Sovereign Ratings 2017: A Spotlight On Rising Political Risks

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Table Of Contents

The U.S. (AA+/Stable/A-1+): When could increased policy uncertainty under President Trump affect the rating?

The U.K. (AA/Negative/A-1+): Which Brexit, and does it matter for the rating?

Italy (BBB-/Stable/A-3): What’s next after Renzi’s referendum defeat?

France (AA/ Stable/A-1+): Could the French presidential elections destabilize the sovereign credit rating?

South Africa (BBB-/Negative/A-3): Is policymaking becoming less predictable?

Turkey (BB/ Stable/B): Will the further centralization of power damage economic fundamentals?

Brazil (BB/Negative/B): What will be the long-term impact of recent political scandals?

Mexico (BBB+/Negative/A-2): Will economic policy become less predictable?

Argentina (B-/ Stable/B): Can the political leadership overcome its legacy of seeking "policy shortcuts"?

Colombia (BBB/Negative/A-2): Will peace boost the rating?
Table Of Contents (cont.)

Malaysia (A-/Stable/A-2): How will the 1MDB scandal affect the sovereign rating?

Philippines (BBB/Stable/A-2): What could be the ratings implications of the new leadership?

Thailand (BBB+/Stable/A-2): What are the rating drivers after King Bhumibol?

Poland (BBB+/Stable/A-2): Is the institutional framework strengthening again?

Appendix: Why Politics Matters For Sovereign Ratings

Related Criteria

Related Research
Sovereign Ratings 2017: A Spotlight On Rising Political Risks

Prevailing political and institutional frameworks shape policies, and policies in turn shape economic outcomes and therefore sovereign ratings. We believe that political and institutional uncertainties are on the rise in so-called emerging and advanced economies alike. Changes in governance quality impact sovereign ratings: Among the 20 largest emerging market sovereigns we rate, the 10 that we have downgraded since January 2012 saw our assessment of their institutional effectiveness worsen by one notch (on a six-rung scale). In contrast, those not downgraded saw their institutional assessment improve by almost half a notch (see chart 2 in "Why Emerging Market Sovereign Ratings Are Falling While Portfolio Inflows Are Rising," published Oct. 3, 2016, on RatingsDirect). Among the five main factors that determine our rating criteria, institutional assessment has been the most important negative driver distinguishing emerging market sovereigns that were downgraded from those that were not (See "Appendix: Why Politics Matters For Sovereign Ratings" for our analytical approach to political risk).

At the same time, it may no longer be possible to separate advanced economies from emerging markets by describing their political systems as displaying superior levels of stability, effectiveness, and predictability of policymaking and political institutions. For example, the lowering of our ratings on the U.S. in 2011 and the U.K. in 2016 stemmed from our negative reassessment of institutional quality and governance effectiveness. The downgrade of more than half of the eurozone sovereigns in early 2012 was driven by similar considerations (see "Standard & Poor's Takes Various Rating Actions On 16 Eurozone Sovereign Governments," Jan. 13, 2012).

Overview

• Political and institutional risks appear to be rising in both emerging and advanced economies.
• Growing protectionist and nationalistic policies, and a focus on domestic agendas to the detriment of economic issues, are the main risk trends we see for sovereigns worldwide.
• We see several key political challenges for sovereigns as we enter 2017.

Ratings have also converged. A decade ago, there was little overlap between sovereign ratings on advanced economies (typically in the 'A' category and above) and ratings on emerging market sovereigns--mostly in the 'BBB' category or in speculative grade ('BB+' and lower). Today this differentiation is much less pronounced. In fact, the biggest sovereign default of all time was by an OECD member normally classified as an advanced economy (Greece).

As the ratings have converged, so have the political and institutional risks. Predictability of policies and democratic choices have diminished in the Western world, as reflected in the surprise votes for Brexit in the U.K. and the election of a non-political outsider to the presidency of the U.S. Voters' rejection of constitutional reform in the Italian referendum last weekend can be seen in a similar context.

The rapid structural changes in advanced economies are perceived as threatening their relative economic positions in society. This sense of falling behind feeds the support of political projects that appear to offer the prospect of returning to what many perceive, rightly or wrongly, to have been a golden era, where jobs were secure and the future less uncertain. When analyzing the socio-demographic voting patterns in the election of Donald Trump, or the referendum decision by the U.K. to leave the EU, we see these motives at play. The same current is observable when analyzing the recently buoyant support for populist parties in Europe. All of these movements have furthermore been able to bring previously apathetic strata of society back to the polling booth to cast their protest vote.
We believe that the success of these political movements will lead to a halt, or maybe even a reversal of globalization, including the risk of protectionist tendencies. This would risk reducing economic efficiency and growth, without self-evident gains in improving social justice. Most of the economic fallout of less open economies will be in the countries turning protectionist themselves. But there can also be non-negligible knock-on effects to third countries, which have important economic ties with the potentially inward-turning countries. The possible effect on emerging markets of a potential U.S. pivot toward itself is a clear reminder of the web of relations that connects the global economy in the 21st century (see "President Trump: The Economic And Ratings Risks For Emerging-Market Sovereigns," published Nov. 14, 2016).

