27 May 2022 Sovereign and Public Sector

Kingdom of Spain
Rating Report

A- STABLE OUTLOOK

Credit strengths

- Status as a euro area member
- Large and diversified economy
- Gradual reduction of external and financial imbalances

Credit challenges

- 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 global shocks.

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%	aaa		0	
Public Finance Risk		25%	bbb-		-1/3	
External Economic Risk		10%	b+		0	
Financial Stability Risk		10%	aaa		0	A-
ESG Risk	Environmental Risk	5%	aaa		0	
	Social Risk	5%	bb		-1/3	
	Governance Risk	10%	bbb+		0	
Overall outcome		a-		+1	-1	

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. In line with our methodology, movements between indicative ratings are not immediate but are executed after analyst review of CVS results. The rating committee approved an implied core variable scorecard (CVS) rating of 'a-'.
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

- Public finances meaningfully improve
- Reforms are introduced to address labour market and productivity challenges, supporting the country's growth potential

Negative rating-change drivers

- 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

Foreign and local currency

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

Lead Analyst

Jakob Suwalski
+49 69 6677389-45
j.suwalski@scoperatings.com

Team Leader

Dr Giacomo Barisone
+49 69 6677389-22
g.barisone@scoperatings.com

Scope Ratings GmbH

Neue Mainzer Straße 66-68
60311 Frankfurt am Main

Phone +49 69 6677389-0

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891-0
Fax +49 30 27891-100

info@scoperatings.com
www.scoperatings.com

Bloomberg: RESP SCOP

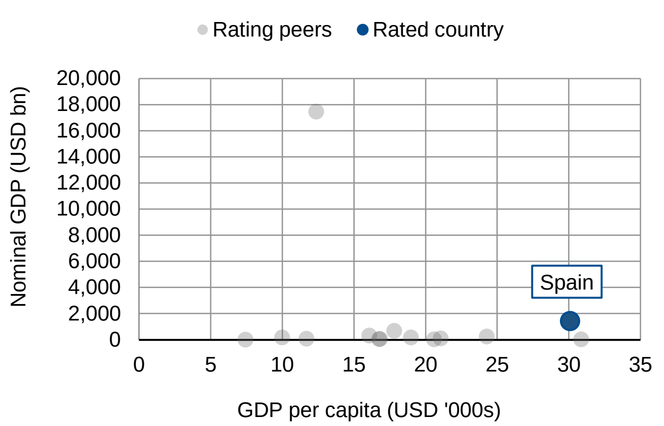
Domestic Economic Risks

- **Growth outlook:** After suffering one of the deepest contractions in the EU in 2020 (-10.8%), the Spanish economy grew by 5.1% in 2021. Despite this strong growth, Spanish GDP still stood about 3.8% below its pre-crisis level as of end-2021, reflecting a slower pace in the recovery relative to European peers. This is due in large part to the slow recovery of the tourism sector as well as to fragile household consumption, in a context of spiking energy prices and persisting labor market fragilities. Global supply chain disruptions because of the war in Ukraine will hinder output growth in some key industries, including automobile (around 10% of GDP). We expect GDP growth to remain robust in the medium term, at +4.6% in 2022 and +3.3% in 2023, before gradually converging to potential. The growth momentum should be supported by the recovery in tourism as well as by the disbursement Spain's NextGenerationEU funds (EUR 70bn in grants).
- **Inflation and monetary policy:** Inflation accelerated significantly in 2021 and stood at 8.4% (year-on-year) in April 2022, well above the euro-area average (7.5%). Price pressures primarily stem from rising energy prices but have become more broad-based in recent months, as reflected in historically high underlying inflation rates (4.4% in April). The European Commission recently agreed to allow Spain and Portugal to implement temporary caps on prices for gas and coal used by power plants due to the limited interconnections between the Iberic peninsula and the rest of the EU energy market, which should help alleviate price pressures in Spain.
- **Labour market:** The recovery on the labour market in 2021 was robust, pushing the number of persons employed above 20m for the first time since 2008. Employment by hours worked was still slightly below pre-crisis levels as of 2022 Q1, however. At the same time, the unemployment rate stood at 13.7%, slightly below end-2019 levels. We expect to decline somewhat in coming years, albeit remaining at an elevated level, supported by the economic recovery and the implementation of the government's recent labour market reform.

