Kingdom of Spain
Rating Report

A- STABLE OUTLOOK

Credit strengths	Credit challenges
• Status as a euro area member • Large and diversified economy • Gradual reduction of external and financial imbalances	• High public and external debt levels • Elevated structural unemployment, low productivity growth • Adverse demographics

Rating rationale:

Core euro area member: Spain benefits from its euro area membership, strengthening the country's resilience to face an unprecedented global shock.

Large and diversified economy: Spain benefits from its large economic size and diversified economic structure driven by high value-added activities.

Gradual reduction of imbalances: The Spanish economy had been on a positive trend in the years leading up to the crisis, which saw a progressive reduction of financial and external imbalances, through the deleveraging of the private sector and the generation of steady current account surpluses.

Debt profile and market access: The Spanish treasury benefits from strong market access, facilitated by the ECB's accommodative monetary policy, including its asset purchase programmes.

Rating challenges include: i) an elevated stock of public debt, resulting from persistent fiscal deficits; ii) the implementation of additional reforms required to reduce the high level of structural unemployment and increase productivity; and iii) adverse demographic developments in form of a rapidly ageing and declining population, placing structural pressure on public finances and weighing on growth potential.

Spain's sovereign rating drivers

Risk pillars		Quantitative scorecard		Reserve currency adjustment (notches)	Qualitative scorecard	Final rating
		Weight	Indicative rating		Notches	
Domestic Economic Risk		35%	aa		+1/3	A-
Public Finance Risk		25%	bb		+1/3	
External Economic Risk		10%	b-		0	
Financial Stability Risk		10%	aa+		0	
ESG Risk	Environmental Risk	5%	aa+		0	
	Social Risk	5%	bb		-1/3	
	Governance Risk	10%	bbb+		0	
Overall outcome		**bbb+**		**+1**	**0**	

Note: The sum of the qualitative adjustments, capped at 1 notch per rating pillar, is weighted equally and rounded to the nearest integer. The reserve currency adjustment applies to currencies in the IMF's SDR basket.
For details, please see Scope's 'Sovereign Ratings' methodology. Source: Scope Ratings GmbH

Outlook and rating triggers

The Stable Outlook reflects Scope's view that risks to the ratings are balanced over the next 12 to 18 months.

Positive rating-change drivers	Negative rating-change drivers
• Public finances meaningfully improve • Reforms are introduced to address labour market and productivity challenges, raising the country's growth potential	• Weaker than expected economic recovery or protracted fiscal deterioration weakens debt sustainability • Reforms are introduced that adversely impact the economic and fiscal outlooks

Ratings and Outlook

Local and foreign currency

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

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Bloomberg: RESP SCOP

Domestic Economic Risks

- **Growth outlook:** Spain suffered the deepest contraction in economic output in the EU in 2020 (-10.8%), worse than France (-8%), Italy (-8.9%) or the euro area (-6.4%). The recovery is now well on its way, following a successful vaccination campaign (more than 85% of the population is vaccinated) and the gradual lifting of Covid-19 related restrictions. We expect economic growth at +5.5% in 2021 and +6.0% in 2022. It should be driven by a strong rebound in private demand as well as by an increase in public investment. As of Q3 2021, Spanish GDP was 6.6% below its pre-pandemic level, reflecting a slower pace in the recovery than its EU peers (1.1% for the euro area, 0.1% for France, 1.4% for Italy). A convalescent tourism sector and a more modest than expected rebound in consumer expenditure, in the context of spiking energy prices and of persisting labor market fragilities, have caused this slow down.

  Spain is set to receive EUR 70bn in grants as part of its Recovery and Resilience Plan, with an additional EUR 70bn in loans available, the second highest allotment in the EU. The governments aims to spend 77% of these grants over the next 3 years, allocating 40% of the funds to green investments and 28% to the digital transition. These investments should also support a reform agenda aimed at tackling the country's long standing structural challenges, especially related to its rigid labor market.

