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Next Generation EU Will Shift European Growth Into A Higher Gear

April 27, 2021

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Key Takeaways

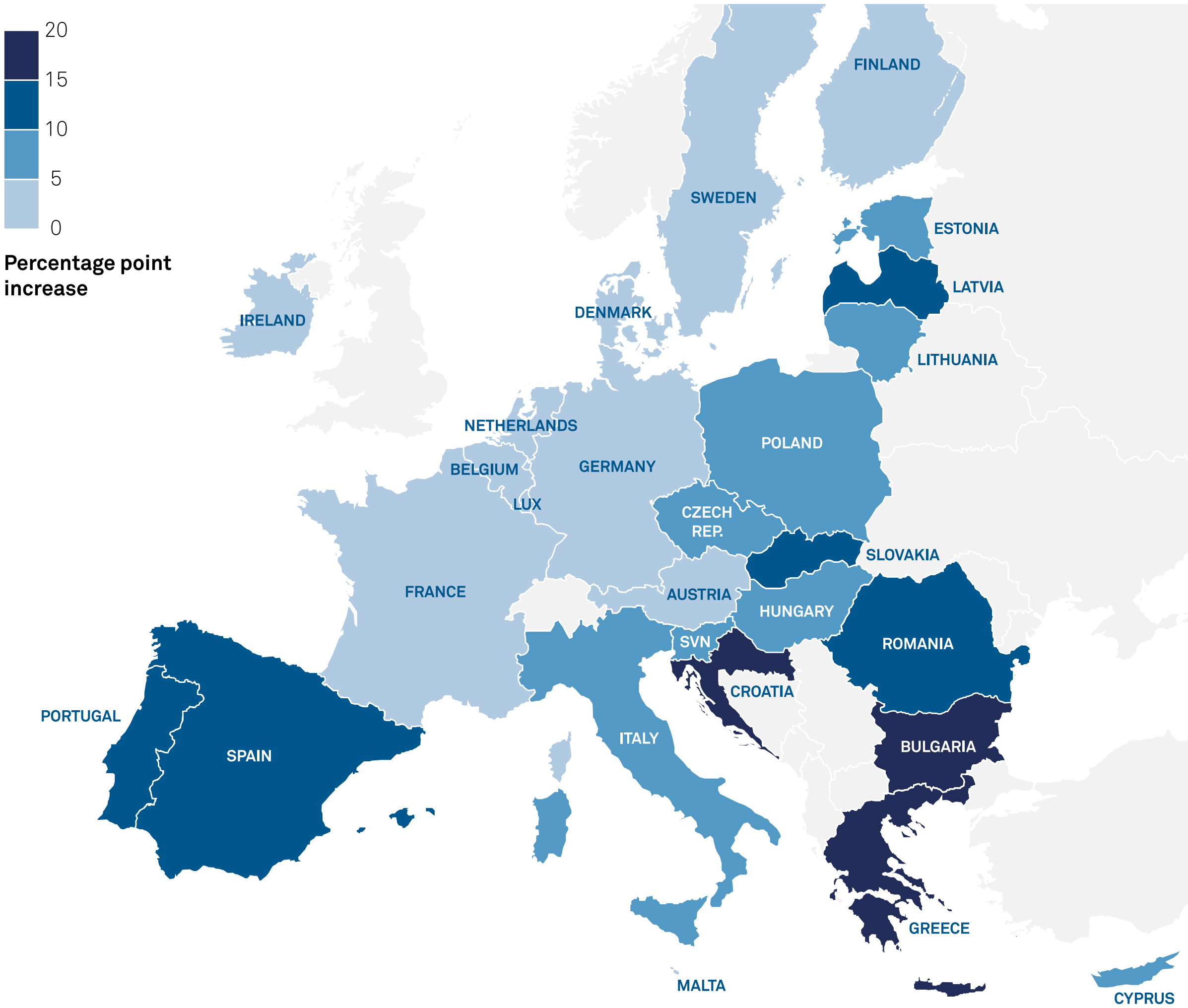
- The Next Generation EU plan could add 1.5% to GDP under our low-impact scenario over the next five years and 4.1% under a high-impact scenario, where we made different assumptions about the timing of disbursements, the absorption of funds, and the size of growth multipliers from public spending.
- The plan aims for growth that reduces economic divides in the EU--including through national structural reform--fosters the transition to a green and digital economy, and strengthens the euro's international role.
- We view the plan at the EU level as supportive of European sovereigns' creditworthiness, though national governments' ability to implement structural reforms hinges on the unwinding of economic imbalances that have worsened because of the pandemic.

