Creditreform Sovereign Rating

Creditreform Rating

Rating Object	Rating Information	
KINGDOM OF SPAIN	Assigned Ratings/Outlook: **A- /negative**	Type: Monitoring, unsolicited
Long-term sovereign rating Foreign currency senior unsecured long-term debt Local currency senior unsecured long-term debt	Initial Rating Publication Date: Rating Renewal: Rating Methodologies:	30-09-2016 24-07-2020 "Sovereign Ratings" "Rating Criteria and Definitions"

Rating Action

Neuss, 24 July 2020

Creditreform Rating has revised its outlook on the Kingdom of Spain to "negative" from "stable", and affirmed the unsolicited long-term sovereign rating of "A-". Creditreform Rating has also affirmed Spain's unsolicited ratings for foreign and local currency senior unsecured long-term debt of "A-".

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Key Rating Drivers

1. Spanish economy's size, wealth, and competitiveness remain vital parts of the generally strong macroeconomic performance profile, as does its recent track record of strong and robust economic growth; structural deficiencies concerning the labor market – despite improvements – continue to present significant challenges; further development of productivity growth to be monitored
2. Real GDP to plunge this year due to Covid-19 but expected to see rebound in 2021, though uncertainty over shape and timing of recovery remains very high; possible delay, as tourism and industries exposed to adapted consumer behavior could suffer for a longer period
3. Strong institutional framework, supported by benefits from EU/EA membership; although political deadlock was brought to an end at the beginning of the year, policy-making has become more challenging in light of minority government and higher political fragmentation; following some backtracking on the pension reform, we closely monitor progress on the labor market front going forward
4. A surging headline deficit and higher borrowing requirements should substantially drive up debt-to-GDP from elevated levels; our expectation of a gradually declining public debt ratio is subject to high uncertainty, not least in the challenging political environment; sound debt management and highly affordable debt due to heavy investor demand and low financing costs remain mitigating factors for now
5. Vulnerabilities persist with regard to very high external liabilities, but continued reduction likely, as current account should remain in surplus, with repercussions from dismal tourism performance offset by declining energy prices

Reasons for the Rating Decision

Creditreform Rating has revised its outlook on the Kingdom of Spain from stable to negative, reflecting

(i) that the prospective drastic fall in economic output and rising unemployment, together with the aid measures taken, will see the general government deficit as well as the debt-to-GDP swell to new highs, aggravating the sovereign's main credit weakness

(ii) uncertainty concerning the sovereign's ability to swiftly bring the debt trend onto a sustained downward trajectory again, also bearing in mind the challenging political environment as regards higher political fragmentation and resulting fragile governments, but also in view of risks of longer-lasting economic damage via the tourism sector and industries exposed to adapting consumer behavior

(iii) our concerns over a more gradual recovery and a protracted phase of reform inertia if policy-makers need a longer time span to agree on and implement necessary reforms

Macroeconomic Performance

Spain's generally strong macroeconomic performance profile remains buttressed by the underlying size, wealth, and the improved cost competitiveness of its economy, as well as by the recent track record of strong and robust economic growth. Persistent structural deficiencies concerning its labor market weigh somewhat on our assessment, as they could hamper the country's resilience to economic shocks. Due to the Covid-19 pandemic, economic activity temporarily almost ground to a halt, and while the response from the government, ECB, and EU has set the stage for a recovery from the second half of the year, the shape of the latter remains highly uncertain, all the more so as this also depends on the timely development of tested vaccines. Against this backdrop, we also see risks of longer-lasting damage to Spain's pivotal tourism industry.

Having enjoyed annual GDP growth of 2.8% on average since 2015, well exceeding euro area average growth of 1.9% over this period, Spain's economic output lost further steam last year, although real GDP still expanded by a respectable 2.0% (euro area: 1.3%). Domestic demand proved less supportive compared to the preceding year, as growth in gross fixed capital formation slowed markedly from 5.3% to 1.8% and as private consumption growth moderated from 1.8% to 1.1%. Investment growth decelerated, due to both a less pronounced increase in construction investment and a weaker expansion of investment in equipment and machinery, with the latter suffering from the global downturn in manufacturing and a more uncertain outlook as regards international trade practices. Household expenditure may have been under pressure from decelerating job creation and rising precautionary savings, but in the end was supported by a stronger wage rise compared to prior years, that came on the back of a higher minimum wage and stronger results from wage negotiations. In light of softer domestic demand that dampened import growth, net exports exerted a positive impact on GDP in 2019, with exports expanding at a rather stable pace (2.6%, 2018: 2.3%).

