18 May 2018

Public Finance

Kingdom of Spain Rating Report

STABLE OUTLOOK

A-

Credit strengths

- Euro area membership
- Large, diversified economy
- Resilient economic recovery
- Reduction of economic, fiscal and external imbalances

Credit weaknesses

- High public and external debt
- Elevated structural unemployment
- Low productivity growth
- Political fragmentation leading to policy inertia

Rating rationale and Outlook:

The A- rating is supported by Spain's euro area membership, the size and diversity of its economy, robust economic recovery, and on-going reduction of economic, fiscal and external imbalances, particularly its significant private-sector deleveraging. Persistently high public and external debt levels, elevated structural unemployment, low productivity growth, and limited structural fiscal adjustment pose challenges. The Stable Outlook reflects Scope's view that the upside potential from a continued reduction in economic, fiscal and external imbalances is balanced by the downside risk stemming from a politically fragmented environment, which is limiting the government's capacity to implement reforms to increase Spain's growth potential and make structural fiscal adjustments.

Figure 1: Sovereign scorecard results

Scope's sovereign risk categories	Spain	Peer comparison	
		Average	Portugal
Domestic economic risk			
Public finance risk			
External economic risk			
Financial risk			
Political and institutional risk			
Qualitative adjustment (notches)	+2		-
Final rating	A-		BBB

AAA AA A BBB BB B CCC CC C

NB. The comparison is based on Scope's Core Variable Scorecard (CVS), which is determined by relative rankings of key sovereign credit fundamentals. The CVS peer group average is shown together with one selected country chosen from the entire CVS peer group. The CVS rating can be adjusted by up to three notches depending on the size of relative credit strengths or weaknesses.

Positive rating-change drivers

- Sustained debt reduction
- Additional reforms raising medium-term growth potential
- External balance sheet improvement

Negative rating-change drivers

- Reversal of fiscal consolidation
- Fading commitment to/reversal of structural reforms

Ratings and Outlook

Foreign currency

Long-term issuer rating	A-/Stable
Senior unsecured debt	A-/Stable
Short-term issuer rating	S-1/Stable

Local currency

Long-term issuer rating	A-/Stable
Senior unsecured debt	A-/Stable
Short-term issuer rating	S-1/Stable

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Related research

Public Finance Quarterly Update, 12 April 2018

Spain's evolving fiscal framework, 17 January 2018

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Bloomberg: SCOP

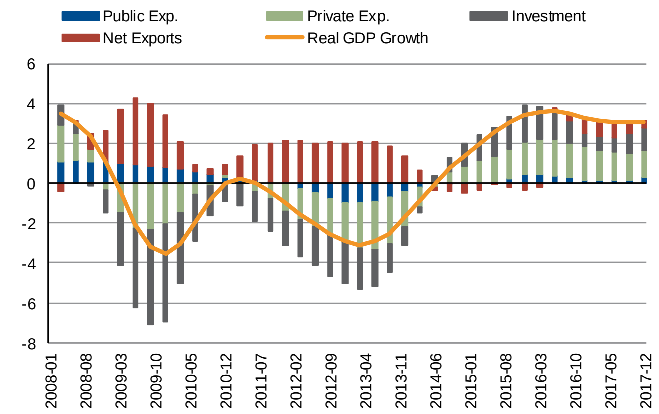
Domestic economic risk

Growth potential of the economy

Robust growth prospects compared to euro area

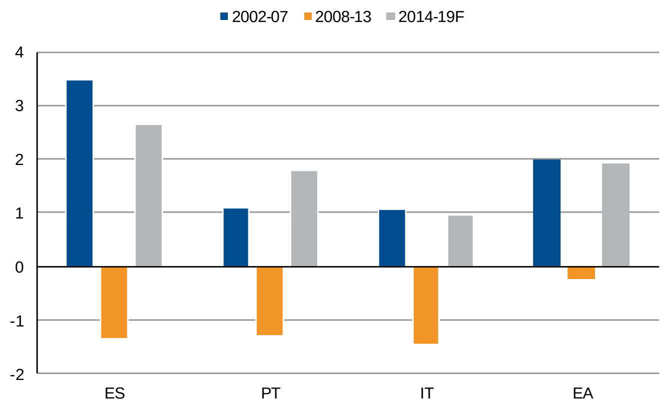
Following two consecutive shocks, namely the Great Financial Crisis and the euro area crisis, during which Spain requested financial assistance to recapitalise financial institutions in July 2012, the Spanish economy has undergone a significant structural adjustment. Since Spain exited the European Stability Mechanism (ESM) programme in January 2014, its economy has grown, on average, around 2.8%, a full percentage point above the euro area average, driven by the government's structural reforms, which were mostly implemented from 2010-2015, wage moderation and resulting cost-competitiveness gains, low oil prices, the European Central Bank's accommodative monetary policy and favourable external conditions, particularly in the euro area. Scope expects this benign combination of factors to continue, sustaining Spain's balanced and employment-intensive economic expansion over the next few years, albeit with less dynamism, moderating economic growth from around 3% to 2.5% over the medium term.

Figure 2: Real GDP growth, %



Source: Haver, INE, Scope Ratings

Figure 3: Average real GDP growth, %



Source: Haver, EC, Scope Ratings

Marked structural economic adjustment

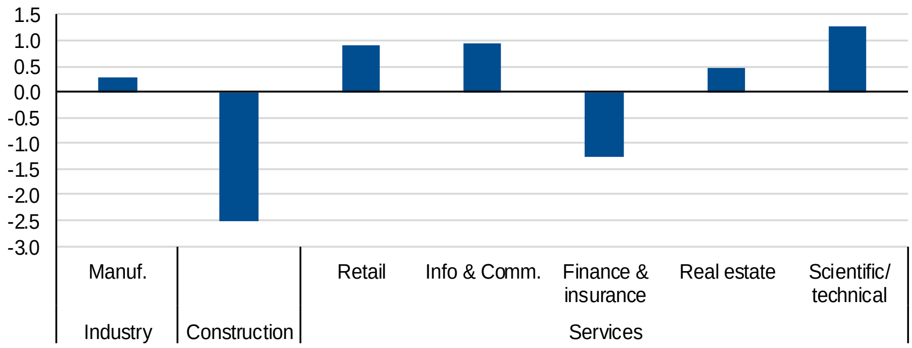
The structural adjustment has resulted in a shift in resources towards the dynamic, export-oriented services sector, which has replaced the outsized construction sector as the engine of growth and job creation. In addition, wage moderation, as evidenced by real unit-labour costs falling by 7.6% since 2009 (based on AMECO data), compared to a broadly stable development in the euro area, have led to gains in cost competitiveness and resulted in significant job creation, with more than half of the 3.8m jobs lost during the crisis now recovered[1]. Scope also notes that banking sector reforms have contributed to tougher bank lending standards, steering the allocation of credit towards more productive and financially sounder firms, supporting the investment recovery[2].

As a result, consumption, investment and net exports have all contributed positively to real GDP growth. Going forward, as the output gap closes in 2018-19, Scope expects fiscal policy support to remain mildly positive, and private consumption and investment to soften gradually. Continued household deleveraging, in light of low overall net wealth and savings rates, is likely to dampen consumption somewhat, whereas investment growth is expected to remain robust over the medium term, even if financial conditions were to tighten slightly following the eventual normalisation of the European Central Bank's monetary policy. Finally, on the back of competitiveness gains, the contribution of net exports is set to remain positive, given a structural adjustment in the Spanish exporting

[1] Based on INE data, Q3 2007 employment peaked at 20.8mn. Q1 2014 was the trough with 16.95mn employed. As of Q1 2018, the number of employed is 18.9mn.
[2] IMF Article IV, October 2017.

sector towards higher value-added products and a greater number of export markets, with the current account stabilising at around 2%.

Figure 4: Structural adjustment in Spanish economy, % of GDP, change from Q1 2010 to Q4 2017

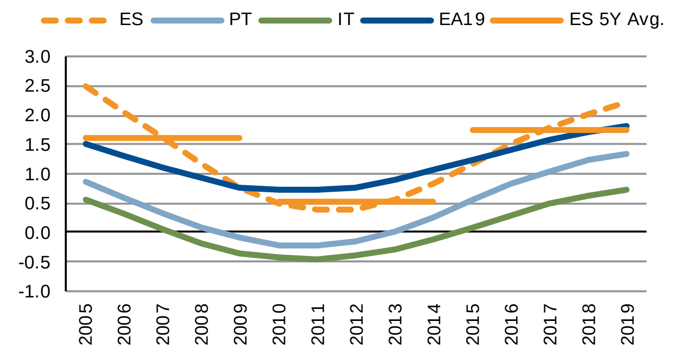


Source: Haver, INE, Scope Ratings

Subdued productivity growth and demographic challenges constrain Spain's growth potential

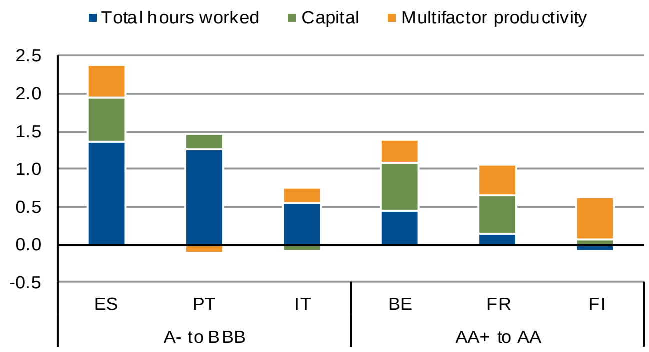
While the short-to-medium-term growth outlook is robust, Spain's long-term economic growth prospects face considerable challenges. The IMF estimates potential growth at around 1.7%, slightly below the European Commission's estimate of 2.1%[3], over the medium term, constrained by weak productivity growth, unfavourable labour force demographics, and high structural unemployment. According to the IMF, productivity levels in Spanish manufacturing, trade and market services sectors are considerably lower than in EU peers due to Spain's corporate structure, which is composed of low-productivity small and micro-firms. The IMF further points to the need to fully implement the Market Unity Law[4], liberalise professional services, enhance access to equity financing for start-ups, reduce size-related requirements, and improve public R&D spending to raise potential growth and competitiveness. These constraints are reflected in the fact that, based on OECD data, about half of real GDP growth over 2014-16 was driven by total hours worked, whereas the contributions from capital and total-factor productivity where approximately equal. While this is slightly better compared to peers such as Portugal or Italy, it points to a need to improve Spain's productivity levels, which are the main growth driver among higher-rated peers[5].

