Kingdom of Spain
Rating Report

SCOPE A- STABLE OUTLOOK

Credit strengths

- Large and diversified economy
- Favourable debt profile
- Status as a euro area member

Credit challenges

- High public debt levels
- Elevated structural unemployment
- Long-term budgetary pressures caused by adverse demographic trends

Rating rationale:

Large and diversified economy: Spain's economy is characterized by its significant size and diversified structure, which is driven by high-value activities. Thanks to its considerable renewable energy production capacity and substantial regasification infrastructure, Spain was able to weather the energy shock of last year, highlighting its comparative advantages.

Favourable debt profile: Public debt is characterised by its long average life, low share of short-term debt, and a stable investor base, with the average cost of debt set to remain moderate compared to historical standards even amid monetary tightening.

Core euro area member: Spain's membership in the euro area confers significant benefits, which contribute to the country's enhanced resilience in the face of global shocks.

Rating challenges include: i) a high level of public debt; ii) elevated structural unemployment and iii) long-term budgetary pressures resulting from unfavorable demographic trends, particularly the increasing expenditure on healthcare and pensions.

Spain's sovereign rating drivers

Risk pillars		Quantitative		Reserve currency	Qualitative*	Final rating
		Weight	Indicative rating	Notches	Notches	
Domestic Economic Risk		35%	aa-	EUR [+1]	0	A-
Public Finance Risk		20%	bb+		0	
External Economic Risk		10%	b+		0	
Financial Stability Risk		10%	aa+		0	
ESG Risk	Environmental Factors	5%	bb-		0	
	Social Factors	7.5%	b+		-1/3	
	Governance Factors	12.5%	a-		0	
Indicative outcome			**a-**		**0**	
Additional considerations					**0**	

Note: *The qualitative scorecard adjustments, capped at one notch per rating pillar, are weighted equally with an aggregate adjustment 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.

Outlook and rating triggers

The Stable Outlook reflects Scope's view that risks to the ratings are balanced.

Positive rating-change drivers

- Growth prospects improve, supported by, for example, reform progress
- Improvement in public finances, putting public debt on a firm downward trajectory

Negative rating-change drivers

- Low economic growth or protracted fiscal deterioration weakens debt sustainability
- Reforms are delayed, adversely impacting economic and fiscal outlooks

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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Bloomberg: RESP SCOP

