Kingdom of Spain
Rating Report

SCOPE A- STABLE OUTLOOK

Credit strengths

- Large and diversified economy
- Favourable debt profile
- Status as a euro area member

Credit challenges

- High public debt levels
- Elevated structural unemployment, low productivity growth
- Structural budgetary pressures stemming from adverse demographic trends

Rating rationale:

Large and diversified economy: Spain benefits from its large economic size and diversified economic structure driven by high value-added activities. Elevated renewable energy production capacity and sizeable regasification capacities provide comparatively strong mitigants against the current energy shock.

Favourable debt profile: Public debt is characterised by long average life, low share of short-term debt and a stable investor base, with the average cost of debt set to remain moderate compared to historical standards in the context of monetary tightening.

Core euro area member: Spain benefits from its euro area membership, strengthening the country's resilience to face global shocks.

Rating challenges include: i) an elevated stock of public debt; ii) elevated structural unemployment and weak productivity gains and iii) structural budgetary pressures stemming from adverse demographic developments, in the form of rising pension and healthcare expenditures.

Spain's sovereign rating drivers

Risk pillars		Quantitative		Reserve currency	Qualitative*	Final rating
		Weight	Indicative rating	Notches	Notches	
Domestic Economic Risk		35%	aa+	EUR [+1]	0	A-
Public Finance Risk		20%	bb		-1/3	
External Economic Risk		10%	b		0	
Financial Stability Risk		10%	aaa		0	
ESG Risk	Environmental Factors	5%	aa-		0	
	Social Factors	7.5%	b+		-1/3	
	Governance Factors	12.5%	a-		0	
Indicative outcome		**a**			**-1**	
Additional considerations					**0**	

Note: *The qualitative scorecard adjustments, capped at one notch per rating pillar, are weighted equally with an aggregate adjustment rounded to the nearest integer. The reserve currency adjustment applies to currencies in the IMF's SDR basket. For details, please see Scope's 'Sovereign Ratings' methodology. Source: Scope Ratings.

Outlook and rating triggers

The Stable Outlook reflects Scope's view that risks to the ratings are balanced.

Positive rating-change drivers

- Growth prospects improve, supported by, for example, structural reform progress
- Improvement in public finances, putting public debt on a firm downward trajectory

Negative rating-change drivers

- Weaker than expected economic recovery or protracted fiscal deterioration weakens debt sustainability
- Reforms are delayed, adversely impacting the economic and fiscal outlooks

Ratings and Outlook

Foreign currency

Long-term issuer rating	A-/Stable
Senior unsecured debt	A-/Stable
Short-term issuer rating	S-1/Stable

Local currency

Long-term issuer rating	A-/Stable
Senior unsecured debt	A-/Stable
Short-term issuer rating	S-1/Stable

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Bloomberg: RESP SCOP

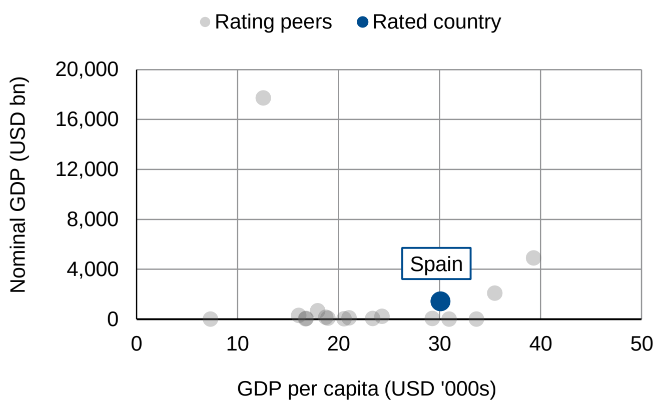
Domestic Economic Risks

- **Growth outlook:** Spain is less reliant on Russian gas than most other euro area peers, making it less vulnerable to sharp restrictions resulting from the war in Ukraine. We expect growth will remain strong this year at 4.5%, primarily reflecting a high carry-over effect, before moderating to 1.0-1.5% in 2023 due to weaker household consumption and business investment. It should then trend back to the medium-term potential, which we estimate at 1.5-2.0% per year. Growth prospects should be supported by high public investment fuelled by EU funds as well as the roll-out of Spain's Recovery and Resilience Plan.
- **Inflation and monetary policy:** Inflation declined to 7.3% year-on-year (YoY) in October, a sizable drop from a peak of 10.8% in July reflecting declining energy prices. Core inflation stood at 6.2%, stable from the previous month. We expect price pressures to moderate gradually in the medium term, all the while remaining elevated relative to historical averages.
- **Labour market:** While remaining among the highest in the euro area, the unemployment rate stands near decades-lows, at 12.7% as of 2022 Q3. This reflects the continued strength of the labour market in the first half of the year, with positive, albeit decelerating, job creations. The quality of job creations has improved since the 2021 labour market reform, with lower shares of part-time and fixed term contracts. We expect labour market dynamics to decelerate in the medium-term, in line with the deterioration of the macroeconomic outlook.