With the corona crisis kicking in in Q1-20, causing massive challenges to the health system in its early stages, Spain underwent a relatively long lockdown phase with a national state of emergency lasting from 14 March to 21 June. Although the full set of restrictions seems to have been introduced relatively late, confinement measures were somewhat stricter as compared with many other European countries, judging by the stringency index provided by Blavatnik School of Government. An almost complete standstill of public life, with shops, hotels, and restaurants being closed down in tandem with disruptions to production and trade flows, led to a drastic fall of real GDP by 5.2% q-o-q already in Q1-20, a markedly steeper decline than in the euro area overall (-3.6%). With the exception of government consumption, all main GDP expenditure components contracted sharply. The number of incoming international tourists fell in March by 64.3% y-o-y to roughly 2 million, dwindling to zero in April and May after the borders had been closed.

In order to mitigate economic fallout from the pandemic, Spanish authorities announced in quick succession numerous measures to support the continuity of productive activity, bolster the health care system and the fight Covid-19, minimize the fallout on the labor market, and protect vulnerable segments of the population.

Drawing on information from the Spanish Treasury dating from June, the overall emergency package amounted to approx. 14% of GDP. In addition, the government reportedly approved further measures at the beginning of July to help the ailing tourism sector as well as the automotive sector, and to back loans intended to foster the digitalization of companies. Furthermore, authorities have earmarked EUR 150bn for an investment plan to facilitate the economic recovery.

Along with governments' scaled-up response to the crisis, the ECB has also supplemented its initial measures with the Pandemic Emergency Purchase Program (PEPP), now totaling EUR 1,350bn and running at least until the end of June 2021. Reinvestments of maturing principal payments from securities purchased under PEPP until at least the end of 2022 will add further to the accommodative stance. An additional envelope of EUR 120bn to the Asset Purchase Program until the end of the year remains in place, as do a number of measures to ensure liquidity to the banking sector, a comprehensive set of collateral measures to mitigate the tightening of financial conditions across the euro area, and measures to temporarily mitigate the effects of rating downgrades on counterparties' collateral availability. In addition, Banco de Espana has maintained the countercyclical capital buffer at 0% and does not anticipate increasing it any time soon.

With the main phase of lockdown occurring in Q2, the negative economic impact should be most severe in that quarter. In April, monthly industrial production slumped by 25.6% compared to the preceding month, after having dropped by 15.6% in March, before expanding again in May (+19.0%, Eurostat). April retail sales dropped by 19.4% against March (volume, Eurostat) but saw some rebound in May (+18.0%). Sentiment indicators such as the composite PMI had plummeted to record lows in April but were up markedly in June amid resuming activities as restrictions were partly lifted, corroborating expectations that Q3 should see some rebound in economic growth. However, new orders and production in the manufacturing sector remained impaired in June, as suggested by the respective

PMI. Contrary to its manufacturing peer, the services PMI snapped back over the 50-point threshold in June, hinting at revived economic activity in the services sector.

Having said that, Spain's tourism industry, which accounts for approx. 11.8% of GDP (2018, OECD data) - the highest share among OECD members - and for 13.5% of total employment, will presumably take longer to recover. Travel restrictions have only been lifted from 21 June for EU members and from 1 July for selected other countries. To reinvigorate its tourism industries, authorities have endorsed the so-called Operation Summer campaign, which will last at least until 31 August and aims at increasing travel security by ensuring compliance with health recommendations, as well as the Safe Tourism Plan that is geared towards preventing crime and theft on public transport. Still, many potential travelers may refrain from embarking on a journey at this stage. Moreover, the aviation industry is trying to cope with Covid-19 and find its way through the devastating situation which is threatening its business operations.

Spain's labor market continues to present a mixed picture, overall still weighing somewhat on our rating assessment. At least in terms of employment creation, Spain's labor market still seemed on a strong footing when the Covid-19 pandemic hit, notwithstanding a moderation towards the end of 2019. Employment growth was rather stable at 2.1% for the year as a whole (2018: 2.2%), and while the quarterly rate slowed to 1.8% y-o-y in Q4-19, it still markedly exceeded the pace of job creation in the euro area as a whole (Q4-19: 1.1%). Other key labor market indicators compare less favorably despite ongoing improvements in some respects. The unemployment rate has declined further to 13.9% in Q4-19 (EA: 7.3%, LFS adjusted data, Eurostat), but continues to be the second-highest in the euro area. Looking at the country's labor participation, we note that, contrary to the increasing trend observed in the euro area, Spain's participation rate has edged down over the last few years and is now in line with the euro area (both at 73.8% in Q4-19).

Enduring structural deficiencies of Spain's labor market include a comparatively high level of long-term unemployment (5.2% in Q4-19, EA: 3.2%), although we are aware of the declining trend. The latter also holds with regard to the share of young people neither in employment nor in training, where we observe a further closing gap to the euro area over the last two years, with Spain recording 11.7% in Q4-19 vs. EA's 10.0% of the total population. Access to the European Social Fund (ESF) and participation in the EU Youth Employment Initiative (YEI) may have proved supportive here. Nevertheless, the country still has some way to go, as also illustrated by the European Social Scoreboard, where Spain may still be perceived as one of the weakest performers among our A-rated sovereigns. Particular challenges are highlighted with a view to labor market dynamism, but also with regard to equal opportunities and, to a lesser extent, as regards social inclusion. In addition, pronounced segmentation is likely to amplify adverse labor market effects from the pandemic, as roughly a quarter (25.6%) of all employees work on the basis of a temporary contract - a significantly higher share than in the euro area overall (14.4%) and indeed the highest in the EU. The observation that SMEs account for a large share of employment (71.9%, EU-28: 66.6%) would add to these concerns.

