

Axesor downgrades Spain's unsolicited rating to A- with a stable outlook due to the impact of the health crisis on the economy and the public finances.

Despite the improvement in economic resilience and the fact that Spain is, along with Italy, the largest recipient of the EU recovery fund, a contraction of 11.8% is expected for 2020, due to the high tertiarization of the Spanish economy and its high dependence on the tourism industry.

Sovereign rating of the Kingdom of Spain

The unsolicited credit rating of A- with stable outlook assesses the improvement in the resilience of the Spanish economy prior to the outbreak of the health crisis, as well as Spain's position as the second recipient of the EU recovery fund. However, a contraction of GDP of 11.8% (over its last forecast of 10.8%) is expected given the tertiarization of the Spanish economy and its high dependence on the tourism industry. In addition, the decline in activity will exacerbate the structural problems of the labor market, increasing the unemployment rate to 20%. Moreover, the deep deterioration of public finances will raise the levels of deficit and public debt above 10.4% and 115% respectively.

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Axesora Rating has downgraded its unsolicited rating on the Kingdom of Spain to A- with stable outlook due to the deep decline that the health crisis is causing on the economy and the public finances.

Despite the fact that the rating reflects the improvement in the resilience of the Spanish economy during the months prior to the outbreak of the crisis and the arrival of 140.000 million euros from the European recovery instrument (*Next Generation Europe*), given the high levels of tertiarization and the dependence on the tourism industry, we expect a contraction of GDP of 11.8%.

In this regard, at Axesora Rating we emphasize that, although the recovery in activity after completion of the State of Alarm and the confinement situation has been extended to the third quarter of the year, the fact that the improvement in the tourism industry has been lower than initial estimates will put negative pressure on the Spanish economy.

Furthermore, the levels of consumption and the retail sales achieved in June are clearly insufficient to return to levels prior to the outbreak of the pandemic, with a households savings rate for precautionary reasons that maintains a positive trend and slows down the potential recovery of the economy. However, Axesora consider this situation an opportunity to boost the consumption in the medium term once the uncertainties surrounding the labor market dissipate.

All this, together with spikes in infections, already observed throughout the summer season, will limit the ability for growth to 2.9% QOQ in the fourth quarter. A figure that could decrease in the event of new general confinements and considering the uncertainty that dominates the current economic scenario.

Among the strengths of the Spanish economy, the report notes the favorable context of the expansionary monetary policy applied by the European Central Bank (ECB), both because of the maintenance of low interest rates as well as the debt purchase programs activated in March, which provide liquidity to the system and stabilizes public debt sustainability in the medium term. In addition, the Rating Committee has assessed the gain in competitiveness of the Spanish economy which, despite the contraction in exports, will allow the foreign sector to maintain its balance. To the aforementioned, household saving rates, which are at maximum levels and will contribute to the recovery whenever the uncertainties dissipate, must be added.

On the contrary, risks are determined by the deterioration of public finances, with an expected deficit of at least 10.4% and the increase in public debt, that could exceed 115% of GDP. Moreover, the decline in activity is expected to exacerbate the structural problems of the labor market, marked by excessive duality, boosting the unemployment rate to levels close to 20% — which will drop to 17% in 2021 — and with a greater impact on youth employment, hospitality and tourism.

Fiscal policy, debt, and liquidity

The rating assesses both the decline in economic activity, as well as the necessary stimulus measures implemented to cope with the impact of the pandemic, which will cause a significant deterioration in public finances and, therefore, will exacerbate the need for further indebtedness. In this respect, Axesor Rating highlights the need to approve the new General State Budget, avoiding a further extension of those approved in 2018, currently in force.

Regarding the deficit, it is expected to exceed 10.4% of GDP in 2020, breaking with the tendency of previous years. For 2021, a slight correction is expected up to around 6.2%. A figure which is more than three points above the budgetary stability objectives agreed in Maastricht, but that will not constitute a non-compliance due to the exemption approved by Brussels because of the exceptional situation resulting from the pandemic.