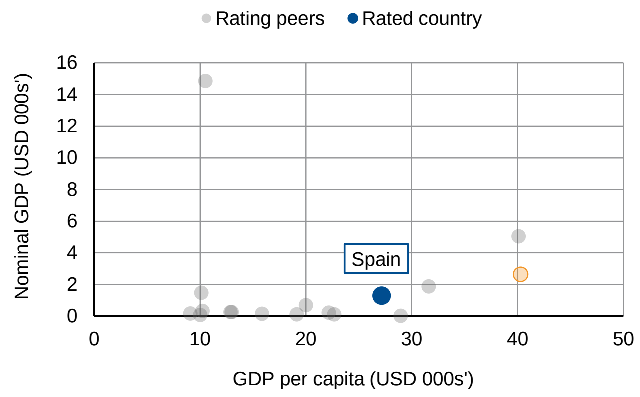
- **Inflation and monetary policy:** Inflation has significantly accelerated and reached its highest level since 1992 in October 2021 (+5.4% annualized rate), well above its peers and the euro area average (+4.1%). This increase is mainly driven by the jump in energy prices and by Covid-19 related supply chain distortions and should therefore be temporary.

- **Labour market:** The government-supported short term work schemes ('ERTEs') cushioned the impact of the pandemic on the labour market and contained the rise in unemployment (+1.4pp in 2020). We expect unemployment to gradually decrease but to remain at a very high level, at 15.4% this year and 14.8% in 2022.

Overview of Scope's qualitative assessments for Spain's *Domestic Economic Risks*

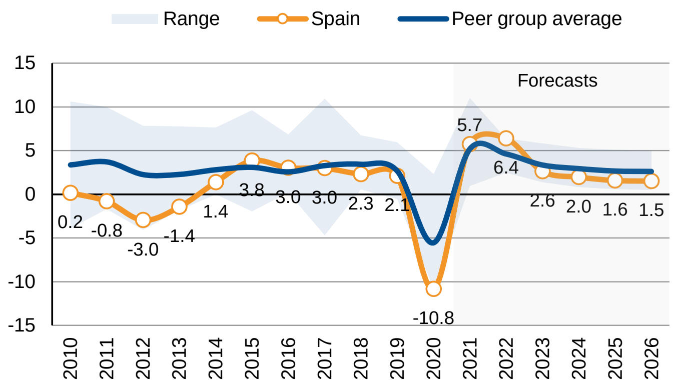
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa	Growth potential of the economy	Neutral	0	Moderate growth potential, but improvements likely due to recovery plan
	Monetary policy framework	Strong	+1/3	ECB is a highly credible and effective central bank; appropriate response to the 2020 global crisis; high weight in the GC's monetary policy decisions
	Macro-economic stability and sustainability	Neutral	0	Large and diversified economy; significant structural unemployment

Nominal GDP and GDP per capita, USD thousands



Source: IMF, Scope Ratings GmbH

Real GDP growth, %



Source: IMF, Scope Ratings GmbH

Public Finance Risks

- **Fiscal outlook:** The Spanish government entered the Covid-19 crisis with weak public finances, with primary deficits averaging below -1.2% of GDP over 2015-19 and an elevated, albeit declining, stock of debt. The additional public spending linked to the health crisis and the drop in GDP caused the general government deficit to jump to -11% in 2020. We expect it to gradually recede in the coming years, to -8% in 2021 and to -4.8% in 2022, before stabilizing at a level below -3.5%, i.e. outside the boundaries of the Stability and Growth pact.

  The 2022 budget bill carries the largest public spending effort in the country's history, with almost EUR 460 bn in spending. Uncertainty around the final budgetary impact of the pension reform remains, representing a key vulnerability for fiscal sustainability.

