Rating Object	Rating Information	
KINGDOM OF SPAIN	Assigned Ratings/Outlook: **A- /stable**	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 26-07-2019 “Sovereign Ratings” “Rating Criteria and Definitions”

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Rating Action

Neuss, 26 July 2019

Creditreform Rating has affirmed the unsolicited long-term sovereign rating of “A-” for the Kingdom of Spain. Creditreform Rating has also affirmed Spain’s unsolicited ratings for foreign and local currency senior unsecured long-term debt of “A-”. The outlook is stable.

Key Rating Drivers

1. Vivid economic growth, outpacing other European major economies by far; we expect economic activity to remain resilient, growing faster than the euro area as a whole, mainly owing to softer but still robust domestic demand
2. Spain can rely on its large, wealthy, and well-diversified economy, which has displayed significant cost competitiveness gains over the recent years; ongoing unwinding of macroeconomic imbalances pertaining to the labor market and private sector debt
3. Sovereign features a strong institutional set-up; PSOE emerged strengthened from the general elections and we view policy continuity as given – however, slowed reform momentum unlikely to become rekindled in light of parliamentary fragmentation and diverging views
4. Fiscal consolidation progressing, with Spain exiting EDP in July; we expect consolidation to move on, thanks to robust nominal GDP growth and small primary surpluses – uncertainties beyond 2019 relate to yield generated by new tax measures, if adopted; public debt ratio should decline gradually but remain very high
5. Slowly improving external position, as persistent current account surpluses have resulted in gradual reduction in the country's negative NIIP which remains among the largest in the EU-28

Reasons for the Rating Decision

Creditreform Rating has affirmed the Kingdom of Spain’s credit ratings, which reflect a low risk that the sovereign may not meet its financial obligations fully and on time. The sovereign’s high creditworthiness is underpinned by its strong macroeconomic performance

profile and institutional framework, while weaknesses related to public and external finances persist.

Macroeconomic Performance

Our assessment continues to reflect Spain's strong macroeconomic performance profile, which is mainly based on robust economic growth and per capita incomes well above the A median. Labor market weaknesses continue to weigh on the country's economic resilience and flexibility, balanced by the large size of the Spanish economy and regained cost competitiveness.

First of all, it has to be stated that the Spanish economy's recovery went into its fifth year in 2018, showing dynamic real GDP growth of 2.6%. Although output growth came in a touch lower than in 2017, when real GDP expanded by 3.0%, Spain was still one of the fastest growing non-Central and Eastern European economies in Europe. Building on the structural reform effort which we dwelled on in our past reviews, Spanish economic expansion averaged at 3.1% p.a. between 2015 and 2018, not only growing faster than the euro area average (2.1% p.a.), but also outpacing the other European major economies by a wide margin.

Robust economic growth was exclusively attributable to vivid domestic demand. On the back of brisk employment growth, contained HICP inflation (2018: 1.7%), and fiscal relief, private consumption growth accelerated from 1.9 to 2.1% in 2017-18. As in the year before, private household spending thus was the main growth engine, contributing 1.3 p.p. to last year's real GDP growth, and climbed to its highest level since 2008 (approx. EUR 637bn in real terms). Thanks to high capacity utilization, low funding costs, and improved financial corporate health, investment activity displayed unabated strong growth, expanding by 5.3% on the year after averaging at 4.8% in 2014-17. Investment in machinery and equipment grew by 5.4%, relatively stable as compared to the two years before (2017: 6.0%, 2016: 5.2%). Also, construction investment growth leapt to 6.2%, up from 1.1 and 4.6% in 2016 and 2017 respectively, mainly driven by the recovery in housing (see below). As measured by GDP, total construction investment reached its highest reading since 2012 (2018: 10.8%), but still was far from the – unsustainable – levels witnessed before the financial crisis (2007: 21.1% of GDP).

Export growth turned out to be less resistant to the elevated uncertainty about global growth and trade-related factors (US-China trade tensions, Brexit fears). At 2.3%, growth in exports of goods and services came in significantly lower than in the previous years (2016 and 2017: 5.2% respectively, 2013-17 average: 4.6%). While the slowdown in goods exports was partly driven by the automotive industry, weaker services exports were related to the slowing momentum in tourism. Quarterly national accounts data shows that exports of touristic services (volumes, s.a.) decelerated significantly, with the average y-o-y growth rate dropping from 9.5 and 9.1% in 2016 and 2017 respectively to a mere 1.7% last year. Accordingly, net external trade pared back, and even detracted 0.2 p.p. from economic growth in 2018.