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

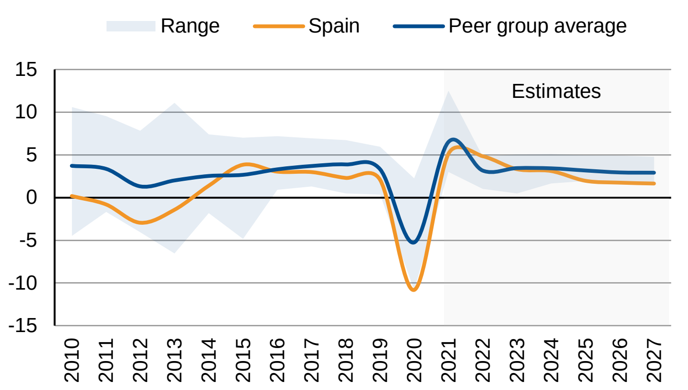
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Growth potential of the economy	Neutral	0	Moderate growth potential, but improvements likely due to recovery plan
	Monetary policy framework	Neutral	0	ECB is a highly credible and effective central bank; effective policy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

Nominal GDP and GDP per capita, USD '000s



Source: IMF WEO, Scope Ratings GmbH

Real GDP growth, %



Source: IMF WEO, Scope Ratings GmbH

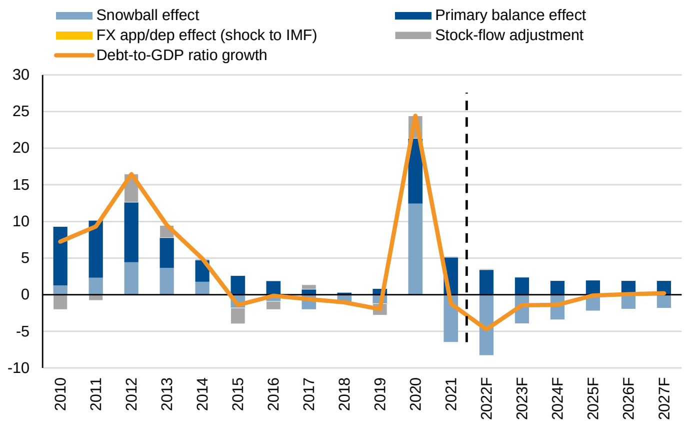
Public Finance Risks

- **Fiscal outlook:** The Spanish government headline budget deficit narrowed to 6.9% of GDP in 2021, a 3.2pps decrease from the previous year. This improvement follows from a stronger than expected growth in tax receipts as well as to a moderate growth in expenditures. The government recently rolled out a set of measures aimed at cushioning the impact of the Ukraine war on the Spanish economy and at managing the arrival of refugees, for a total of EUR 16bn. The implementation of the 2021 pension system reform, which includes the indexation of pension payments to inflation, could lead to large increases in public expenditures. Long term challenges to the fiscal outlook relate to Spain's rapidly ageing population which adds to pressures on social expenditures. We expect the budget deficit to gradually narrow to 4.3% of GDP by 2023, before stabilizing at an elevated, negative level, of around 3.8%.
- **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. It declined moderately, albeit at a faster pace than initially forecasted, to 118.4% in 2021, largely owing to the recovery in economic output. Looking ahead, we expect debt levels to gradually recede, to 114.0% of GDP in 2022, 112.6% in 2023, before stabilizing at above 111.0% of GDP in the period up to 2027.
- **Market access:** Net funding needs for 2022 are estimated around EUR 75bn, similar to 2021 and well below 2020 (110bn). The average cost of debt is low, at about 1.64% in 2021. Similarly to peers, the improvement in the growth outlook as well as the expectation of monetary tightening have led to a gradual increase in funding costs for the Spanish government in recent months, bringing the average cost at issuance to 0.49% in May 2022, up from -0.02% in 2021. 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 27% by Banco de España, as of Q3 2021.