With its €750 billion Next Generation plan, the EU aims to repair the damage that COVID-19 wrought and reset economic growth onto a higher and more sustainable path. How powerful is the plan? S&P Global Ratings estimates that Next Generation EU could add as much as 4.1% to GDP by 2026, according to our high-impact scenario. In a low-impact scenario, we believe the plan could add 1.5% to the EU's output by that time. Our scenario approach makes specific assumptions about these economic levers:

- The multiplier effects of public spending,
- The deployment of funds available,
- The timing of the implementation of the plan, and
- The absorption rates of EU funds in each country.

The two scenarios combine these levers differently to understand the potential impact of the EU fiscal stimulus on growth (see box 1 for details). Yet, we acknowledge the difficulties of estimating the economic impact in the five years ahead because of uncertainties about the plan's implementation. We assume the funds will be spent from mid-2021, though delays are likely.

Next Generation EU: Cumulative GDP Impact By 2026 Under Our High-Impact Scenario
S&P Global Ratings' estimate of Recovery and Resilience Facility component of the plan



Source: S&P Global Ratings.

Next Generation EU And Our Analytical Approach

In response to increasing evidence of economic divergence among EU countries resulting from the effects of the pandemic, EU heads of state agreed in July 2020 the Next Generation EU program, which empowers the European Commission to raise financing in the capital markets of up to €750 billion (5.6% of EU GDP) for spending at the national level. Of that, €672.5 billion (5.1% of EU GDP) will be disbursed under the newly created Recovery and Resilience Facility (RRF). Grants are to make up nearly half of the RRF. That decision was followed up on Feb. 10, 2021, by a political agreement under which the European Parliament assented to the RRF and the EU multiannual financial framework (MFF).

Together with a three-layer safety net worth up to €540 billion, the Next Generation EU program is part of the EU response to counteract the economic damage from COVID-19, an asymmetric yet common shock to member states, and foster its environmental and social objectives. We think the plan could be somewhat of a Hamiltonian moment for the EU, as it intends to raise the financial means on the capital markets under its own credit signature (see "The EU's Recovery Plan Is The Next Generation Of Fiscal Solidarity," published June 8, 2020).

The next step is for member states to submit to the Commission their plans for investment projects, and supporting reforms, to deploy the RRF. These national recovery and resilience projects and related reform plans are due to be submitted to Brussels by the end of April.

Some funds are already supposed to flow this year: €39.8 billion under the React-EU facility and a fraction of the €338 billion in grants under the RRF, including by national treasuries prefinancing a portion of the expected inflows.

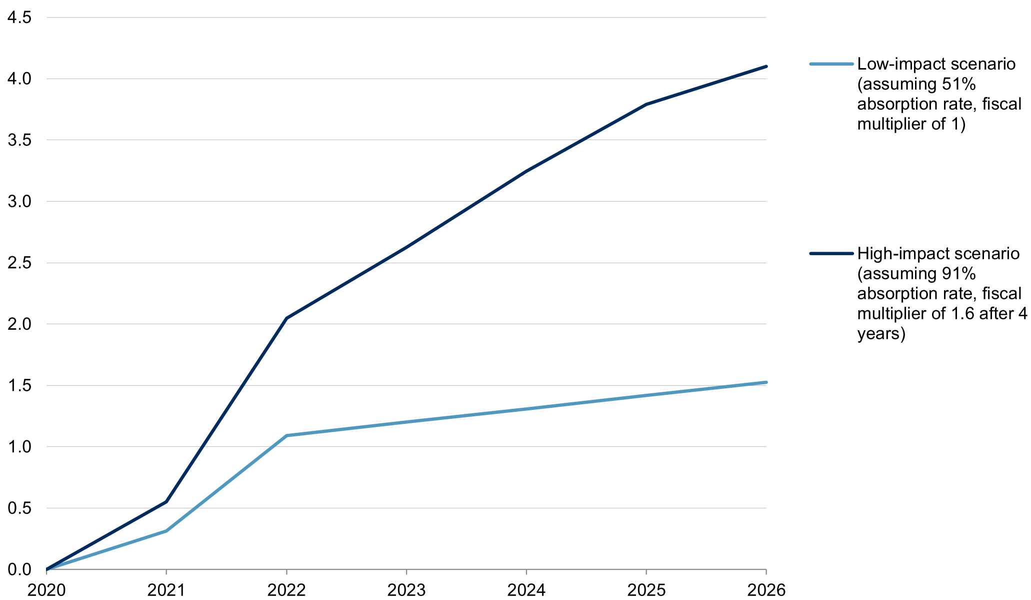
For our scenario analysis, we consider the EU recovery plan in a narrow sense: grants disbursed under Next Generation EU, that is, React-EU and the RRF, the Just Transition Fund, and a share of European Agricultural Fund for Rural Development (EAFRD). The plan is likely to be larger than that, since in addition to grants received, member states can borrow up to 6.8% of GDP from the EU. For now, given very low interest rates on European government bonds, only a few governments have suggested they would take the benefit of this proposal, for example by on-lending to the private sector at very low borrowing costs via the banking system. Therefore, the present analysis focuses only on grants. At the same time, our analysis does not incorporate the impact of structural economic and budgetary reforms governments are planning to undertake to become eligible for RRF funds because we have no visibility about them, despite their clear benefits if managed properly.