We expect economic prospects for the Spanish economy in 2019/20 to remain favorable. Real GDP growth should soften to 2.3% this year and 2.0% in 2020, mainly reflecting the maturing economic cycle. Still, Spanish economic expansion will prospectively perform well above the euro area average.

Private household spending is poised to cool somewhat, but remain robust. Up to June 2019, high-frequency data such as the number of total registered workers in the social security system do not point to a significant loss in momentum as opposed to the second half of 2018. However, the pace of employment growth is likely to gradually lose some steam going forward. Concurrently, a record-low saving ratio hints at a slowdown in consumption growth, as consumers should become more inclined to save. The households' saving ratio dwindled from 12.83% in Q4-14 to 4.78% in the fourth quarter of 2018 (Eurostat data). As revealed by INE data on the annual variation of savings, Q1-19 has been the first quarter with positive savings since the second quarter of 2015. Notwithstanding, private consumption should be fostered by healthier household balance sheets (see below), still upbeat consumer confidence, and faster wage growth coupled with modest HICP inflation. Against the backdrop of rising rates under collective bargaining (newly signed/revised agreements: +2.3 and 2.1%, respectively) and the substantial minimum wage increase of 22.3% to EUR 1,050, wages should spike this year.

As a corollary of the maturing investment cycle, investment growth is likely to come in a touch lower after years of vibrant growth. Moreover, soft data on industrial activity points to risks stemming from the external environment. While the EU Commission's industrial confidence indicator had been diminishing throughout 2018, stabilizing at historical high levels in the first half of 2019, survey data shows that new orders and export expectations have plummeted. Additionally, the manufacturing PMI shifted into contraction territory in June, falling to the lowest level in more than six years.

On balance, investment activity is also set to remain firm in a context of an urgent need for replacement investments, enhanced corporate profitability, a conducive monetary environment, and the ongoing recovery of the residential property market. Capacity utilization in the industrial sector is thus high and upward trending, posting at 80.4% in the second quarter of 2019 (Q2-18: 80.3%), well above the long-term average (2000-18: 77.3%). Judging by data on return on investment and return on equity, which amounted to 6.5 and 9.9% in 2018 respectively (cumulative quarters, Central Balance Sheet Data Office statistics), profitability of Spanish non-financial corporations (NFCs) has continued to improve. Furthermore, financing conditions should remain very accommodative, as the ECB decided to postpone monetary policy normalization further. At its June meeting, the governing council decided to keep the refinancing rate at its present level at least through the first half of 2020. The development of the residential property market (see below) and buoyant sentiment in the Spanish construction sector are consistent with a further robust year in construction investment. In June 2019, the construction confidence indicator hit its highest level since October 2007. Also, building permits eased at the beginning of the year, but the 2018 reading for buildings to be constructed (units) still stood 3.5% above the level seen in 2017.

At the same time, we see a rather muted growth contribution from net external trade, as growth should be curbed by the challenging external environment characterized by weaker global growth and international trade, and aggravated by uncertainties associated with the shape of the future EU-UK agreement as well as a further escalation of trade tensions. We believe that external headwinds will subside, albeit very gradually, and economic activity in Spain's main trading partners and the euro area in general is likely to strengthen. Tourist inflows should pick up only moderately due to increased competition from other prime destinations. The number of tourist arrivals seen in 2018 surpassed the 2017 level by only 1.2%, corresponding to a sharp slowdown in view of an average yearly increase of 7.3% from 2013 to 2017, but appear to have regained some momentum since the last quarter of 2018. Despite the disappointing outturn in May, when INE recorded a decline of 1.6% y-o-y, tourist arrivals in the first five months of 2019 exceeded the previous year's level by 2.7% (Jan-Mai 2018: +2.3%). However, total tourist expenditure increased by a relatively weak 0.5% y-o-y as compared to an average increase of 4.1% in the twelve months up to April 2019.