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

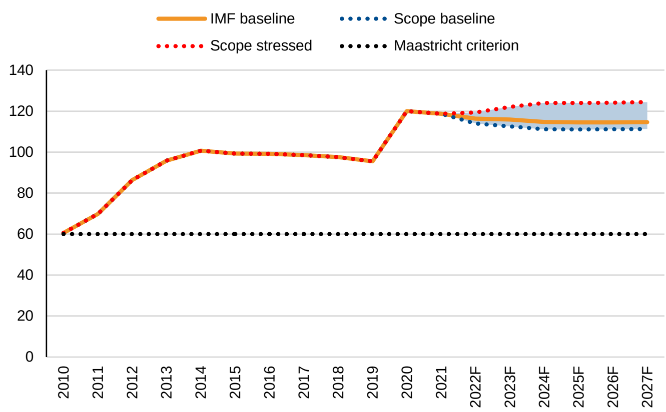
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb-	Fiscal policy framework	Weak	-1/3	Structural fiscal deficits including Spain's pension system
	Debt sustainability	Neutral	0	Debt to remain elevated over medium term; low interest burden; contingent liability risks from Covid-19
	Debt profile and market access	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: Scope Ratings GmbH

Debt-to-GDP forecasts, % of GDP



Source: IMF WEO, Scope Ratings GmbH

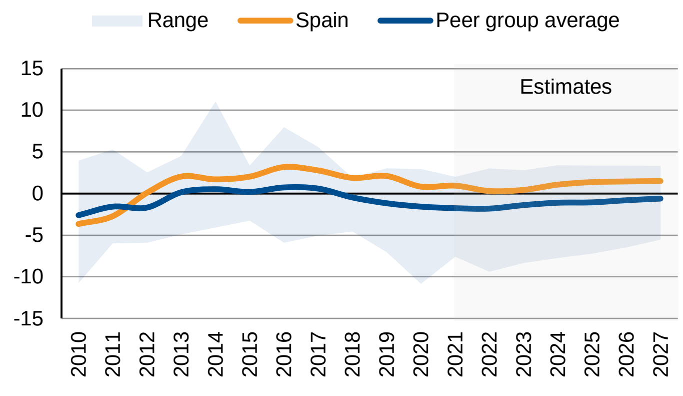
External Economic Risks

- **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. After decreasing in 2020 to 0.8% of GDP, largely due to a fall in travel receipts, the current account surplus increased in 2021 (+0.1pp) on the back of recovering tourism receipts. In the context of rising energy import prices and underperformance of key exports sectors due to global supply chain disruptions, we expect Spain's current account balance to improve to pre-crisis levels only gradually.
- **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 increasing to about 186% in 2020, primarily due to the denominator effect. The economic recovery allowed for a partial reversal of this increase, down to about 178% as of end-2021. The composition of external debt changed favorably 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 net international investment position stood at -64.4% of GDP as of end-2021, a 7.6pps improvement from pre-crisis levels, largely owing to favorable changes in valuations.
- **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*

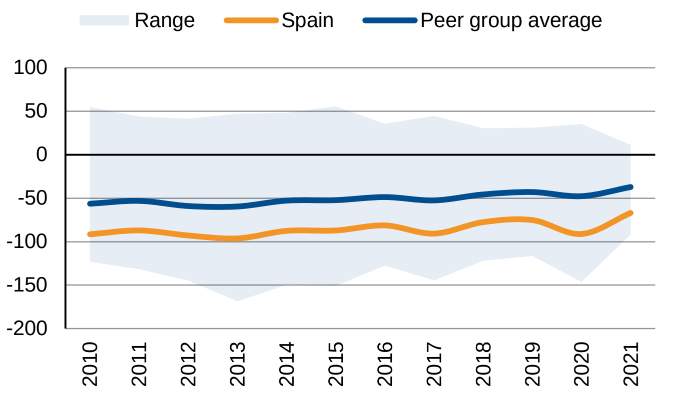
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
b+	Current account resilience	Neutral	0	Tourism exports temporarily weakened; resilience in non-tourism and non-energy trade surplus
	External debt structure	Neutral	0	Elevated debt stock, with meaningful shares by the government 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 WEO, Scope Ratings GmbH

