MOODY'S
INVESTORS SERVICE

Credit Opinion: Spain, Government of

Global Credit Research - 21 Nov 2014

Ratings

Category	Moody's Rating
Outlook	Positive
Government Bonds	Baa2
Other Short Term -Dom Curr	(P)P-2
Spain	
Outlook	No Outlook
Country Ceiling: Fgn Currency Debt	A1/P-1
Country Ceiling: Fgn Currency Bank Deposits	A1/P-1
Fondo de Reestructuracion Ordenada Bancaria	
Outlook	Positive
Bkd Issuer Rating	Baa2
Bkd Senior Unsecured -Dom Curr	Baa2
Bkd ST Issuer Rating	P-2

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Key Indicators

Spain

	2008	2009	2010	2011	2012	2013	2014F	2015F
Real GDP (% change)	1.1	-3.6	0.0	-0.6	-2.1	-1.2	1.2	1.6
CPI Inflation (yearend, % change)	1.4	0.8	3.0	2.4	2.9	0.3	0.0	1.0
General Government Balance/GDP	-4.4	-11.0	-9.4	-9.4	-10.3	-6.8	-5.5	-4.7
General Government Primary Balance/GDP	-2.9	-9.3	-7.5	-7.0	-7.4	-3.5	-2.2	-1.3
General Government Debt/GDP	39.4	52.7	60.1	69.2	84.4	92.1	98.3	100.8
General Government Debt/Revenues	107.3	151.4	165.8	192.0	228.2	245.6	257.2	265.9
General Government Interest Payment/Revenues	4.2	4.9	5.2	6.8	7.9	8.7	8.6	9.0
Current Account Balance/GDP	-8.9	-4.1	-3.9	-3.2	-0.3	1.4	0.3	0.5

Opinion

Credit Strengths

The credit strengths of Spain include:

- Large and diversified economy

- High income level

- First positive results from the government's efforts to address the key imbalances in the economy, in particular

the large fiscal deficit, the problems within the banking sector and the high level of unemployment

Credit Challenges

The credit challenges for Spain include:

- Continuation of fiscal adjustment within an environment of only moderate growth given the ongoing rebalancing of the economy and the de-leveraging of the private sector

- Stabilisation and eventual reduction of the general government debt ratio that has increased substantially from its pre-crisis levels

Rating Rationale

In a fundamental assessment, as used in our sovereign bond methodology, Spain exhibits 'high (-)' Economic Strength. This assessment balances Spain's position as one of the largest economies in the world with the country's still significant macro imbalances and moderate medium-term growth outlook. On the one hand, Spain's economy is widely diversified, with a competitive export sector and high levels of wealth, which have been acting as a shock absorber in the economic and financial crisis. On the other hand, the country's growth outlook remains moderate: our base-case scenario anticipates that the Spanish economy will grow at around 2% on average over the coming years, given the need for the private sector to further reduce its high debt levels.

We assess Spain's Institutional Strength as 'very high (-)', reflecting the country's strong scores on the World Bank's World Governance Indicators. In addition, the Spanish authorities have established a good track record of implementing a wide range of structural reforms. The supervision and regulation of the banking sector - which we considered a weakness before - has also been improved, which supports our assessment of the country's Institutional Strength score.

We consider Spain's Fiscal Strength to be 'low', reflecting the ongoing large budget deficit and the difficulty that the government faces in stabilising and eventually reversing the rising debt trajectory. Given that budget deficits are only gradually declining, we expect the debt ratio to continue to rise, reaching a peak in the middle of the decade of around 101% of GDP. This compares to a debt ratio of 69% of GDP in 2011 and a low of 36% of GDP in 2007. In addition, our debt projections rest crucially on the assumption that the budget deficit will consistently be reduced every year and that the economy continues to grow.