In a low-impact scenario, we assume each country absorbs the plan's funds at the 51.4% EU-27 average rate for funds entitled under the last MFF (2014-2020). We set the multiplier effect at a conservative 1 and assume that only one-half of the grants scheduled for 2021 are affectively paid out, the rest in 2022. In this scenario, the cumulative effect on EU economic growth would be 1.5% of GDP in 2026, with strong differences across countries (see tables 1 and 2 in the appendix). The strongest impact on annual growth occurs in 2022, when the bulk of the funds should be spent, followed by a decreasing but positive boost to growth through 2026.

In a high-impact scenario, we adopt a resolutory more optimistic assumption about the absorption rate, considering that Next Generation EU grants do not have to be cofinanced and are expected to involve less red tape than past regular EU funds. We therefore set the absorption rate at 91.3% for the EU-27, the average for funds entitled over the previous MFF (2007-2013). The multiplier effect is 1.6 after four years, in line with our own estimations. We assume here as well that 50% of the grants scheduled for this year are effectively paid out, the rest in 2022. Under such assumptions, the cumulative effect on EU economic growth would be 4.1% of GDP in 2026, with even stronger differences among countries than under the low-impact scenario (see appendix).

Chart 1

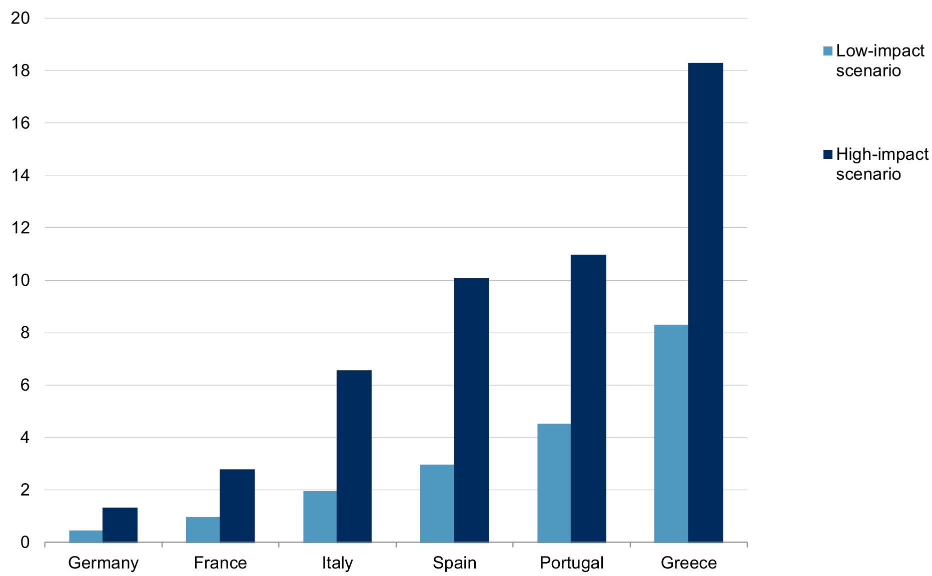
The Next Generation EU Plan: S&P Global Ratings' Scenarios For GDP Growth
EU economy, % of 2020 GDP



Source: S&P Global Ratings.

Chart 2

The Next Generation EU Plan: S&P Global Ratings' Scenarios For GDP Growth By Country
Cumulative growth 2021-2026, as % of 2020 GDP



Source: S&P Global Ratings.

Next Generation EU is in many ways supportive of European sovereign creditworthiness

All countries in the EU would benefit from the plan's direct effects on growth, though its power will mostly depend on the timing of disbursement, the absorption of EU funds, and the multiplier effects of public spending. Under our low-impact scenario, the level of GDP increases 1.5% above where it would have been without the Next Generation EU plan. At 1.3%, the eurozone figure is nearly identical. Under the high-impact scenario the gap remains equivalent, with GDP 4.1% higher after five years in the EU and the eurozone level 3.9% higher than in the absence of Next Generation EU. All member states see GDP increasing at least 0.2% under the low-impact scenario and 0.5% under the high-impact scenario. However, these estimates do not incorporate second-round effects of higher growth of individual economies through trade channels. Therefore, the results from this perspective, even under the high-impact scenario, may be conservative.