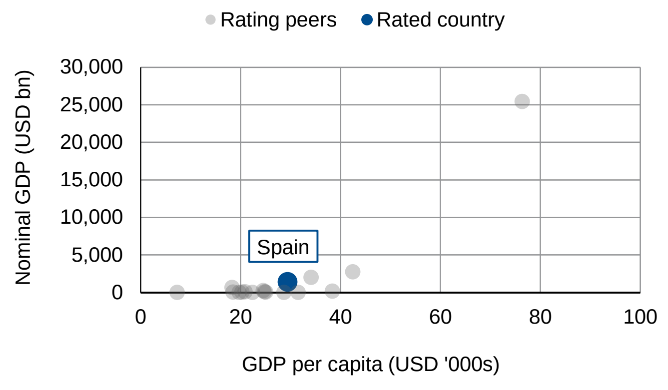
Domestic Economic Risks

- **Growth outlook:** Despite facing significant headwinds, the Spanish economy demonstrated resilience in 2022. The real GDP growth rate was consistent with the previous year, standing at 5.5%. The robust output growth in the first half of the year offset a marked slowdown in momentum in H2 2022, which was due to declining private demand, persistent price pressures, and tightening lending conditions. We anticipate growth to gradually recover in the coming months, with a projected growth rate of 1.6% in 2023. This growth will be supported by lower inflation rates and a recovery in international tourism, which will support services exports. As a result, we expect the economic output to surpass its pre-pandemic level by H2 2023. We anticipate growth to accelerate to 2.1% in 2024, before trending back to the medium-term potential estimated to be between 1.5% to 2.0% per annum. Medium-term growth prospects are expected to be bolstered by elevated levels of public investment, which will be augmented by significant EU funding as part of Spain's Recovery and Resilience Plan.
- **Inflation and monetary policy:** CPI inflation in Spain stood at 3.3% YoY in March 2023, down from a peak of 10.8% in July 2022 due to base effects and declining energy prices. However, core inflation, which excludes volatile food and energy prices, has remained elevated, stabilising at 7.5% in March. This reflects the pass-through of energy costs to the rest of the economy and the persistence of domestic price dynamics. Although we anticipate headline inflation to continue to decline over the medium term due to the ECB's tighter monetary policy, underlying price pressures are likely to ease only gradually.
- **Labour market:** Spain's unemployment rate, while still among the highest in the euro area, has reached decades-low levels, standing at 12.8% (SA) as of February 2023. This reflects the ongoing strength of the labor market, which has continued to create jobs, albeit at a decelerating pace. In 2022, the average number of employed persons increased by nearly 620,000. Moreover, the quality of job creation has improved since the labor market reform of 2021, with lower shares of part-time and fixed-term contracts. We expect labor market dynamics to moderate in the medium term, in line with the deceleration of economic growth, which will only allow for a modest decline in the unemployment rate.

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

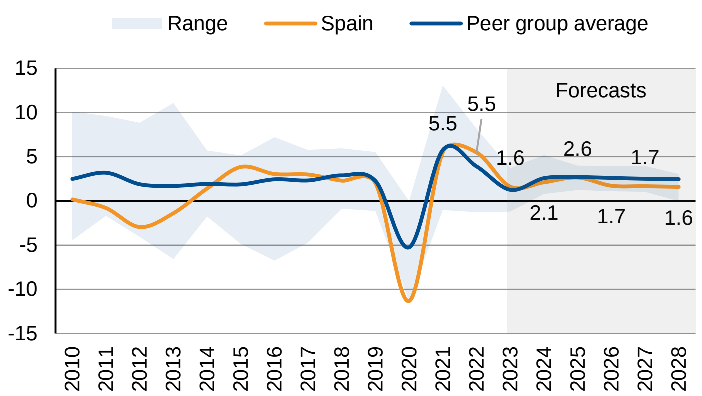
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa-	Growth potential of the economy	Neutral	0	Moderate growth potential, but medium-term improvements likely due to recovery plan
	Monetary policy framework	Neutral	0	ECB is a highly credible and effective central bank
	Macro-economic stability and sustainability	Neutral	0	Large and diversified economy