We assess Spain's Susceptibility to Event Risk as 'moderate (-)'. Market funding risks have materially declined, but Spain's high funding requirements mean that maintaining investor confidence is important, even with the potential conditional support through the ECB's Outright Monetary Transactions (OMT). We consider the risk for the sovereign emanating from the banking sector to have declined materially, following several rounds of bank capital injections, the transfer of real-estate assets to the so-called bad bank Sareb and the bail-in of junior creditors in some instances. The above combination of factor scores leads to a model-indicated rating range of A3-Baa2.

Rating Outlook

The outlook on the Baa2 rating is positive, indicating that we expect the positive trends to continue. More specifically, we expect the economic recovery to continue and pick up slightly in the course of next year with domestic demand increasingly contributing to growth. We also expect wage moderation to continue, deepening the competitiveness gains achieved to date. In our central scenario, the budget deficit is expected to be gradually reduced further in the coming years.

What Could Change the Rating - Down

We would consider downgrading Spain's rating if the economic improvement or the fiscal consolidation stalled, leading to a later stabilisation of the public debt ratio than envisaged in our baseline scenario.

What Could Change the Rating - Up

We would consider upgrading the rating if we anticipated that the public debt ratio can be brought onto a declining trend within our forecast horizon. This could be achieved through a faster pace of fiscal consolidation and/or stronger nominal GDP growth than under our current baseline assumption.

Recent Developments

On November 9, an unofficial vote without any legal consequences (instead of the previously scheduled non-binding official consultation) resulted in approximately 2.3 million people (about 42% of eligible voters) casting their votes, of which around 80% expressed their preference for both Catalunya being a state as well as for that state to be independent. The vote has no legal implications and was carried out without an official census of voters, election commission or support of public servants, following the Constitutional Court's decision to suspend the consultation process until it reaches a decision on its constitutionality. Over the long term, the most likely outcome of the debate on Catalunya's status is that questions of greater devolution of fiscal authority will be re-opened for discussion once the 2015 electoral cycle has passed, a policy stance that has the support of Prime Minister Rajoy.

Spain has an eventful political calendar in 2015. Catalunya is likely to call early regional elections next year. Moreover, national elections are scheduled for next year. The political debate ahead of the election is likely to be materially affected by the sudden rise of the left-wing, anti-establishment party Podemos - currently polling at above 20% and thus competing with the ruling People's Party and the Spanish Socialist Worker's Party. Given the electoral calendar, reform ambitions are likely to be subdued throughout 2015, in comparison to what we have observed in recent years.

The Spanish economy continues to outperform that of the euro area as a whole in spite of negative growth headwinds coming from its major trading partners. The economic recovery has continued further in Q3 2014, with real GDP growth coming in at 0.5% quarter on quarter and 1.6% year on year. The recovery continues to be broad-based, with private consumption and, crucially, business investment contributing positively to growth. However, we are marginally reducing our growth forecasts for 2014 and 2015 to 1.2% and 1.6% (from 1.3% and 1.9%, respectively), reflecting the impact of the euro area-wide slowdown on Spain.

It appears that, to some extent, a virtuous cycle has now been put in motion where a positive growth performance has enabled the labour market situation to improve further, with employment increasing by 1.6% year-over-year in Q3 2014, only the second such increase since mid-2008. This should support private consumption going forward, while households will also benefit in 2015 from the cut in the personal income tax. The unemployment rate declined to 23.7% of the labour force in Q3, but optimism on the labour market front is tempered by the fact that this improvement is partially driven by a declining active population, which in turn is due to discouraged workers leaving the workforce and emigration abroad.

Budget execution until August indicates some improvement in the general government's public finances: the deficit (in national accounting terms) stood at EUR 45.4 billion (4.3% of estimated GDP), around EUR 6 billion below the level in August 2013. Rising total revenues (+1.3% year-over-year) and lower expenditure (-1.1%) - which in turn reflects mainly lower transfers to the social security system and lower gross fixed capital formation expenditure - both contributed to the improved result. The government aims to reduce its deficit to 5.5% of GDP this year at the general government level which should be achievable given the current economic outlook.

