

MOODY'S INVESTORS SERVICE

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 |

Contacts

| Analyst | Phone |
|------------------------|-----------------|
| Sarah Carlson/London | 44.20.7772.5454 |
| Alpona Banerji/London | |
| Alastair Wilson/London | |
| Yves Lemay/London | |

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 | | | |
| Growth Dynamics | | | |
| Average Real GDP Growth (2009-18F) | 50% | 0.1 | H- |
| 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) | | 25% | 1,393.5 | |
| National Income | | | | |
| GDP per Capita (PPP, US\$, 2013) | | | 31,941.6 | |
| Factor 2: Institutional Strength | | | | |
| Institutional Framework and Effectiveness | | 75% | | VH- |
| 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% | 92.1 | |
| General Government Debt/GDP (2013) | | | 245.6 | |
| General Government Debt/Revenues (2013) | | | | |
| Debt Affordability | | 50% | 8.7 | |
| General Government Interest Payments/Revenue (2013) | | | 3.3 | |
| General Government Interest Payments/GDP (2013) | | | | |
| Government Financial Strength (F1xF2xF3) | | | | H- |
| Factor 4: Susceptibility to Event Risk | | Max. Function | | M- |
| Political Risk | | | 1.0 | |
| World Bank Voice & Accountability Index (2013) | | | | |
| Government Liquidity Risk | | | 20.4 | |
| Gross Borrowing Requirements/GDP | | | 44.2 | |
| Non-Resident Share of General Government Debt (%) | | | A3 | |
| Market-Implied Ratings | | | | |
| Banking Sector Risk | | | ba1 | |
| Average Baseline Credit Assessment (BCA) | | | 255.4 | |
| Total Domestic Bank Assets/GDP | | | 128.1 | |
| Banking System Loan-to-Deposit Ratio | | | | |
| External Vulnerability Risk | | | 4.7 | |
| (Current Account Balance + FDI Inflows)/GDP | | | -- | |
| External Vulnerability Indicator (EVI) | | | -95.7 | |
| Net International Investment Position/GDP | | | | |
| 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-, M+, M-, L+, L-, VL+, VL, VL-(3) Indicator Value: If not

explicitly stated otherwise, the indicator value corresponds to the latest data available.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on <http://www.moodys.com> for the most updated credit rating action information and rating history.



© 2015 Moody's Corporation, Moody's Investors Service, Inc., Moody's Analytics, Inc. and/or their licensors and affiliates (collectively, "MOODY'S"). All rights reserved.

CREDIT RATINGS ISSUED BY MOODY'S INVESTORS SERVICE, INC. AND ITS RATINGS AFFILIATES ("MIS") ARE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES, AND CREDIT RATINGS AND RESEARCH PUBLICATIONS PUBLISHED BY MOODY'S ("MOODY'S PUBLICATIONS") MAY INCLUDE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES. MOODY'S DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL, FINANCIAL OBLIGATIONS AS THEY COME DUE AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT. CREDIT RATINGS DO NOT ADDRESS ANY OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK, MARKET VALUE RISK, OR PRICE VOLATILITY. CREDIT RATINGS AND MOODY'S OPINIONS INCLUDED IN MOODY'S PUBLICATIONS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. MOODY'S PUBLICATIONS MAY ALSO INCLUDE QUANTITATIVE MODEL-BASED ESTIMATES OF CREDIT RISK AND RELATED OPINIONS OR COMMENTARY PUBLISHED BY MOODY'S ANALYTICS, INC. CREDIT RATINGS AND MOODY'S PUBLICATIONS DO NOT CONSTITUTE OR PROVIDE INVESTMENT OR FINANCIAL ADVICE, AND CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT AND DO NOT PROVIDE RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. NEITHER CREDIT RATINGS NOR MOODY'S PUBLICATIONS COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MOODY'S ISSUES ITS CREDIT RATINGS AND PUBLISHES MOODY'S PUBLICATIONS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL, WITH DUE CARE, MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE.