Nominal GDP and GDP per capita, USD



Source: IMF World Economic Outlook (WEO), Scope Ratings

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

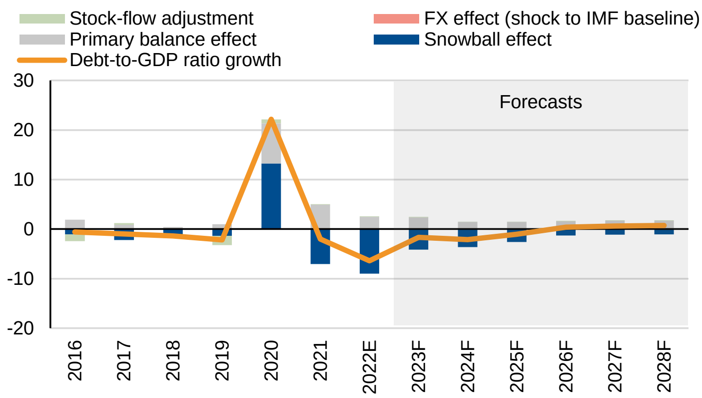
Public Finance Risks

- **Fiscal outlook:** The government deficit declined to 4.8% of GDP in 2022, which is an improvement of 2.1 percentage points from the previous year. This is despite the implementation of measures aimed at mitigating the impact of the energy crisis on the private sector, which amounted to 1.5% of GDP. The decline was due to robust revenue growth. Rising pension payments and the extension of energy support measures are likely to put pressure on the budget, and hence we expect a further but moderate decline in the fiscal deficit to 4.4% of GDP in 2023. Continued robust nominal growth should have a positive impact on fiscal receipts, which will be mostly offset by the aforementioned pressures. As a result, we anticipate a further moderation in the headline budget to about 3.7% of GDP in 2024. We expect the budget to stabilize at a level above 3% of GDP in subsequent years, given rising costs of pension payments and energy support measures, both of which are to put pressure on public finances.
- **Debt trajectory:** The debt-to-GDP ratio decreased to 113.2% in 2022, a 5-percentage point decline from the previous year, driven by strong nominal growth. However, it remains 15 percentage points higher than pre-pandemic levels. The ratio is expected to continue declining to 111.4% in 2023, with a stabilisation around 109% in the period leading up to 2027, due to the persistence of primary deficits and rising debt-servicing costs. The fiscal outlook for the long term presents significant challenges, due to the fiscal pressures stemming from ageing demographics. Recent estimates from AIReF suggest that these challenges could increase debt levels by as much as 44 percentage points of GDP by 2050.
- **Market access:** The Spanish government has net funding needs of EUR 70bn in 2023, which is broadly similar to the previous year. As with other countries, funding costs have increased since the second half of 2021, owing to the tightening of global funding conditions. While the large debt stock and rising interest rates pose risks, the favourable debt structure mitigates them to some extent. This includes a relatively long average maturity of 7.9 years, a moderate share of inflation-indexed liabilities (around 5% of the total), and a stable ownership structure, which includes 28% held by Banco de España as of Q2 2022. The Spanish government has also requested access to EU loans worth EUR 84bn, which should help ease medium-term borrowing cost pressures.

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

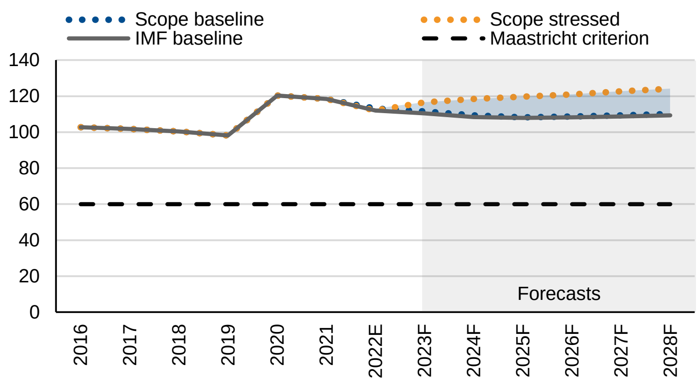
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb+	Fiscal policy framework	Neutral	0	Solid revenue growth; long-term budgetary pressures resulting from population ageing
	Debt sustainability	Neutral	0	Debt to remain elevated over medium term; moderate but gradually increasing interest burden
	Debt profile and market access	Neutral	0	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: IMF WEO, Scope Ratings forecasts