The outturn of national accounts data for this year's first quarter underscores our view of Spain's sustained economic activity, as economic output rose by 0.7% q-o-q or 2.4% on the year (Q4-18: 2.3%, Q3-18: 2.5%), placing Spain among the fastest-growing economies in the euro area. The first quarter was characterized by robust growth in gross fixed capital formation (4.7% y-o-y). While household spending eased to 1.5% y-o-y, Q1 saw exports stagnating.

We expect that strong and resilient economic growth will remain supportive of closing the GDP per capita gap towards the EU-28 average, and a continued correction of Spain's macroeconomic imbalances. According to latest IMF estimates, Spaniards commanded over a per capita income of USD 40,139 in 2018 (PPP terms), up from USD 38,320 a year before. Spanish GDP per capita now accounts for 93% of the weighted EU-28 average, up from 89% in 2014 and equaling the level of 2012. At the same time, Spain's GDP p.c. lies well above the median of our A-rated universe (USD 35,938), but falls significantly short of the levels observed in the other European major economies UK (USD 45,705), France (USD 45,775), and Germany (USD 52,559), while having overtaken Italy (USD 39,637) last year. Sub-par per capita incomes are partly explained by comparatively poor labor productivity. As measured by GDP per hour worked, Spanish labor productivity totaled only 95.5% of the EU-28 total in 2018 (based on PPS), and also lay notably below the levels seen in other European major economies. Meanwhile, we note that the economy's large size somewhat shields Spain against external shocks, contributing positively to its risk-bearing capacity. Nominal GDP totaled USD 1.426tr in 2018 (IMF data), making Spain the 13th largest economy in the world (5th in Europe).

Despite the ongoing recovery, we continue to view the Spanish labor market as a key weakness. Job creation has been extraordinarily strong over the last few years, especially when considering the size of the economy. Employment has expanded by an annual rate of at least 2.0% for 18 consecutive quarters, climbing to its highest level since the last quarter of 2008, and having increased by a remarkable 2.4m persons since having reached its trough in Q4-13. The first quarter of 2019 saw employment growth of 2.5%, stepping up a gear

after having weakened moderately in 2018. By contrast, labor participation has continued to disappoint. Although on par with the euro area and posting above rates in France and Italy, Spain's activity rate has declined over the last three years (-0.6 p.p.), diverging from the Europe-wide trend of increasing activity rates, and also trailing its A-rated peers.

The annual harmonized unemployment rate dropped from 17.2 to 15.3% in 2017-18, equating to the lowest level since 2008. Yet, Spain features the second-highest unemployment rate in the EU-28 (behind Greece). Moreover, structural unemployment has been persistently high over the last years. While having been on the retreat ever since peaking in 2014, long-term and very long-term unemployment are very high by European standards (Q4-18: 5.8 and 3.7%, 3rd highest level in the EU-28 respectively), and Spain has still a long way to go before reaching its pre-crisis levels (Q1-08: 1.7 and 0.8%). What is more, youth unemployment and fixed-term contracts remain pervasive. Whereas the share of 15-24 year old jobless Spaniards almost halved from 21.0 to 11.3% in 2013-18 (still the second highest reading in the EU-28), Spain has the highest temporary contract share in Europe, having followed a firm upward trend since 2013 (Q4-18: 22.8% of total employment).

According to the European Social Scoreboard, Spain exhibits one of the most challenging labor markets in the EU-28 – with a reasonable performance with regard to social protection and inclusion, whilst coming off badly concerning equal opportunities and access to labor, and dynamic labor markets and fair working conditions.

The enduring clean-up of private sector balance sheets is a further token of diminishing macro-financial vulnerabilities in Spain. We assess that Spanish households still face a higher debt burden than other major euro area economies, but they have certainly made palpable progress in deleveraging over the last ten years. In the year up to Q4-18, household debt declined by 3.2 p.p. to 97.0% of disposable income (-9.8 p.p. since Q4-15). NFC finances are also improving further, as Spanish corporates reduced their debt from 78.3% of GDP in Q4-17 to 74.9% in the fourth quarter of 2018, after (peak in Q2-10: 117.9%).