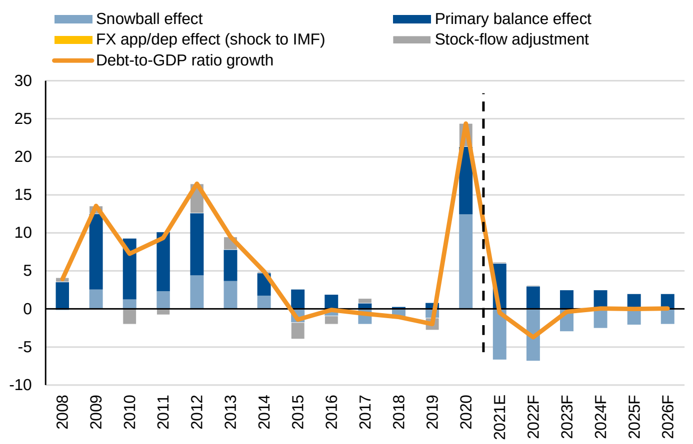
- **Debt trajectory:** The government debt-to-GDP ratio jumped to almost 120% of GDP in 2020, an increase of nearly 25pp from the previous year. The withdrawal of emergency measures and the economic recovery will support a decrease in the debt burden. We expect the debt-to-GDP ratio to remain stable in 2021, before decreasing to 115.7% in 2022 and stabilizing at an elevated level, above 115%, in the period up to 2026. Significant contingent liabilities were built up over the crisis, in the form of government guarantees on corporate loans and on exports, for a total of 151 bn (13.4% of GDP) as of October 2021. Adverse demographics represent a significant long-term challenge for public debt sustainability. Under a no policy-change scenario, the IMF expects additional spending from pension and health expenditures of 24.3% and 45% of GDP, respectively, between 2020 and 2050.

- **Market access:** Net funding needs for 2022 are estimated around EUR 80bn, similar to 2021 and well below 2020 (110bn). As a result of the ECB's accommodative policy stance, Spain benefits from low, declining funding costs, at 0.02% in 2021, bringing the average cost of debt down to 1.64%. Risks stemming from a large debt stock are partially mitigated by the resilient debt structure, with an average maturity of more than 8 years, and a majority of the debt being held by residents (59%), including 22% by Banco de España, as of Q2 2021.

Overview of Scope's qualitative assessments for Spain's *Public Finance Risks*

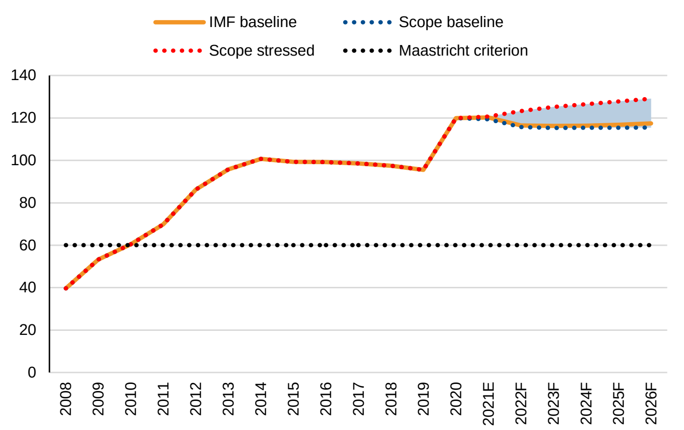
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb	Fiscal policy framework	Neutral	0	Limited structural budgetary adjustments before the crisis; appropriate countercyclical response
	Debt sustainability	Neutral	0	Debt to remain elevated over medium term; low interest burden; contingent liability risks from Covid-19
	Debt profile and market access	Strong	+1/3	Strong market access and solid investor base; safe debt composition with large central bank holdings

Contributions to changes in debt levels, pps of GDP



Source: Scope Ratings GmbH

Debt-to-GDP forecasts, % of GDP



Source: Scope Ratings GmbH

External Economic Risks

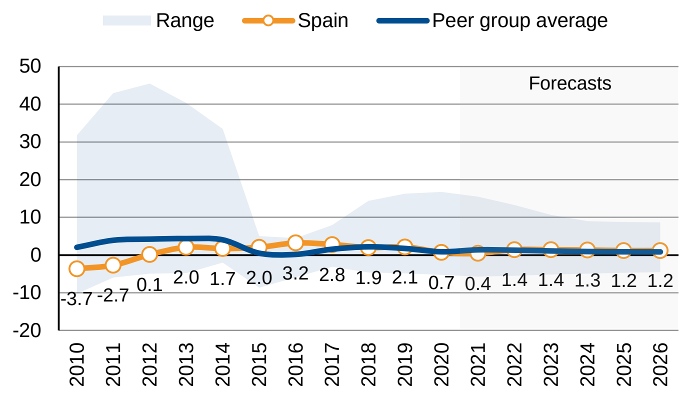
- **Current account:** Spain had recorded steady current account surpluses in the period leading up to the crisis, averaging around 2% of GDP between 2012 and 2019. The current account surplus slipped to 0.7% in 2020, mainly driven down by the decrease in travel receipts. The recovery in net trade of services, which were still 1.7% below pre-pandemic level as of Q3 2021, should drive the rebound in the current account balance, though it will be partially offset in the medium term by the increase in energy and commodity prices.
- **External position:** Spanish gross external debt had stabilized at a rather elevated level in the decade prior to the crisis, averaging above 160% of GDP between 2010-19, before jumping to 186.3% in 2020, in great part due to the fall in GDP. The composition of external debt changed favourably over the period as the share accounted for the public sector (public administrations, central bank) rose to almost half of the debt stock, up from 14% in 2010.