The second trend toward rising political and institutional risk could be considered a reflection of complacency. Years of quasi-effortless growth thanks to generous terms of trade, global demand, and cheap financing have led some emerging market policymakers to succumb to complacency. Attempts to further enhance resilience and underlying growth potential appear to have become a second-order priority in many places. Why push for further opening up of markets and antagonize important stakeholders at home, when things appear to be running rather smoothly anyway?

Instead, politically more rewarding issues have attracted policymakers' attention. Some have thereby failed to establish robust regulation that would have prevented excessive leverage from creeping into the economy. Central banks may have been put under pressure to accommodate political priorities. Others were tempted to accommodate domestic stakeholders by increasing current government spending, for example on subsidies, or civil servants, or by directing credit into favored sectors or regions. Anecdotally, in some countries, perceptions of corruption have been on the rise. The vulnerabilities that were thus created are now being felt (see "The Emerging Market Sovereign Outlook: What's Gone Wrong?," Oct. 20, 2015).

In the following, S&P Global Ratings' analysts answer questions we frequently receive from investors. They discuss the key political challenges facing sovereigns in 2017, two decades after the Asian crisis and one decade since the first rumblings of what would become known as the great financial crisis. Each country has its own idiosyncratic aspects and may be in a different stage of a "populism cycle." For example, the pendulum of political risk may be swinging back toward the traditional political mainstream in Brazil, Argentina, and Greece, while it is still in its early stages in places as diverse as the U.S. and the Philippines.

An analytical case-by-case approach is always appropriate when analyzing sovereign risk. But never more so than when political and institutional risks move to center stage.

**The U.S. (AA+/Stable/A-1+): When could increased policy uncertainty under President Trump affect the rating?**

**Analyst: Lisa Schineller**

The recent election of Donald J. Trump as the 45th president of the U.S., after a campaign that heightened debate about economic issues, including international trade, immigration, globalization of industry, inequality, and the stagnation of real incomes of the middle class, has increased uncertainty about future government policies. Mr. Trump ran on a platform that was at odds with some policies of the traditional Republican leadership and its historical base. Given his lack of experience in public office, and his win as a political outsider without an established policy track
record, there is a higher degree of uncertainty over policy formulation and execution. However, we note in general that there is often a difference between campaign rhetoric and concrete policy proposals and execution once in office. In addition, policy will be informed by the Republican establishment in Congress as well as some experienced policymakers who have been tapped to join the administration.

U.S. policymaking and political institutions tend to be transparent and accountable. The checks and balances of the U.S. system of government have generally generated a stable backdrop for economic policy, notwithstanding several budgetary impasses in recent years.

That said, we believe there is a risk of policy uncertainty and potential missteps, given the absence of a policy track record for Mr. Trump, and the untested nature of some members of the incoming Trump Administration in public office, including the president himself. If these risks crystallize, there could be downward pressure on the U.S. 'AA+' rating. For example, a meaningful relaxation of fiscal policy without countervailing measures to address the longer-term fiscal challenges of the U.S., if serious enough, could lead to a rating action. Similarly, measures that would materially lower the U.S.' medium-term growth prospects could put downward pressure on the rating. On the other hand, we could raise the rating if we see evidence that policy efforts point to more proactive fiscal and public policies that result in a lower debt burden—be it through fiscal measures or a stronger trajectory in trend growth.

The recent elections show that both major political parties in the U.S. have failed to respond effectively to concerns of key constituencies. The platforms and leadership of both parties will be under pressure for additional change, a reflection of deeper changes in American society and economy. However, the country's long-standing political institutions and checks and balances are expected to remain stable, supporting predictability and continuity.

**The U.K. (AA/Negative/A-1+): Which Brexit, and does it matter for the rating?**

**Analyst: Ravi Bhatia**

We currently believe that a so-called hard Brexit is the most likely outcome: The U.K. would not be able to count on continued unfettered access to export goods and services to the remaining EU-27.

Six months after the June referendum, the U.K. government is yet to define what its plan for a post-EU world might be. We note that the priority of Prime Minister Theresa May's government appears to be to control immigration, including citizens from the EU, which currently face no restrictions to living or working in the U.K. We agree that the question of immigration was probably a key driver in generating the Brexit majority on June 23.

But an insistence on control over freedom of residence of European citizens will probably cost the U.K. access to the single market for goods, services, and capital as well, or at least much of it. Unambiguous statements from senior European leaders have underlined repeatedly their dogged commitment to the indivisibility of the four fundamental freedoms of movement (people, capital, goods, and services). If both sides hold on to their stance, and we believe there is a good chance they will, there is actually not very much to be negotiated: The two positions are mutually exclusive and won't yield a meaningful compromise. A hard Brexit would follow.