Moreover, the Spanish economy has made huge strides in recouping lost ground in terms of cost competitiveness over the last years. In 2018, real unit labor costs (ULC) again evolved more favorably than in Spain's key trading partners and the euro area as a whole, as moderate real labor productivity growth (+0.4%, AMECO data) was concomitant to a slight decline in real compensation per employee (-0.1%). Spanish real ULC has fallen by 6.3% since 2010, a considerably more favorable development than in main trading partners such as Germany (+2.0%), France (+0.9%), and Italy (-2.6%), as well as the EA-19 (-1.5%). Besides Spain's determined reform effort, wage containment was at the heart of this development, as real wages were virtually flat in 2010-18 (-0.1%).

Due to the enhanced competitive edge, foreign trade has increased its share of GDP, standing at 66.6% in 2018, up from 65.7 and 61.2% in 2017 and 2013 respectively, and exports are roughly 34% above their pre-crisis peak in real terms. Despite the demanding external environment, Spain's global export market share has been broadly stable over the last three years (2018: 1.97%, 2016: 1.98%), preserving the gains achieved since 2012 (1.82%). At the same time, the Spanish economy was able to expand its services export market

share to 2.62% in 2018, now well above its trough from 2015 (2.41%). The increasingly diversified export base also mirrors Spain's improved competitiveness. As illustrated by DataComex data on the period between 2005 and 2018, the export share of non-EMU economies such as Morocco (+1.4 p.p.), China (+1.2 p.p.), Poland (+1.0 p.p.), and Korea, Rep. (+0.4 p.p.) ticked up significantly, whereas the respective readings for e.g. France (- 4.3 p.p.), Portugal (-2.3 p.p.), and Germany (-0.7 p.p.) went down. What is more, the number of regularly exporting firms moved up by another 2.4% in 2018, after having risen by 32% between 2012 and 2017.

Sustaining its competitiveness gains could become more challenging for the Spanish economy further out, since productivity growth should remain rather moderate, while wages can be expected to show a somewhat more dynamic development (see above). To be sure, Spain's very high unemployment rate points to sufficient labor market slack to keep wages at bay.

Nevertheless, Spain displays a comparatively low volume of R&D expenditure, amounting to a mere 1.2% of GDP in 2017, well below the euro area average and other EU major economies. The share of high-tech exports accounts for only 5.5% of total exports, one of the lowest readings among euro area economies. Furthermore, Spain made improvements in terms of lifting onerous product market regulation, as suggested by the latest edition of the OECD PMR indicator (2018: 1.07, 2013: 1.44 – OECD avg. 1.40); yet, regulatory barriers in services sectors and above average state involvement in business operations remain in place. While Spain ranks at a stable 26 out of 140 economies in the World Economic Forum's Global Competitiveness Index 4.0 (2017 backcast: 25), it ranks poorly at 80 and 120 when it comes to the efficiency of the legal framework in settling disputes, and the burden of government regulation respectively. In the same vein, the EIB Investment Survey 2018 documents that 79% of the respondents cite business regulations as the main long-term barrier to investment. According to the 2019 Doing Business report, Spain fell two places to rank 30. The World Bank concludes that the Spanish business environment is particularly hampered by shortcomings in dealing with construction permits (rank 78 out of 190 economies), getting credit (73), and starting a business (86).

Institutional Structure

Spain's credit ratings continue to be backed by the sovereign's strong institutional set-up, which is aided by the benefits that come with membership in the European Union and the European Monetary Union, which entails free movement of labor and capital, as well as access to broader and deeper capital markets, and advantages stemming from the euro's reserve currency status.

The latest scores of the World Bank's Worldwide Governance Indicators (WGI) signal a generally high quality of Spain's institutional framework. The sovereign's WGIs are broadly aligned with its A-rated peers, but stand well below euro area median values, and show a particularly dismal performance as related to most of the other European major economies. While we have observed a considerable deterioration with regard to the perception of the extent to which public power is exercised for private gain over the last five years, Spain was placed at an unchanged rank 67 out of 209 economies on the WGI control of

corruption more recently (euro area median rank 41). Spain receives higher rankings as regards the WGIs voice and accountability (rank 39) and rule of law (rank 40), which are comparable to other sovereigns from our A-rated universe. It has to be highlighted that the WGI government effectiveness weakened for the second year in a row (now rank 39/209 economies).