With the corona crisis starting to unfold in Q1-20, things began to turn for the worse on the labor market; the monthly figure of registered unemployed workers thus exploded in the

second quarter, shooting up by 21.1%, 25.3%, and 28.1% from April until June (unadjusted SEPE data). Worryingly also, the share of young people not in employment or education has risen. While the enacted short-term work scheme ERTE should limit the labor market fallout in the near term, we think that a significant share of furloughed workers will inevitably end up becoming laid off, essentially in industries which tend to be more labor intensive. To be sure, workers are gradually exiting ERTE, as the number of affected workers has come down by approx. 41% since peaking at 3.387m. Nevertheless, 1.966m were still registered in the Spanish furlough scheme as of 24 June (self-employed 290K, Ministerio de Inclusion, Seguridad Social y Migraciones).

Overall, we tentatively expect real GDP to fall by 10.8% in 2020 and to recover by 7.8% in 2021. The economy is set to record a large drop in real GDP this year, given the slump in Q1 and a considerably sharper decline in Q2. Private consumption should see a tremendously steep decline in the first half of the year before recovering in the second half of the year as restrictions have been eased considerably and as the emergency measures such as the furlough schemes to maintain jobs, and support incomes, should act as a cushion. Having said this, some local lockdowns in Galicia and Catalonia at the beginning of July, reportedly affecting a six-digit number of people, serve as a reminder that renewed waves of infection remain unpredictable. Thus, downside risks to our forecast prevail, as the nascent recovery may be significantly hampered going forward. Uncertainty also persists as regards employment developments, as a larger number of insolvencies may not be avoided. Whilst in 2019 real wages increased by a rate of between 4.4% and 5.0% (Ministerio de Asuntos Económicos), wage gains to this tune seem unlikely to be repeated this year and next in light of a priority to maintain jobs, although the minimum wage was further raised by 5.6% to EUR 950 at the beginning of this year. Consumer confidence only improved to a very small extent in June, remaining strongly negative overall, although this may partly be owed to the late lifting of the most severe restrictions.

In light of a more mature cycle and the challenging international trade environment, we would have expected a slower pace for gross fixed capital formation in the absence of Covid-19 anyway. Given the dramatic events of the last few months, investment now appears set to experience a sharp contraction in 2020 given that, after the weak start to the year, investment in machinery and equipment will likely remain impaired by an unclear picture as to how demand will recover in the aftermath of the most acute phase of the corona crisis. Residential construction had shown some moderation before corona, as also reflected in a falling number of residential building permits (Q4-19: -13.6% y-o-y, Eurostat), and is thus unlikely to boost economic recovery. As far as net trade is concerned, we expect large declines for both exports and imports in 2020 before resuming growth next year. Export growth should be heavily affected, as tourism spending accounts for the bulk of Spanish service export revenues. According to Eurostat data, revenues from travel-related services exports accounted for roughly 52% of total revenues from services exports in 2018, the second-highest reading in the EU (BPM6 data). Since easing energy prices will likely drag on import growth, we believe that net external trade's contribution will be broadly neutral.

Turning to the underlying structural features of the Spanish economy, its size and wealth remain credit positive, as these contribute to some resilience in the face of the Covid-19 shock. With nominal GDP amounting to USD 1,397.9bn according to the IMF (2019), Spain is estimated to be the 13th largest economy in the world and to boast a per capita income of USD 41,592 (PPP terms, up from USD 40,172 in 2018), well above the median among the A-rated peers in our rating universe (USD 36,701). The sector 'trade, transport, accommodation, and food services', which also incorporates tourism-related services, makes up 22.4% of total gross value added (GVA), compared to 18.3% in the euro area, thus underscoring a source of vulnerability in the current circumstances. The flipside of the coin, a lower GVA share of manufacturing compared to the euro area (12.5% vs. 16.3%) helps to explain why Spain was less hard-hit by the industrial downturn observed over the last two years. Noteworthy also seems that a markedly lower contribution of business services and ICT than in the euro area (8.9% and 3.7% vs. EA 11.6% and 5.0%) suggests that Spain has room to improve as regards industries which tend to be more conducive to fostering productivity growth.

Indicators we draw on to assess the country's competitiveness deliver slightly mixed signals, with some of them now pointing to a less favorable picture. We observe that, in the latest vintage of the World Economic Forum's Global Competitiveness Index, Spain climbed three places to rank 23 out of 141 economies, with improvements in 9 out of 12 pillars considered. Meanwhile, Spain maintained its ranking of 30 among 191 economies examined in the latest edition of the World Bank's Ease of Doing Business ranking. Starting a business (rank 90), dealing with construction permits (rank 79), and registering property (rank 59) continue to be considered somewhat challenging, while resolving insolvencies is deemed a comparatively smooth process, signaled by a remarkable rank of 18.