  The pandemic caused a reversal in the pre-crisis, decreasing trend in the net international investment position which stood at -71.9% in 2019, a 10p.p. improvement from 2016, before falling to -80.1% in 2020. It has since partially recovered, however, due to GDP growth and favorable valuation effects.
- **Resilience to shocks:** Spain, along with all euro area members, benefits from the euro's status as a global reserve currency, significantly mitigating risks to external shocks.

Overview of Scope's qualitative assessments for Spain's *External Economic Risks*

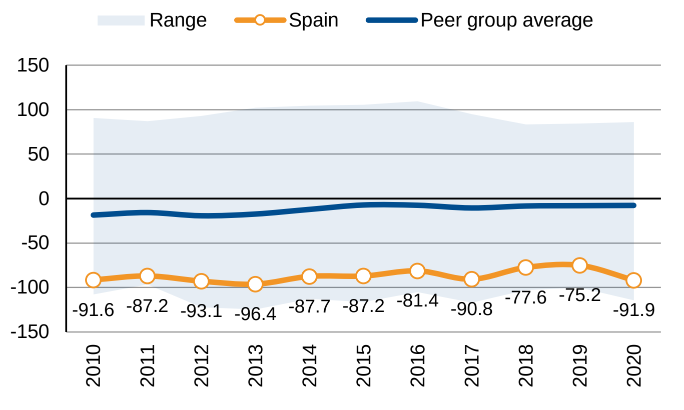
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
b-	Current account resilience	Neutral	0	Tourism exports temporarily weakened; resilience in non-tourism and non-energy trade surplus
	External debt structure	Neutral	0	Elevated debt stock, with meaningful shares by the government and central bank
	Resilience to short-term shocks	Neutral	0	Euro area membership shields against short-term external shocks

