.2	1.5	1.7
US	2.9	2.2	2.0	1.8

f = forecast. Source: Fitch Solutions

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As we mentioned last month, policy missteps remain the largest risk to global growth. Various models are now pointing to a 30-40% probability of recession hitting the US economy in the next 12 months or so, and while we do not forecast a recession in either 2019 or 2020, slower growth leaves the US and global economies vulnerable to policy shocks, such as another rise in trade tensions, a hard Brexit or even a rise in military tensions.

Developed Markets

Economic growth lost further traction across developed markets (DMs) this month, with a string of poor forward-looking data releases showing no signs of bottoming out. While keeping our 2019 DM growth projection at 1.7%, due to growth in the US this year still being relatively robust, we have cut our 2020 growth forecast by 0.1pp to 1.6%. Germany is teetering on the brink of a technical

TABLE: EMERGING MARKETS – REAL GDP GROWTH, % y-o-y

	2018	2019f	2020f	2021f
Emerging Markets Aggregate Growth	**4.6**	**4.2**	**4.6**	**4.7**
Latin America	**1.6**	**1.4**	**2.1**	**2.6**
Argentina	-2.5	-2.6	-2.6	2.3
Brazil	1.1	1.0	2.4	2.2
Mexico	2.0	1.1	1.5	2.2
Middle East And North Africa	**1.4**	**0.7**	**2.4**	**3.6**
Saudi Arabia	2.2	1.7	1.9	1.6
UAE	1.7	2.6	2.9	3.1
Egypt	5.3	5.6	5.5	4.9
Sub-Saharan Africa	**2.8**	**2.9**	**3.3**	**3.5**
South Africa	0.8	0.7	1.7	2.4
Nigeria	1.9	2.0	1.6	1.4
Emerging Asia	**6.4**	**6.1**	**6.1**	**5.9**
China	6.6	6.3	6.1	5.7
India*	6.8	6.4	7.0	7.1
Indonesia	5.2	5.3	5.3	5.4
Malaysia	4.7	4.6	4.5	4.4
Philippines	6.2	5.7	6.1	6.1
Thailand	4.1	2.8	3.5	3.6
Emerging Europe	**3.2**	**1.7**	**2.6**	**2.5**
Russia	2.3	1.2	1.7	2.0
Turkey	2.6	-1.1	2.0	3.2
Hungary	4.9	3.8	2.6	2.5
Romania	4.1	3.7	3.0	3.1
Poland	5.1	3.9	3.5	2.6

*f = forecast; *Fiscal years ending March 31 (2018 = 2018/19). Source: Fitch Solutions*

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recession, as Brexit-related uncertainties, a generalised slowdown in global trade and weaker demand from China sap growth in the country's external sector and weigh on business confidence. This has led us to revise down our 2019 and 2020 real GDP forecasts for Germany to 0.7% and 1.1% respectively, from 0.9% and 1.4% previously. As Germany accounts for approximately 30% of the eurozone output, this forecast revision has also lowered our aggregate eurozone growth forecast by 0.1pp in both 2019 and 2020 to 1.2% and 1.3% respectively. Furthermore, we have cut our 2019 real GDP growth forecasts for the UK to 1.2%, from 1.5% previously, in light of the poor quarterly performance and a string of disappointing data releases. While we are maintaining our 2020 forecast at 1.5%, we note that risks to growth are significantly skewed to the downside. Leading indicators support our view for softer growth ahead. The UK, Germany and Japan manufacturing purchasing managers' index (PMI) readings fell further into contractionary territory in August, coming in at 47.4, 43.5 and 49.3 respectively. The US manufacturing PMI also declined in August to its lowest level in almost a decade, due to a subdued rise in production and lacklustre client demand.