Turning to less favorable developments, one would have to highlight that Spanish real productivity growth per person generally lagged behind that of its main trading partners and the euro area overall in 2016-19 (Spain: 0.2%, EA 1.4%). While over a longer time span (2010-2019) real unit labor cost developments clearly favor Spain over its main trading partners and the euro area (Spain: -6.5%, EA: -0.9%, AMECO data), to a large extent on the back of wage restraint, Spain had to give some ground more recently (2016-19: 0.1%, EA: 0.5%), not least owing to stronger wage growth in 2019. Our conclusions appear to be mirrored by the evolution of Spain's global export market share, which increased from 1.84% to 2.03% between 2012 and 2017, but has since edged down (2019: 1.98%).

As to prospects for medium-to-longer-term growth, we see the need to enhance productivity growth, also pointing out that Spain moves below the EU average when it comes to innovation performance. In this context we recall that the country's R&D spending is relatively low by European standards (1.2% of GDP in 2018, EA: 2.2%), thus leaving scope for improvement in order to ultimately increase productivity and the country's potential growth. The corona shock has certainly set strong impulses for accelerating digital transformation. Following the recent landmark agreement among the EU countries over its financing, the individual programs under Next Generation EU (NGEU, including the European Recovery and Resilience Facility RRF) may also be tapped in order to foster the

economy's potential growth, also with a view to greening Spain's economy. To our understanding, Spain should receive approx. EUR 140bn, equivalent to about 11% of 2019 GDP, with roughly EUR 73bn thereof as grants and the remaining part in the shape of loans. A recent step to combine the goal of becoming a more sustainable economy with raising green tax revenue is the Spanish Cabinet's intention to introduce a tax on plastic waste.

Potential risks from private sector balance sheets as regards macro-financial stability appear contained at this stage, with deleveraging having continued over the last year. The debt of non-financial corporations declined to 72.8% of GDP in 2019 (2018: 75.4%), moving somewhere into the mid-field by EU comparison and well below levels preceding the global financial crisis. Private household debt measured against disposable income remains more elevated, but also not excessive compared with other European countries, and is also continuing on a downward path, posting at 91.2% in 2019 (2018: 94.9%).

Institutional Structure

Spain's credit rating remains underpinned by its strong institutional framework, which in turn is also supported by the advantages the country can draw from its EU and euro area membership, enabling the country to build on access to a large market with common standards as well as deep and broad capital markets. Against this backdrop, the sovereign can also reap the benefits of the ECB's current accommodative monetary policy. Also, Spain is a beneficiary of EU support, reflected in allocations from the EU Cohesion policy funds.

Looking at the latest edition of the World Bank's Worldwide Governance Indicators (WGI), we observe that the sovereign's scores remain below those of the euro area median. When it comes to the quality of effectively formulating and implementing policies, the sovereign stands at rank 44 out of 209 economies (EA median rank 35), while being placed at rank 42 with regard to the quality of property rights and courts (EA: rank 32), rank 58 with a view to the control of corruption (EA: rank 41), and at rank 36 regarding the freedom of speech and media (EA: rank 25). We note a persistent and significant gap compared with the AA-rated sovereigns in our rating universe. While we positively assess that the sovereign has improved as regards the extent to which public power is exercised for private gain (rank 58 after 67), we would flag the deterioration in terms of government effectiveness (rank 44 after 39) and political stability (rank 95 after 90). The weaker result of the WGI political stability ties in with simmering tensions over the Catalonian independence movement, as well as with the impression of fading cohesion in society and increasingly difficult-to-reach political consensus over recent years.

It has to be highlighted that the political landscape has become increasingly polarized and fragmented, mirrored by four general elections within four years, two of which took place in 2019 alone, thus paying testament to this conclusion, as do the difficulties in forming a government following the latest election in November 2019, again a snap election. While PSOE again became the strongest party, it obtained only 28.0% of the vote, 0.7 p.p. less than in the April election, and lost three seats. The minority government it eventually embarked on with the left-wing Unidas Podemos in January seems fragile, as it only commands 155 seats in the 350-seat Congress of Deputies.

We have to reiterate that the sovereign's reform momentum has eased over the recent years, partly driven by the above-mentioned political impasse, as caretaker governments, in our view, did not sufficiently tackle the economy's structural impediments. At the same time, we would positively highlight that Spain features an overall high degree of responsiveness towards country-specific recommendations issued by the European Commission, having achieved full implementation or substantial progress in 36% of all EC recommendations. Having said this, we understand that authorities may water down some elements of past labor market reforms which we perceive as a cornerstone of the economy's recovery over the last years. Following some backtracking on the pension reform, we closely monitor progress on the labor market front going forward.