MOODY'S CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT INTENDED FOR USE BY RETAIL INVESTORS AND IT WOULD BE RECKLESS FOR RETAIL INVESTORS TO CONSIDER MOODY'S CREDIT RATINGS OR MOODY'S PUBLICATIONS IN MAKING ANY INVESTMENT DECISION. IF IN DOUBT YOU SHOULD CONTACT YOUR FINANCIAL OR OTHER PROFESSIONAL ADVISER.

ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY LAW, INCLUDING BUT NOT LIMITED TO, COPYRIGHT LAW, AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON

WITHOUT MOODY'S PRIOR WRITTEN CONSENT.

All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, all information contained herein is provided "AS IS" without warranty of any kind. MOODY'S adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MOODY'S considers to be reliable including, when appropriate, independent third-party sources. However, MOODY'S is not an auditor and cannot in every instance independently verify or validate information received in the rating process or in preparing the Moody's Publications.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability to any person or entity for arising from or in connection with the information contained herein or the use of or inability to use any such information, even if MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers is advised in advance of the possibility of such losses or damages, including but not limited to: (a)(b) any loss or damage arising where the relevant financial instrument is not the subject of a particular credit rating assigned by MOODY'S.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability for any direct or compensatory losses or damages caused to any person or entity, including but not limited to by any negligence (but excluding fraud, willful misconduct or any other type of liability that, for the avoidance of doubt, by law cannot be excluded) on the part of, or any contingency within or beyond the control of, MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers, arising from or in connection with the information contained herein or the use of or inability to use any such information.

NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER.

Moody's Investors Service, Inc., a wholly-owned credit rating agency subsidiary of Moody's Corporation ("MCO"), hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by Moody's Investors Service, Inc. have, prior to assignment of any rating, agreed to pay to Moody's Investors Service, Inc. for appraisal and rating services rendered by it fees ranging from \$1,500 to approximately \$2,500,000. MCO and MIS also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually at www.moodys.com under the heading "Investor Relations — Corporate Governance — Director and Shareholder Affiliation Policy."

For Australia only: Any publication into Australia of this document is pursuant to the Australian Financial Services License of MOODY'S affiliate, Moody's Investors Service Pty Limited ABN 61 003 399 657AFSL 336969 and/or Moody's Analytics Australia Pty Ltd ABN 94 105 136 972 AFSL 383569 (as applicable). This document is intended to be provided only to "wholesale clients" within the meaning of section 761G of the Corporations Act 2001. By continuing to access this document from within Australia, you represent to MOODY'S that you are, or are accessing the document as a representative of, a "wholesale client" and that neither you nor the entity you represent will directly or indirectly disseminate this document or its contents to "retail clients" within the meaning of section 761G of the Corporations Act 2001. MOODY'S credit rating is an opinion as to the creditworthiness of a debt obligation of the issuer, not on the equity securities of the issuer or any form of security that is available to retail clients. It would be dangerous for "retail clients" to make any investment decision based on MOODY'S credit rating. If in doubt you should contact your financial or other professional adviser.

For Japan only: Moody's Japan K.K. ("MJKK") is a wholly-owned credit rating agency subsidiary of Moody's Group Japan G.K., which is wholly-owned by Moody's Overseas Holdings Inc., a wholly-owned subsidiary of MCO. Moody's SF Japan K.K. ("MSFJ") is a wholly-owned credit rating agency subsidiary of MJKK. MSFJ is not a Nationally Recognized Statistical Rating Organization ("NRSRO"). Therefore, credit ratings assigned by MSFJ are Non-NRSRO Credit Ratings. Non-NRSRO Credit Ratings are assigned by an entity that is not a NRSRO and, consequently, the rated obligation will not qualify for certain types of treatment under U.S. laws. MJKK and MSFJ are credit rating agencies registered with the Japan Financial Services Agency and their registration numbers are FSA Commissioner (Ratings) No. 2 and 3 respectively.

MJKK or MSFJ (as applicable) hereby disclose that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MJKK or MSFJ (as applicable) have, prior to assignment of any rating, agreed to pay to MJKK or MSFJ (as applicable) for appraisal and rating services rendered by it fees ranging from JPY200,000 to approximately JPY350,000,000.

MJKK and MSFJ also maintain policies and procedures to address Japanese regulatory requirements.