NIIP, % of GDP



Source: IMF WEO, Scope Ratings GmbH

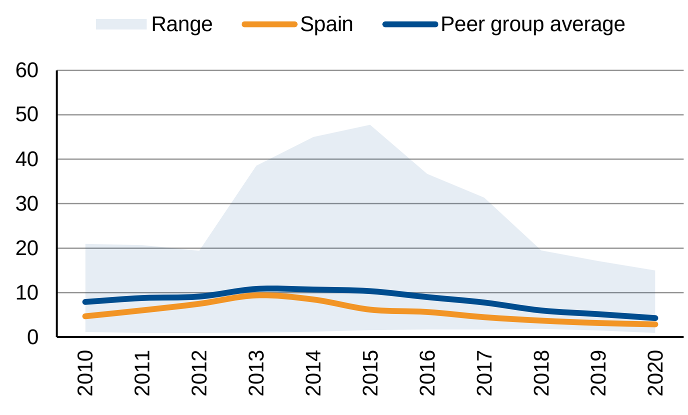
Financial Stability Risks

- **Banking sector**: After suffering a net loss in 2020, the banking sector recovered swiftly and edged back to pre-crisis profitability levels as measured by aggregate return on assets (+0.67%). Consolidation and increasing interest rates should further support sector-wide margins in the medium-term. Liquidity improved over the crisis, bringing the liquidity coverage ratio to 203% at end-2021, above the euro-area average (174.7%) and its pre-pandemic level (157.7%). Capitalisation is comfortable and increasing, with a tier 1 capital ratio of 15% in 2021, albeit remaining below the European Union average. The non-performing loans ratio remained on a downwards trends and stood at 2.9% in 2021 Q3 (down from 3.2% at end-2019), but rising stage 2 loans (+14% in 2021) point to underlying fragilities, especially in the sectors most hard-hit by the Covid-19 crisis.
- **Private debt**: After increasing since the beginning of the Covid-19 crisis, non-financial corporates indebtedness declined slightly in 2021H2, down to about 103% of GDP at end-2021, following a sharp decline in new loans to NFCs (-21.6%). Household debt moderated somewhat as well to 58% of GDP, largely owing to the rebound in economic output. Strong residential real estate activity pushed the volume of new mortgage loans to historically high levels in 2021. Despite an increase in the share of fixed-rate loans, the overall stock of mortgage loans remained variable-rate, exposing households to a degree of interest risks in a context of expected monetary policy tightening.
- **Financial imbalances**: Spanish housing market activity picked up pace in 2021, with transactions standing 18% above their pre-crisis level over the year, while supply remained constrained. This caused an acceleration in price increases, up to +6.5% (year-on-year) in 2021 Q4. Rising materials costs and labor shortages in the construction sector will weigh on supply growth in the medium-term, which could exacerbate price pressures.

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

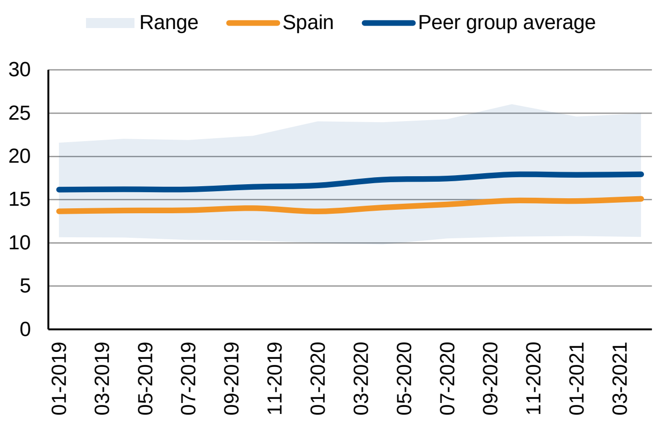
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	Banking-system capitalisation remains sound, but profitability pressures
	Banking sector oversight	Neutral	0	Effective oversight under European Banking Union authorities and the Bank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