Debt-to-GDP forecasts, % of GDP



Source: IMF WEO, Scope Ratings forecasts

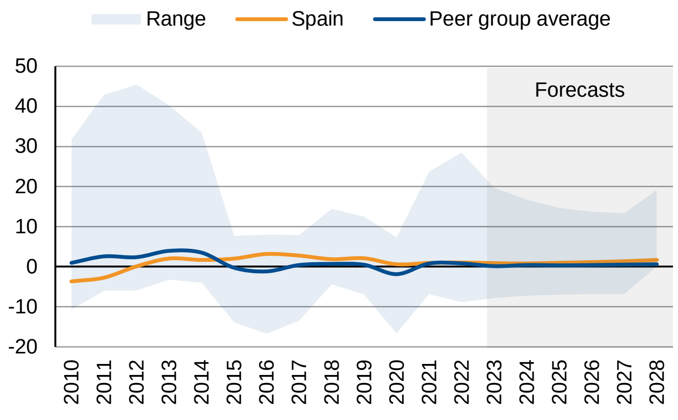
External Economic Risks

- **Current account:** In 2022, Spain's current account balance remained robust, recording a surplus of 0.6% of GDP despite the drag from nominal energy imports on the trade of goods. Meanwhile, the trade of services balance posted its highest level in a decade, reaching about 6.8% of GDP, boosted by the recovery in international tourism receipts. Looking ahead, the current account balance is expected to remain subdued in the medium term, compared to pre-pandemic levels, due to the weaker growth prospects among Spain's trading partners and the strong import demand driven by heightened investment activity.
- **External position:** Prior to the crises, Spanish gross external debt had remained at a high level, averaging around 170% of GDP between 2010-19. However, due to the pandemic's economic impact, this level surged to above 200% in 2021 Q1. As the economy recovered, the increase in gross external debt has been reversed, with levels falling to about 176% by the end of Q2. This reduction in debt levels has been accompanied by improvements in the composition of external debt, including longer maturities, a higher proportion of public sector debt (52%), and a moderate share of banking sector liabilities (23%). Spain's net international investment position, which measures the difference between the country's external financial assets and liabilities, has also improved. It currently stands at about -61% of GDP, a substantial improvement from the peak of above 95% seen in 2014.
- **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*

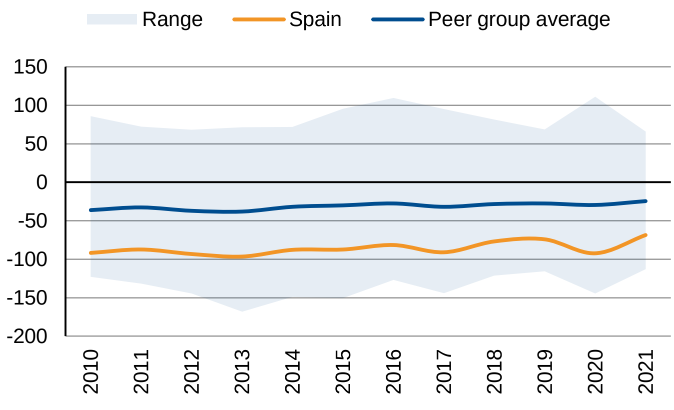
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
b+	Current account resilience	Neutral	0	Strong recovery in tourism exports; resilience in non-tourism and non-energy trade surplus
	External debt structure	Neutral	0	Elevated debt stock, with meaningful shares by the government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