Underpinning a moderation in the quality of policy formulation and implementation, we observe a slackened reform momentum in the years beyond 2015. This is also confirmed by the EU Commission's assessment of the progress on country-specific recommendations, which concludes that the pace of implementation of its recommendation has slowed since 2014.

Apart from several fiscal reforms implemented by Royal Decree Law, as Parliament rejected the 2019 budget (see below), the government envisioned steps to enhance the business environment and improve the economy's competitiveness. In this vein, the Strategic Framework for SME Policy 2030 has been ratified, centered around themes such as regulation, financing, digitalization, and internationalization, and envisaging almost EUR 0.5bn to boost the SME sectors competitive edge.

Furthermore, authorities have tabled several initiatives targeted towards Spain's labor market challenges. In March this year, Royal Decree Law 6/2019 was enacted, aiming at warranting equal treatment and opportunities for women on the labor market, whilst Law 8/2019 entails the obligation for corporates to record their employees working time. In April 2019, the government adopted the so-called Reincorpora-t Plan, an action plan with extensive measures to tackle long-term unemployment to be implemented over 2019-21. Already at the end of last year, the Council of Ministers endorsed the 2019-21 Action Plan for Youth Employment. Also in December 2018, measures to foster job creation and unemployment benefits were approved, including a reduction in the minimum number of days for temporary workers to receive unemployment benefits and the extension of the extraordinary unemployment benefit. Policy-makers also took action to cater for a greater protection for self-employed workers.

In our view, political dynamics imply some risks to advancing needed reforms to improve productivity and labor market conditions, and to foster the business environment. During last year's review, we attached a high probability to early elections, a scenario which materialized at the beginning of this year. In February, PM Sanchez called snap elections, just eight months after succeeding Rajoy.

Eventually, Sanchez' PSOE emerged strengthened from the general elections held in April 2019, winning 28.7% of the votes and 123 mandates, up from 22.6% and 85 seats in parliament in October 2016. We assume that the next government will be headed by Sanchez and his PSOE, as no other party constellation poses any serious threat. Following the devastating election results of PP, which lost half of its seats in congress (from 137 to 66 seats), the right-wing camp is too weak to challenge PSOE.

We believe that broad policy continuity should be warranted, with the new government broadly following along the lines of its main policy priorities stipulated during the last, albeit

short-lived, administration – in particular the consolidation of public finances, while placing greater emphasis on education, social and environmental issues.

However, we see the decelerating reform momentum as unlikely to be rekindled. There is an elevated probability that Sanchez will be leading a minority government, governing with changing majorities. Although minority governments are not unusual in Spain, we believe that governing has become more challenging in light of the increasingly fragmented parliament and diverging views. The congress now comprises 13 parties, up from nine parties in the 2016 general election. Together with Podemos, PSOE could count on 165 seats, just short of the necessary 175 seats. Ciudadanos achieved its best result so far with 57 seats (+15 mandates), and the far-right Vox party moved into parliament with 10.3% or 24 seats (2016: 0.2%). Thus, the current political constellation may hamper the sovereign's responsiveness and ability to meet the country's structural challenges going forward.

After caretaking PM Sanchez did not secure an absolute majority on 23 July, it cannot be ruled out that Sanchez will fail to obtain even a simple majority in the second vote on 25 July. In that case, there will be two months left for further attempts, followed by a second round of general elections, prospectively in November 2019. In our view, this outcome would be tantamount to another lost year for Spain, in view of the political gridlock back in 2015/16. According to current polls, PSOE and PP could gain ground, while Podemos and Vox would have to face losses.

Meanwhile, we see lingering and elevated political tensions between Catalonia and Madrid, and the (tail-) risk of a secession from Spain. However, we stick to our baseline scenario, which assumes that Catalonia will remain part of Spain, though the back and forth between Catalonia and the State will persist. To be sure, we believe that risks have somewhat subsided, as Sanchez' PSOE is striving for dialogue and signaling a certain degree of willingness to reach a compromise, possibly one granting larger autonomy rights to Catalonia, which must not be confused with independence from the Spanish State.