That said, not all countries may benefit equally. Indeed, Next Generation EU is designed to reduce the economic divides among EU national economies and accelerate the green and digital transition.

Another benefit would go beyond the individual EU member states, because of the way the plan will effectively be financed. Having the EU issue debt securities to finance the recovery plan, which is novel, could boost the international role of the euro as a green safe asset (See "The EU Recovery Plan Could Create Its Own Green Safe Asset," published on July 15, 2020) and help reduce the financial fragmentation of the public-sector bond market denominated in euros.

An additional economic benefit is related to each country's structural reform plans, which if fully implemented, would likely boost EU economic growth in the years to come. We view positively the conditionality of EU funds on these structural reforms because it strongly encourages governments to tackle key weaknesses that the crisis has exacerbated. By improving the business environment, the labor market, and education, among other factors, growth potential would increase. Economic growth is critical to reducing the current large budget deficits as well as government debt (in GDP terms) back to pre-pandemic levels and beyond. However, governments may shy away from implementing unpopular economic reforms. Any permanent economic dislocation related to the pandemic could cement opposition to labor and other market reforms--worsened by increased political fragmentation in many countries--with negative implications for growth and sovereign ratings.

Overall, we view the policy response at the EU level as supportive of European sovereigns' creditworthiness. That's because under the Next Generation plan, EU sovereigns have significant financial levers that can be deployed with substantial flexibility compared to traditional EU structural funds, which require cofinancing. However, as discussed above, the sheer volume of financial support available presents an absorption challenge. This suggests to us that the successful deployment of funds will require a reorganization of public administration to increase the speed, efficiency, and quality of spending.

Assumptions about the size of fiscal multipliers can lead to large forecasting gaps

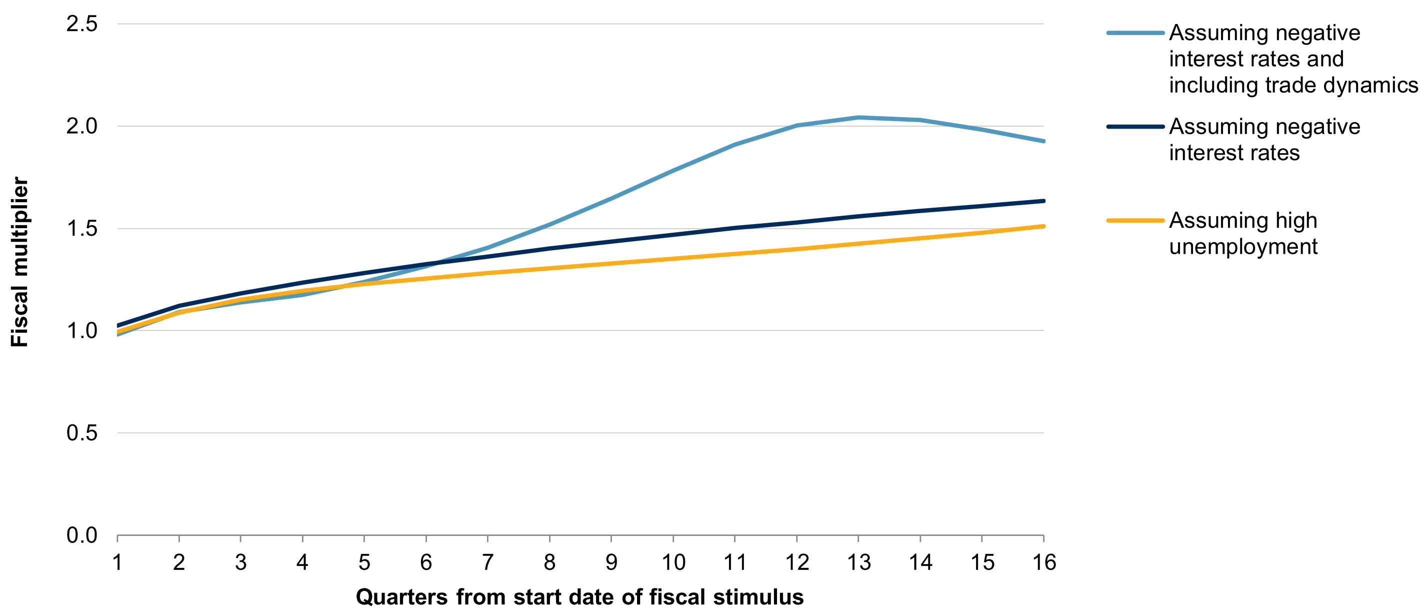
While our assumptions for the first three economic levers can be taken from past observations or can be deduced rationally, the multiplier is a trickier but essential assumption. Underestimating the size of fiscal multipliers can lead to large forecasting errors, which was the case following the financial crisis (see Blanchard O. and Leigh D., "Growth Forecast Errors and Fiscal Multipliers," IMF, WP/131). There is no clear consensus about the size of multipliers for the European economy. Because fiscal stimulus and growth are linked, econometrics offers only limited tools to isolate the impact they have on each other. Indeed, in many simulations of the impact of fiscal stimulus, fiscal multipliers are considered merely as endogenous variables (subject to influence by other variables inside the scope of analysis). What's more, the academic literature on fiscal multipliers has found that the impact of a fiscal stimulus on growth varies according to the context in which the economy evolves, which reduces the data sample available to estimate such effects.