Current account balance, % of GDP



Source: IMF, Scope Ratings GmbH

NIIP, % of GDP



Source: IMF, Scope Ratings GmbH

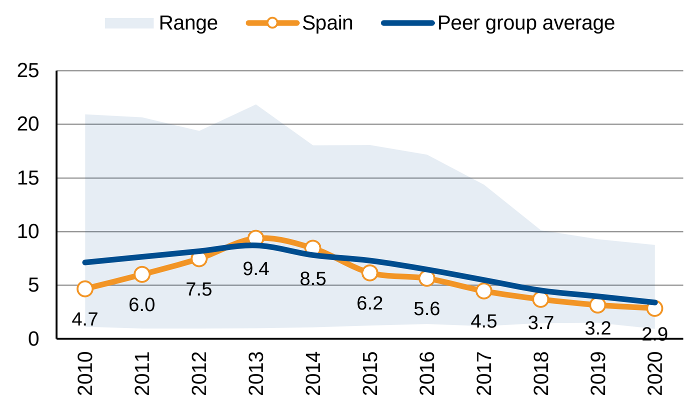
Financial Stability Risks

- **Banking sector**: The Spanish banking sector suffered a net loss in 2020, translating into a negative return on assets (-0.21%). Sector-wide margins returned to positive territory in Q1 2021 and should be supported in the medium-run by increased consolidation. Liquidity improved over the pandemic as reflected in a liquidity coverage ratio of 205.3% as of Q2 2021, well above its pre-crisis level (157.7% in Q4 2019) and the euro area average (173.8%). The sector maintained adequate capital buffers (CET-1 ratio at 14.9% at end 2020) though they remain below the European Union average. Non-performing loans (NPL) ratios are elevated compared to peers but declined to 2.9% in December 2020, down from a high of 9.4% in 2014.
- **Private debt**: Favourable financing conditions, supported by government guarantees and accommodative monetary policy, have led to the first annual increase in the outstanding amounts of bank loans to households and non-financial corporations (NFC) since 2008. NFC debt stood at 106.4% of GDP as of Q2 2021, a 14p.p. rise from 2019, though mainly driven by the decrease in GDP level. Household indebtedness increased as well, as reflected in the debt to gross disposable income ratio (GDI) which stood at 94.9% in Q2 2021, 4.2 pp above pre-crisis level. The debt burden to GDI ratio decreased over the same period, due to the decline in the average cost of outstanding debt. Household wealth also expanded following a period of rise in financial and real asset prices and of deposits accumulation.
- **Financial imbalances**: An increase in house sales combined with a constrained supply led to the first acceleration in the rate of increase of housing prices in Q2 2021 (+3.3% year-on-year) since early 2019. New mortgage loans increased by 40% in H1 2021 compared to H1 2019, though the outstanding amount of housing loans only grew marginally, due to a parallel increase in mortgage repayments. Average loan-to-price ratios remained relatively unchanged, and the share of floating-rate mortgages decreased slightly, pointing to stable credit standards.

Overview of Scope's qualitative assessments for Spain's *Financial Stability Risks*

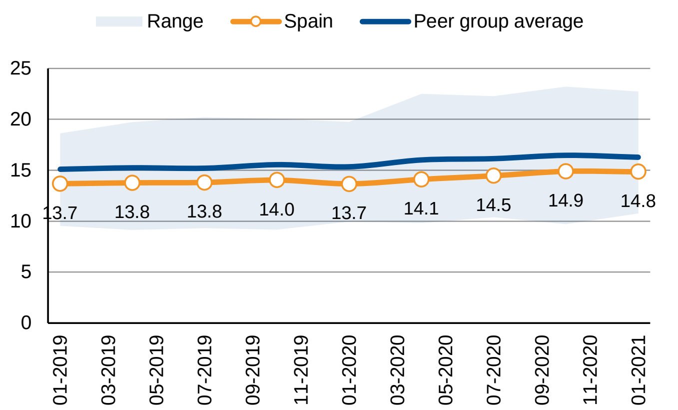
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa+	Banking sector performance	Neutral	0	Banking-system capitalisation remains sound, but profitability pressures
	Banking sector oversight	Neutral	0	Effective oversight under European Banking Union authorities and the Bank of Spain
	Financial imbalances	Neutral	0	High private indebtedness; no sign of credit-fueled growth