Figure 5: GDP potential growth, %



Source: Haver, AMECO, Scope Ratings

Figure 6: Percentage point contribution to GDP growth %, 2014-16 average



Source: OECD, Scope Ratings

[3] IMF Article IV, October 2017. EC data based on AMECO. Scope notes that the EC's March 2018 country report on Spain estimates potential growth at 1.3%.
[4] The Market Unity Law establishes a single market in Spain by eliminating differential treatment of economic activity by the central, regional and local authorities. A recent decision by the Constitutional Court, which found one principle of the Market Unity Law to be in violation of the constitution, could delay its implementation.
[5] IMF Article IV, October 2017.

Economic policy framework

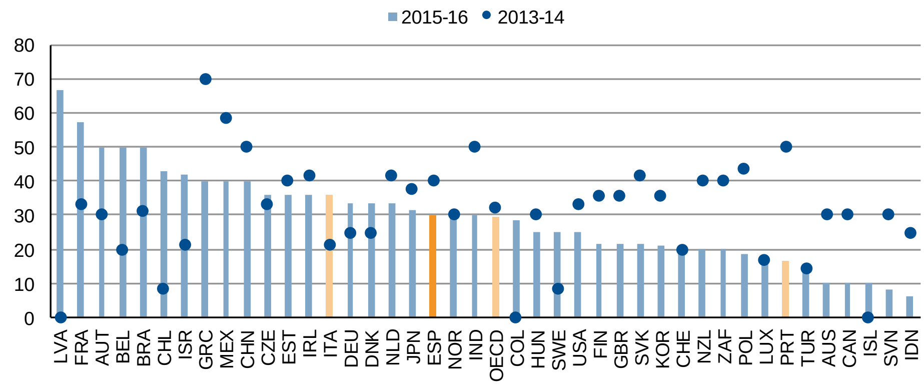
Comprehensive reforms during crisis period…

Economic growth has also benefited from an overall effective economic policy framework, and in particular from the comprehensive reforms of the Spanish authorities combined with the changes in the institutional architecture of the euro area, both mostly during 2012-15, along with the on-going accommodative monetary policy pursued by the European Central Bank. During the crisis, the Spanish authorities demonstrated an ability to legislate and implement comprehensive economic, public sector and financial sector reforms that are underpinning Spain's economic recovery and expansion[6].

…at the national…

In this context, Scope notes the implementation of politically difficult labour market and pension reforms. The former increased firms' internal flexibility and raised the wage bargaining system's responsiveness to business cycle developments, leading to wage moderation, which in turn is credited with increasing employment elasticity to real GDP[7]. The latter, if implemented as legislated[8], would markedly enhance the sustainability of the pension system but also increase the risk of a reduction in purchasing power, and thus the standard of living, of current and future pensioners. This tension is reflected in the setup of a permanent parliamentary committee on the pension system (Toledo Pact) that is reviewing the implementation of the reforms, as well as the latest proposals by the government to postpone, and possibly even reverse, elements of these reforms, which Scope assesses as credit-positive overall.

Figure 7: OECD responsiveness to reform, Range 0 (not responsive) to 100 (very responsive)



Source: OECD, Scope Ratings

…and European level.

At the same time, Spain, along with all euro area member states, benefited from the overhaul of the euro area architecture, which now provides for a greater degree of resilience to adjust to crises as and when they emerge. While further progress is needed to deepen the Economic and Monetary Union – notably the completion of the Banking and Capital Markets unions – the establishment of the European Stability Mechanism as the conditional lender of last resort for sovereigns, along with the European Central Bank's unconventional and accommodative monetary policy programmes, has been appropriate for Spain.

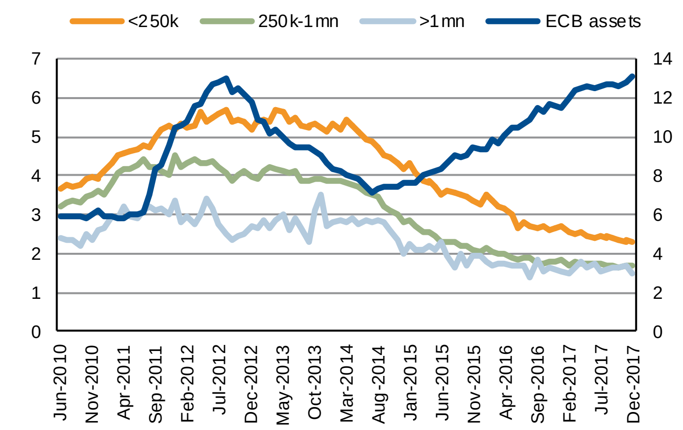
The ECB's accommodative monetary stance is determined by: i) the low level of interest rates and the expectation that they will remain low over a prolonged period, ii) the extension of net purchases of securities under the asset purchase programme (APP) until at least September 2018, iii) the large volume of the securities portfolio acquired over the

[6] For an overview, please see http://www.tesoro.es/sites/default/files/Presentacion/Kingdom_of_Spain.pdf
[7] EC, Country report Spain 2018; March 2018.
[8] The pension reforms of 2011 and 2013 linked pensions to life expectancy via the so-called sustainability factor (a discount applied to the first pension received by those that retire from 2019 onwards), gradually raising the statutory retirement age to 67, lengthening the accrual period for a full pension, and increasing the number of contributory years used to calculate the pension base. EC 2018. IMF Article IV.

three years during which the APP has been in place, and iv) the commitment to reinvest securities as they mature for as long as may be necessary[9].

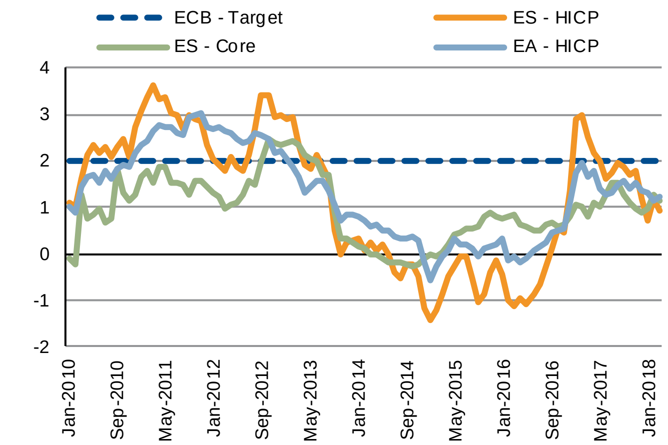
In Scope's opinion, the national structural reforms, combined with the euro area governance reforms and the ECB's actions, have led to a significant decline in financing rates for all sectors of the economy including non-financial corporations, whose borrowing rates have dropped between 200 and 300bp depending on loan size and maturity. At the same time, Scope notes that in the case of Spain, the sustained accommodative monetary policy stance is also adequate in light of still-subdued price levels. While headline inflation rose above 2% last year driven by higher energy prices, the price level is converging towards core inflation of around 1.2%. This is in line with euro area core inflation but still markedly below the ECB's target of close to but below 2%.

Figure 8: NFC borrowing rates (%) and ECB assets (% of GDP, RHS)



Source: Haver, Banco de Espana, ECB, Scope Ratings

Figure 9: Harmonised index of consumer prices, %



Source: Haver, ECB, Eurostat, Scope Ratings

Macro-economic stability and sustainability

Labour market duality an enduring imbalance

Scope identifies Spain's structural unemployment, particularly the observed labour market duality, as an enduring macro-economic imbalance. While Spain has recovered around two million of the 3.8m jobs lost during the crisis and reduced unemployment to around 16%, the lowest level in eight years, this remains among the highest levels in Europe. In addition, Scope notes that most jobs have been created in the lower-skill services segment, including wholesale, accommodation and services, education and health, and professional and administrative services, which have labour productivity levels below those of the economy-wide average. In Scope's opinion, the absorption of low-skilled labour from the construction sector in new, predominantly low-productivity sectors is part of a transition that could weigh on productivity in the long run[10].

Temporary contracts could reduce Spain's growth potential

In addition, temporary contracts have accounted for a bit more than half of new jobs, resulting in Spain having one of the highest shares of temporary employment in the EU, with many temporary contracts of very short duration. According to the European Commission, transition rates from temporary to permanent contracts are very low relative to the EU average, which reflects the still-significant gap between the cost of permanent

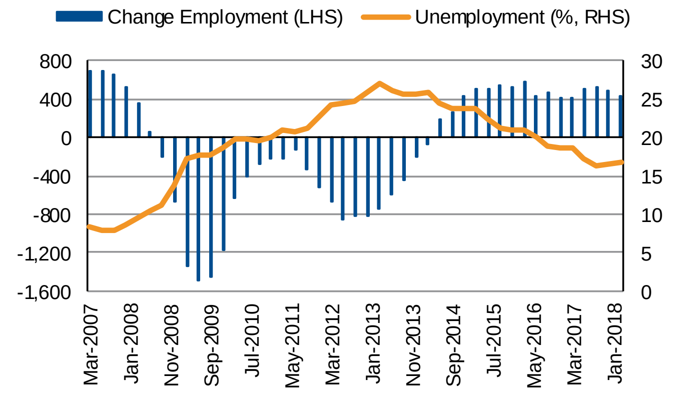
[9] https://www.bde.es/f/webbde/SES/Secciones/Publicaciones/InformesBoletinesRevistas/BoletinEconomico/Informe%20trimestral/18/Files/be1801e-ite.pdf
[10] IMF Article IV, October 2017.

and temporary workers to firms. Scope notes that this matters in the context of potential GDP growth as employers tend to invest less in temporary workers' human capital[11].

Youth and long-term unemployment could lead to higher inequality and social exclusion

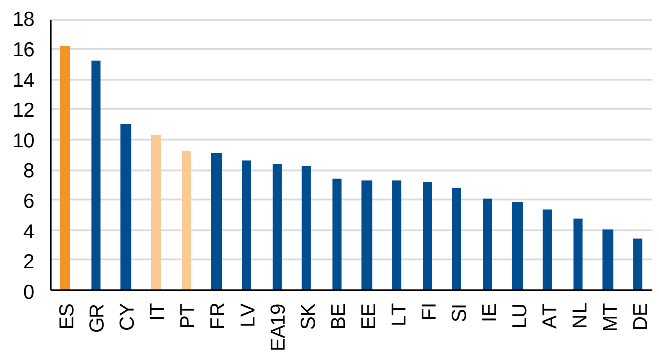
Finally, youth unemployment is still more than double the national average, while those without employment for more than a year account for almost half of the unemployed. In Scope's opinion, this not only limits Spain's growth potential but increases the risk of sustained income inequality, poverty and social exclusion among vulnerable groups.

Figure 10: Employment and unemployment, 4-quarter moving sum ('000s), % labour force



Source: Haver, INE, Scope Ratings

Figure 11: Structural unemployment %, 2017-2019F average



Source: Haver, AMECO, Scope Ratings

Public finance risk

Fiscal policy framework

Comprehensive fiscal framework at EU and euro area level

As a European Union member, Spain is part of the EU's fiscal policy framework, which is centred around the 1997 Stability and Growth Pact (SGP). This pact has been modified via the 2005 reforms, the 2011 Six Pack (five regulations and one directive), and the 2013 Two Pack (two regulations), as well as the Treaty on Stability, Coordination, and Governance of 2012 (Fiscal Compact).