For these reasons, we compute the fiscal multiplier for the European economy using state-of-the-art estimation methods that isolate the size of the fiscal multiplier depending on the state of the economy and its monetary policy stance (for the methodology see "The Case For Bold Fiscal Stimulus In The Eurozone," Nov. 17, 2020). Our economic modeling suggests fiscal stimulus has the highest impact on growth when demand is depressed and interest rates are negative, which is the current state of the European economy. In the current context, both fiscal and monetary policy are aimed at getting the economy back on track. As there is a lot of slack in the economy, fiscal stimulus is unlikely to feed into high import spillovers or trigger inflationary pressures and therefore, monetary policy is likely to remain supportive, enabling governments, firms, and consumers to finance their investments at low costs, in response to the demand created by the fiscal expansion. According to our estimates, the Next Generation EU stimulus could boost growth between 1.6 and 2 times the amount spent after four years in the eurozone, that is, for every €100 spent, economies would generate up to €200 (see chart 3).

Chart 3

€100 Of Eurozone Spending Today Can Generate €150-€200 After Four Years

S&P Global Ratings' fiscal multiplier, under high unemployment and negative interest rates



Source: S&P Global Ratings' estimates.

The full deployment of funds is subject to conditions that would foster the green and the digital transition

In our simulation, we assume the European Commission validates the full amount of spending plans submitted by the member states. For countries to receive the full amount of grants to which they are entitled, the national recovery plans need to meet the conditions agreed by EU member states in July 2020. Notably, the RRF, which represents with €338 billion the bulk of grants under Next Generation EU, clearly prioritizes the green and digital transitions: Each national plan needs to include a minimum 37% of spending on climate investment and reforms and 20% to foster the digital transition. The plans will be assessed by the European Commission against these criteria and might see their allocations reduced in case they are not met. A clearer view in this regard will be possible after all countries submit their draft plans to the European Commission by the end of April. A look at the draft plans that were submitted well in advance shows important divergences among member countries. The German and French plans, most of which are financed with the countries' own resources, overshoot the targets for the green and digital criteria. The Spanish government is planning to spend 37% of its funds on green priorities and 33% on digitization.

However, it seems less clear for the time being whether all countries' plans will meet these requirements. Consequently, there is a possibility that some countries will not be eligible for the full allocations of funds.

Delays in spending are likely, with differences by country

We assume the funds will be spent from mid-2021, though delays are likely. This is because the EU may take more time than expected to disburse the funds and because the approval of projects to finance might take some time in countries less able to frontload spending ahead of receiving the EU grants. However, such delays would affect the timing of spending, reducing spending in 2021 to the benefit of 2022, and therefore constitute a postponement rather than a loss in GDP growth.

It is important to note that EU countries do not have to wait for the EU money to start spending in line with their fiscal recovery plans. Indeed, most sovereigns have been prefinancing spending, at the national level, that they expect to reimburse with EU inflows. As a result, they already started spending last year to kickstart economic recovery. Indeed, the EU will accept projects that started in 2020 as long as they fall under the recovery plan submitted and approved by the EU. This means that even for net beneficiaries of the EU stimulus, countries just have to prefinance the stimulus themselves, which doesn't come at excessive cost given currently low interest rates.