The Prime Minister has announced that the government will invoke Article 50 of the EU Treaty by March 2017. She
will have to negotiate terms of a new deal by the two-year deadline. In fact, the effective time for talks may be shorter, considering the string of elections in Europe and the need to accommodate the ratification process of any post-EU agreement in each and every EU member state.

Given that the U.K.'s exports of goods and services to the EU equal around 13% of U.K. GDP, versus less than 3% of EU27 GDP for EU exports to the U.K., the bargaining power seems to be largely on the EU's side.

The rating could come under pressure if the Brexit process were to contribute to the sterling losing its privileged status as a reserve currency, or if public finances or GDP per capita weaken markedly beyond our current expectations. In addition, we could lower our ratings if significant constitutional issues arise and create further financial and economic uncertainty, including the risk to territorial integrity should Scotland mount a credible move toward independence.

**Italy (BBB-/Stable/A-3): What's next after Renzi's referendum defeat?**

**Analyst: Marko Mrsnik**

The defeat of the proposed constitutional reform in last Sunday's national referendum does not directly impact Italy's creditworthiness, nor does the decision of Prime Minister Matteo Renzi to resign as a consequence. In our view, the result does not immediately affect Italy's economic and budgetary policies. The rejected reform was aimed at clarifying the responsibilities of the central and local governments and converting Italy's bicameral parliamentary framework into a unicameral system in order to streamline Italy's legislative process. From the perspective of political stability and effectiveness, we believe that the proposed reform would have been potentially beneficial.

Nevertheless, over the past several years, the current bicameral parliamentary framework has not impeded the resolve of Renzi's administration to legislate and implement several structural reforms since he took office in 2014--despite a thin parliamentary majority and stiff opposition, including from within the government coalition. These included reforms to the labor market, education, and banking sectors. Other government reforms, including to the public administration and the judiciary (to improve its efficiency and reduce the backlog of pending cases) were also being prepared. Their progress, however, appeared generally slow and uneven, focused on the time-consuming implementation of enabling laws, and we don't anticipate they will be accelerated before the next parliamentary election.

Overall, we expect that, following the resignation of Prime Minister Renzi, the next government is likely to reduce legislative activity on economic and medium-term budgetary policies, especially given the fragmented political landscape. We think reform delivery will therefore decelerate before the next parliamentary elections. In light of continuing pressures on the banking system, finding a solution for some of Italy's financial institutions may become a priority for the next government.

In our opinion, the referendum result will not automatically lead to a reversal of those economic reforms that Mr. Renzi managed to implement in recent years. The rating on Italy already reflects a slow pace of economic growth and a modest degree of budgetary consolidation. Downward pressure on the ratings would therefore emerge were there to be an overt reversal of past reforms, or in the event that Italy's external or fiscal performance deviated materially and negatively from our current projections.
France (AA/Stable/A-1+): Could the French presidential elections destabilize the sovereign credit rating?

Analyst: Marko Mrsnik

The first round of France's presidential election is scheduled to take place on April 23, 2017. If no candidate wins an outright majority, which is highly likely, a run-off will follow a fortnight later. Our baseline expectation is that the next president of France is likely to continue or even accelerate the current moderate pace of reform, with a focus on unblocking the labor market, and hence generating better growth outcomes. This expectation is also reflected in our change of the outlook to stable from negative in October. Given the surge of support for populism, reflected in the Brexit vote and the Trump victory in the U.S. elections, as well as the failure of opinion polls to detect those trends, a victory by Marine Le Pen of the National Front (FN) cannot be ruled out, although this is not our baseline assumption.

A victory by Le Pen, who is on record as favoring both the breakup of the EU and a referendum to reintroduce the French franc, would likely be a blow to financial and economic stability, not only in France but across the monetary union. While the FN has yet to publish its full manifesto, it is expected to include measures that could be incompatible with EU obligations, including retaking control of national borders.

Alternatively, a victory by the Republican candidate Francois Fillon or, less likely, the yet-to-be-announced Socialist candidate, would in our view likely build on ongoing reform efforts. For example, Mr. Fillon has laid out a comprehensive economic reform platform, which could ease bottlenecks in France's labor and product market, and also reduce the size of the state in the economy (with general government currently spending 56% of French GDP). To the extent that the implementation of such a program lastingly enhances France's economic and fiscal performance, the sovereign rating could experience upward pressure.

South Africa (BBB-/Negative/A-3): Is policymaking becoming less predictable?

Analyst: Gardner Rusike

We believe that political events have distracted from growth-enhancing reforms, while low GDP growth continues to affect South Africa's economic and fiscal performance and overall debt stock. Economic growth has moved from weak to weaker and we believe that 2017 will mark the third year in a row with negative per capita growth. GDP per capita has grown by just over 3.5% since the beginning of the decade. Flat public wage spending has exacerbated economic stagnation, leading unemployment to reach a 13-year high of 27%.

Economic stagnation, as well as perceived corruption, should be a recruiting ground for radical opposition parties, such as the Economic Freedom Fighters. So far, however, the centrist Democratic Alliance appears to be benefiting more, supporting pro-business policies while advocating educational reforms and a generally anti-corruption platform.