NPLs, % of total loans



Source: IMF, Scope Ratings GmbH

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings GmbH

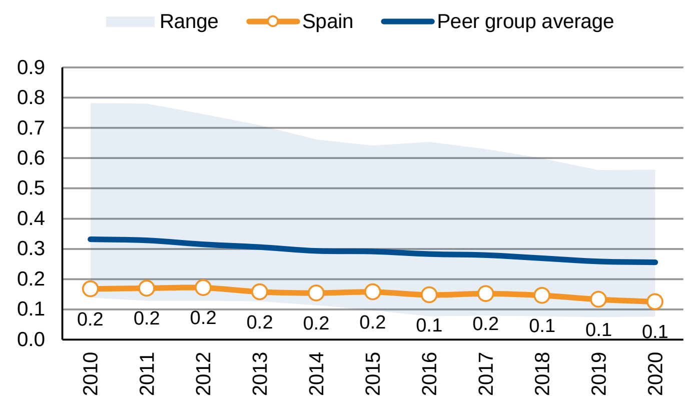
ESG Risks

- **Environment:** The Spanish government aims to reach carbon neutrality by 2050, targeting a 97% renewable energy mix by then. It has made significant progress in its electricity transition, increasing the share of renewables in the electricity mix from 24% in 2009 to 38% in 2019, putting it well on track to attain its 2030 objective (42%). With an overall energy mix dominated by oil (40% of the total energy supply in 2020) and natural gas (26%), Spain remains heavily dependent on imports for its energy supply (73%). The topography of Spain makes it particularly exposed to the adverse effects of climate change, with increased risks of reduced water resources, coastal erosion, loss of biodiversity and natural ecosystems, and more frequent extreme weather-related phenomena.
- **Social:** Despite achieving improvements in the European Commission Social scoreboard, Spain still faces considerable employment and social challenges. The labour market is characterized by low employment rates and high gender disparities. The percentage of young people neither in employment nor in education and training ('NEETs') is elevated (17.3% in 2020, against a 13.7% EU average). The government aims to take specific steps to tackle these issues, through investments in digital skills, labor market reforms, and a 12.5 bn package aimed at the inclusion of youth.
- **Governance:** The PSOE-UP ruling coalition, led by PM Pedro Sánchez, needs the external support of the Catalan separatist (ERC) to have parliamentary majority. The parties have conflicting views on key policy areas, including the pension reform. The government was able to obtain approval for its budget bill 2022, reducing uncertainty as to the stability of the current political balance.

Overview of Scope's qualitative assessments for Spain's *ESG Risks*

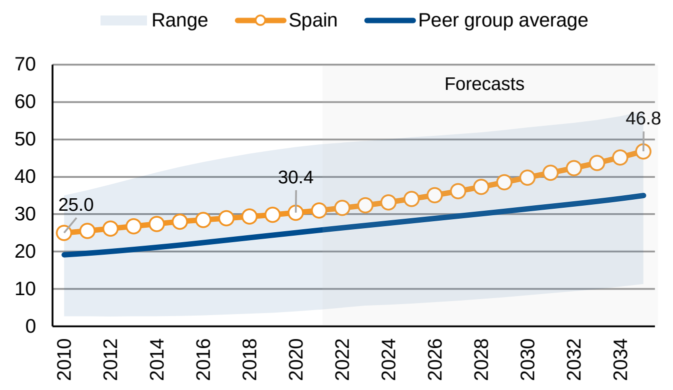
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a-	Environmental risks	Neutral	0	Exposure to natural disasters; ambitious commitment to achieve carbon neutrality by 2050
	Social risks	Weak	-1/3	Adverse demographic trends; high income inequality and risk of social exclusion
	Institutional and political risks	Neutral	0	Some reform momentum on labour market; pension reform under discussion; fragmented parliament

CO2 emissions per GDP, mtCO2e



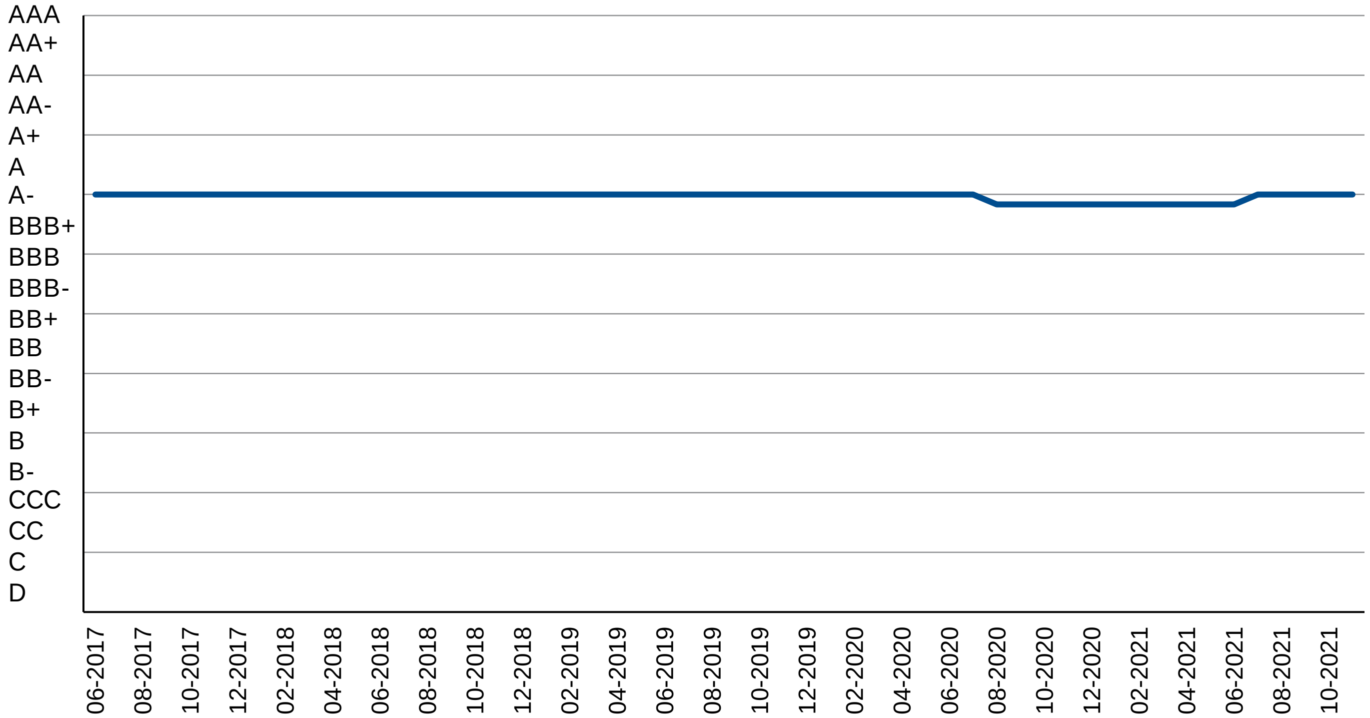
Source: European Commission, Scope Ratings GmbH