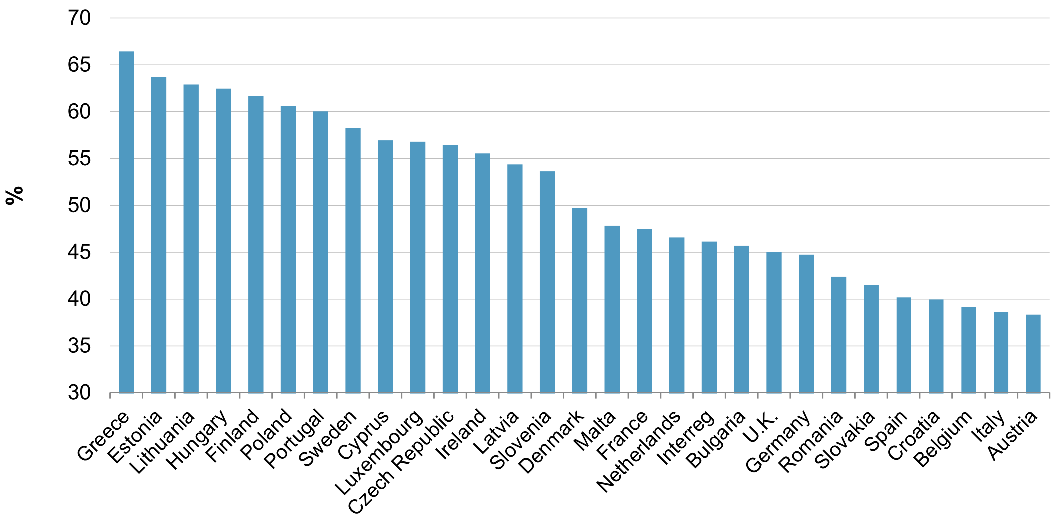
The extent and speed at which countries absorb funds are other crucial determinants of the economic impact

Member states may not be able to absorb the EU funds in full. On average, all EU funds (cohesion funds, European Regional Development Fund, European Social Fund) entitled under the last MFF were absorbed at an average 51.4% after seven years, though widely varying by country, ranging from 38% for Austria to 66% for Greece (see chart 4). Past absorption rates of EU funds may prove a bit misleading this time, given the different nature of the recovery plan (no cofinancing and less red tape, for example) and the fact that all economies are running below their potential and so have more space to absorb stimulus.

Chart 4

Absorption Rates Of EU Funds By Country After Seven Years

Based on average for 2014-2020 multiannual financial framework



Source: S&P Global Ratings.

Which Countries Benefit The Most?

We determine the size of Next Generation EU transfers and loans to individual countries by population, per capita GDP (a lower figure leads to a higher allotment), average unemployment over the last five years, as well as our estimate for the contraction of GDP during 2020 and 2021. We estimate the rise in GDP to 2026 from what would be the case without the Next Generation EU plan.

Greece and Bulgaria. A high level of pre-pandemic structural unemployment, lower per capita GDP relative to peers, a large investment gap, a large service sector (particularly tourism), as well as a relatively high past absorption rate for EU funds explain why the two largest benefactors are Greece and Bulgaria. Under our estimates, the Next Generation EU plan would boost GDP in these two economies 8.3% and 6.1% under our low-impact scenario and 18.3% and 18.2% under the high-impact scenario.

Portugal, Latvia, Croatia. Under our low-impact scenario, the plan would lift GDP 4.5% by 2026 for Portugal and Latvia, and 5.8% for Croatia. Portugal and Croatia have very large tourism sectors. Even in the case of Latvia, tourism generates an estimated 8% of total employment. Under the high-impact scenario, GDP for Portugal, Croatia, and Latvia would rise 10.9%, 16.3%, and 12%. The high-impact outcome for Croatia largely reflects its weaker track record for absorbing funds.

Lithuania, Spain, and Estonia. We see a rise in GDP at just under 4% for Lithuania, Spain, and Estonia. Among larger economies, Spain stands out as a major benefactor of Next Generation EU funds. Under the high-impact scenario this is even clearer, as we project GDP to rise 10.1%, compared with 8.5% for Lithuania and 8.2% for Estonia. The higher bump for Spanish GDP under the high-impact scenario again reflects Spain's weaker track record for absorbing EU funds (all of which required cofinancing, whereas Next Generation EU funds do not).

Appendix: S&P Global Ratings' estimates of growth impact by country

Tables 1 and 2 show the marginal economic effect of the Next Generation EU plan on each 27 member states' GDP, that is the increase arising from the plan over the baseline. We present the results on annual basis on one side and on a cumulative basis (that is, compared with 2020 GDP) on the other side.

Table 1

S&P Global Ratings' Low-Impact GDP Growth Scenario For The Next Generation EU Plan

Assumptions: Absorption rate = the average for total EU funds 2014-2020; multiplier = 1; full allotment of entitled grants; one-half of grants due in 2021 are postponed to 2022

	Implied annual GDP growth						Cumulative GDP growth (compared to 2020 GDP=100)						
	2021	2022	2023	2024	2025	2026	2020	2021	2022	2023	2024	2025	2026
Belgium	0.1	0.3	0.0	0.0	0.0	0.0	100.0	100.1	100.4	100.4	100.5	100.5	100.6
Bulgaria	1.1	3.0	0.5	0.5	0.5	0.5	100.0	101.1	104.1	104.6	105.1	105.6	106.1

Table 1

S&P Global Ratings' Low-Impact GDP Growth Scenario For The Next Generation EU Plan (cont.)