- The 1997 SGP included three EU-wide rules: ceilings of 3% of GDP for the overall fiscal deficit and 60% of GDP for public debt (corrective arm), and a requirement for medium-term budget positions to be 'close to balance or in surplus' (preventive arm).
- The 2005 reform of the SGP aimed at enhancing the economic rationale underlying the rules and improving their flexibility by introducing country-specific medium-term objectives (MTOs) set in structural terms.
- The Six Pack reform in 2011 was designed to improve enforcement by adding an expenditure benchmark to the preventive arm and making the debt criterion in the corrective arm operational.
- The Fiscal Compact and Two Pack reforms of 2012 and 2013 reinforced monitoring and surveillance in the euro area and called for anchoring EU rules at the national level. In 2015, revised guidance on the implementation of the SGP increased its flexibility to encourage investment and structural reforms and to account for the economic cycle.

In Scope's opinion, the successive revisions have improved the rules-based system by: i) better aligning fiscal targets with the final debt objective, ii) providing more flexibility while also strengthening enforcement mechanisms, and iii) bringing more specificity to the definition of the rules. As such, these reforms have enhanced the EU's fiscal governance and in particular the fiscal governance of the euro area. At the same time, Scope is

[11] EC, Country report Spain 2018; March 2018.

mindful that the overall framework has become overly complex, resulting in both unintended violations and the exploitation of loopholes, which has come hand-in-hand with weak enforcement at the European level[12].

Evolving fiscal framework at the national level

In addition to the European context, Spain has its own fiscal framework between the central government and the autonomous regions. The legislative response to the crisis led to several changes to the framework, which is characterised by two constitutional fiscal arrangements, diverse competencies and preferences for autonomy among the regions, and, given starkly different economic fundamentals, varying degrees of reliance on funding instruments, including central government facilities and market securities.

Central government now implicit financier of the regions

In Scope's opinion, the central government's funding mechanisms accessed by the regions that have had difficulty refinancing debt in the market over the past few years have fundamentally changed not only the means of regional financing but the relationship between the central and regional governments. In Scope's view, given that the financing facilities are now becoming permanent *de facto*, the central government's role has moved away from being the implicit guarantor of the regions to being their explicit financier. In addition to changes in the regions' financing system, the crisis also led to increasing discontent with the prevailing financing model and shifts in regional attitudes towards considerations of intra-regional solidarity and the desirable level of fiscal equalisation between regions. In some regions, such as Catalonia, the regional leadership[13] has persistently sought higher levels of self-government, including secession, while, in others support for greater centralisation has risen[14].

Further reforms to fiscal framework needed

As a result, while the Spanish fiscal framework has improved markedly since the crisis, Scope is mindful that further reforms are needed. In Scope's view, the complexity of the matter, including constitutional differences, varying preferences for autonomy, the need for central and regional budgetary stability, the balance between access to favourable central government finance at the expense of budgetary control, and the need to preclude perverse incentives, can only be addressed on a Spanish and not a region-specific basis. As such, Scope expects the Spanish authorities, along with all regions including Catalonia, to gradually address the shortcomings of the current fiscal framework.

Fiscal consolidation leading to likely EDP exit

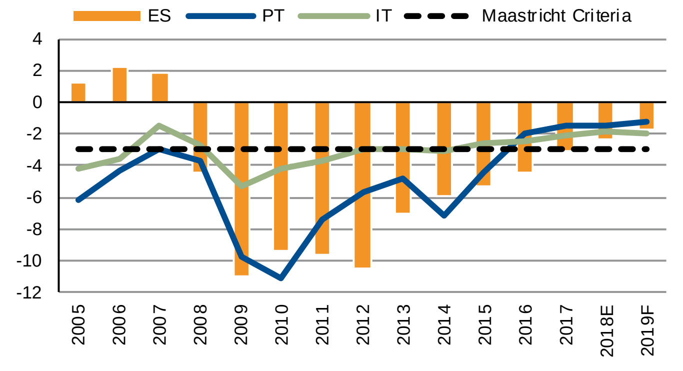
Against this backdrop, Scope assesses Spain's fiscal developments at the general and regional government levels. Scope notes that Spain has successfully reduced its fiscal balances every year since 2012, and it expects the country to exit the EU's excessive deficit procedure in 2018, recording a deficit of around 2.5% this year, slightly above the government's target of 2.2%, as stipulated in its updated 2018-2021 Stability Programme.

Fiscal consolidation in all layers of government

This consolidation took place at all layers of government between 2012 and 2017, with the fiscal balance falling by about 6pp at the central government level, from around negative 7.9% of GDP to negative 1.9%. Regional governments also reduced their fiscal balances, on average, to a deficit of negative 0.3% last year, better than the target of negative 0.6% but with wide dispersion among the regions[15]. Scope notes that the government's use of enforcement tools, applied for the first time in 2016, speaks to the increased effectiveness of the fiscal framework. Finally, the higher deficit of the social security system, which has been in deficit every year since 2010 and recorded a deficit of negative 1.5% in 2017, was partly compensated by the 0.6% surplus of local governments, above their target of a balanced budget[16].

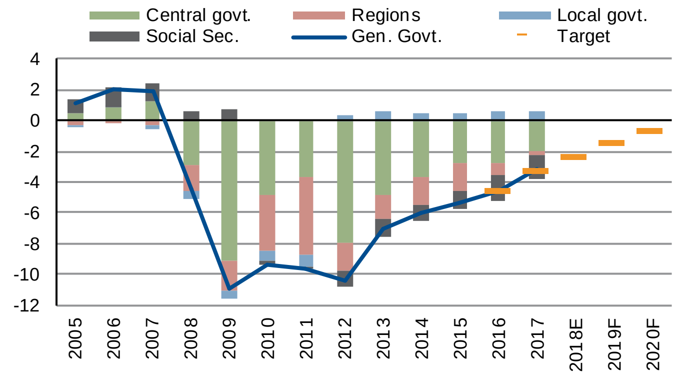
[12] IMF 2015, 'Reforming Fiscal Governance in the European Union'
[13] Notably, public support for an 'independent state' of Catalonia has steadily declined since 2013, particularly since October 2017. http://upceo.ceo.gencat.cat/wsceop/6508/Abstract%20in%20English%20-874.pdf
[14] See Scope's 'Spain's evolving fiscal framework: implications for the sovereign and its regions', January 2017
[15] With the exception of Castilla y Leon, all regions improved their fiscal balances vis-à-vis 2016, with 11 achieving the negative 0.6% deficit target.
[16] Spain's Stability Programme Update 2018-2021. https://ec.europa.eu/info/sites/info/files/2018-european-semester-stability-programme-spain-es_0.pdf

Figure 12: Overall fiscal balances, % of GDP



Source: Haver, AMECO, Scope Ratings

Figure 13: Fiscal balances by level of government, % of GDP



Source: Haver, MINHAP, Scope Ratings

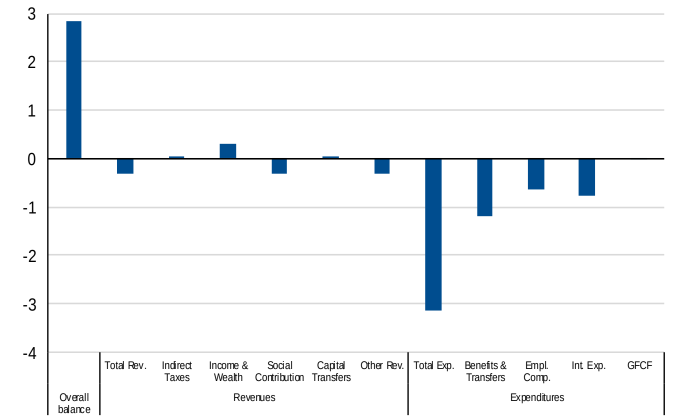
Limited structural adjustment

This positive development notwithstanding, Scope notes that the adjustment has been mostly cyclical, benefiting from improving labour market conditions, resulting in lower benefits, as well as reduced interest expenditure. In fact, Spain's cyclically adjusted primary balance turned negative in 2016, and it is expected to remain in deficit during the coming years, suggesting a mildly expansionary structural fiscal stance. As a result, while the narrowing of Spain's headline fiscal deficit is credit-positive, the relaxation of the fiscal stance, leading to an estimated structural balance deficit of around 3% for the 2017-2019 period (based on EC data), the highest among all euro area member states and well above the medium-term objective of a structural balance by 2020 under European and national rules, points to a need for further fiscal consolidation[17].

2018 budget still needs to be approved

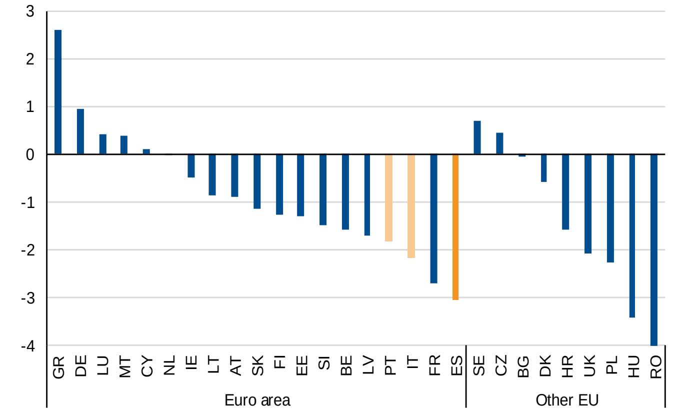
In addition, the government has yet to adopt a 2018 budget, which is expected to be implemented in June of this year, and therefore currently operates on an extension of the 2017 budget. In Scope's opinion, if implemented, the new budget is likely to be slightly expansionary, increasing minimum pensions and possibly lowering income taxes. Looking ahead, the 2019 regional and local elections scheduled for 26 May 2019 could also lead to some fiscal slippage, for instance, by relaxing the spending rule to allow local governments to invest rather than save their fiscal surpluses. However, Scope does expect Spain's deficits to be well below the 3% Maastricht criterion going forward.

Figure 14: Change in Spain's budget balance, % of GDP, diff. between avg. 2017-2019F vs. avg. 2014-2016



Source: Haver, AMECO, Scope Ratings

Figure 15: Structural balance, % of GDP, 2017-2019F



Source: Haver, AMECO, Scope Ratings

[17] The IMF projects the structural deficit to remain at around 2.5% over the medium term.