NPLs, % of total loans



Source: IMF WEO, Scope Ratings GmbH

Tier 1 ratio, % of risk-weighted assets



Source: IMF WEO, Scope Ratings GmbH

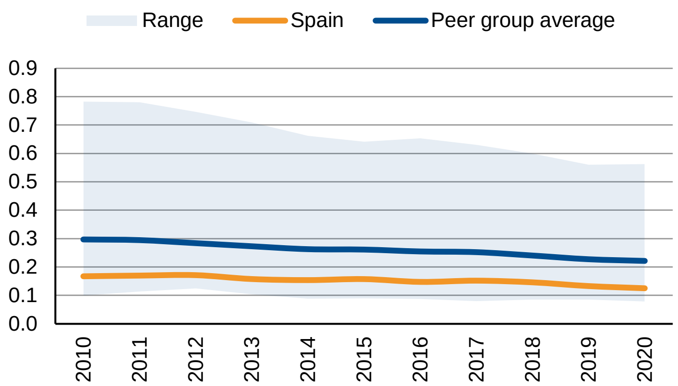
ESG Risks

- **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%). This dependence makes the country vulnerable to external geopolitical tensions, as was recently the case due to the diplomatic spat between Algeria and Morocco. 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 (15.2% in 2020, against a 13.2% EU average). The government aims to take specific steps to tackle these issues, through investments in digital skills, labor market reforms, and a EUR 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. Despite conflicting views on key policy areas within the coalition, the government was able to obtain approval for its budget bill 2022, reducing uncertainty as to the stability of the current political balance. Existing tensions within the coalition, however, could hinder the passing of key reforms.

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

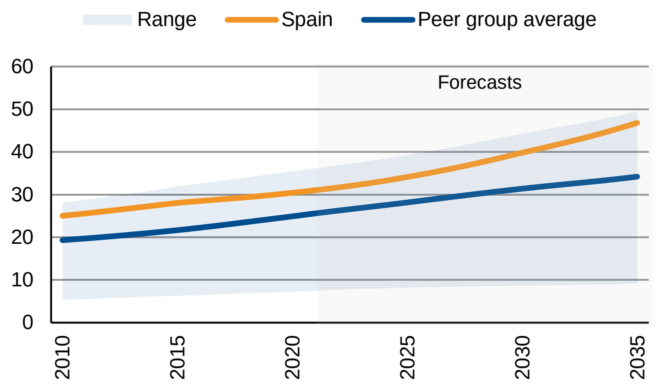
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a-	Environmental risks	Neutral	0	Exposure to natural disasters; ambitious commitment to achieve carbon neutrality by 2050
	Social risks	Weak	-1/3	Adverse demographic trends; high income inequality and risk of social exclusion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