Fiscal Sustainability

Risks to the sovereign's fiscal sustainability continue to be its main weakness, mainly reflecting very high government debt and elevated, though receding, interest expenses, as well as building pressure from age-related expenditure, and some political uncertainty balanced somewhat by progress in fiscal consolidation and an improving debt trend, as well as prudent debt management.

The government has thus shown remarkable effort in improving its public finances by reducing its deficit by 8.0 p.p. GDP in only seven years (2012: -10.5% of GDP). Fiscal consolidation has advanced further since our last review, buoyed by cyclical tailwinds. The general government headline deficit fell from 3.1% of GDP in 2017 to 2.5% of GDP last year. In early June, the European Council accordingly decided to abrogate Spain's excessive deficit procedure, which had been in place since 2009. The recent deficit decline of 0.6 p.p. GDP was mainly due to vivid economic growth which translated into a significantly higher tax revenues and social security contributions, but was also due to higher EU funds inflows. While revenue generated by current taxes on income and wealth, as well as VAT, leapt by 8.8 and

6.0% respectively, net social contributions rose by a healthy 4.9% on the year. It has to be emphasized that expenditure increased substantially after years of restraint, rising at a rate of 4.5% (2010-17 average: -0.4%), largely driven by rising public wages and social transfers, growing by 3.2 and 4.6% respectively.

Going forward, we expect to see further improvements in the budget, with the headline deficit narrowing to 2.2% of GDP in 2019 and 1.8% of GDP in 2020, mainly driven by tax-rich GDP growth and brightening labor market conditions, as well as decreasing interest expenditure. We note that the State Budget 2019 was rejected by the parliament, so that the 2018 budget was rolled over to the current year, which should curb spending pressures to some degree. Authorities have implemented several measures on minimum wages, pensions, and Social Security via Royal Decree Laws. Among the measures with the largest budgetary impact were the minimum wage hike, the 2.25% increase for public employees, as well as the revaluation of public pensions, implying a CPI compensation and higher minimum, contributory, and non-contributory pensions (3%, 1.6%, and 3%). Moreover, unemployment benefits for people over 52y have been reinstated and parental leave extended. These should be largely covered by rising contribution bases (maximum base for the General Social Security System, minimum base, base for self-employed).

An extensive tax package shall be implemented from 2020 onwards, containing several revenue-increasing measures, such as an exemption limitation on dividends and capital gains, the introduction of a higher minimum corporate tax, higher personal income, wealth, and environmental taxes, as well as a new financial transaction tax and a digital services tax. Authorities reckon with a budgetary impact of EUR 5.64bn or 0.5% of 2018 GDP. In general, we believe that somewhat more conservative estimates may be appropriate regarding revenue estimates beyond 2019, since yield generated by new taxes is difficult to forecast, if these are adopted at all.

Indeed, the tax measures are still waiting to be adopted. As elaborated above, the presumably PSOE-led government will have to rely on changing majorities, resulting in a considerable degree of uncertainty as to the shape of the future fiscal path. By the same token, consolidation may be watered down by further expansionary measures going forward, e.g. associated with the far-reaching Agenda for Change. Furthermore, we might well see some backtracking on past structural reforms. A case in point is the deviation from the landmark pension reform back in 2013, with the decision to suspend the revaluation index (the so-called IRP) in 2018/19 and postpone the implementation of the sustainability factor. If authorities were to repeal the IRP and permanently return to indexing pensions to consumer prices, this would pose additional fiscal sustainability risks in the medium to long term.

This is mainly due to Spain's elevated age-related expenditure (2016: 24.0% of GDP), which has to be monitored vigilantly. While Spain is confronted with demographic challenges broadly comparable to the EU as a whole, the EU Ageing Report documents ageing costs to rise by 0.6 p.p. of GDP by 2030. According to simulations by the EU Commission, however, relinking pensions to the CPI would raise pension expenditure to some 14 and 18% of GDP by 2030 and 2050 respectively, as compared to 12.6 and 13.9% of GDP in the Ageing Report's baseline scenario – potentially undermining fiscal consolidation efforts and derailing public debt dynamics.