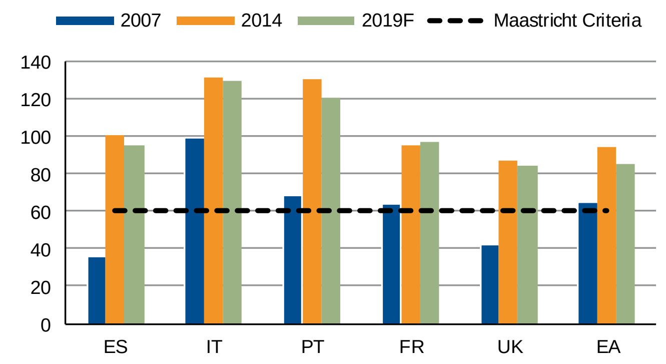
On-going fiscal consolidation but debt levels still high

As a result, Spain's general government debt level has remained relatively stable since 2014 at slightly below 100% of GDP and below Portugal (126%) and Italy (132%) but significantly above the 60% Maastricht criterion. In Scope's opinion, this elevated debt burden constitutes a major rating constraint, as it is harmful to economic growth and entails a source of vulnerability for the economy, in addition to reducing the stabilising capacity of the public budget[18].

Limited pension liabilities but elevated implicit healthcare liabilities

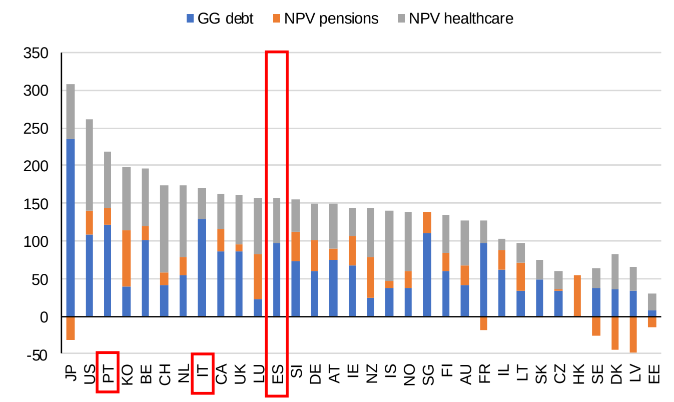
In addition, Scope is mindful that, in line with peers, the ageing population is contributing to fiscal pressures in Spain. In line with Portugal and Italy, pension-related expenditure is not expected to increase over the 2060 horizon but to decrease slightly, according the latest EC ageing report. However, Spain's healthcare-related expenditure is set to increase from about 6% of GDP to around 7% by 2060. Based on these figures and applying a discount rate of 1% in excess of GDP growth, the IMF estimates the net present value of Spain's pension spending over the 2015-2050 horizon to be negative, at -1.3% of GDP, while implicit healthcare liabilities amount to 60% of GDP[19]. Thus, Spain's general government debt, including implicit future pension- and healthcare-related liabilities amount to around 155% of GDP, which compares favourably to Portugal (218%) and Italy (168%).

Figure 16: Debt levels, % of GDP



Source: Haver, EC, Scope Ratings

Figure 17: Implicit liabilities, % of GDP



Source: Haver, IMF Fiscal Monitor, Scope Ratings

In addition to age-related implicit obligations, Scope also considers Spain's potential contingent liabilities stemming from higher land expropriation costs for the distressed motorways and compensation payments[20] as well as the financial sector. Although another 0.1% of GDP was budgeted for stock-flow adjustments in 2017, bringing cumulative support for the financial sector to slightly below 5% of GDP[21], contingent liabilities, are, in Scope's opinion, likely to be limited going forward. This also includes the risks related to the asset management company SAREB[22].

Debt sustainability

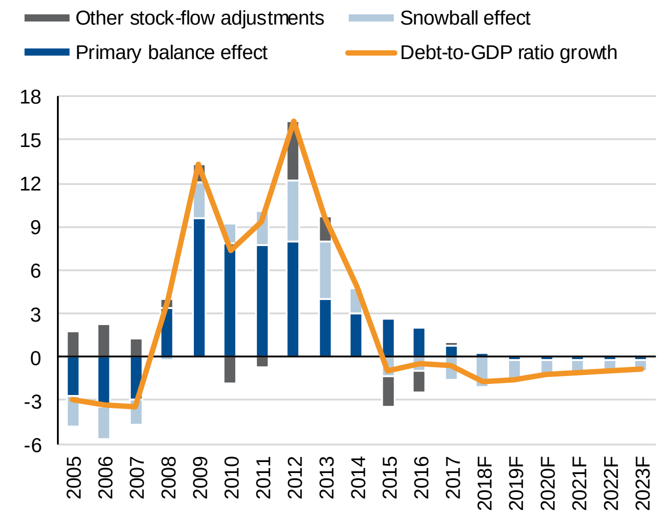
Challenging debt dynamics, even in optimistic scenario

Scope's public debt sustainability analysis, based on IMF forecasts and a combination of growth, interest-rate and primary-balance shocks, confirms that slower growth and primary balances remain the key risks to Spain's debt sustainability. The results reflect Spain's high debt level, expected narrowing fiscal deficits going forward, and more moderate growth rates. Scope's baseline scenario is for the debt-to-GDP ratio to fall to

[18] Banco de España 2018, 'The challenges of public deleveraging'.
[19] IMF Fiscal Monitor, April 2018.
[20] The EC notes that these costs pose a risk to the 2018-19 outlook given the Supreme Court decisions to declare void the ATLL water concession in Catalonia. At the same time, the government's intention to resell the motorways that reverted to the state in 2018, could, if materialised, improve the government balance in 2019.
[21] 3.7% of GDP for 2012, 0.3% of GDP for 2013, 0.1% of GDP for 2014, 0.05% of GDP for 2015, 0.2% of GDP for 2016, and 0.1% of GDP for 2017. IMF Article IV.
[22] Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria S.A.

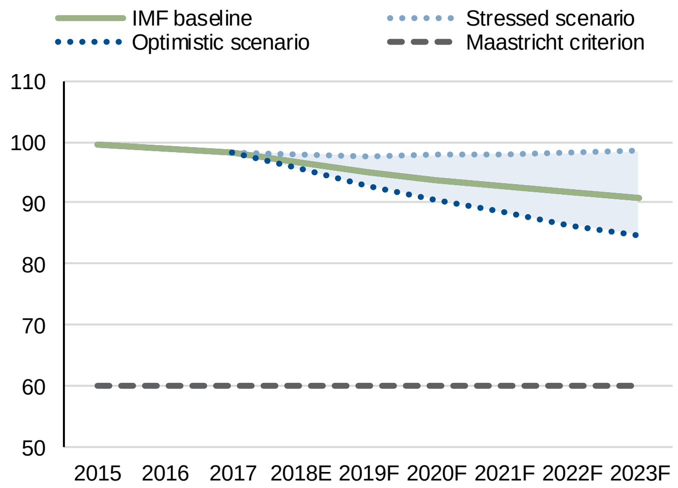
around 90% by 2023, while a more adverse scenario assuming a combined 0.5 percentage point shock to real GDP growth (lower), interest payments (higher) and the primary balance (lower) for each year over the forecast horizon would lead to a debt-to-GDP level of around 98% by 2023. This would be in line with the 100% peak of 2014 and still be markedly below the debt level of Italy (131%) and Portugal (124%).

Figure 18: Contribution to gov. debt changes, % of GDP



Source: IMF, Scope Ratings. NB: Other includes stock-flow adjustments.

Figure 19: Government debt, % of GDP



Source: Scope Ratings

Scenario	Time period	Real GDP growth avg. (%)	Primary bal. (% of GDP)	Real eff. int. rate (%)	Debt end period (% of GDP)
History	2013-2017	1.9	-2.5	2.4	98.4
IMF baseline	2018-2023	2.0	0.1	0.7	90.9
Optimistic scenario		2.5	0.6	0.8	84.7
Stressed scenario		1.5	-0.4	1.1	98.5

Source: IMF, Scope Ratings

These estimates confirm the need for Spain to maintain relatively high growth rates as well as sustain a significant level of fiscal consolidation over a multi-year period. Accordingly, a recent Bank of Spain study[23] shows that in a moderate growth and inflation environment, an annual primary surplus of 2% is needed for the debt-to-GDP ratio to fall to 60% by 2030, which is three percentage points higher than the average primary balance over the 1995-2017 period.

Market access and funding sources

Significantly lengthened debt maturity

Spain's relatively high debt level results in one of the highest gross financing needs in the euro area at EUR 215bn for 2018 (which includes funding to the regions and to the Social Security), or around 17% of GDP, in line with Italy and Portugal (both around 16%). However, Scope notes that in the current favourable financing environment, which has resulted in the cost of debt outstanding dropping from around 4% in 2011 to 2.5% this year, the treasury's prudent debt funding strategy extended the average life of debt outstanding from around six years in 2013 to above seven years since 2017, slightly above Portugal (six years) and in line with the euro area average. This maturity extension is also reflected in the average life of Spain's medium and long-term issuances increasing

[23] Banco de España 2018, 'The challenges of public deleveraging'.

from five years in 2012 to above 10 years in 2017, and even 14 years as of May 2018, following the successful placement of a EUR 6bn 30-year bond priced at 2.6% at issuance[24].

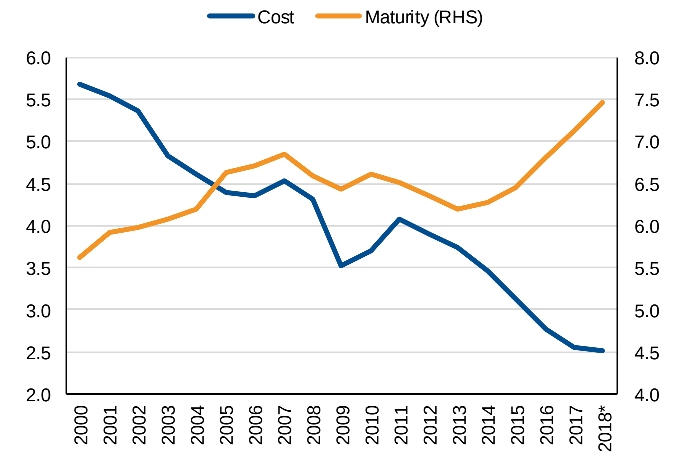
ECB's purchases shift investor base

In addition, Scope notes that as a result of the ECB's public-sector purchase programme, the composition of Spain's debt holders has changed. Currently, the Bank of Spain holds around EUR 198bn in Spanish bonds, or around 21% of total issued debt, compared to around 5% prior to the ECB's purchases. This increase has resulted in a pronounced drop in the holdings of Spanish banks to around 18% this year from 35% in 2012, while non-resident holdings have remained fairly constant at around 44%. Scope notes that as the ECB's asset purchase programme comes to an end – expected in September of this year – future demand is likely to come from domestic banks and foreign central banks, two stable sources of funding.