That said, political tensions within the ruling Africa National Congress (ANC) party are still high and quite likely more important. The former finance minister was removed from office late last year on what is believed to be an attempt by the presidency to limit the Treasury's traditional independence; the Constitutional Court ruled against President Jacob Zuma on March 31, 2016; and the ANC lost some of the key cities (including Johannesburg and Pretoria) in the August
municipal elections. Furthermore, the fraud charges against the current finance minister, Pravin Gordhan, and other former tax-authority employees in October 2016, were pursued before being dropped in the same month. Finally, a North Gauteng High Court ruling led to the publication of the "State of Capture" report, which sheds light on alleged corruption between private individuals and public officials. After an unprecedented challenge to President Jacob Zuma's leadership, the ANC national executive committee announced in late November that calls for Zuma to resign had failed.

We believe that the strained political environment raises risks related to the effectiveness, stability, and predictability of economic policymaking. To date, it is our view that the capacity and independence of key institutions (namely the treasury, the Reserve Bank, and the judiciary) remain intact. At the same time, one trigger that could lead to South Africa losing its foreign currency investment-grade rating would be if we believed that institutions had become weaker due to political interference affecting the government's policy framework. We believe that next year the run-up to the ANC's elective conference in December 2017 will provide important pointers to assess the future of South Africa's institutions and policy direction.

Turkey (BB/Stable/B): Will the further centralization of power damage economic fundamentals?

Analyst: Trevor Cullinan

Even before July's attempted coup, President Erdogan had been pressing for fundamental constitutional reform to convert the country's political framework from a parliamentary to a highly centralized presidential system. Since July, the focus on centralizing power has redoubled. While a muscular security response in the aftermath of an attempted coup is understandable, there is concern that the reaction to the coup is chipping away at checks and balances. Affected parts of the government include the judiciary, police, armed forces, higher education, and the civil service, alongside parts of the private sector and the political opposition (both the co-heads of Kurdish Party HDP have been arrested). Informal political pressure on the Central Bank (CBRT) has also increased, with Turkey's Presidential Office commenting regularly on the need to keep interest rates low, and also advising retail depositors not to sell local currency for dollars, while encouraging commercial banks to collect gold deposits and re-deposit these with the CBRT. Signs of weakened business and financial confidence abound; and private investment growth is moribund. To the extent that domestic tensions also raise questions about property rights, net foreign direct investment will finance only around 1% of GDP of Turkey's current account deficit (expected at around 5% of GDP in 2017-2019), less than one-third of the financing it reached during the ruling AKP party's first term in office.

We think overt interference with the CBRT is driving more lira weakness during a period of rising global interest rates, and pressures on key Turkish exports, not least tourism. Although, after overseeing a multi-month course of monetary easing, the central bank finally reversed course in November by raising its overnight lending and repo rates, the tightening comes late in the day, and in the face of mounting internal and external pressures. A persistently weak lira could introduce material financial stress in the corporate sector, given the large net open foreign currency position of nonfinancial companies (about 30% of GDP).

During past episodes of currency weakness, Turkish retail depositors, which hold an estimated $82 billion in foreign
currency deposits, a figure well in excess of the CBRT's net reserves, have sold dollars to support the domestic exchange rate. The question is whether retail depositors will once again be net lira buyers. A sudden stop of external financing would put considerable pressure on corporate balance sheets and weaken Turkey's growth, ultimately becoming a difficulty for the country's banks and public finances.

**Brazil (BB/Negative/B): What will be the long-term impact of recent political scandals?**

**Analyst: Lisa Schineller**

Brazil has recently undergone economic contraction, ongoing investigations of corruption allegations, and impeachment proceedings that resulted in a change of government. GDP is set to decline by nearly 8% cumulatively during 2015 and 2016. Fiscal improprieties and a loss of political backing led to the impeachment of former president Dilma Rousseff in August this year; she was replaced by former vice president Michel Temer. The series of corruption investigations have damaged the reputation of the entire political class. Brazil's judiciary has indicted several members of Congress, prominent state-level leaders, and also implicated some large private-sector companies, whose senior officials have been indicted and imprisoned.

The ongoing investigations and impeachment process have clearly exacted a severe toll on the economy. They helped undermine the political standing of the previous Rousseff administration, hindering it from pursuing corrective fiscal and other policies needed to staunch the loss of creditworthiness in recent years. The threat of future revelations of corruption and illegal activity has also affected the Temer administration, resulting in the loss of several ministers. It may also further impact Congress as well, potentially weakening the administration's ability to implement its economic agenda.

The downgrades since 2014 reflect significant deterioration in public finances and the country's growth trajectory. However, we have kept our assessment of Brazil's institutional effectiveness as neutral.

The Temer administration has sought to impose a constitutional cap on government spending, a first step toward addressing the country's large fiscal deficits, and to gradually stabilize its debt burden. The spending cap seems likely to be approved by Congress. Subsequently, the administration plans to pursue a politically sensitive proposal to reform the country's costly pension system, thereby addressing a major source of fiscal deficits. This is likely to be politically challenging.