Old age dependency ratio, %



Source: United Nations, Scope Ratings GmbH

Appendix I. Rating history



Appendix II. Rating peers

Rating peers are related to sovereigns with an indicative rating in the same rating category or in adjacent categories per Scope's Core Variable Scorecard.

Peer group
Bulgaria
China
France
Hungary
Italy
Japan
Malta
Portugal
Romania
Russia
Slovakia

Publicly rated sovereigns only; the full sample may be larger.

Appendix III. Statistical table for selected CVS indicators

This table presents a selection of the indicators (24 out of 29) used in Scope's quantitative model, the Core Variable Scorecard.

	2016	2017	2018	2019	2020	2021F	2022F
Domestic Economic Risk							
GDP per capita, USD 000s'	26.5	28.2	30.4	29.6	27.2	30.5	33.2
Nominal GDP, USD bn	1232.6	1312.1	1421.6	1393.2	1280.5	1440.0	1570.9
Real growth, %[1]	3.0	3.0	2.3	2.1	-10.8	5.5	6.0
CPI inflation, %	-0.2	2.0	1.7	0.7	-0.3	2.2	1.6
Unemployment rate, %[1]	19.6	17.2	15.3	14.1	15.5	15.4	14.8
Public Finance Risk							
Public debt, % of GDP[1]	99.2	98.6	97.5	95.5	119.9	119.4	115.7
Interest payment, % of government revenue	6.4	6.0	5.7	5.3	5.0	4.7	4.5
Primary balance, % of GDP[1]	-1.9	-0.7	-0.3	-0.8	-8.9	-6.0	-3.0
External Economic Risk							
Current account balance, % of GDP	3.2	2.8	1.9	2.1	0.7	0.4	1.4
Total reserves, months of imports	1.8	1.7	1.6	1.8	2.3	-	-
NIIP, % of GDP	-81.4	-90.8	-77.6	-75.2	-91.9	-	-
Financial Stability Risk							
NPL ratio, % of total loans	5.6	4.5	3.7	3.2	2.9	-	-
Tier 1 ratio, % of risk weighted assets	13.1	13.4	13.7	14.0	14.9	14.8	-
Credit to private sector, % of GDP	111.8	105.9	99.6	94.7	108.5	-	-
ESG Risk							
CO^2 per EUR 1,000 of GDP, $mtCO^2e$	147.8	152.1	146.2	133.0	125.3	-	-
Income quintile share ratio (S80/S20), x	7.3	6.6	6.6	-	-	-	-
Labour force participation rate, %	74.4	74.2	74.1	74.2	-	-	-
Old age dependency ratio, %	28.5	28.9	29.4	29.9	30.4	31.0	31.7
Composite governance indicator[2]	0.9	0.8	0.8	0.9	1.1	-	-

[1] Forecasted values are produced by Scope and may differ from those presented in the charts of the previous sections
[2] Average of the six World Bank Governance Indicators
Source: European Commission, IMF, World Bank, Scope Ratings GmbH

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps) as of 25 November 2021	34.3

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