Voluntary early repayments to the ESM

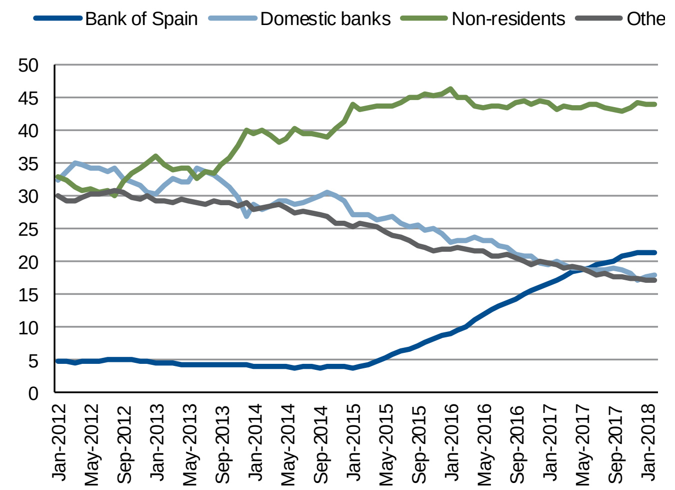
As a further sign of market access, Scope notes that Spain has made seven voluntary early repayments to the ESM, reducing the amount outstanding from the original loan of EUR 41.3bn to EUR 26.7bn[25]. Finally, while Spain never lost access to market financing during the height of the crisis, Scope views positively the fact that the ESM has been established as a credible, conditional lender of last resort to all euro area member states, including Spain.

Figure 20: Cost (%) and maturity of outstanding debt (years)



Source: Tesoro; *May 2018

Figure 21: Government debt holders, % of total



Source: Tesoro

External economic risk

Current-account vulnerabilities

From external debtor to creditor

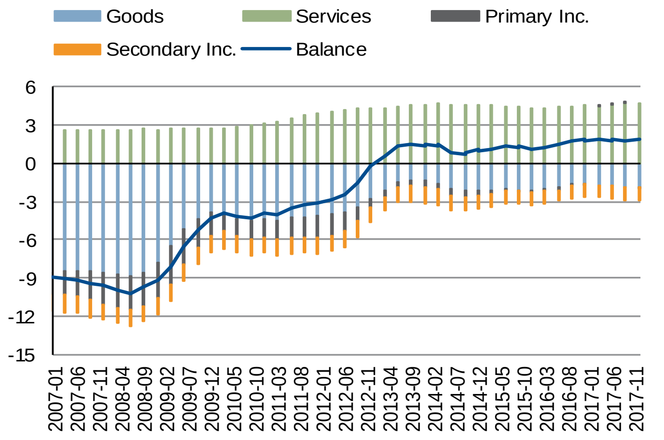
Spain recorded its fifth annual consecutive current account surplus in 2017 at 1.9%, driven by a smaller energy trade deficit given lower oil prices, strong performance for services exports including tourism, and lower interest rates. Spain's economy has become much more open, with the proportion of exports of goods and services relative to GDP increasing from around 23% in Q4 2009 to 34% by the end of 2017.

Scope expects this positive trend to continue over the medium term. This is due to cost-competitiveness gains as well as structural improvements to Spain's export base, reflected in an increase in the number of regular exporters and a diversification of export destinations. These improvements have allowed Spain to not only keep its share of world

[24] http://www.tesoro.es/sites/default/files/Presentacion/Kingdom_of_Spain.pdf; Bloomberg
[25] One repayment was made for EUR 2bn on 23 February 2018. The second repayment is for EUR 3bn, and it is scheduled for May 2018.

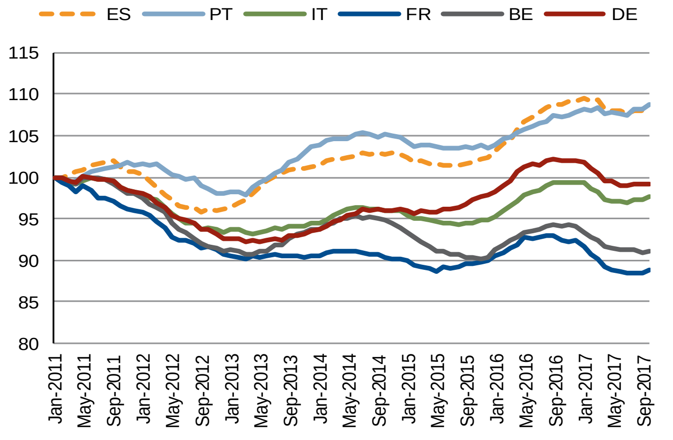
merchandise exports but increase that share, in contrast to most euro area peers. However, Scope notes that maintaining current-account surpluses for a sustained period of time will be necessary to gradually improve Spain's net debt position, which remains a source of vulnerability.

Figure 22: Sustained current-account surpluses, % of GDP



Source: Haver, Bank of Spain, Scope Ratings

Figure 23: Share of world exports, 2011 = 100



Source: IMF, Scope Ratings

External debt sustainability

Negative net IIP a credit vulnerability

Over the past few years, positive economic growth and current-account surpluses have led to a marked decline in Spain's external debt and an improvement in the country's net international investment position, which conforms to that of its peers at around negative 80% of GDP as of Q4 2017. In addition, Scope is mindful that the reduction in Spain's net IIP has been somewhat offset by valuation effects due to an increase in the market value of portfolio debt securities issued by Spanish residents. Over the 1996-2017 period, the Bank of Spain estimates that valuation effects have amplified Spain's negative net IIP by around negative 35 percentage points. Still, even accounting for these effects, Spain's net IIP remains far below the European Commission's threshold of negative 35% of GDP used in its macro-economic imbalance procedure to identify external vulnerabilities. As a result, from a stock perspective, Spain remains vulnerable to external crises[26].

High level of external debt…

Scope notes that while the level of the NIIP is key for external sustainability, and in the case of Spain it is a credit constraint, both the size and the composition of the international balance sheet also matter when assessing external vulnerabilities. Specifically, Scope notes that vulnerabilities embedded in the balance sheet – related to its size, composition, and structure – may exacerbate the risks stemming from the NIIP level. In this context, Scope notes that the size of gross external liabilities remains elevated, with Spain's total external debt at around 166% of GDP as of Q4 2017, broadly unchanged since Q1 2010 and above that of Italy (124%) but below Portugal (212%).

…but improved composition…

Yet risks have abated given the change in the composition of external debt. Specifically, the government and central bank's share has increased from around 21% of total external debt to above 50% while financial institutions have, in the context of the on-going deleveraging process, reduced their share of Spain's total external debt from 45% to

[26] Excessive net foreign liabilities are a common harbinger of external crises, which often lead to severe output losses. A standard early warning model indicates that net foreign liabilities in excess of around 35% of GDP are associated with heightened risks of an external crisis. The risks become even more substantial at levels beyond 50% of GDP. https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op198.en.pdf?dd48dc2fe1941f6f88e9c75eb4becc18

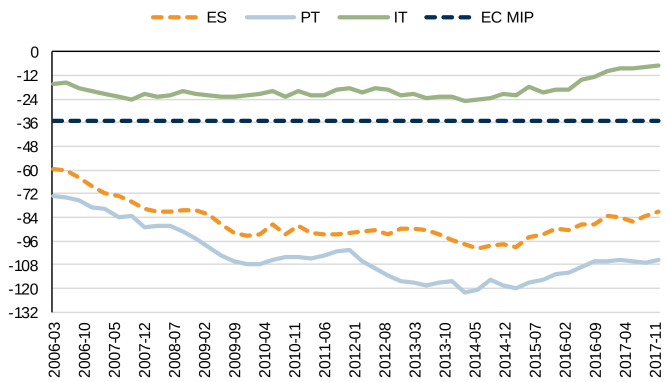
around 21% over the same period. In addition, Scope notes the favourable maturity structure of external debt in the public sector[27].

…and debt-equity mix.

Scope also notes that the share of portfolio debt securities of Spain's foreign liabilities, whose non-contingent nature may complicate the absorption of shocks, has fallen markedly from around 36% in Q1 2010 to around 27% as of Q4 2017, speaking to an improvement in the debt-equity mix of Spain's external balance sheet.

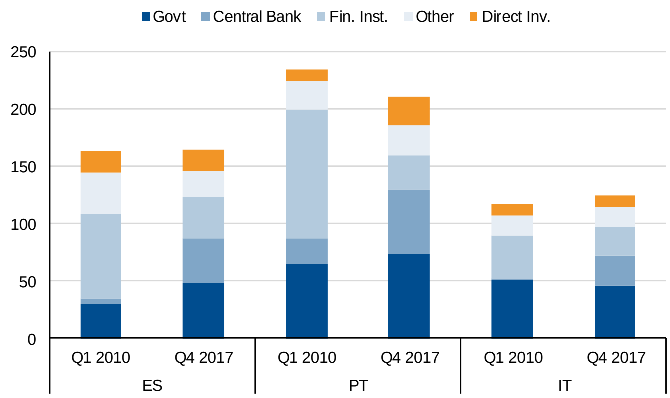
Finally, the NIIP burden – as measured by the investment income balance – is currently relatively light in Spain, in line with other peripheral economies. This reflects a broad-based decline in aggregate yields during the post-crisis period, particularly for portfolio debt and 'other investment'[28]. While Scope is mindful that the net payments associated with Spain's external position could increase markedly if euro area interest rates were to normalise, the expected gradual normalisation of the ECB's monetary policy along with the structural improvements in Spain's external balance sheet should mitigate these risks.

Figure 24: Net international investment position, % of GDP



Source: Haver, national central banks, Eurostat, Scope Ratings

Figure 25: External debt composition, % of GDP



Source: Haver, national central banks, Eurostat, Scope Ratings

Vulnerability to short-term external shocks

Limited vulnerability to short-term shocks

Spain's still-negative net international investment position is high at around 80% of GDP, exposing the sovereign to shocks or sudden shifts in market sentiment. However, it is Scope's opinion that the structural improvements in Spain's external sector, combined with the strengthened euro area architecture and the ECB's expansionary monetary policy stance, markedly reduce Spain's risk to external shocks. Scope expects Spain's external imbalances, a legacy issue from the crisis, to be unwound over a sustained period of time. In this context Scope will monitor closely the development of euro area interest rates, which, if raised again towards pre-crisis levels, could heighten Spain's external vulnerabilities.

Financial stability risk

Financial sector performance

Better-capitalised banking sector with improving asset quality…

Given stronger bank balance sheets, a more resilient financial system has emerged after the crisis, allowing Spanish banks to perform credit intermediation despite some macro-financial challenges. Solvency and profitability have improved for most banks despite low

[27] EC 2018.
[28] https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op198.en.pdf?dd48dc2fe1941f6f88e9c75eb4becc18

interest rates. Capitalisation has improved with a Common Equity Tier 1 (CET1) ratio of 12.7%, some 16bp below the December 2016 figure, marked by the resolution of Banco Popular Español. This is in line with European peers[29].