While we acknowledge that more fragmented parliaments have become a widespread phenomenon these days, and that the current minority government seems able to obtain necessary backing in managing the corona crisis, we would flag concern as far as necessary reforms to tackle the economy's structural deficiencies pertaining to the labor market and to productivity are concerned. What is more, given the current political constellation, striking consensus over fiscal priorities, specifically amid the significantly worsened starting point, may become particularly arduous.

Fiscal Sustainability

Spain's fiscal sustainability risks continue to represent the main credit weakness in our assessment. Risks in this regard have increased considerably in light of the corona crisis, as efforts to combat the pandemic and the associated economic damage sends the deficit and the debt level up dramatically, the latter from an already elevated level and in a political environment featuring a government coalition lacking a majority. We consider sound debt management and the fact that debt has become increasingly affordable as elements that mitigate fiscal risks.

While the country has managed to reduce a double-digit general government deficit to below 3% in the years from 2012 to 2018, aided also by brisk economic growth, consolidation progress slowed towards the end of that period. Last year, the headline deficit rose to 2.8% (2018: 2.5%), 0.8 p.p. above the target envisaged in the 2020 Draft Budgetary Plan (DBP20), mainly due to a more expansionary policy. Stronger increases than seen in the prior year both with regard to social benefits (6.1%, 2018: 4.3%) and compensation of employees (5.0%, 2018: 3.4%) drove 2019 total outlays up by 4.1% last year (2018: 4.8%), leaving the spending level at 41.9% of GDP compared to the DBP20 forecast of 41.3%. The revenue side also contributed to the slippage, albeit to a lesser extent, with the revenue-to-GDP ratio coming in at 39.1%. General government revenue growth did not match the strong increase seen in 2018 (6.2%), coming in at 3.3% against the backdrop of a moderate increase (1.5%, 2018: 8.8%) of taxes on income and wealth. A slower expansion of revenue from taxes on production and imports, as well as from VAT, compared to 2018 reflects the slowing economic activity and deteriorating trading environment.

After the 2018 budget law had been further extended last fall, budget and public debt targets, as well as a medium-term fiscal path, were eventually approved by the Lower House (end of February) and the Upper House (early March), foreseeing a deficit to the tune of

1.8% of GDP for 2020 and a gradual reduction to 0.9% of GDP by 2023. However, the dramatic events in connection with the spreading coronavirus have completely overthrown the medium-term outlook for Spain's public finances. Receding revenues due to interruptions to production, and the strict lockdowns in combination with the emergency packages to alleviate the negative effects on the economy and the emerging shift towards stimulus for a recovery as the restrictions are gradually lifted, will have the general government deficit soar this year. Immediately, budget affecting measures announced so far to our understanding would amount to about EUR 46bn, while tax deferrals and guarantees/credit lines would add up to almost EUR 125bn. Overall, we expect the deficit to leap to about 11.0% of GDP this year. The assumed GDP growth rebound and the absence of a broad wave of new infections that would require lockdowns beyond local areas should lead to a slight reduction of the deficit in the following year, although we acknowledge that uncertainty around our estimates remains very high. As long as effective medication and vaccines remain a vague prospect, risks seem firmly skewed to the downside.

The sharply increasing headline deficit, coupled with plunging economic activity, will at least temporarily reverse the downward trend of the public debt ratio. General government debt was reduced from its peak at 100.7% of GDP in 2014 to 95.5% of GDP in 2019 (2018: 97.6%), although we note that this was largely driven by brisk economic growth, partly also due to stock-flow adjustments, whereas debt continued to increase in nominal terms. In this context, it has to be emphasized that Spain continues to post a debt ratio substantially above that of its A-rated peers in our rating universe and well beyond the level of the euro area as a whole (84.1%).

The Covid-19 pandemic thus deepens the sovereign's key vulnerability. We project the public debt ratio to skyrocket to approx. 117% of GDP this year, buttressed by resuming economic growth and aid measures concentrated on the current year, before it should recede somewhat in 2021. As stated above, uncertainties surrounding this remain pronounced, not least as this also depends on the realization of guarantees for instance. To this end, we are aware of media reports mentioning that Spanish airlines have already received government-backed loans to the tune of EUR 1.8bn. Further transport companies, among them state-owned rail company Renfe, are to receive another EUR 1.8bn in loans.

According to latest available Eurostat data, the public guarantees figure continued on its downward path, falling to 4.9% of GPD in 2019 (2018: 5.6%). Outstanding ESM loans totaled EUR 23.7bn, from an initial EUR 41.3bn, after Spain made voluntary repayments between 2014 and 2018. Remaining repayments are due from 2022 to 2027. SAREB, the asset management company tasked with the sale of legacy financial and real estate assets from the banking crisis, further reduced its portfolio to EUR 32.6bn in 2019 (-4,9% vs. 2018), from an initial EUR 50.8bn in 2012. Divestment remains challenging, and the company reported another net loss of EUR 947m in 2019. Against the backdrop of the corona crisis, valuations of the portfolio may go down, thereby impeding the assets sale process going forward.