Assumptions: Absorption rate = the average for total EU funds 2014-2020; multiplier = 1; full allotment of entitled grants; one-half of grants due in 2021 are postponed to 2022

	Implied annual GDP growth						Cumulative GDP growth (compared to 2020 GDP=100)						
	2021	2022	2023	2024	2025	2026	2020	2021	2022	2023	2024	2025	2026
Czech Republic	0.5	1.2	0.2	0.2	0.2	0.2	100.0	100.5	101.7	101.9	102.1	102.3	102.5
Denmark	0.1	0.2	0.0	0.0	0.0	0.0	100.0	100.1	100.2	100.2	100.3	100.3	100.3
Germany	0.1	0.2	0.0	0.0	0.0	0.0	100.0	100.1	100.3	100.3	100.3	100.4	100.4
Estonia	0.7	1.7	0.3	0.3	0.3	0.3	100.0	100.7	102.4	102.7	103.0	103.3	103.6
Ireland	0.0	0.1	0.0	0.0	0.0	0.0	100.0	100.0	100.2	100.2	100.2	100.2	100.2
Greece	1.6	4.2	0.6	0.5	0.5	0.5	100.0	101.6	105.9	106.5	107.1	107.7	108.3
Spain	0.6	1.5	0.2	0.2	0.2	0.2	100.0	100.6	102.2	102.4	102.5	102.7	102.9
France	0.2	0.5	0.1	0.1	0.1	0.1	100.0	100.2	100.7	100.7	100.8	100.9	100.9
Croatia	1.2	3.0	0.4	0.4	0.4	0.4	100.0	101.2	104.2	104.6	105.0	105.4	105.8
Italy	0.4	1.0	0.1	0.1	0.1	0.1	100.0	100.4	101.4	101.5	101.7	101.8	101.9
Cyprus	0.6	1.6	0.2	0.2	0.2	0.2	100.0	100.6	102.3	102.5	102.8	103.0	103.3
Latvia	0.9	2.3	0.3	0.3	0.3	0.3	100.0	100.9	103.3	103.6	103.9	104.3	104.6
Lithuania	0.7	1.9	0.3	0.3	0.3	0.3	100.0	100.7	102.6	102.9	103.2	103.4	103.7
Luxemburg	0.1	0.1	0.0	0.0	0.0	0.0	100.0	100.1	100.2	100.2	100.2	100.2	100.2
Hungary	0.8	2.1	0.3	0.3	0.3	0.3	100.0	100.8	102.9	103.2	103.4	103.7	104.0
Malta	0.4	0.8	0.1	0.1	0.1	0.1	100.0	100.4	101.3	101.4	101.4	101.5	101.6
Netherlands	0.1	0.2	0.0	0.0	0.0	0.0	100.0	100.1	100.3	100.3	100.3	100.4	100.4
Austria	0.1	0.2	0.0	0.0	0.0	0.0	100.0	100.1	100.3	100.3	100.4	100.4	100.4
Poland	0.6	1.7	0.3	0.3	0.3	0.3	100.0	100.6	102.4	102.6	102.9	103.2	103.5
Portugal	0.9	2.3	0.3	0.3	0.3	0.3	100.0	100.9	103.3	103.6	103.9	104.2	104.5
Romania	0.7	1.8	0.3	0.3	0.3	0.3	100.0	100.7	102.5	102.7	103.0	103.3	103.5
Slovenia	0.6	1.4	0.2	0.2	0.2	0.2	100.0	100.6	101.9	102.1	102.3	102.5	102.7
Slovakia	0.7	1.7	0.2	0.2	0.2	0.2	100.0	100.7	102.4	102.7	102.9	103.1	103.4
Finland	0.1	0.4	0.1	0.1	0.1	0.1	100.0	100.1	100.5	100.6	100.6	100.7	100.7
Sweden	0.1	0.3	0.0	0.0	0.0	0.0	100.0	100.1	100.3	100.4	100.4	100.4	100.5
EU-27	0.3	0.8	0.1	0.1	0.1	0.1	100.0	100.3	101.1	101.2	101.3	101.4	101.5
Eurozone	0.3	0.7	0.1	0.1	0.1	0.1	100.0	100.3	100.9	101.0	101.1	101.2	101.3

Source: S&P Global Ratings.