The near-term impact of the corruption investigations has been negative for both the economy and for the standing of Brazilian public officials. However, Brazil was able to change its political leadership within a stable institutional framework, holding public officials to account while maintaining political stability. The country's independent federal prosecutors and judges have subjected powerful public figures, as well as business leaders, to unprecedented investigation and accountability. Many Brazilians now feel that the country's powerful elites are more accountable than before, auguring well for governance and political stability. The long-term impact of the scandals could well be positive, if they result in greater transparency and accountability in politics, along with reforms to stabilize public finances and restore GDP growth.
Mexico (BBB+/Negative/A-2): Will economic policy become less predictable?

Analyst: Joydeep Mukherji

Democracy has brought political stability, regular changes of government, and predictable economic policies, but it has not created economic dynamism or improved public security in Mexico. For nearly two decades, successive Mexican administrations have maintained generally stable public finances, low inflation, and modest economic growth. Presidential power has alternated smoothly over the past 16 years between the center-left Partido Revolucionario Institucional (PRI) and the center right Partido Acción Nacional (PAN) without substantial changes in macro-economic policy. The center left Partido de la Revolución Democrática (PRD) has also followed similar economic policies at the local level (notably in Mexico City). Mexico's independent central bank enjoys broad political support.

Mexico has undertaken more structural reforms than most emerging market countries but its growth rate has been disappointing, due in part to non-economic factors. Real per capita GDP growth during 2011-2015 averaged 1.7%, which is slow for an emerging economy. Even during the global boom years, Mexico's growth lagged most emerging market peers, averaging 3.4% during 2004-2008, or 2.4% on a per capita basis. We expect GDP to grow by around 1.8% in 2017.

The current government led by President Enrique Pena Nieto of the PRI will remain in office until late 2018. Hence, we expect continuity in economic policy during that period. However, the government could become politically weakened by a potentially prolonged period of low GDP growth. Low economic growth could influence the outcome of elections in the politically important State of Mexico in 2017, as well as the next presidential elections due in mid-2018.

Various scandals, continued drug-related violence, and perceptions of rising corruption have damaged the reputation of the entire political class and all political parties in Mexico. Many Mexicans perceive that, unlike Brazil, the Mexican judiciary has not aggressively pursued allegations of corruption against powerful elected officials.

In addition, the domestic political consequences of a potential renegotiation of NAFTA, likely on less favorable terms for Mexico, could have an impact on the 2018 elections, favoring candidates who are opposed to closer economic integration with the global economy. Such factors could favor a shift toward populism after the next national elections. However, our base case remains that there will be broad continuity in economic policies after the 2018 elections, due in part to persistent public memory of high inflation and financial crises in the last two decades of the 20th century, which limits public support for radically different fiscal and monetary policy.

Argentina (B-/Stable/B): Can the political leadership overcome its legacy of seeking "policy shortcuts"?

Analyst: Delfina Cavanagh

We assess Argentina's institutional effectiveness as a weakness, reflecting a track record of unstable and often poor economic policies. Argentina has many of the structural features of wealthy countries, including deep technical and managerial skills. Nevertheless, its economic performance over the long term has been poor, with variable levels of inflation, sharp devaluation of its currency, bursts of good growth followed by sharp contractions, and multiple

Mauricio Macri was elected president in late 2015 after 12 years of rule by populist governments of President Nestor Kirchner (2003-2007) and his wife Cristina Fernandez de Kirchner (2007-2015). Macri’s election heralded a substantial change in the country’s economic policies. Macri inherited an economy with high inflation, severe distortions in relative prices, massive government subsidies, limited options for funding the fiscal deficit, and an overvalued exchange rate. Moreover, the government lacked access to external commercial funding due to its 2014 default on external debt.

The Macri administration began its term with bold steps to regain access to international capital markets, resolving its default with external creditors and issuing $16.5 billion in external debt in April 2016. It also took steps to liberalize the exchange rate, establish a more credible monetary policy, and gradually reduce the fiscal deficit. However, the President lacks a majority in both chambers of the Congress, forcing him to negotiate with various opposition groups. The government has limited capacity to advance with difficult reforms, especially before mid-term Congressional elections due next year. Argentina’s continued polarized political landscape could block or delay Macri’s legislative plans.

Argentina’s deeper political challenge is to strengthen institutions to enable them to withstand changes in government and in economic conditions, providing stability to a country that has experimented unsuccessfully with various types of development strategies in the past. The best long-term rating trajectory for Argentina would result from a combination of gradual institution-building and structural reform to encourage more investment. The worst trajectory would result from the lack of progress in either. Institution-building will likely be more important than structural reform in Argentina over the long term if the country aspires to a sovereign rating comparable with other countries with similar levels of income and human capital.

Colombia (BBB/Negative/A-2): Will peace boost the rating?

