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Credit Opinion: Spain, Government of

Global Credit Research - 26 Feb 2015

Ratings

Category	Moody's Rating
Outlook	Positive
Issuer Rating	Baa2
Senior Unsecured	Baa2
Other Short Term -Dom Curr	(P)P-2
Parent: Spain	
Country Ceiling: Fgn Currency Debt	Aa2/P-1
Country Ceiling: Fgn Currency Bank Deposits	Aa2/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	1.4	2.0
CPI Inflation (yearend, % change)	1.4	0.8	3.0	2.4	2.9	0.3	-1.0	0.4
General Government Balance/GDP	-4.4	-11.0	-9.4	-9.4	-10.3	-6.8	-5.6	-4.7
General Government Primary Balance/GDP	-2.9	-9.3	-7.5	-7.0	-7.4	-3.5	-2.3	-1.4
General Government Debt/GDP	39.4	52.7	60.1	69.2	84.4	92.1	98.3	101.4
General Government Debt/Revenues	107.3	151.4	165.8	192.0	228.2	245.6	257.3	267.5
General Government Interest Payment/Revenues	4.2	4.9	5.2	6.8	7.9	8.7	8.6	8.7
Current Account Balance/GDP	-9.3	-4.3	-3.9	-3.2	-0.3	1.4	-0.1	0.5

Opinion

Credit Strengths

The credit strengths of Spain include:

- Large and diversified economy

- High income level

- Initial 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, which has increased substantially from its pre-crisis levels

Rating Rationale

In line with our sovereign bond methodology, our fundamental assessment of Spain is that it 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 macroeconomic 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 that have acted as a shock absorber in the economic and financial crisis. On the other hand, the country's growth outlook remains moderate: our baseline 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 had previously considered to be a weakness - has also been improved, and supports our assessment of the country's Institutional Strength.

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 of over 102% in 2016. This compares to a debt ratio of 92% of GDP in 2013 and a low of 36% of GDP in 2007. Crucially, our debt projections rest on the assumption that the budget deficit will consistently be reduced throughout the forecast period 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 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 Spain's Baa2 rating is positive, reflecting our expectation of continued positive trends. In particular, we expect the ongoing economic recovery to pick up slightly, with domestic demand increasingly contributing to growth. We also expect wage moderation to continue, further deepening the competitiveness gains achieved to date. Our baseline scenario envisages that Spain's budget deficit will gradually be 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 we currently envisage under our baseline scenario.

What Could Change the Rating - Up

Any future rating upgrades will likely be driven by a number of factors. Improvements in Spain's debt trajectory, the pace of fiscal consolidation and/or nominal GDP growth than under our current baseline assumptions would all put upward pressure on the rating. The robustness of recent institutional improvements, most notably evidence of the effectiveness of the controls imposed in recent years over regional and local government finances, is also likely to be a key rating consideration given the pressure that these have placed on the general government's finances in the past. The degree of political consensus that exists around the future path of fiscal consolidation and structural economic reform is also a key rating consideration given Spain's considerable debt burden and lingering macroeconomic imbalances. Given Spain's continued high indebtedness and reliance on a foreign investor base, a future upgrade would also be dependent on there being no re-emergence of the elevated financial and debt market disruption seen across the euro area in recent years; this includes heightened uncertainty over a possible exit of any member of the monetary union.

Recent Developments

Spain's economic performance has, to some extent, decoupled from that of the euro area as a whole. While it is still vulnerable to adverse growth trends among its major euro area trading partners, domestic demand has emerged as the major driver of growth, and we expect this to remain the case in 2015 and 2016. According to preliminary estimates from the National Statistical Institution (INE), the economic recovery continued in Q4 2014, with real GDP growth coming in at 0.7% quarter on quarter, resulting in growth of 1.4% for 2014. The recovery continues to be broad-based, with private consumption and, crucially, business investment contributing positively to growth. We expect growth to pick up in 2015, registering 2.0% for the year.

A virtuous cycle has now been put in motion, with a positive growth performance enabling the labour market situation to improve further, and employment increasing by 2.5% year-over-year in Q4 2014, the largest increase since 2007. This should support private consumption going forward, while households will also benefit in 2015 from the cut in personal income tax. The unemployment rate declined to 23.7% of the labour force in 2014, but optimism on the labour market front is tempered by the fact that this improvement is partially driven by a shrinking labour force, which, in turn, is due to discouraged workers leaving the workforce and emigrating abroad.

Budget execution until November 2014 indicates some improvement in the general government's public finances: the deficit (in national accounting terms) stood at EUR 49.1 billion (4.6% of estimated GDP), which is around EUR 5 billion below the level in January-November 2013. Rising total revenues (+1.7% year-over-year) and a smaller increase in expenditure (+0.2%) - 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 aimed to reduce its deficit to 5.5% of GDP in 2014 at the general government level which should be broadly achievable.

However, improvements across the different levels of government are uneven, a fact that has been noted both by Spain's Independent Authority for Fiscal Responsibility and the European Commission. While the central government has been outperforming targets, the regional governments registered a deterioration in their fiscal position in 2014. The Commission also noted in November 2014 that no preventative measures had been applied to Spanish regions that were at risk of non-compliance, in contrast to the processes that are outlined in Spain's Stability Law. The underperformance by the regions makes the general government budget target more challenging to reach in 2015 and beyond. Moreover, while the headline deficit is expected to fall through 2016 - largely as a result of the economic cycle rather than new fiscal initiatives - European Commission forecasts indicate that improvements in Spain's structural budget balance will start to reverse in 2015.

The unpredictability of the Spanish political landscape is a key risk in 2015, and political uncertainty has risen in advance of the national elections, which will be held at the year-end. 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. Polls suggest that Podemos's popularity has risen to around 25%, which means that it is competing with the ruling People's Party and has overtaken the Spanish Socialist Worker's Party in garnering overall support. Given the electoral calendar, no additional reform initiatives are likely to materialize in 2015.

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)		0.1	
Volatility in Real GDP Growth (Standard Deviation, 2004-13)		2.8	
WEF Global Competitiveness Index (2014)		4.5	
Scale of the Economy	**25%**		

Nominal GDP (US$ billion, 2013)		1,393.5	
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)		92.1	
General Government Debt/Revenues (2013)		245.6	
Debt Affordability	**50%**		
General Government Interest Payments/Revenue (2013)		8.7	
General Government Interest Payments/GDP (2013)		3.3	
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 (%)		44.2	
Market-Implied Ratings		A3	
Banking Sector Risk			
Average Baseline Credit Assessment (BCA)		ba1	
Total Domestic Bank Assets/GDP		255.4	
Banking System Loan-to-Deposit Ratio		128.1	
External Vulnerability Risk			
(Current Account Balance + FDI Inflows)/GDP		4.7	
External Vulnerability Indicator (EVI)		--	
Net International Investment Position/GDP		-95.7	
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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