Current account balance, % of GDP



Source: IMF WEO, Scope Ratings

Net international investment position (NIIP), % of GDP



Source: IMF, Scope Ratings

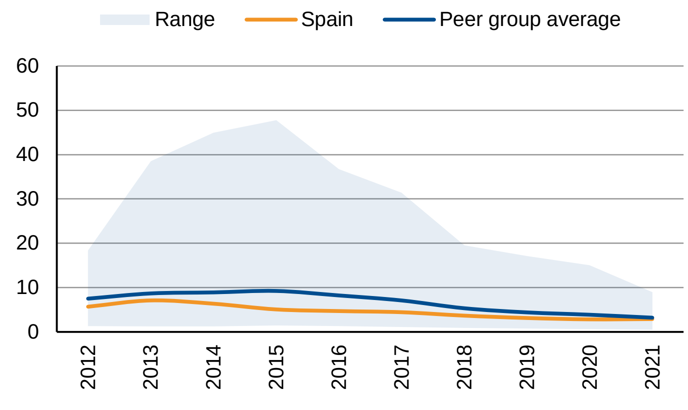
Financial Stability Risks

- **Banking sector**: The Spanish banking sector has demonstrated resilience, aided by healthy capitalisation and liquidity buffers, with tier-1 and liquidity coverage ratios of 14.1% and 171.1% respectively as of Q4 2022. Profitability remains strong, with a sector-wide return on equity of 10.4%, surpassing the EU average of 8.3%. This is largely due to a rise in interest margins, even with the impact of the government's windfall tax on the sector's profits. Despite the expiry of the debt moratorium and grace period of ICO loans, the non-performing loans ratio remains stable and moderate relative to pre-pandemic levels, standing at 2.8% as of Q4 2022. We expect the sector's profitability to continue to benefit from the high interest rate environment, despite challenges related to slower credit growth and weaker short-term economic prospects.
- **Private debt**: Following the pandemic-induced increase in private sector leverage, primarily due to denominator effects, private sector indebtedness has resumed its pre-pandemic declining trend in line with the economic recovery. As of end-2022, non-financial corporates indebtedness stood at 97% of GDP, somewhat above its end-2019 level, but still below the euro area average of 109%. Meanwhile, household indebtedness is moderate, at 53% of GDP, 4 percentage points below the euro area average. Additionally, the household debt service to gross disposable income ratio is lower than most peers, standing at 5.7%. Although there has been an increase in the share of fixed-rate contracts in recent years, about 75% of the total outstanding household mortgage loans remain on variable rate terms, which exposes borrowers to interest rate risks in the context of monetary policy tightening.
- **Financial imbalances**: In 2022, housing transactions reached historically high levels, however, towards the end of the year, the market exhibited signs of cooling, with a decline in sales of around 10% YoY in December. Residential real estate price growth has decelerated, with a YoY growth rate of 5.5% in Q4 2022, down from 8.5% in the first quarter of the year. We expect a further moderation in housing market dynamics over the medium term as tighter lending conditions weigh on demand. Moreover, high construction costs are anticipated to constrain supply in the medium term, which should prevent a sharp correction in housing prices.

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

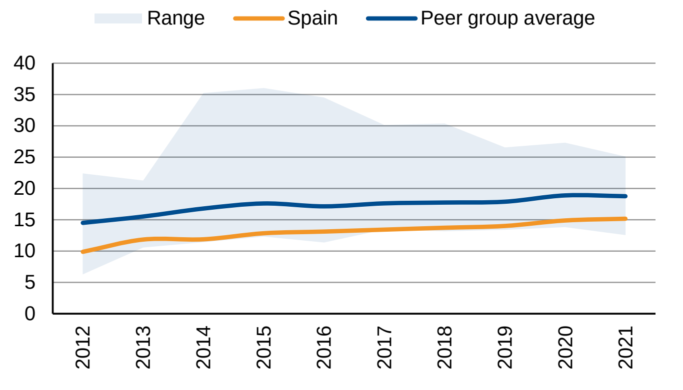
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa+	Banking sector performance	Neutral	0	Banking-system capitalisation remains sound, improvements in profitability
	Banking sector oversight	Neutral	0	Effective oversight under European Banking Union authorities and the Bank of Spain
	Financial imbalances	Neutral	0	Private sector deleveraging process