CO2 emissions per GDP, mtCO2e



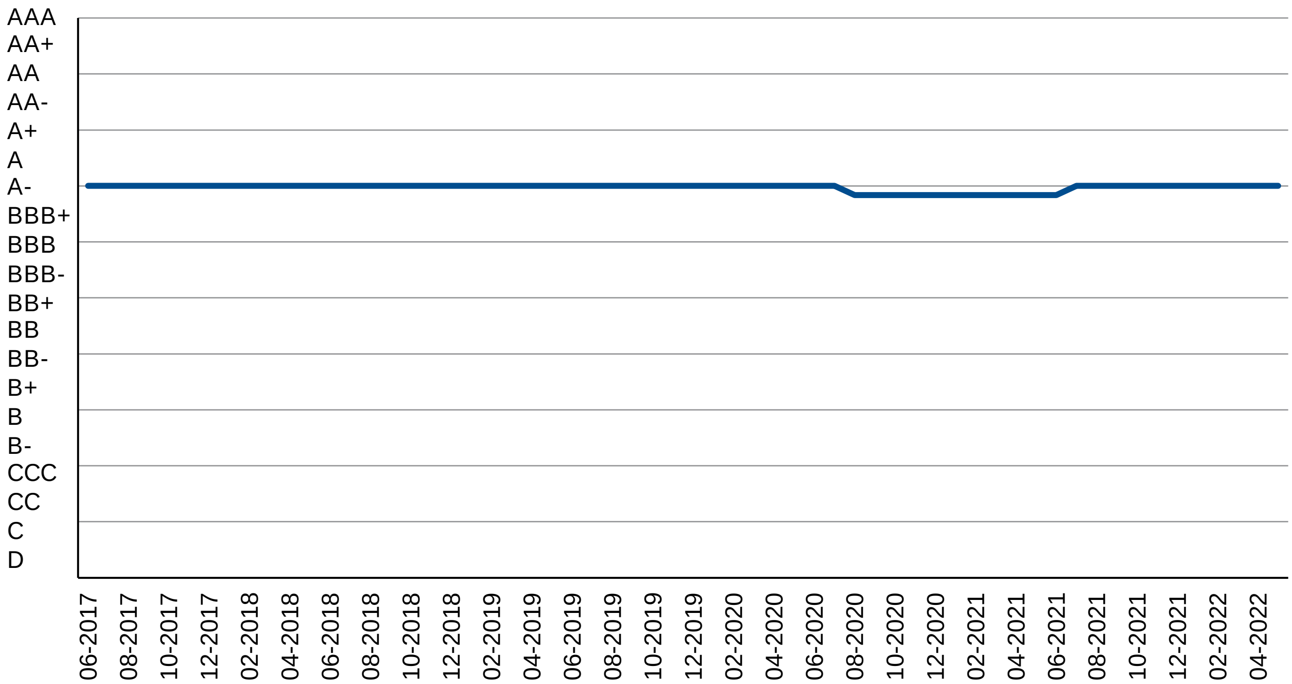
Source: European Commission, Scope Ratings GmbH

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
Croatia
Cyprus
Hungary
Latvia
Poland
Portugal
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	2021E	2022F	2023F
Domestic Economic Risk								
GDP per capita, USD 000s'	26.5	28.2	30.4	29.6	27.0	30.1	30.2	31.8
Nominal GDP, USD bn	1232.6	1312.1	1421.6	1393.2	1280.5	1426.2	1435.6	1519.1
Real growth, %[1]	3.0	3.0	2.3	2.1	-10.8	5.1	4.6	3.3
CPI inflation, %	-0.2	2.0	1.7	0.7	-0.3	3.1	5.3	1.3
Unemployment rate, %[1]	19.6	17.2	15.3	14.1	15.5	14.8	13.4	13.1
Public Finance Risk								
Public debt, % of GDP[1]	99.2	98.6	97.5	95.5	120.0	118.4	114.0	112.6
Interest payment, % of government revenue	6.4	6.0	5.7	5.3	5.0	4.5	4.5	4.6
Primary balance, % of GDP[1]	-1.9	-0.8	-0.3	-0.8	-8.9	-5.1	-3.4	-2.4
External Economic Risk								
Current account balance, % of GDP	3.2	2.8	1.9	2.1	0.8	0.9	0.3	0.4
Total reserves, months of imports	1.8	1.7	1.6	1.7	2.3	-	-	-
NIIP, % of GDP	-81.4	-90.8	-77.6	-75.2	-91.3	-67.0	-	-
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	15.3	-	-
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, $mtCO^{2}e$	147.8	152.1	146.2	133.0	125.3	-	-	-
Income quintile share ratio (S80/S20), x	7.3	6.6	6.6	6.5	-	-	-	-
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	32.4
Composite governance indicator[2]	0.9	0.8	0.8	0.9	0.8	-	-	-

[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 WEO, World Bank, Scope Ratings GmbH

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps) as of 26 May 2022	53

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris

23 Boulevard des Capucines
F-75002 Paris

Phone +33 6 62 89 35 12

Oslo

Karenslyst allé 53
N-0279 Oslo

Phone +47 21 62 31 42

Madrid

Paseo de la Castellana 141
E-28046 Madrid

Phone +34 91 572 67 11

Milan

Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Scope Ratings UK Limited

London

52 Grosvenor Gardens
London SW1W 0AU

Phone +44 20 7824 5180

info@scoperatings.com
www.scoperatings.com

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