The report highlights the significant contraction in revenues, on average lower than those recorded during the same period of 2019, more pronounced in the collection of VAT and personal income tax. By contrast, the level of expenditure has risen by almost 30% year on year because of the aforementioned stimulus measures and health costs caused by the pandemic.

Moreover, the Rating Committee notes that the fact that, despite the improvement, the deficit of the Social Security accounts for almost half of the deficit for the fiscal year 2019, "stresses the need to carry out structural reforms to remedy the situation", even more taking into account the high dependency rate and the effects that the growing population aging has on the potential economic growth due to the lower propensity to consume.

Regarding public debt, the above-mentioned deterioration in public finances will raise public debt to levels around 115%, a situation that would stagnate in 2021. It should be noted that maximum levels close to 1.2 trillion euros have been reached in the second and third quarters of the year.

The assessment takes into account the budgetary resources allocated to pay the interest on the debt, which amounts to almost 5,9% of current revenue, a figure which is not expected to worsen in the medium term due to the current expansionary monetary environment.

Financial sector

The rating assesses the appropriate levels of capitalization (above the levels required by the regulator), as well as solvency and liquidity levels that the banking sector has to face the crisis. However, the problem of profitability that is forcing entities to rethink their business models towards activities that generate higher level of revenue, and the challenges of adapting to new regulations, technological changes, and sustainable financing, persist.

The report specifically mentions the merger by the acquisition of Bankia by CaixaBank, which it considers "the starting gun" for new movements within the financial sector. But that requires maintaining tight regulation to prevent the rebound of systemic risk associated with increasingly large entities."

Regarding late payments, uncertainty is expected to affect the current levels of 5% negatively. However, the Committee points out that at the present time the starting point is advantageous compared to the moments prior to the crisis. It also regards as positive the measures adopted by the Government and financial institutions to alleviate the impact of the health crisis on the economy.

Foreign Sector

Although during the first half of the year the foreign sector caused a shortfall in economic growth of nearly 2.7% year on year, with a drop in exports of 33.64% year on year, the decline in imports of 29.5% in the same period allowed to cushion the negative pressure on the evolution of GDP. Thus, the current account balance improved in the second quarter to 0.5% of GDP, compared with -0.3% in the previous three months.

However, given the commercial weakness of the current scenario, at Axesor Rating we expect a contraction of the current account surplus to 1% (compared to 1.9% at the end of 2019), a behavior which is expected to be extended to 2021.

The rating also penalizes the high volume of external debt, with 886,000 million euros at the end of the first quarter of 2020, one of the highest in the European Union -including the position of the Bank of Spain in the context of monetary policy- although we highlight the downward trend observed thanks to the external surpluses that has allowed the gain in competitiveness in the past.

2030 Agenda

Axesor Rating positively assesses the record of compliance with the Sustainable Development Goals and the 2030 Agenda and highlights the first issuance of green bonds worth 500 million euros that the Instituto de Crédito Oficial (ICO) launched in the first half of the year and which followed other issuances made by the Community of Madrid, Navarra and Andalusia, among others.

It also points out the adherence in 2015 to the United Nations 2030 Agenda for the promotion of inclusive and environmentally friendly economic growth and the reduction of inequalities, accompanied by the appointment of a High Commissioner for the 2030 Agenda, a Sustainable Development Council and, recently, the Mixed Commission in the Parliament to ensure follow-up.

However, the Committee warns of the negative effects of political instability on the compliance with the milestones set for the period. And the completion of the Spanish Sustainable Development Strategy, the adoption of the law on Climate Change and Ecological Transition or the provision in the General State Budget of the resources needed to achieve them are still pending.

Moreover, the rating report confirms the strength of the institutional framework, bolstered by Spain's membership of the European Union and the increasing leadership within the European institutions, with a decision axis that, following the departure of United Kingdom, is expected to go through Berlin, Paris and Madrid.

Added to the above-mentioned is the presence of security, surveillance, and control mechanisms to preserve the proper development of economic relations, with Spain in the top positions in the different governance indicators of the World Bank.

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