Fiscal risks that could arise from Spain's large banking sector, one of the largest in the EU in terms of assets-to-GDP (Q4-19: 295.2% of GDP) and dominated by domestic banks, seem manageable when it comes to current capitalization and asset quality. Drawing on EBA data, we note that the CET1 ratio rose to 12.2% as of Q4-19, up from 11.9% a year earlier,

although still markedly below the EU level (15.0%). A falling NPL ratio signals steadfast efforts in dealing with the legacy of the banking sector crisis, reaching 3.2% in Q4-19, 0.6 p.p. below the level in Q4-18, thus further narrowing the gap to the EU (2.7%). However, profitability remains under pressure in the lower-for-longer interest rate environment and, given that a rising number of insolvencies and job losses - and thus a likely rising number of defaults on loans - seems inevitable as a consequence of the pandemic, we would flag concerns over resurfacing risks in this respect. Having said this, it has to be added that declining lending activity in the private sector did not add to banks' exposure between Mar-19 and Mar-20, except for consumption loans to households to some degree. Looking at the most recent lending dynamics, we note increases in loans to non-financial corporations, with May-20 seeing an increase of 7.2% year-on-year, suggesting that companies are making ample use of government-backed bank loans in the wake of the Covid-19 crisis.

We would stick with our conclusion that risks associated with the residential property market seem contained, all the more so as in the current phase demand for housing should be curbed. We observe that house price dynamics had been abating even before the pandemic hit, with year-on-year growth having come down to 3.7% in Q4-19 (Q4-18: 6.7%), and the 3-year growth rate having stabilized around 19%, well below increases seen during the boom phase in the mid-1990s (Eurostat data). Affordability indicators have been moving slightly above their long-term average, but do not point to serious overvaluation.

We would continue to highlight age-related expenditure as a potential risk to fiscal sustainability in the medium to longer term, which the latest EU Aging Report projects to rise from elevated levels. Due to the decision to reverse some elements of the 2013 pension reform, concerns associated with rising aging costs are back on the agenda, implying additional fiscal pressure through higher medium- to long-term pension expenditure.

Risks are mitigated by ongoing sound debt management and increasing debt affordability, which, at the same time, are among the main elements informing the affirmation of the sovereign's credit rating. Interest costs declined by 2.9% in 2019 compared with the preceding year, leaving them at 2.3% of GDP or 5.8% of total general government revenue (2018: 6.2%), thus continuing on a downward trend although still comparing relatively high from a European perspective. The average maturity of outstanding debt was at 7.55y at the end of 2019, slightly up from 7.45y at the end of the prior year, and increased further to 7.72y as of 8 June (Ministry of Economic Affairs). Concurrently, the average cost of debt outstanding (1.99%) and cost at issuance (0.31%) reached new historic lows. The investor base remains diversified and foreign currency denominated debt negligible. Long-term government bond yields post at historically low levels, despite some Covid-19 related volatility. By mid-July the yield on 10-year government bonds stood at roughly 0.4%, with the Bund spread remaining contained. We assume that high investor demand will remain in place and financing costs should remain very favorable for the time being, also given that the ECB remains firmly committed to ensuring an accommodative monetary policy stance, not least through its various asset purchase programs. What is more, we view the funds that Spain is to receive following the abovementioned EU agreement on NGEU as a significant factor which should attenuate some fiscal pressure over the medium term.

Foreign Exposure

With a view to Spain's external position, vulnerabilities persist, but they are balanced to some extent by sustained current account surpluses that have contributed to a further narrowing of the still highly negative net international investment position (NIIP).

Spain has been operating a current account surplus since 2012 that has contributed to alleviating its pronounced net international debtor position. In particular, the deficit in goods trade was reduced amid growing cost competitiveness and an expanding range of export destinations. At the same time, the surplus in services trade was enhanced markedly. In 2019, the current account surplus in percent of GDP was broadly stable (2.0%, 2018: 1.9%), with relatively small changes in the goods trade balance, which posted a slightly lower deficit, and the services trade balance which recorded a slightly diminished surplus. Primary and secondary income balances remained stable compared to 2018. Developments have continued in Q1 (based on a moving four-quarter sum) insofar as the deficit in goods trade narrowed further to -2,1% of GDP, while the surplus in services trade shrank to 4.9% of GDP, showing first signs of things to come as lower tourism numbers due the corona crisis started to show effect. With the full effect of the pandemic to be felt in Q2, the surplus in services trade is set to diminish further. Overall, we expect the current account surplus to widen slightly for 2020 as a whole, mainly due to falling energy prices and despite the adverse impact on service exports related to tourism.

The constant current account surpluses over the last years have helped to reduce net external liabilities, as also reflected in a less negative NIIP in the course of this period. Having said that, Spain remains one of the biggest net international debtors in the EU. In 2019, the NIIP narrowed further from -80.2% to -74.0% of GDP, mainly on the back of the narrowing 'other investment' component. Conversely, the dominating element of the NIIP, the negative position in the portfolio investment balance, last year exerted a widening effect on the NIIP.