Asset quality has improved, with the volume of consolidated total non-performing assets of Spanish deposit institutions falling significantly in 2017 by 21% year on year to EUR 116.1bn. Consequently, driven by the combination of higher economic growth and active management by banks, the non-performing loans (NPL) ratio decreased from 5.6% in December 2016 to 4.4% in December 2017, in line with most euro area countries and significantly below Italy (16%) and Portugal (13%). However, Scope notes that NPLs remain high among loans to SMEs and in the construction and real estate sectors[30].

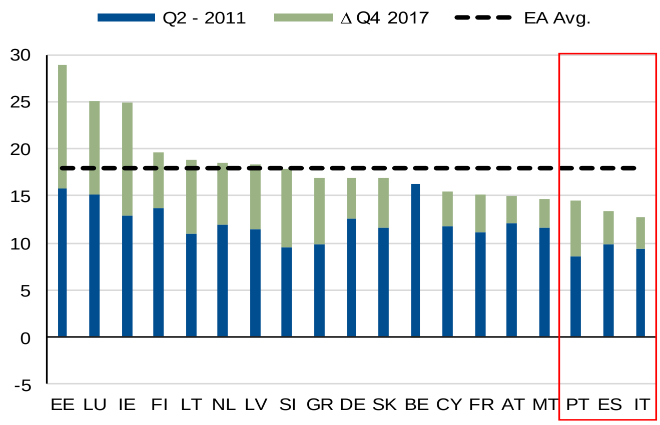
…though profitability remains a challenge

Banking system profitability, though higher than the euro area average, remains a challenge, with return on equity at around 6% last year, excluding a loss of more than EUR 12bn recorded by Banco Popular Español as a result of its resolution in June 2017. As the Bank of Spain notes, Spanish deposit institutions' net interest margins in the domestic business remain under pressure as a result of the low level of interest rates coupled with the decline in business volume and the still-high level of non-productive assets on banks' balance sheets. For international Spanish banks, the performance of their overseas subsidiaries has continued to be relatively strong despite growing uncertainties in some host countries, such as Turkey.

ECB's fixed rate full allotment until 2019 ensures ample liquidity

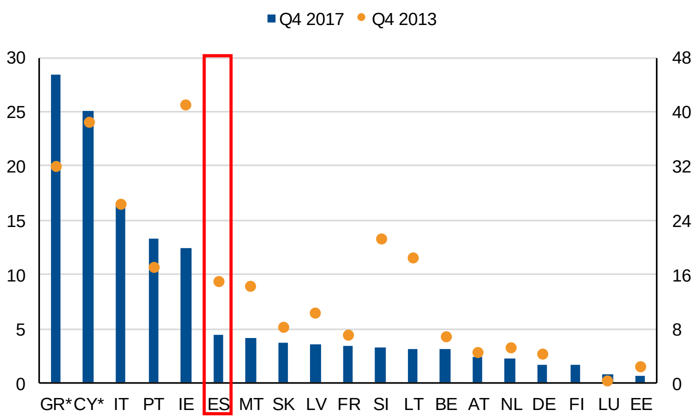
Finally, banks are also benefiting from ample liquidity and cheap funding due to the ECB's targeted longer-term refinancing operations and asset purchase programme. Funding challenges are thus set to rise over the medium term as the ECB unwinds its unconventional monetary policies, potentially affecting both liquidity and profitability of banks given their relatively large share of long-duration sovereign debt. However, as the Eurosystem continues to conduct regular one-week and three-month lending operations which, as announced by the ECB in October 2017, will continue to be executed at a fixed rate with full allocation until at least the end of the last reserve maintenance period of 2019[31], it is Scope's opinion that liquidity issues remain a limited risk.

Figure 26: Banking sector capitalisation, Regulatory Tier 1 Capital to risk-weighted assets, in %



Source: Haver, IMF, Scope Ratings; NB. If not Q4 2017 then latest available.

Figure 27: Banking sector asset quality, Non-performing loans to total gross loans, in %



Source: Haver, IMF; NB. *RHS. If not Q4 2017 then latest available

[29] Bank of Spain, Financial stability report, May 2018
[30] Ibid.
[31] Ibid.

Financial sector oversight and governance

Oversight and governance shared between the Bank of Spain and the ECB

Scope notes that macro-prudential oversight for banking is a shared responsibility between the Bank of Spain and the ECB. The Bank of Spain is the national competent and designated authority for exercising macro-prudential powers under the Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD) IV respectively. Similar to other countries in the banking union, macro-prudential oversight is shared with the ECB, which can request more stringent measures under the CRR/CRD IV framework than those applied by national authorities. At the European level, the European Systemic Risk Board can also recommend national authorities and European institutions to adopt measures to mitigate systemic risk on a 'comply-or-explain' basis[32].

Banking, insurance and capital markets assessed by three separate institutions along with European regulators

Scope notes that Spain has not yet established a national macro-prudential authority, with the Bank of Spain, Dirección General de Seguros y Fondos de Pensiones (DGSyFP), and Comisión Nacional del Mercado de Valores (CNMV) independently conducting financial stability analysis of banking, insurance, and capital markets respectively. These agencies also contribute to systemic risk surveillance at the European level under the leadership of the ESRB, along with the European Banking Authority, the European Insurance and Occupational Pensions Authority, and the European Securities and Markets Authority, which oversee their respective sectors[33].

Under this evolving framework, the IMF's Financial Sector Assessment Programme identified room to: i) improve corporate governance of Spanish financial institutions in the credit cooperative sector, ii) address the fragmentation of resolution arrangements, and iii) enhance systemic risk surveillance and the macro-prudential toolkit by legislatively establishing a Systemic Risk Council and making use of macro-prudential tools, including possible limits on loan-to-value and debt-service-to-income ratios given the continued importance of real estate exposures on banks' balance sheets[34].

Restructuring and consolidation of banking sector

Against this backdrop, Scope notes a significant turnaround in the Spanish financial sector after a comprehensive process of restructuring and consolidation in recent years. Since the crisis, the entire Spanish banking sector has significantly adjusted its business model and lowered its cost base, especially by reducing its branch network and its number of staff by 39% and 32% respectively[35]. This has increased the resilience of the sector as a whole, as evidenced by the resolution of Banco Popular in June 2017[36] and the uncertainty related to Catalonia in October 2017, with both events having limited and contained impact on financial stability and market volatility.

SAREB's losses not a concern

Finally, the Spanish asset management company SAREB, which the government capitalised with around EUR 2.2bn in 2012, has overall been successful in contributing to the stabilisation of the Spanish banking sector. SAREB continues to make progress in the divestment of its real estate portfolio, which has declined from about EUR 50bn in 2012 to around EUR 37bn in 2017[37]. However, the slower-than-expected recovery in real estate prices, the underestimated costs of carrying the portfolio before SAREB's inception, and the difficulty of accurately valuing transferred assets have resulted in recurring losses[38]. While not a systemic concern, going forward Scope does not expect SAREB to benefit proportionally from the real estate sector's recovery, given that its portfolio is geographically skewed, with about 75% located in areas where the price recovery has been slower due to previous over-building.

[32] IMF, Financial Sector Assessment Programme, November 2017
[33] Ibid.
[34] Ibid.
[35] European Commission; Post-Programme Surveillance Report, Autumn 2017
[36] Spain's sixth-largest bank, Banco Popular, was resolved in June 2017 via sale of business after market pressure that led to the bank's illiquidity. IMF Article IV.
[37] https://www.sareb.es/en_US/about-us/how-we-work/sareb-in-figures
[38] European Commission, Post-Programme Surveillance Report, Autumn 2017

Macro-financial vulnerabilities and fragility

On-going private-sector deleveraging process

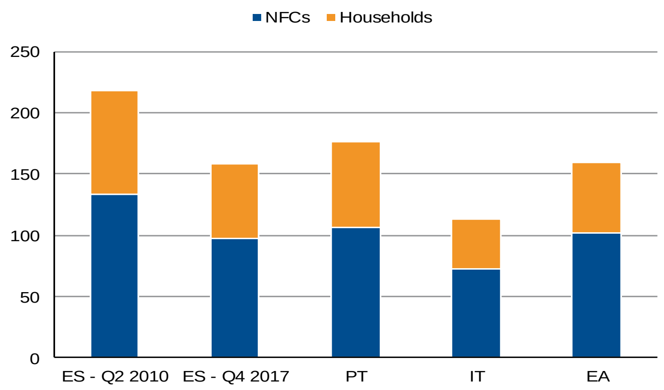
Over the past few years, the Spanish private sector has significantly reduced its indebtedness to levels similar to those of its euro area peers. Non-financial corporates (NFCs) have reduced their liabilities by around EUR 306.5bn since Q2 2010. In turn, households reduced their liabilities more gradually given that most loans are long-term mortgages, but still by around EUR 202.6bn over the same period. As a result, corporate sector indebtedness fell from 133.1% of GDP to 96.8% as of Q4 2017, slightly below the euro area average of 101.7%, while household indebtedness decreased from around 85.1% to 61.3%, just above the euro area average of 58.0%.

This marked decline in liabilities, and thus vulnerabilities, has so far been compatible with investment and private consumption given the increase in confidence, employment, and economic stability; a development Scope expects to continue over the medium term. However, Scope also notes that certain segments of corporates, particularly construction and real estate services, as well as low-income households remain overleveraged, pointing to the need for further deleveraging to reduce this fragility.

Slowing deleveraging process along a pick-up in credit growth

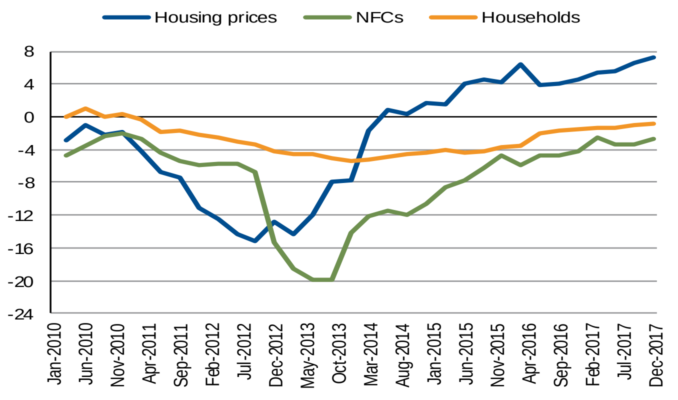
The significant deleveraging process has resulted in weak demand for credit despite declining lending rates. However, while overall credit growth to corporates and households remains negative, the contraction is slowing, and going forward Scope expects deleveraging to be mainly driven by real GDP growth along with a pick-up in credit growth, particularly among the most solvent and productive corporates. In addition, improved profit margins have enabled firms to finance new investment with retained earnings, while large corporations have also shifted to non-bank financing, diversifying the sources of funding of the Spanish economy, which, overall, remains heavily bank-financed compared to EU peers[39].