Analyst: Lisa Schineller

Even before the signing of the peace deal, our assessment of the country’s institutional effectiveness ceased to be constrained by the domestic armed conflict with the FARC guerrillas, thanks to the noteworthy improvement in public security over the past decade. Nevertheless, successfully implementing a peace accord would mark a significant achievement for Colombia.

Colombia has suffered more than five decades of violence, while enjoying GDP growth exceeding 4% on average. But the impressive long-term economic numbers at the macro level contrast with immense social problems and injustices associated with the prolonged armed conflict. Ending the conflict could sustain economic growth, while delivering more of its benefits to the people directly and indirectly victimized by it.

The original peace agreement signed by President Juan Manuel Santos and the left-wing FARC guerrillas (the largest of the country’s two guerrilla groups) was narrowly rejected by Colombian voters in a recent referendum in October 2016. Afterward, the government and FARC settled on a revised agreement, incorporating modest changes to controversial aspects of the initial agreement (which was criticized by political opponents as being too lenient toward
the guerrillas). The revised agreement has been approved by Congress but will not be put to a second referendum.

Colombia will need to pass new laws and constitutional reforms to fully implement the peace deal, ensuring that there will be heavy debate and controversy about the details of the deal. Former president Alvaro Uribe, who led the opposition to the original deal, has so far continued to oppose the revised deal, but it remains to be seen how he and his followers will influence its implementation.

The long-term benefits of peace could include faster GDP growth, especially if Colombia can build a better physical infrastructure. However, there would also be costs, especially in compensating victims and in implementing new or expanded social programs. The key to success is to create a political consensus on measures that address an immense social debt and on an economic policy that creates jobs and sustains growth. This remains a long-term challenge that will dominate the political discourse and policymaking for years to come. We believe that the eventual trajectory on which society and the economy embarks will determine the sovereigns creditworthiness over the long term.

**Malaysia (A-/Stable/A-2): How will the 1MDB scandal affect the sovereign rating?**

**Analyst: YeeFarm Phua**

We believe the Malaysian government will remain committed to its fiscal and economic reforms. Although challenges to the political environment from the fallout of the 1Malaysia Development Bhd. (1MDB) corruption allegations have yet to dissipate, we believe they will not impede effective policymaking.

When Prime Minister Najib Razak tabled the Malaysian government's 2017 budget in late October, observers looked keenly for signs of an early election over the coming year. Indeed, allocations targeted at key constituencies of UMNO, the leading party in the ruling coalition, are suggestive of efforts to shore up electoral support. These measures include increments to the 1 Malaysia People's Aid (BR1M) program, which provides direct cash transfers to low-income households, a raft of outlays aimed at supporting Bumiputera (ethnic Malay) business interests, and a significant expansion to credit access for civil servants. However, the overall spending program is relatively conservative, supporting our belief that Malaysia remains committed to long-term fiscal consolidation. The government is targeting a broadly unchanged budget deficit of 3.0% of GDP, and assumptions regarding revenue growth and commodity prices are prudent. As such, we do not view the 2017 budget as having a material impact on our sovereign ratings on Malaysia.

In another recent development, the central bank has re-enforced a prohibition on the facilitation of non-deliverable ringgit forwards (NDFs) amid heavy downward pressure against the currency. With the ringgit having weakened by approximately 6.1% versus the U.S. dollar since the beginning of November, the central bank has backstopped the currency via onshore intervention in an effort to curb excessive volatility. The ringgit has been one of Asia's worst-performing currencies during the latest period of U.S. dollar strength, spurring the central bank--Bank Negara Malaysia (BNM)--to launch renewed efforts against the NDF market, which it asserts is highly speculative in nature.

We hold the view that the NDF market is largely utilized for speculative purposes, and we therefore see little impact on the real economy, trade finance, or other ringgit-denominated transactions stemming from the central bank's action. Furthermore, BNM has opposed the NDF market for more than two decades, and the recent re-enforcement of these
rules does not reflect any change in capital controls.

Finally, while the corruption allegations regarding 1MDB continue to cast a shadow over Malaysia, we believe that Prime Minister Najib Razak's position is secure for the time being. The prime minister has effectively consolidated his position within UMNO, and opposition to the broader Barisan Nasional coalition remains fractured. While it remains to be seen whether or not the Prime Minister opts for snap polls in 2017, further negative developments in the 1MDB saga would be necessary in order to have a material impact on the sovereign's ratings profile.

Philippines (BBB/ Stable/ A-2): What could be the ratings implications of the new leadership?

Analyst: Kyran Curry

The government under President Rodrigo Duterte that emerged from the May 2016 general election has developed a "10-point plan" to reduce poverty, promote a "law abiding society", and achieve peace settlements with separatists in Mindanao. Other priorities include macroeconomic stability guided by orthodox fiscal, economic, and development policies. The president has a strong focus on improving "law and order," which has allegedly resulted in numerous instances of extrajudicial killings since he came to power. We believe this could undermine respect for the rule of law and human rights, through the challenges it presents to the judiciary, media, and other democratic institutions. When combined with the president's policy pronouncements elsewhere on foreign policy and national security, we believe that the stability and predictability, as well as potentially effectiveness of policymaking is on the decline.