Table 2

S&P Global Ratings' High-Impact GDP Growth Scenario For The Next Generation EU Plan

Assumptions: Absorption rate = The average for total EU funds 2007-2013; multiplier = 1.6 after four years (linear progression); full allotment of entitled grants; one-half of grants due in 2021 are postponed to 2022

	Implied annual GDP growth						Cumulative GDP growth (compared to 2020 GDP=100)						
	2021	**2022**	**2023**	**2024**	**2025**	**2026**	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**	**2026**
Belgium	0.5	0.5	0.3	0.3	0.2	0.2	100.0	100.2	101.0	101.3	101.6	101.9	102.0
Bulgaria	4.4	4.5	2.4	2.5	1.9	1.4	100.0	102.2	108.6	111.2	114.1	116.6	118.2
Czech Republic	1.5	1.5	0.8	0.9	0.7	0.5	100.0	100.8	102.9	103.7	104.7	105.5	106.0
Denmark	0.2	0.2	0.1	0.1	0.1	0.1	100.0	100.1	100.4	100.6	100.7	100.8	100.9
Germany	0.3	0.3	0.2	0.2	0.1	0.1	100.0	100.2	100.6	100.8	101.0	101.2	101.3
Estonia	2.1	2.0	1.1	1.2	0.9	0.7	100.0	101.1	103.9	105.1	106.3	107.5	108.2
Ireland	0.1	0.2	0.1	0.1	0.1	0.0	100.0	100.1	100.3	100.3	100.4	100.5	100.5
Greece	4.8	4.6	2.4	2.5	1.7	1.2	100.0	102.4	109.1	111.7	114.5	116.9	118.3
Spain	2.9	2.5	1.3	1.4	0.9	0.6	100.0	101.4	105.2	106.6	108.1	109.4	110.1
France	0.7	0.7	0.4	0.4	0.3	0.2	100.0	100.4	101.4	101.8	102.2	102.6	102.8
Croatia	4.3	4.2	2.1	2.2	1.5	1.0	100.0	102.1	108.2	110.5	113.0	115.1	116.3
Italy	1.9	1.6	0.9	0.9	0.6	0.4	100.0	100.9	103.4	104.3	105.2	106.1	106.5
Cyprus	2.1	2.0	1.1	1.2	0.8	0.6	100.0	101.1	104.0	105.1	106.4	107.4	108.1
Latvia	3.1	3.1	1.6	1.7	1.2	0.8	100.0	101.5	105.9	107.6	109.4	111.0	112.0
Lithuania	2.2	2.2	1.2	1.2	0.9	0.6	100.0	101.1	104.2	105.5	106.7	107.9	108.5
Luxemburg	0.3	0.1	0.1	0.1	0.0	0.0	100.0	100.1	100.4	100.4	100.5	100.6	100.6
Hungary	2.4	2.3	1.2	1.2	0.9	0.6	100.0	101.2	104.5	105.7	107.0	108.1	108.8
Malta	1.5	1.1	0.6	0.7	0.4	0.3	100.0	100.8	102.5	103.1	103.8	104.3	104.6
Netherlands	0.3	0.3	0.2	0.2	0.1	0.1	100.0	100.1	100.6	100.7	100.9	101.1	101.2
Austria	0.4	0.4	0.2	0.2	0.2	0.1	100.0	100.2	100.8	101.0	101.2	101.4	101.5
Poland	2.0	2.1	1.1	1.2	0.9	0.6	100.0	101.0	103.9	105.1	106.4	107.5	108.2
Portugal	3.0	2.8	1.5	1.5	1.0	0.7	100.0	101.5	105.6	107.1	108.7	110.2	110.9
Romania	2.5	2.6	1.4	1.5	1.1	0.7	100.0	101.3	104.9	106.4	107.9	109.3	110.1
Slovenia	1.9	1.8	1.0	1.0	0.7	0.5	100.0	101.0	103.6	104.6	105.7	106.6	107.2
Slovakia	2.8	2.8	1.5	1.5	1.1	0.8	100.0	101.4	105.4	107.0	108.6	110.1	110.9
Finland	0.4	0.5	0.2	0.3	0.2	0.1	100.0	100.2	100.8	101.1	101.3	101.6	101.7
Sweden	0.3	0.3	0.2	0.2	0.1	0.1	100.0	100.2	100.6	100.8	100.9	101.1	101.2
EU-27	1.1	1.0	0.6	0.6	0.4	0.3	100.0	100.6	102.0	102.6	103.2	103.8	104.1
Eurozone	1.1	1.0	0.5	0.6	0.4	0.3	100.0	100.5	102.0	102.5	103.1	103.6	103.9

Source: S&P Global Ratings.

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This report does not constitute a rating action.