The broad-based weakening of underlying economic momentum is resulting in converging central bank monetary policies across DMs. After delivering a cut of 25 basis points (bps) in July, we expect the Fed to cut interest rates by another 25bps to 1.75-2.00% by the end of 2019 and remain on hold thereafter. With a quick solution to Brexit remaining elusive, there is little chance that the ongoing downside pressure on the UK economy will abate any time soon. This has led us to revise down our forecast for the bank's policy rate in 2019. We believe that the Bank of England will keep the policy rate unchanged at 0.75% this year, down from a previous forecast of 1.00%. Persistently subdued inflation and inflation expectations against a backdrop of weakening growth momentum were key factors driving the ECB's decision to cut its deposit rate by 0.1% to -0.5% and restart bond purchases at a pace of EUR20.0bn a month as of November. While we expect the main policy rate to be kept at 0.00% in 2019 and 2020, we believe that further monetary stimulus will be delivered over the next few quarters through additional cuts to the deposit rate and/or larger monthly bond purchases.

Emerging Markets

Emerging markets (EMs) and other risk assets have experienced volatility recently, but there has been some respite since the start of September amid news of the resumption in trade talks between the US and China. This was followed by more recent announcements by the US administration of a delay in the implementation of new or increasing tariffs on imports of Chinese goods to the US. However, we caution that optimism earlier in the year regarding progress in trade US-China negotiations had proved to be misplaced with little warning, and on that basis the current reprieve in market sentiment could be short-lived unless further concrete steps are announced.

In terms of our 2019 real GDP growth forecasts, we have seen downward revisions for all regions in the past month, resulting in a lowering of the EM aggregate forecast by 0.2pp to 4.2%, with risks still tilted to the downside. At the regional level, 2019 forecasts have been revised lower by 0.2pp each for Sub-Saharan Africa (SSA) to 2.9%, and emerging Asia to 6.1%. We have seen smaller downward revisions to the 2019 forecasts for the Middle East and North Africa (MENA) by -0.1pp to 0.7%, for emerging Europe (1.7%) and for Latin America (1.4%).

Revisions in SSA and MENA reflect a further downward revision to the oil price forecast at the start of September, whereby our Oil & Gas team lowered its average Brent crude price forecast to USD64.0 per barrel (/bbl) in 2019, down from USD67.0/bbl.

In SSA, we have consequently seen downward revisions to the 2019 growth forecasts for oil producers Nigeria (-0.3pp to 2.0%) and Angola (-0.7pp to -0.4%). In the latter, the downward revision represents an extension of the recession that began in 2016, and we expect the trend to continue through to 2020, when we see the Angolan economy contracting by 0.2% – marking five

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years of recession. In Nigeria, while Q219 growth marked the ninth consecutive quarter of real GDP expansion, economic growth still remains below the long-term average of 7.0% in the 20 years prior to the 2016 recession.

Our expectations for slower growth in the MENA region are driven by economic weakness in the GCC. This is a result of lower oil price forecasts and lower oil production due to an anticipated further tightening in compliance with OPEC+ cuts. The ongoing weakness will sharpen the focus on fiscal consolidation efforts amid widening deficits, which is likely to slow progress in the development of the non-oil sector.

The downward revision in emerging Europe was driven by Russia, where we see 2019 growth slowing by 0.2pp to 1.2% in 2019 due to lower oil prices and existing pressures on production, and on the sluggish growth outlook as external conditions remain unfavourable. In Turkey, we now see a less severe economic contraction of 1.1% in 2019, compared with 1.9% previously, after a contraction that was less severe than expected in Q219, given the combined support provided by the government and central bank.

In emerging Asia, we saw downward revisions to India (-0.4pp to 6.4%), Thailand (-0.3pp to 2.8%) and the Philippines (-0.2pp to 5.7%). In the case of India, the revision came on the back of a weaker-than-expected growth print in Q119, due mainly to a steep decline in private consumption. The downward revisions to growth forecasts for Thailand and the Philippines stem from weaker domestic activity, coupled with a more substantial deterioration in the external outlook.

In Latin America, the biggest revision was for Argentina, where we now see a deeper recession than previously expected (-1.3pp to a contraction of 2.6%). This follows the loss of investor confidence in policy continuity after the primary elections at the time of writing, in which the incumbent party under President Mauricio Macri looks set to lose its bid for re-election in the October general election.