Figure 28: Private sector debt, % of GDP



Source: Haver, ECB, Scope Ratings

Figure 29: Housing prices and credit, %, y-o-y growth



Source: Haver, ECB, Scope Ratings

Finally, Scope notes that labour market improvements and the prevailing low interest rate environment have led to an increase in consumer demand, which is up 12.8% year on year. However, the savings rate of Spanish households, measured as gross disposable income, has dropped to 7.7% (down from 13.4% in 2009), which is below the euro area average of 12%. In Scope's opinion, this limits the potential increase in credit demand for mortgages over the medium term. It is in this context that Scope assesses increases in housing prices, which have steadily recovered since Q2 2014 but remain, on average, around 15% below the levels observed in Q1 2010. Overall, therefore, as the Bank of Spain notes, the Spanish economy is currently situated in a low phase of the financial

[39] Ibid.

cycle, along with a gradual economic recovery that limits vulnerabilities stemming from credit, prices in the real estate sector, the debt burden of the non-financial private sector, liquidity and extreme events in the financial markets[40].

Institutional and political risk

Perceived willingness to pay

Spain joined the European Union in 1986 and has fully adopted the EU's regulatory framework, providing an anchor for institutional stability and predictability. In Scope's view, Spain is as likely as any EU peer to honour debt obligations in full and on time[41]. Indeed, Spain's request to the EFSF/ESM for a financial assistance package to recapitalise its bank in 2012 and 2013, and the subsequent seven voluntary early repayments of this loan speak to Spain's willingness to repay its creditors on time.

Recent events and policy decisions

Political fragmentation constrains policy implementation

Following the 2011-2015 legislative period, during which the conservative Partido Popular headed by Prime Minister Mariano Rajoy governed with an absolute majority, Spain's political landscape has fragmented with the arrival of the left-wing, anti-austerity Podemos party and the centrist Ciudadanos party. Scope believes that the current minority government, again led by Partido Popular with 134 of 350 seats in the Congress of Deputies, is significantly constrained in formulating and implementing a comprehensive reform agenda to: i) raise Spain's growth potential and ii) increase the structural fiscal adjustment needed to reduce the country's public debt level. The political limitations and subsequent policy inertia are also evidenced, for instance, by the postponement of the 2018 budget, in part due to the political crisis in Catalonia. Specifically, the centre-right Basque Nationalist Party has refrained from supporting the budget given the Partido Popular's approach to the Catalan separatist movement.

Catalonia crisis unresolved

Scope notes that the inconclusive election results in Catalonia in December 2017 – Ciudadanos (pro-union[42]) won most votes (25.4%) and seats (37/ 135) while the separatists (ERC, JuntsXCat and CUP) won 70 of the 135 seats together, but again only 47.5% of the popular vote – cemented the status quo and political paralysis, mirroring the division within Catalonia. Thus, regardless of the government to be formed in Catalonia – which is likely to take place before May 22 to avoid a repeat of elections – Scope's view is that it is highly unlikely that Catalonia will become independent in the near to medium term owing to multiple institutional, economic, and financial reasons that the electoral outcome has only confirmed[43]. However, a sustainable solution possibly providing greater fiscal and/or political autonomy to Catalonia will require political agreement among Spain's major parties which, at this juncture, appears unlikely.

Political paralysis could lead to early elections

Given the complexity of the matter, the political capital needed to address the issue is therefore unlikely to be found under the current minority government, also given the local and regional elections scheduled for May 2019. Thus, given the overall political standstill, it is Scope's opinion that national elections could take place prior to the scheduled end of this legislature's term, which is set for June 2020.

Geopolitical risk

Spain has been a member of NATO since 1982, is not engaged in any bilateral wars, and is thus, in Scope's opinion, just as likely to be affected by geopolitical threats as its European partners.

[40] Bank of Spain, Financial stability report, May 2018
[41] Article 135 of the Spanish Constitution stipulates that 'All Public Administrations shall adapt their actions to the principle of budgetary stability'.
[42] Pro-independence: ERC = Republican Left of Catalonia, JuntsXCat = Junts per Catalunya, CUP = Popular Unity Candidacy; Anti-independence: PP = Partido Popular, PSC = Socialists' Party of Catalonia, Cs = Ciudadanos
[43] See Scope's 'Catalan election will not lead to the region's independence – regardless of the result', December 2017

Methodology

The methodology applicable for this rating and/or rating outlook, Public Finance Sovereign Ratings, is available at www.scoperatings.com.

Historical default rates from Scope Ratings can be viewed in Scope's rating performance report at https://www.scoperatings.com/#governance-and-policies/regulatory-ESMA. Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA) at http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope's definition of default and definitions of rating notations can be found in Scope's public credit rating methodologies at www.scoperatings.com.

The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months. A rating change is not automatically ensured, however.

I. Appendix: CVS and QS results

Sovereign rating scorecards

Scope's Core Variable Scorecard (CVS), which is based on the relative rankings of key sovereign credit fundamentals, provides an indicative "bbb" (bbb) rating range for the Kingdom of Spain. This indicative rating range can be adjusted by up to three notches on the Qualitative Scorecard (QS) depending on the size of relative credit strengths or weaknesses versus peers based on analysts' qualitative findings.

For the Kingdom of Spain, the following relative credit strengths have been identified: i) economic policy framework, ii) fiscal policy framework, iii) market access and funding sources, iv) current-account vulnerability, v) external debt sustainability, vi) vulnerability to short-term external shocks, vii) banking sector performance, and viii) banking sector oversight and governance. Relative credit weaknesses are: i) recent events and policy decisions. The combined relative credit strengths and weaknesses generate a two-notch adjustment and indicate a sovereign rating of A- for the Kingdom of Spain. A rating committee has discussed and confirmed these results.

Rating overview

CVS category rating range	bbb
QS adjustment	A-
Final rating	A-

To calculate the rating score within the CVS, Scope uses a minimum-maximum algorithm to determine a rating score for each of the 24 indicators. Scope calculates the minimum and maximum of each rating indicator and places each sovereign within this range. Sovereigns with the strongest results for each rating indicator receive the highest rating score; sovereigns with the weakest results receive the lowest rating score. The score result translates to an indicative rating range that is always presented in lowercase.

Within the QS assessment, analysts conduct a comprehensive review of the qualitative factors. This includes but is not limited to an economic scenario analysis, a review of debt sustainability, fiscal and financial performance, and policy implementation assessments.

There are three assessments per category for a total of 15. For each assessment, the analyst examines the relative position of a given sovereign within its peer group. For this purpose, additional comparative analysis beyond the variables included in the CVS is conducted. These assessments are then aggregated using the same weighting system as in the CVS.

The result is the implied QS notch adjustment, which is the basis for the analysts' recommendation to the rating committee.

Foreign- versus local-currency ratings

The Kingdom of Spain has almost no foreign-currency-denominated public debt. Consequently, Scope sees no reason to believe that Spain would differentiate between any of its contractual debt obligations based on currency denomination. Furthermore, the recent history of sovereign defaults does not provide a strong justification for a rating bias in favour of either local-currency or foreign-currency debt.

II. Appendix: CVS and QS results

CVS

Rating indicator	Category weight
Domestic economic risk	**35%**
Economic growth	
Real GDP growth	
Real GDP volatility	
GDP per capita	
Inflation rate	
Labour & population	
Unemployment rate	
Population growth	
Public finance risk	**30%**
Fiscal balance	
GG public balance	
GG primary balance	
GG gross financing needs	
Public debt	
GG net debt	
Interest payments	
External economic risk	**15%**
International position	
International investment position	
Importance of currency	
Current-account financing	
Current-account balance	
T-W effective exchange rate	
Total external debt	
Institutional and political risk	**10%**
Control of corruption	
Voice & accountability	
Rule of law	
Financial risk	**10%**
Non-performing loans	
Liquid assets	
Credit-to-GDP gap	
Indicative rating range	**bbb**
QS adjustment	**A-**
Final rating	**A-**

QS

Maximum adjustment = 3 notches

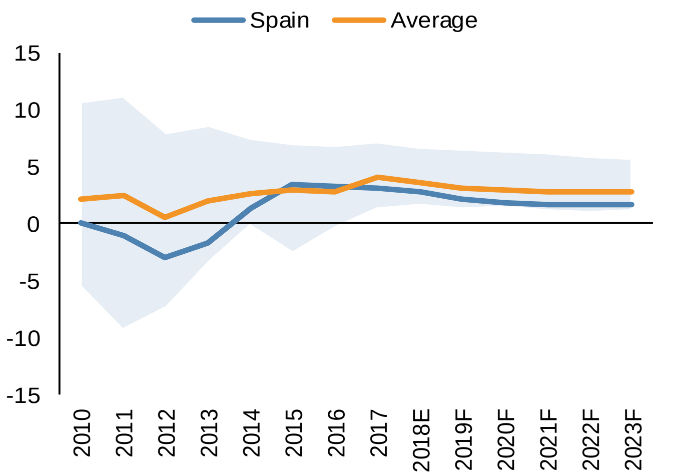
	+2 notch	+1 notch	0 notch	-1 notch	-2 notch
Growth potential of the economy	Excellent outlook, strong growth potential	Strong outlook, good growth potential	◉ Neutral	Weak outlook, growth potential under trend	Very weak outlook, growth potential wel under trend or negative
Economic policy framework	Excellent	◉ Good	Neutral	Poor	Inadequate
Macro-economic stability and sustainability	Excellent	Good	◉ Neutral	Poor	Inadequate
Fiscal policy framework	Exceptionally strong performance	◉ Strong performance	Neutral	Weak performance	Problematic performance
Debt sustainability	Exceptionally strong sustainability	Strong sustainability	◉ Neutral	Weak sustainability	Not sustainable
Market access and funding sources	Excellent access	◉ Very good access	Neutral	Poor access	Very weak access
Current account vulnerability	Excellent	◉ Good	Neutral	Poor	Inadequate
External debt sustainability	Excellent	◉ Good	Neutral	Poor	Inadequate
Vulnerability to short-term external shocks	Excellent resilience	◉ Good resilience	Neutral	Vulnerable to shock	Strongly vulnerable to shocks
Perceived willingness to pay	Excellent	Good	◉ Neutral	Poor	Inadequate
Recent events and policy decisions	Excellent	Good	Neutral	◉ Poor	Inadequate
Geopolitical risk	Excellent	Good	◉ Neutral	Poor	Inadequate
Banking sector performance	Excellent	◉ Good	Neutral	Poor	Inadequate
Banking sector oversight and governance	Excellent	◉ Good	Neutral	Poor	Inadequate
Financial imbalances and financial fragility	Excellent	Good	◉ Neutral	Poor	Inadequate

*** Implied QS notch adjustment = (QS notch adjustment for domestic economic risk)*0.35 + (QS notch adjustment for public finance risk)*0.30 + (QS notch adjustment for external economic risk)*0.15 + (QS notch adjustment for institutional and political risk)*0.10 + (QS notch adjustment for financial stability risk)*0.10**