As of now, we expect general government debt to follow on its gradual downward trajectory in the medium term, aided by nominal GDP growth above the euro area average and slowly increasing primary surpluses. It should be pointed out that in 2019 the government will likely achieve its first primary surplus since 2007 (3.5% of GDP). Still, general government gross debt will remain very high, totaling 97.1% of GDP in 2018, down from 98.1% a year before and slightly below its peak of 100.4% of GDP reached in 2014. Hence, the sovereign is exposed to significantly higher debt levels than all other A-rated peers (median 48.9% of GDP), representing a key weakness, and is highly vulnerable to a growth shock.

Risks should be increasingly mitigated by gradually declining interest costs and prudent debt management. Despite being still relatively high from a European perspective, interest outlays should continue on the downward path on which they have been since 2014. Interest expenditure stood at 6.3% of general government revenue, 0.4 p.p. lower than in the year before, and almost 3 p.p. below its 2014 level (9.0%). The Spanish Treasury has taken advantage of the current interest rate environment, as average life of debt outstanding increased to 7.5y in 2018, up from 7.1y in 2017 and 6.2y in 2013. At the same time, the cost of debt outstanding has dwindled to a new historic low, having declined from 2.55 to 2.39% in 2017-2018 (2011: 4.07%, 1999: 5.65%). Additionally, Spain has a diversified holding structure from a geographical and investor base point of view, and a negligible share of foreign currency denominated debt. Long-term government bond yields remain at historically low levels and have been trending downwards since the turn of the year, standing at only 0.395% at the end of June after having hovered at around 1.5% over the last few years.

Contingent liability risks continued to subside, with public guarantees ticking down from 6.7% of GDP in 2017 to 5.6% last year (Stability Program 2019). As of October 2018, the outstanding amount of ESM loans amounted to EUR 23.7bn, more than 40% below the original program volume of EUR 41.3bn, with Spain now having made one scheduled and nine voluntary repayments since the start. Also, as regards legacy issues, SAREB continues to fulfil its mandate, further reducing its portfolio by another 7.6% to EUR 34.8bn in 2018 (EUR 50.8bn at the time of its inception) – although divestment may become more challenging, in our view. Concurrently, the asset management company again incurred a net loss of EUR 878m in 2018, up from 565m in 2017.

Fiscal risks arising from the banking sector continue to appear limited at the current juncture. As evidenced by EBA data, asset quality also improved throughout 2018, with the non-performing loan ratio lying at 3.6% in the first quarter of 2019 (Q1-18: 4.5%), slightly above the EU-28 average of 3.1%. The share of NPLs has been persistently declining (in 2018 mainly due to sales transactions), having fallen from 6.3% in Q1-16. That being said, the CET 1 ratio still posts well below the EU average (14.7%) and has more or less stagnated over the last two years, standing at a mere 11.8% in Q1-19, after 11.7 and 11.9% in the first quarter of 2017 and 2018 respectively.

We also see fiscal risks implied by the residential property market as contained, with housing prices recovering from the pronounced correction after the Great Financial Crisis. Three-year house price growth has stabilized over the last quarters, albeit at elevated levels of just below 15%. At the end of last year, real house prices stood 14.6% above the level observed three years ago, as compared to 14.3% in Q4-17. ECB MFI lending data does not

point to excessive mortgage lending, which nevertheless still appears to be recovering, with credit growth becoming less negative over time. In May, outstandings stood 1.2% below the previous year's level (Apr-18: -2.3% y-o-y).

Financial sector risks may be further alleviated by the introduction of new macro-prudential tools, as well as the newly established macro-prudential Spanish authority (AMCESFI), mandated with the identification, prevention, and mitigation of developments or actions that could entail systemic risks in the financial sector.

Foreign Exposure

Vulnerabilities stemming from Spain’s external position persist, although current account surpluses have resulted in a gradual reduction in the country's large and negative net international investment position (NIIP).

Spain’s current account also mirrors its gains in cost competitiveness (see above), as it posted the sixth surplus in a row after recording a deficit for almost 20 years (according to Eurostat records). Still, the surplus has been narrowing over the last two years, falling from 2.3% of GDP in 2016 via 1.8% in 2017 to 0.9% of GDP in 2018. Dragged down by weaker external demand, oil price rises, the high degree of trade-related uncertainty, and softer readings on tourist arrivals, the trade in goods deficit widened by 0.7 p.p. to 2.6% of GDP, and the trade in services balance deteriorated from 4.8 to 4.5% of GDP.