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Index Tables

	Short-Term Political	Trend	Regional Rank	Global Rank
Hungary	73.5	=	1	45
Turkmenistan	72.5	=	2	48
Latvia	**72.3**	**=**	**3**	**51**
Lithuania	70.8	=	4	61
Kazakhstan	70.4	=	5	64
Poland	69.6	=	6	69
Uzbekistan	69.0	=	7	70
Croatia	66.3	=	8	82
Russia	65.6	=	9	85
Bulgaria	65.2	=	10	87
Romania	64.6	=	11	91
Azerbaijan	64.4	=	12	94
Belarus	61.7	-	13	105
Montenegro	61.7	=	13	105
Georgia	60.0	=	15	113
Armenia	59.0	=	16	120
Turkey	58.5	=	17	121
Serbia	57.5	=	18	124
Tajikistan	56.5	=	19	129
Ukraine	56.0	+	20	132
Kyrgyzstan	55.2	=	21	135
North Macedonia	55.0	=	22	136
Albania	53.5	=	23	141
Moldova	45.8	=	24	164
Kosovo	41.0	=	25	170
Bosnia-Herzegovina	38.5	=	26	173

Regional ave 60.9/Global ave 62.7/Emerging markets ave 59.2

	Long-Term Political	Trend	Regional Rank	Global Rank
Lithuania	78.4	=	1	31
Latvia	**77.3**	**=**	**2**	**34**
Poland	75.6	=	3	36
Bulgaria	72.0	=	4	51
Croatia	71.4	=	5	54
Albania	71.3	=	6	56
Romania	70.6	=	7	61
Montenegro	70.3	=	8	64
Hungary	70.2	=	9	65
Kazakhstan	70.0	=	10	66
Serbia	64.9	=	11	80
North Macedonia	61.7	=	12	92
Russia	61.7	=	12	92
Armenia	61.5	=	14	96
Moldova	58.2	=	15	109
Georgia	57.9	=	16	110
Uzbekistan	56.8	=	17	114
Belarus	56.2	=	18	120
Bosnia-Herzegovina	55.8	=	19	122
Turkey	55.3	=	20	125
Kosovo	53.5	=	21	132
Turkmenistan	52.4	=	22	139
Azerbaijan	51.3	=	23	141
Kyrgyzstan	43.6	=	24	164
Ukraine	42.6	=	25	166
Tajikistan	40.2	=	26	171

Regional ave 61.6/Global ave 61.9/Emerging markets ave 57.1

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	Short-Term Economic	Trend	Regional Rank	Global Rank
Lithuania	71.9	-	1	21
Poland	71.7	+	2	22
Hungary	67.7	-	3	34
Russia	67.5	=	4	36
Latvia	**67.1**	**-**	**5**	**38**
Romania	64.8	+	6	45
Bulgaria	61.5	=	7	56
Croatia	59.0	-	8	64
Kazakhstan	55.6	=	9	76
North Macedonia	54.0	-	10	80
Ukraine	52.9	+	11	83
Azerbaijan	52.5	=	12	84
Montenegro	48.5	-	13	97
Georgia	46.9	=	14	101
Turkey	46.5	+	15	107
Serbia	46.3	=	16	111
Albania	45.2	=	17	116
Armenia	44.0	+	18	125
Kyrgyzstan	44.0	=	18	125
Moldova	43.3	=	20	128
Belarus	41.7	-	21	138
Uzbekistan	41.5	-	22	140
Turkmenistan	40.6	=	23	145
Kosovo	39.6	=	24	151
Tajikistan	39.4	-	25	153
Bosnia-Herzegovina	38.8	+	26	156

Regional ave 52.0/Global ave 52.2/Emerging markets ave 48.0

	Long-Term Economic	Trend	Regional Rank	Global Rank
Lithuania	74.1	=	1	23
Hungary	70.1	=	2	32
Russia	70.1	=	2	32
Latvia	**68.1**	**=**	**4**	**37**
Poland	68.1	=	4	37
Romania	67.7	=	6	42
Bulgaria	64.1	=	7	53
Croatia	59.8	-	8	64
Turkey	58.2	+	9	67
Kazakhstan	57.0	=	10	74
North Macedonia	53.3	+	11	87
Montenegro	51.3	=	12	101
Georgia	50.5	=	13	109
Albania	50.3	=	14	110
Serbia	50.1	=	15	111
Moldova	49.3	=	16	117
Azerbaijan	49.1	=	17	118
Uzbekistan	48.6	-	18	121
Ukraine	46.4	-	19	128
Bosnia-Herzegovina	45.5	=	20	131
Kosovo	44.4	=	21	138
Armenia	43.9	=	22	141
Turkmenistan	43.4	=	23	142
Kyrgyzstan	41.8	=	24	150
Belarus	40.0	=	25	158
Tajikistan	35.2	-	26	173