However, Spain's Independent Authority for Fiscal Responsibility has stated that the main risks to the fiscal outturn in 2014 and 2015 come from the regional governments, which are likely to register a deficit similar to that of 2013 this year, so reaching this year's budget target will require outperformance by all other levels of government. So far, this aim is achievable in 2014, but may prove to be somewhat more challenging in 2015 given the difference between the 2% GDP growth forecast that underpins the 2015 budget and our forecast of 1.6% growth.

Rating Factors

Spain, Government of

Rating Factors	Sub-Factor Weighting	Indicator	Factor Score
Factor 1: Economic Strength			**H-**
Growth Dynamics	**50%**		
Average Real GDP Growth (2009-18F)		0.2	
Volatility in Real GDP Growth (Standard Deviation, 2004-13)		2.7	
WEF Global Competitiveness Index (2014)		4.5	
Scale of the Economy	**25%**		
Nominal GDP (US$ billion, 2013)		1,358.7	

National Income	**25%**		
GDP per Capita (PPP, US$, 2013)		31,941.6	
Factor 2: Institutional Strength			**VH-**
Institutional Framework and Effectiveness	**75%**		
World Bank Government Effectiveness Index (2013)		1.1	
World Bank Rule of Law Index (2013)		1.0	
World Bank Control of Corruption Index (2013)		0.8	
Policy Credibility and Effectiveness	**25%**		
Inflation Level (%, 2009-18F)		1.3	
Inflation Volatility (Standard Deviation, 2004-13)		1.3	
Economic Resiliency (F1xF2)			**H+**
Factor 3: Fiscal Strength			**L**
Debt Burden	**50%**		
General Government Debt/GDP (2013)		93.9	
General Government Debt/Revenues (2013)		248.7	
Debt Affordability	**50%**		
General Government Interest Payments/Revenue (2013)		9.0	
General Government Interest Payments/GDP (2013)		3.4	
Government Financial Strength (F1xF2xF3)			**H-**
Factor 4: Susceptibility to Event Risk	**Max. Function**		**M-**
Political Risk			
World Bank Voice & Accountability Index (2013)		1.0	
Government Liquidity Risk			
Gross Borrowing Requirements/GDP		20.4	
Non-Resident Share of General Government Debt (%)		43.5	
Market-Implied Ratings		A1	
Banking Sector Risk			
Average Baseline Credit Assessment (BCA)		ba1	
Total Domestic Bank Assets/GDP		261.9	
Banking System Loan-to-Deposit Ratio		128.1	
External Vulnerability Risk			
(Current Account Balance + FDI Inflows)/GDP		4.1	
External Vulnerability Indicator (EVI)		--	
Net International Investment Position/GDP		-98.2	
Government Bond Rating Range (F1xF2xF3xF4)			**A3 - Baa2**
Assigned Foreign Currency Government Bond Rating		**Baa2**	

Note: While the information used to determine the grid mapping is mainly historical, our ratings incorporate expectations around future metrics and risk developments that may differ from the ones implied by the rating range. Thus, the rating process is deliberative and not mechanical, meaning that it depends on peer comparisons and should leave room for exceptional risk factors to be taken into account that may result in an assigned rating outside the indicative rating range.
For more information please see our Sovereign Bond Rating Methodology

Footnotes:(1) Rating Range: Factors 1, Economic Strength, and Factor 2, Institutional Strength, combine with equal weight into a construct we designate as Economic Resiliency or ER. An aggregation function then combines ER and Factor 3, Fiscal Strength (FS), following a non-linear pattern where FS has higher weight for countries with moderate ER and lower weight for countries with high or low ER. As a final step, Factor 4, a country's Susceptibility to Event Risk, is a constraint which can only lower the preliminary Government Financial Strength rating range as given by combining the first three factors.(2) 15 Ranking Categories: VH+, VH, VH-, H+, H, H-, M+, M, M-, L+, L, L-, VL+, VL, VL-(3) Indicator Value: If not explicitly stated otherwise, the indicator value corresponds to the latest data

available.

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