We expect a further slight moderation in the current account surplus, as net exports should once again underperform in 2019 before being broadly balanced in 2020. External headwinds should abate slowly, i.e. export markets in Spain’s main trading partners should strengthen and uncertainty fade out very gradually, while solid domestic demand is likely to result in firm import growth.

Robust nominal GDP growth and persistent current account surpluses should result in a gradual reduction in the country's negative NIIP. In 2018, the NIIP decreased from -83.5 to -77.1% of GDP. Nevertheless, Spain’s negative NIIP remains very large, counting among the largest negative NIIPs in the EU-28. What is more, Spain displays significantly weaker performance than other major economies in Europe and A-rated peers. Meanwhile, negative valuation effects impeded greater progress in external deleveraging. When excluding valuation effects, however, the NIIP posted at a still high -43.3% of GDP at the end of 2018. The same applies to Spain’s (declining) net external debt, which was the fourth highest in the EU-28 in 2018 at 81.5% of GDP. We acknowledge that external risks are somewhat tempered by the composition of external liabilities in terms of maturities (predominantly long-term) and sectors, with the Bank of Spain and the public administrations standing for 40.4 and 49.4 p.p. of the country’s gross external debt in Q4-18 (Q4-13: 22.3 and 41.1 p.p. GDP).

Rating Outlook and Sensitivity

Our Rating outlook on the Spain’s credit ratings is stable, as we assume that the risk situation underlying the key factors affecting sovereign credit risk – including macroeconomic performance, institutional structure, fiscal sustainability, and foreign exposure – is likely to remain fundamentally unchanged over the next twelve months.

Downward pressure on Spain's credit ratings or the related outlook could emanate from notably weaker-than-expected medium-term growth which may, among others, be prompted by a sharp and protracted slowdown in euro area growth, further escalating trade tensions, and/or a disorderly Brexit. As regards the latter, the immediate fallout from a disorderly Brexit may be not as high as in other European economies due to a relatively limited exposure to UK-related trade and capital flows, as signaled by the Brexit Risk Indicator (ES: 1.96, EU-27 median 2.0; see "What if... Consequences of a hard Brexit for the EU-27 states").

We could also consider a downgrade if we observe a reversal of past structural reforms, if the current account shifts into negative territory, or due to resurfacing tensions with Catalonia, or significant fiscal slippages translating into a reversal of government debt dynamics. Since the recent fiscal consolidation was largely driven by cyclical factors and further progress should also be highly reliant on robust GDP growth, weaker medium-term growth is also likely to have a bearing on fiscal metrics.

We could raise Spain's ratings if the government committed to a credible medium-term fiscal path, leading to sustainably lower general government debt levels. Upward pressure could also result from stronger medium-term growth, resuming structural reform momentum, as well as from further significant progress in correcting imbalances pertaining to the labor market or the external sector.

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Ratings*

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

*) Unsolicited

Economic Data

	2013	2014	2015	2016	2017	2018	2019e
Real GDP growth	-1.7	1.4	3.6	3.2	3.0	2.6	2.3
GDP per capita (PPP, USD)	32,226	33,387	35,009	36,522	38,32	40,139	41,538
HICP inflation rate, y-o-y change	1.5	-0.2	-0.6	-0.3	2.0	1.7	1.0
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	83.2	83.3	83.0	83.5	83.4	n.a.	n.a.
Fiscal balance/GDP	-7.0	-6.0	-5.3	-4.5	-3.1	-2.5	-2.2
Current account balance/GDP	1.5	1.1	1.2	2.3	1.8	0.9	n.a.
External debt/GDP	160.2	168.0	168.4	167.0	166.2	166.8	n.a.

Source: International Monetary Fund, Eurostat, own estimates

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

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.

The rating was conducted on the basis of CRAG´s "Sovereign Ratings" methodology in conjunction with its basic document "Rating Criteria and Definitions". 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 the following internet page: www.creditreform-rating.de/en/regulatory-requirements/.

To prepare this credit rating, CRAG has used 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, 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).

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".

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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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