Source: Scope Ratings GmbH

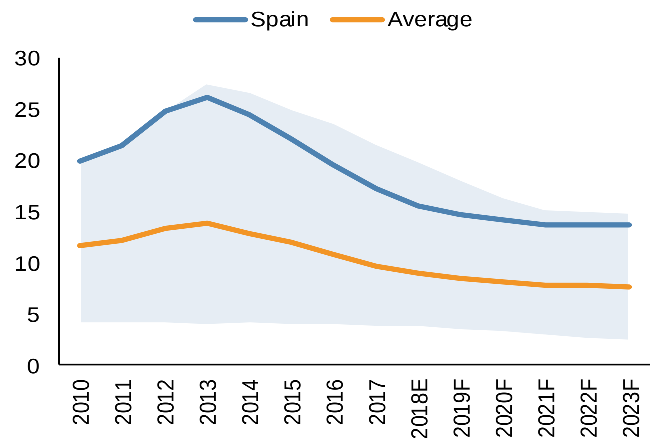
III. Appendix: Peer comparison

Figure 30: Real GDP growth



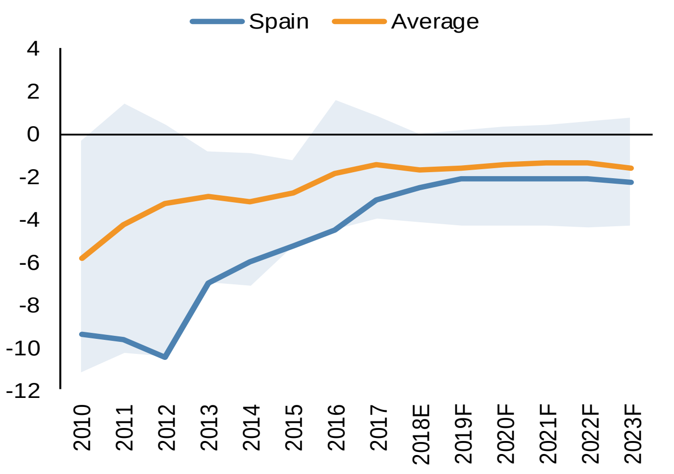
Source: IMF, Calculations Scope Ratings GmbH

Figure 31: Unemployment rate, % labour force



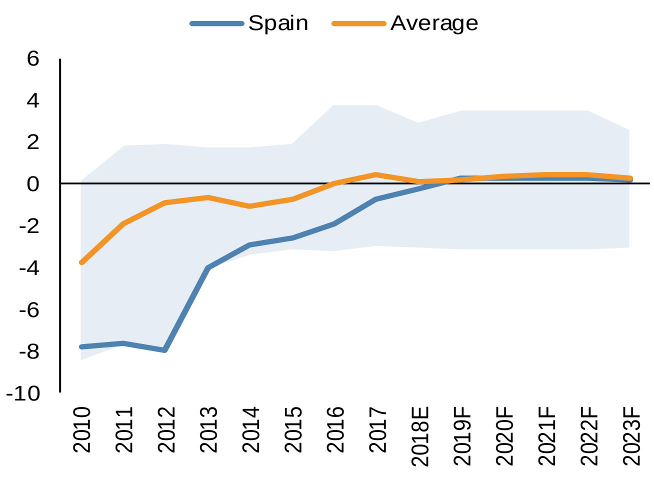
Source: IMF, Calculations Scope Ratings GmbH

Figure 32: General government balance, % of GDP



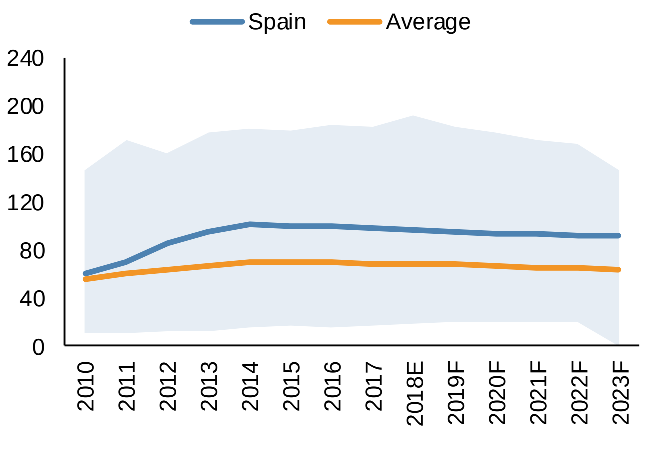
Source: IMF, Calculations Scope Ratings GmbH

Figure 33: General government primary balance, % of GDP



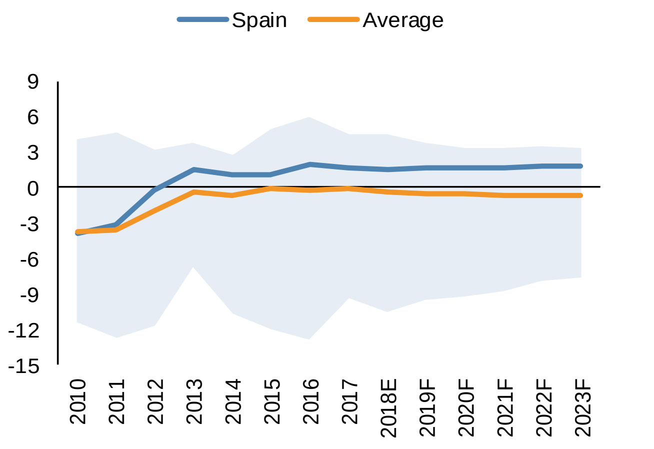
Source: IMF, Calculations Scope Ratings GmbH

Figure 34: General government gross debt, % of GDP



Source: IMF, Calculations Scope Ratings GmbH

Figure 35: Current account balance, % of GDP



Source: IMF, Calculations Scope Ratings GmbH

IV. Appendix: Statistical tables

	2013	2014	2015	2016	2017	2018E	2019F
Economic performance							
Nominal GDP (EUR bn)	1,025.7	1,037.8	1,080.0	1,118.5	1,163.7	1,215.1	1,263.1
Population ('000s)	46,593.0	46,455.0	46,410.0	46,399.0	46,333.0	46,268.0	46,202.0
GDP per capita PPP (USD)	32,603.9	33,709.7	34,818.1	36,304.9	-	-	-
GDP per capita (EUR)	22,013.8	22,340.3	23,270.7	24,106.6	25,115.2	26,262.9	27,338.9
Real GDP, % change	-1.7	1.4	3.4	3.3	3.1	2.8	2.2
GDP growth volatility (10-year rolling SD)	2.9	2.8	2.8	2.7	2.6	2.7	2.3
CPI, % change	1.4	-0.1	-0.5	-0.2	2.0	1.7	1.6
Unemployment rate (%)	26.1	24.4	22.1	19.6	17.2	15.5	14.8
Investment (% of GDP)	18.7	19.5	20.4	20.5	21.1	21.5	21.7
Gross national savings (% of GDP)	20.2	20.5	21.5	22.4	22.8	23.1	23.3
Public finances							
Net lending/borrowing (% of GDP)	-7.0	-6.0	-5.3	-4.5	-3.1	-2.5	-2.1
Primary net lending/borrowing (% of GDP)	-4.0	-3.0	-2.6	-2.0	-0.8	-0.2	0.2
Revenue (% of GDP)	38.6	38.9	38.5	37.7	38.2	38.2	38.0
Expenditure (% of GDP)	45.6	44.8	43.8	42.2	41.3	40.7	40.1
Net interest payments (% of GDP)	2.9	3.0	2.7	2.5	2.3	2.3	2.3
Net interest payments (% of revenue)	7.6	7.7	7.0	6.7	6.1	6.0	6.1
Gross debt (% of GDP)	95.5	100.4	99.4	99.0	98.4	96.7	95.1
Net debt (% of GDP)	81.1	85.5	85.7	86.5	86.3	85.2	84.0
Gross debt (% of revenue)	247.5	258.2	258.3	262.6	257.4	253.4	250.5
External vulnerability							
Gross external debt (% of GDP)	160.2	168.0	168.6	166.7	164.8	-	-
Net external debt (% of GDP)	94.7	97.7	94.0	88.5	84.9	-	-
Current-account balance (% of GDP)	1.5	1.1	1.1	1.9	1.7	1.6	1.7
Trade balance [FOB] (% of GDP)	-1.4	-2.1	-2.1	-1.6	-1.9	-1.6	-1.6
Net direct investment (% of GDP)	-1.8	0.6	2.6	1.5	1.7	-	-
Official forex reserves (EOP, EUR mil)	20,093.0	27,076.0	35,560.0	44,474.0	43,098.0	-	-
REER, % change	1.8	-0.4	-4.4	0.6	1.2	-	-
Nominal exchange rate (EOP, USD/EUR)	1.4	1.2	1.1	1.1	1.2	-	-
Financial stability							
Non-performing loans (% of total loans)	7.9	6.7	5.3	4.8	-	-	-
Tier 1 ratio (%)	11.9	11.8	12.7	13.0	-	-	-
Consolidated private debt (% of GDP)	177.2	165.8	155.2	147.1	139.3	-	-
Domestic credit-to-GDP gap (%)	-40.8	-47.8	-54.2	-55.4	-	-	-

Source: IMF, European Commission, European Central Bank, Bank of Spain, World Bank, Haver Analytics, Scope Ratings

V. Regulatory disclosures

This credit rating and/or rating outlook is issued by Scope Ratings GmbH.

Rating prepared by Alvise Lennkh, Lead Analyst

Person responsible for approval of the rating: Dr Giacomo Barisone, Managing Director

The ratings/outlook were first assigned by Scope as subscription rating in January 2003. The subscription ratings/outlooks were last updated on 30.06.2017.

The senior unsecured debt ratings as well as the short term issuer ratings were last assigned by Scope on 30.06.2017.

The main points discussed by the rating committee were: i) Spain's growth potential; ii) macroeconomic stability and sustainability; iii) fiscal consolidation, outlook and public debt sustainability; iv) external debt sustainability and vulnerability to shocks; v) banking sector performance and private-sector deleveraging vi) political fragmentation; and vii) peers.

Solicitation, key sources and quality of information

The rating was initiated by Scope and was not requested by the rated entity or its agents. The rated entity and/or its agents did not participate in the ratings process. Scope had no access to accounts, management and/or other relevant internal documents for the rated entity or related third party.

The following material sources of information were used to prepare the credit rating: public domain and third parties. Key sources of information for the rating include: Ministry of Finance of Spain, the Bank of Spain, the BIS, the European Commission, the European Central Bank, Institute Nacional de Estadística, Spanish Treasury, the Statistical Office of the European Communities (Eurostat), the IMF, the OECD, and Haver Analytics.

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