Rating Outlook and Sensitivity

Our rating outlook for Spain's long-term credit ratings is negative, as we assume that the risk situation underlying the key factors affecting sovereign credit risk is likely to deteriorate. We would refrain from providing some forward guidance on the time frame underlying our outlook at this stage, owing to the unusually high uncertainty that surrounds developments around the novel coronavirus, as well as the associated economic fallout at the current juncture.

In this vein, we could reinstate the stable outlook or raise the sovereign's credit rating if the debt trend resumes its downward trajectory and we see a credible commitment to bringing the public debt ratio down to more sustainable levels, or if economic activity recovers relatively swiftly and Covid-19 does not entail lasting effects weighing on Spain's medium-term growth potential. In such a scenario, further nationwide Covid-19 outbreaks can be avoided and government measures could lead to a containment in the number of bankruptcies while the labor market impact turns out to be only transitory. Also, the tourism sector would adapt sooner to the 'new normal', contributing to economic growth. Upward

pressure on the rating could also be prompted by a revitalized structural reform momentum.

We could lower our ratings if fiscal metrics fail to improve and the expected substantial deterioration in the public debt ratio becomes more entrenched. Larger, new infection waves requiring broad-based lockdowns and/or policy-makers' failure to minimize the economic fallout would seem conducive to such an adverse scenario, as would a markedly delayed recovery. A negative rating action could also be triggered if Spanish medium-term growth weakens materially, implying that the lost output due to Covid-19 is significantly larger than expected at this stage, and the fallout from the pandemic causes a lasting negative impact on its labor market and the tourism sector. No further progress or a reversal of progress achieved as regards tackling structural labor market deficiencies, as well as structural reforms more generally, possibly as a result of failure to reach consensus in the fragmented political landscape, may also lead to a downgrade.

Analysts

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Ratings*

Long-term sovereign rating	A- /negative
Foreign currency senior unsecured long-term debt	A- /negative
Local currency senior unsecured long-term debt	A- /negative

*) Unsolicited

Economic Data

[in %, otherwise noted]	2014	2015	2016	2017	2018	2019	2020e
Real GDP growth	1.4	3.8	3.0	2.9	2.4	2.0	-10.8
GDP per capita (PPP, USD)	33,373	34,985	36,476	38,265	40,172	41,592	n.a.
HICP inflation rate, y-o-y change	-0.2	-0.6	-0.3	2.0	1.7	0.8	-0.2
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	83.3	83.0	83.5	83.4	83.5	n.a.	n.a.
Fiscal balance/GDP	-5.9	-5.2	-4.3	-3.0	-2.5	-2.8	-11.0
Current account balance/GDP	1.7	2.0	3.2	2.7	1.9	2.0	n.a.
External debt/GDP	169.1	168.9	167.7	167.0	168.3	169.4	n.a.

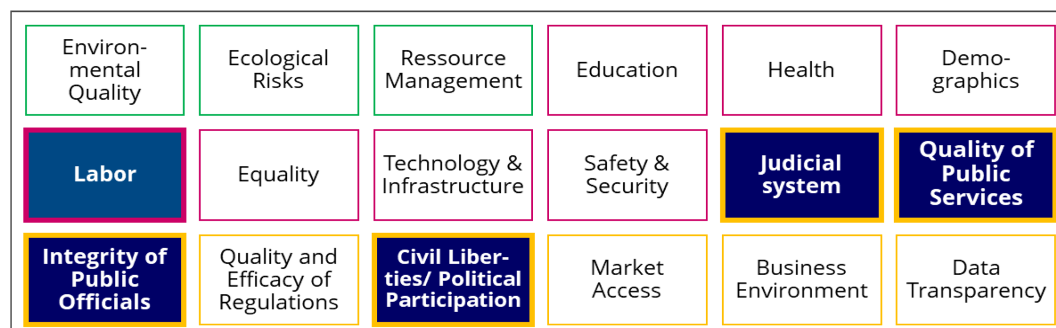
Source: International Monetary Fund, Eurostat, own estimates

ESG Factors

While there is no universal and commonly agreed typology or definition of environment, social, and governance (ESG) criteria, Creditreform Rating views ESG factors as an essential yardstick for assessing the sustainability of a state. Creditreform Rating thus takes account of ESG factors in its decision-making process before arriving at a sovereign credit rating. In the following, we explain how and to what degree any of the key drivers behind the credit rating or the related outlook is associated with what we understand to be an ESG factor, and outline why these ESG factors were material to the credit rating or rating outlook.

For further information on the conceptual approach pertaining to ESG factors in public finance and the relevance of ESG factors to sovereign credit ratings and to Creditreform Rating credit ratings more generally, we refer to the basic documentation, which lays down key principles of the impact of ESG factors on credit ratings.