Non-performing loans, % of total loans



Source: IMF, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

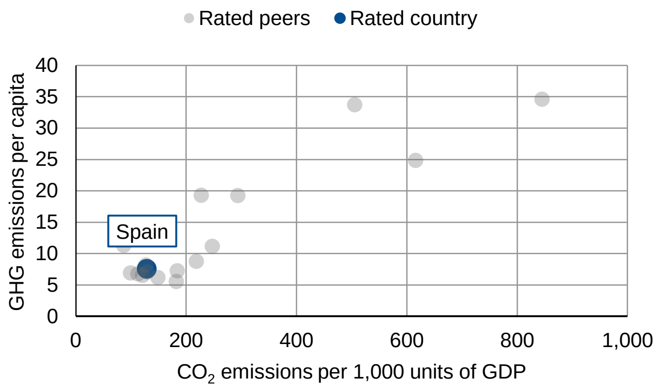
ESG Risks

- **Environment:** The Spanish government has set an ambitious goal of achieving carbon neutrality by 2050, with a target of 97% renewable energy mix by that time. The country has already made significant strides in its electricity transition, increasing the share of renewables in its electricity mix from 34% in 2010 to nearly 47% in 2021, putting it well on track to achieve its 2030 objective of 74%. However, the unique topography of Spain makes it particularly vulnerable to the adverse effects of climate change, with increased risks of dwindling water resources, coastal erosion, loss of biodiversity and natural ecosystems, and more frequent extreme weather-related phenomena.
- **Social:** Despite making progress in the European Commission Social Scoreboard, Spain continues to grapple with significant employment and social challenges. The labour market is characterized by low employment rates and notable gender disparities. Moreover, the percentage of young individuals who are neither employed nor enrolled in education and training is high, standing at 14.1% in 2021, which is higher than the EU average of 13.1%. The government is taking steps to address these challenges by investing in digital skills, implementing labour market reforms, and introducing a EUR 12.5 billion package to promote youth inclusion.
- **Governance:** The ruling coalition in Spain, led by PM Pedro Sánchez and comprised of PSOE-UP, relies on external support from the Catalan separatist party, ERC, to maintain a parliamentary majority. The coalition has managed to remain relatively stable since its formation, successfully negotiating key reforms and budget bills. The next general elections are scheduled for December 2023.

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

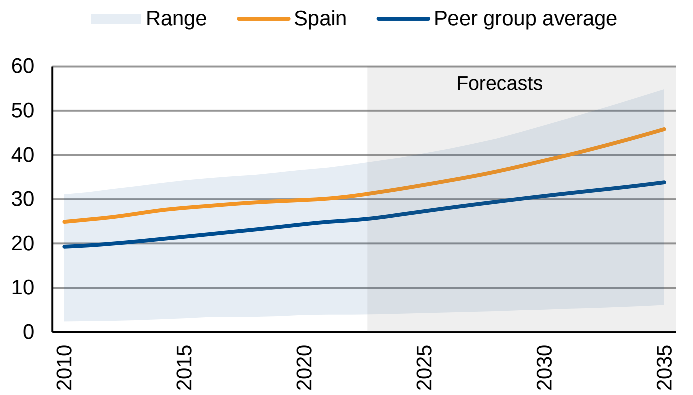
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb-	Environmental factors	Neutral	0	Exposure to natural disasters; ambitious commitment to achieve carbon neutrality by 2050
	Social factors	Weak	-1/3	Adverse demographic trends; high income inequality; significant structural unemployment
	Governance factors	Neutral	0	Some reform momentum on labour market

Emissions per GDP and per capita, $mtCO_2e$



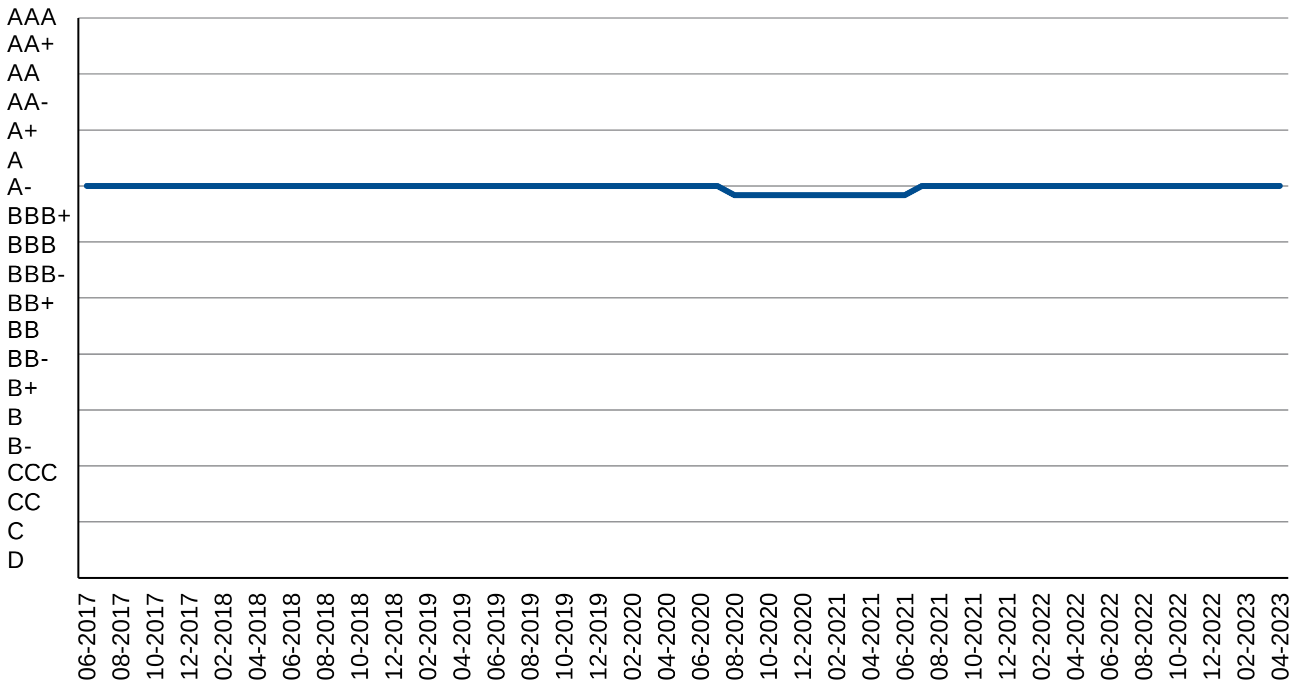
Source: European Commission, Scope Ratings