We believe that in the past, the stability, effectiveness, and predictability of policymaking in the Philippines have been subject to unusually wide changes from one presidency to the next. In the past, the economic fundamentals of the Philippines have proven relatively resilient against the repeated policy reorientations. In this context, it remains to be seen whether the Duterte presidency is simply "more of the same" and the latest instalment of the policy shifts that have occurred in the country, or whether some more fundamental change may be under way.

While the radical shift in domestic policymaking is undeniable, we believe President Duterte will broadly continue with the fiscal and economic development policies of the previous administration. In spite of additional spending on poverty reduction and social and economic infrastructure, we forecast fiscal deficits will average around 1% of GDP over 2016-2018. We estimate the deficits will allow the net general government debt burden to decline to about 18% of GDP in 2019 from its (low) peak of 28% of GDP in 2010, which represents a rating strength. That said, we believe that the rising pressure on the Philippines' institutional and governance settings has the potential to hamper the country's ability to develop and implement swift policy responses.

Thailand (BBB+/ Stable/ A-2): What are the rating drivers after King Bhumibol?

Analyst: YeeFarm Phua

After a reign of over 70 years, King Bhumibol Adulyadej passed away on Oct. 13. The much-revered monarch was regarded as a pillar of moral integrity in Thai society and his death has left a huge vacuum in the everyday lives of Thais. Fears that his passing will result in a period of social instability have receded, with Crown Prince Maha
Vajiralongkorn proclaimed king in early December.

Maha does not benefit from the overwhelming popularity of his late father. Some observers point to the possibility of the monarchy gradually losing its institutional prestige, opening up new uncertainties about the country's future path. On its own, we do not view the potential erosion as having a material impact on the sovereign ratings. In Thailand's constitutional monarchy, the king has little direct role in the setting of policies and the day-to-day running of the government.

The seemingly irreconcilable class and regional divide in Thai politics remains the key uncertainty affecting the sovereign credit quality. Thailand's political landscape has been in flux after a military coup deposed the elected government of Thaksin Shinawatra in September 2006. Since then, there have been frequent—and at times extra-constitutional—changes in the government. The latest military coup in May 2014 restored order on the streets of Bangkok but appears to have done little to mend the underlying social and political fissures.

The result of the August referendum on a new constitution affirmed the military government as the center of power. Many see the new constitution as allowing the military to exert significant political control even after a newly elected government comes into office. With a low voter turnout for the referendum, it is possible that the next election would yield a government with a weak mandate to bridge the political divide in the kingdom.

Consequently, we maintain our view that there is significant political uncertainty in the country. We expect that Thailand will continue to find it challenging to push ahead with policies that could reinvigorate economic development. Private-sector investment could see only a weak recovery over the next year or two. We expect economic performance will remain relatively subdued and provide little support for meaningful sovereign credit metric improvements. Amid these continuing tensions, it will benefit political stability significantly if the new king quickly establishes himself as a solid pillar of Thai society, thus contributing to institutional and constitutional stability.

Poland (BBB+/Stable/A-2): Is the institutional framework strengthening again?

**Analyst: Felix Winnekens**

Despite our recent outlook revision on Poland to stable from negative, the fundamental reasons for our downgrade of the sovereign in January 2016 remain in place. These include, in particular, the conflict over the Constitutional Tribunal, which has left the court virtually paralyzed throughout the year and has little chance of being resolved in a satisfying manner. Moreover, additional changes that have in our view led to a perceived weakening of public media independence and far-reaching changes regarding the civil service and judiciary have significantly eroded Poland's system of institutional checks and balances.

Furthermore, we think that the government's extensive social spending agenda could jeopardize support for sustainable public finances. Two key government initiatives will have a lasting impact on government spending. First, and most importantly, the pension reforms that originally would have resulted in an increase in the retirement age for both men and women to 67 could be reversed. The current initiative now going through the legislative process is for reductions in the retirement age to 60 for women (from 61) and 65 for men (from 66) could have an adverse budgetary impact as early as 2017. This reversal could be especially detrimental for the long-term sustainability of Poland's public
finances given its adverse demographic profile. Second, an enhanced child allowance program will increase spending permanently and cost an estimated 1% of GDP annually. Implementing further election promises, such as an increase in the tax-free income threshold, could also have a negative, albeit smaller impact on the budget going forward.

The outlook revision to stable earlier this month reflects reduced concerns over the central bank's independence. At the time of the January 2016 downgrade, our concern was that the new administration would use its ability to appoint nine new monetary policy council members, including the governor, with a view to increase political influence over the institution. Moreover, the planned forced conversion of Swiss franc-denominated mortgage loans, had it been implemented, could have opened up the National Bank of Poland (NBP) to political pressures. Almost one year later, however, our near-term concerns over actual or perceived political influence on the NBP have abated following the appointments of credible and experienced members to the monetary policy council.