Regional ave 53.9/Global ave 54.3/Emerging markets ave 50.0

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TABLE: LATVIA – MACROECONOMIC DATA AND FORECASTS

	2018e	2019f	2020f	2021f	2022f	2023f	2024f	2025f	2026f	2027f	2028f
Nominal GDP, USDbn	34.8	34.6	36.5	38.9	41.6	44.4	47.2	49.7	52.2	54.9	57.7
Nominal GDP, EURbn	29.5	31.2	32.8	34.7	36.6	38.6	40.7	42.9	45.0	47.3	49.7
GDP per capita, USD	18,065	18,152	19,327	20,837	22,492	24,264	26,032	27,638	29,308	31,078	32,953
GDP per capita, EUR	15,309	16,353	17,412	18,604	19,816	21,099	22,442	23,826	25,266	26,791	28,408
Real GDP growth, % y-o-y	4.8	2.7	2.6	3.2	2.9	2.9	2.8	2.7	2.5	2.5	2.5
Private final consumption, % of GDP	58.8	59.5	60.0	60.1	60.1	60.2	60.3	60.3	60.3	60.3	60.3
Private final consumption, real growth % y-o-y	4.5	4.2	3.5	3.3	3.0	3.0	3.0	2.7	2.5	2.5	2.5
Government final consumption, % of GDP	17.7	17.7	17.7	17.7	17.6	17.6	17.4	17.3	17.2	17.1	17.0
Government final consumption, real growth % y-o-y	4.0	3.0	2.7	3.0	2.5	2.5	2.0	2.0	2.0	2.0	2.0
Fixed capital formation, % of GDP	22.8	24.3	24.6	24.6	24.6	24.6	24.6	24.7	24.8	25.0	25.1
Fixed capital formation, real growth % y-o-y	16.4	9.5	4.1	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Population, mn	1.93	1.91	1.89	1.87	1.85	1.83	1.82	1.80	1.78	1.77	1.75
Unemployment, % of labour force, eop	7.0	7.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
Consumer price inflation, % y-o-y, ave	2.5	2.7	2.6	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Lending rate, %, ave	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4
Central bank policy rate, % eop	0.00	0.00	0.00	0.00	0.50	1.00	1.00	1.00	1.00	1.00	1.00
Exchange rate EUR/USD, ave	0.85	0.90	0.90	0.89	0.88	0.87	0.86	0.86	0.86	0.86	0.86
Exchange rate EUR/EUR, ave	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Budget balance, USDbn	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3
Budget balance, % of GDP	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.5	-0.5	-0.5	-0.5
Goods and services exports, USDbn	20.1	19.8	20.7	21.7	22.9	24.1	25.3	26.3	27.4	28.5	29.6
Goods and services imports, USDbn	20.6	20.1	21.0	22.0	23.1	24.3	25.4	26.4	27.4	28.4	29.5
Balance of trade in goods and services, USDbn	-0.4	-0.3	-0.3	-0.3	-0.2	-0.2	-0.1	-0.1	0.0	0.0	0.1
Balance of trade in goods and services, % of GDP	-1.2	-0.9	-0.9	-0.7	-0.6	-0.4	-0.3	-0.2	0.0	0.1	0.2
Current account balance, USDbn	-0.5	-0.4	-0.5	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.3	-0.3
Current account balance, % of GDP	-1.5	-1.3	-1.2	-1.2	-1.0	-1.0	-0.9	-0.8	-0.7	-0.6	-0.5
Foreign reserves ex gold, USDbn	7.9	8.4	8.7	9.0	9.1	9.2	9.2	9.2	9.2	9.2	9.2
Import cover, months	-5.4	-5.5	-5.5	-5.5	-5.4	-5.2	-5.1	-4.9	-4.7	-4.5	-4.4

e/f = Fitch Solutions estimate/forecast. Source: National sources, Fitch Solutions

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