ESG Factor Box



The governance dimension plays a pivotal role in forming our opinion on the creditworthiness of the sovereign. As the World Bank's Worldwide Governance Indicators Rule of Law, Government Effectiveness, Voice and Accountability, and Control of corruption have a material impact

on Creditreform Rating's assessment of the sovereign's institutional set-up, which we regard as a key rating driver, we consider the ESG factors 'Judicial System and Property Rights', 'Quality of Public Services and Policies', 'Civil Liberties and Political Participation', and 'Integrity of Public Officials' as highly significant to the credit rating.

The social dimension plays an important role in forming our opinion on the creditworthiness of the sovereign. Labor market metrics constitute crucial goalposts in Creditreform Rating's considerations on macroeconomic performance of the sovereign, and we regard the ESG factor 'Labor' as significant to the credit rating or adjustments thereof.

While Covid-19 may have significant adverse effects on several components in our ESG factor framework in the medium to long term, it has not been visible in the relevant metrics we consider in the context of ESG factors – though it has a significant bearing concerning economic prospects and public finances. To be sure, we will follow ESG dynamics closely in this regard.

Appendix

Rating History

Event	Publication Date	Rating /Outlook
Initial Rating	30.09.2016	BBB+ /stable
Monitoring	01.09.2017	BBB+ /positive
Monitoring	27.07.2018	A- /stable
Monitoring	26.07.2019	A- /stable
Monitoring	24.07.2020	A- /negative

Regulatory Requirements

In 2011 Creditreform Rating AG (CRAG) was registered within the European Union according to EU Regulation 1060/2009 (CRA-Regulation). Based on the registration Creditreform Rating AG is allowed to issue credit ratings within the EU and is bound to comply with the provisions of the CRA-Regulation.

This sovereign rating is an unsolicited credit rating. Neither the rated sovereign nor a related third party participated in the credit rating process. Creditreform Rating AG had no access to the accounts, representatives or other relevant internal documents for the rated entity or a related third party. Between the disclosure of the credit rating to the rated entity and the public disclosure no amendments were made to the credit rating.

Unsolicited Credit Rating	
With Rated Entity or Related Third Party Participation	NO
With Access to Internal Documents	NO
With Access to Management	NO

The rating was conducted on the basis of CRAG's "Sovereign Ratings" methodology (v1.2, July 2016) in conjunction with its basic document "Rating Criteria and Definitions" (v1.3, January 2018). CRAG ensures that methodologies, models and key rating assumptions for determining sovereign credit ratings are properly maintained, up-to-date, and subject to a comprehensive review on a periodic basis. A complete description of CRAG´s rating methodologies and basic document "Rating Criteria and Definitions" is published on our website.

To prepare this credit rating, CRAG has used the following substantially material sources: International Monetary Fund, World Bank, Organization for Economic Co-operation and Development, Eurostat, European Commission, European Banking Authority, European Central Bank, World Economic Forum, European Investment Bank, Bruegel Insitute, Blavatnik School of Government, Tesoro Publico de Espana, Banco de Espana, Instituto Nacional de Estadistica, Autoridad Independiente de Responsabilidad Fiscal española (AIReF), Sociedad de Gestión de Activos procedentes de la Reestructuración Bancaria (SAREB), Ministerio de Inclusion, Seguridad Social y Migraciones, Ministerio de Asuntos Económicos.

A Rating Committee was called consisting of highly qualified analysts of CRAG. The quality and extent of information available on the rated entity was considered satisfactory. The analysts and committee members declared that the rules of the Code of Conduct were complied with. No conflicts of interest were identified during the rating process that might influence the analyses and judgements of the rating analysts involved or any other natural person whose services are placed at the disposal or under the control of Creditreform Rating AG and who are directly involved in credit rating activities or approving credit ratings and rating outlooks. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant quantitative and qualitative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all risk factors is described in CRAG´s "Sovereign Ratings" methodology. The main arguments that were raised in the discussion are summarized in the "Reasons for the Rating Decision".

As regards the rating outlook, the time horizon is provided during which a change in the credit rating is expected. This information is available within the credit rating report. There are no other attributes and limitations of the credit rating or rating outlook other than displayed on the CRAG website. In case of providing ancillary services to the rated entity, CRAG will disclose all ancillary services in the credit rating report.

The date at which the credit rating was released for distribution for the first time and when it was last updated including any rating outlooks is indicated clearly and prominently in the rating report; the first release is indicated as "initial rating"; other updates are indicated as an "update", "upgrade or downgrade", "not rated", "affirmed", "selective default" or "default".

In accordance with Article 11 (2) EU-Regulation (EC) No 1060/2009 registered or certified credit rating agency shall make available in a central repository established by ESMA information on its historical performance data, including the ratings transition frequency, and information about credit ratings issued in the past and on their changes. Requested data are available on the ESMA website: https://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

An explanatory statement of the meaning of each rating category and the definition of default are available in the credit rating methodologies disclosed on the website.

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