Old age dependency ratio, %



Source: United Nations, Scope Ratings

Appendix I. Rating history (foreign-currency long-term debt)



NB. Positive/Negative Outlooks are treated with a +/-0.33-notch adjustment. Credit Watch positive/negative with a +/-0.67-notch adjustment.

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, including a methodological reserve-currency adjustment.

Peer group*
Croatia
Cyprus
Estonia
Italy
Latvia
Lithuania
Poland
Portugal
Slovakia
United States

*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 30 – with the governance indicator reflecting a composite of six indicators) used in Scope's quantitative model, the Core Variable Scorecard, in line with Scope's Sovereign Rating Methodology. The metrics and sources for the data presented here ensure comparability across global peers and may therefore differ from national and other selective international statistics.

Pillar	Core variable	Source	2019	2020	2021	2022	2023
Domestic Economic	GDP per capita, USD '000s	IMF	29.6	26.9	30.1	29.4	31.2
	Nominal GDP, USD bn	IMF	1,394.5	1,275.9	1,428.3	1,400.5	1,492.4
	Real growth, %	IMF	2.0	-11.3	5.5	5.5	1.5
	CPI inflation, %	IMF	0.8	-0.3	3.0	8.3	4.3
	Unemployment rate, %	WB	14.1	15.5	14.8	-	-
Public Finance	Public debt, % of GDP	IMF	98.2	120.4	118.4	112.0	110.5
	Interest payment, % of revenue	IMF	5.2	4.9	4.5	4.6	4.8
	Primary balance, % of GDP	IMF	-1.0	-8.1	-4.9	-2.5	-2.4
External Economic	Current account balance, % of GDP	IMF	2.1	0.6	1.0	1.1	0.9
	Total reserves, months of imports	IMF	1.7	2.3	2.1	-	-
	NIIP, % of GDP	IMF	-74.0	-92.1	-68.4	-61.1	-
Financial Stability	NPL ratio, % of total loans	IMF	3.2	2.9	2.9	3.1	-
	Tier 1 ratio, % of risk-weighted assets	IMF	13.7	13.7	14.8	14.9	-
	Credit to private sector, % of GDP	WB	94.6	108.9	-	-	-
ESG	CO_2 per EUR 1,000 of GDP, $mtCO_2e$	EC	133.5	123.9	128.6	-	-
	Income share of bottom 50%, %	WID	21.0	21.1	21.1	-	-
	Labour-force participation rate, %	WB	74.2	-	-	-	-
	Old-age dependency ratio, %	UN	29.6	29.8	30.2	30.7	31.5
	Composite governance indicators*	WB	0.9	0.8	0.8	-	-

* Average of the six World Bank Worldwide Governance Indicators.

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps) as of 14.04.2023	50

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