Appendix: Why Politics Matters For Sovereign Ratings

S&P Global Ratings' sovereign ratings methodology explicitly references political factors that shape sovereign credit risk. Institutional effectiveness is one of our five key rating factors, the others being economic structure and growth prospects, external liquidity and international investment position, fiscal flexibility and performance, and monetary flexibility.

The institutional assessment explicitly analyzes the effectiveness, stability, and predictability of the sovereign's policymaking and political institutions, the sovereign's debt payment culture, as well as the transparency and accountability of institutions, among other things (see "Sovereign Rating Methodology," section V.C.1, published Dec. 23, 2014).

We analyze the effectiveness, stability, and predictability of policymaking, political institutions, and civil society, based on:

- The track record of a sovereign in managing past political, economic, and financial sector crises.
- The predictability in the overall policy framework and developments that may affect policy responses to a future crisis or lead to significant policy shifts.
- Actual or potential challenges to political institutions, possibly involving domestic conflict, from popular demands for increased political or economic participation, or from significant challenges to the legitimacy of institutions on ethnic, religious, or political grounds.
- The cohesiveness of civil society, as demonstrated by social mobility, social inclusion, prevalence of civic organizations, degree of social order, and capacity of political institutions to respond to societal priorities.

Effective policymaking and stable political institutions enable governments to address periods of economic distress and take measures to correct imbalances. This helps sustain long-term growth prospects and limit the risk of sharp deterioration of a sovereign's creditworthiness. Stable and well-established institutions generally ensure a certain degree of predictability in the general direction of policymaking, even when political power shifts between competing parties and policy details change as a result.

Conversely, succession risks, a high concentration of power, and potential or actual challenges to political institutions
are factors that can pose risks to institutional stability and, in turn, lead to substantial policy shifts and affect the continuity of key credit characteristics. The analysis of the risk of challenges to political institutions is based on the history of internal political conflicts, including extra-constitutional changes of government.

The accountability and transparency of institutions, data, and processes are based on the analysis of:

- The existence of checks and balances between institutions.
- The perceived level of corruption in the country, which correlates strongly with the accountability of its institutions.
- The unbiased enforcement of contracts and respect for the rule of law, which correlates closely with respect for creditors' and investors' interests.
- The independence of statistical offices and the media, as well as the history of data revisions or data gaps, as measures of the transparency and reliability of the information.

The transparency and accountability of institutions bear directly on sovereign creditworthiness because they reinforce the stability and predictability of both political institutions and the political framework. They do this even though they may not reinforce the stability of a ruling political class or party. In addition, transparent and accountable institutions, processes, and data are important because they enhance the reliability and accuracy of information and help make known in a timely manner any significant shifts in a country's policymaking or the occurrence of risks relevant to sovereign credit risk.

One important distinction needs to be emphasized: We believe that political factors matter in assessing sovereign credit risk. But this is not the same as taking political positions in a normative way. That we don't do. Our ratings have no bias in favor of one particular political party or even one particular political system. Terms like "democratic," "election," or "authoritarian" do not appear in our methodology at all. What matters in our assessment of sovereign credit risk are the results.

### Selected Sovereign Credit Ratings*

<table>
<thead>
<tr>
<th>Country</th>
<th>Long-term rating/Outlook/short-term rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S.</td>
<td>AA+/Stable/A-1+</td>
</tr>
<tr>
<td>U.K.</td>
<td>AA/Negative/A-1+</td>
</tr>
<tr>
<td>Italy</td>
<td>BBB-/Stable/A-3</td>
</tr>
<tr>
<td>France</td>
<td>AA/Stable/A-1+</td>
</tr>
<tr>
<td>South Africa</td>
<td>BBB-/Negative/A-3</td>
</tr>
<tr>
<td>Turkey</td>
<td>BB/Stable/B</td>
</tr>
<tr>
<td>Brazil</td>
<td>BB/Negative/B</td>
</tr>
<tr>
<td>Mexico</td>
<td>BBB+/Negative/A-2</td>
</tr>
<tr>
<td>Argentina</td>
<td>B-/Stable/B</td>
</tr>
<tr>
<td>Colombia</td>
<td>BBB/Negative/A-2</td>
</tr>
<tr>
<td>Malaysia</td>
<td>A-/Stable/A-2</td>
</tr>
<tr>
<td>Philippines</td>
<td>BBB/Stable/A-2</td>
</tr>
<tr>
<td>Thailand</td>
<td>BBB+/Stable/A-2</td>
</tr>
<tr>
<td>Poland</td>
<td>BBB+/Stable/A-2</td>
</tr>
</tbody>
</table>

*Sovereigns listed in the order that they appear in the article. Foreign currency ratings as of Dec. 6, 2016.*
Related Criteria

• Sovereign Rating Methodology, Dec. 23, 2014

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• President Trump: The Economic And Ratings Risks For Emerging-Market Sovereigns, Nov. 14, 2016
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• Standard & Poor’s Takes Various Rating Actions On 16 Eurozone Sovereign Governments, Jan. 13, 2012

Only a rating committee may determine a rating action and this report does not constitute a rating action.

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