Overview of Scope's qualitative assessments for Spain's *Domestic Economic Risks*

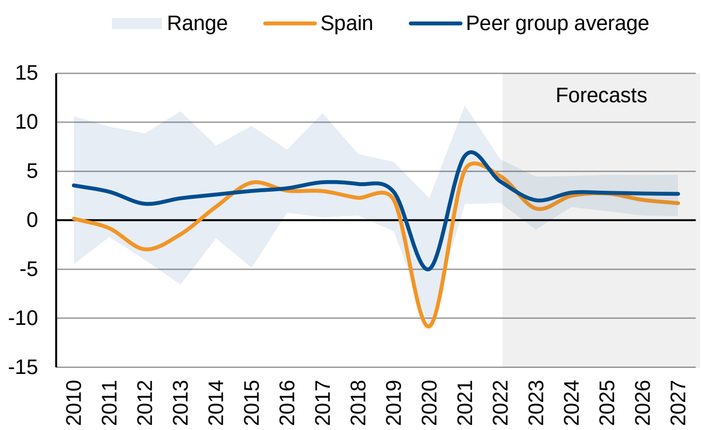
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa+	Growth potential of the economy	Neutral	0	Moderate growth potential, but improvements likely due to recovery plan
	Monetary policy framework	Neutral	0	ECB is a highly credible and effective central bank
	Macro-economic stability and sustainability	Neutral	0	Large and diversified economy; significant structural unemployment

Nominal GDP and GDP per capita, USD



Source: IMF World Economic Outlook (WEO), Scope Ratings

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

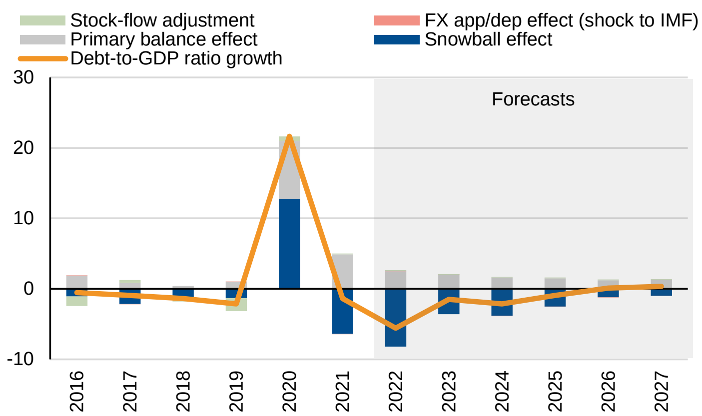
Public Finance Risks

- **Fiscal outlook:** Following a marked reduction of the budget deficit in 2021 to 6.9% of GDP, the fiscal outlook has worsened following the outbreak of the Ukraine conflict. Accelerating inflation is leading to pressures on current expenditures, primarily through higher personnel spending and pension payments (set to rise by 8.5% in 2023), while the slowdown in the post-pandemic economic recovery is set to weigh on revenue growth. Funds allocated to alleviate the impact of the energy crisis on the private sector amounted to 3.2% of GDP in the 13 months to October 2022. Additionally, rising funding costs will lead to a gradual increase in interest payments, albeit from a low level of around 2.1% of GDP in 2022. Long term challenges to the fiscal outlook relate to Spain's rapidly ageing population which adds to pressures on social expenditures. We expect the budget deficit to narrow to 4.5% of GDP in 2022 and 4.3% of GDP in 2023, before gradually declining to 3.2% by 2027.
- **Debt trajectory:** The debt-to-GDP ratio is set to decline to 113% this year, down from nearly 120% in 2020, on the back of still-robust GDP growth. It should however remain almost 15pp above its pre-pandemic level, however. We anticipate debt levels to recede only moderately in coming years, as the progressive reduction in primary deficits is partially offset by higher interest payments and lower nominal growth. The debt-to-GDP ratio is expected to recede further to about 112% in 2023, before stabilizing around 107% in the period up to 2027.
- **Market access:** Net funding needs for 2023 are expected at EUR 70bn, slightly down from 2022 (EUR 75bn). Similarly to peers, funding costs have risen in recent months, reflecting the tightening of monetary policy and elevated inflation expectations. Risks stemming from a large debt stock and rising interest rates are partially mitigated by the favourable debt structure, with an average maturity of 8 years, a moderate share of inflation-indexed liabilities (around 6% of total) and a stable ownership structure (including 28% held by Banco de España as of end-2021).

Overview of Scope's qualitative assessments for Spain's *Public Finance Risks*

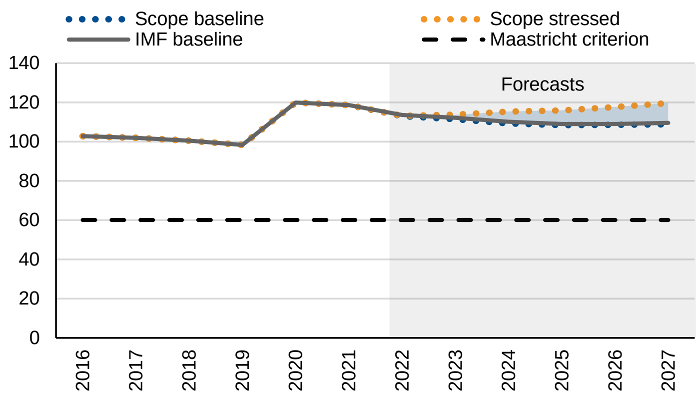
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb	Fiscal policy framework	Weak	-1/3	Underlying fiscal position is weak; structural pressures resulting from population ageing
	Debt sustainability	Neutral	0	Debt to remain elevated over medium term; low interest burden
	Debt profile and market access	Neutral	0	Strong market access and solid investor base; safe debt composition with large central bank holdings

Contributions to changes in debt levels, pps of GDP



Source: IMF WEO, Scope Ratings forecasts

Debt-to-GDP forecasts, % of GDP



Source: IMF WEO, Scope Ratings forecasts

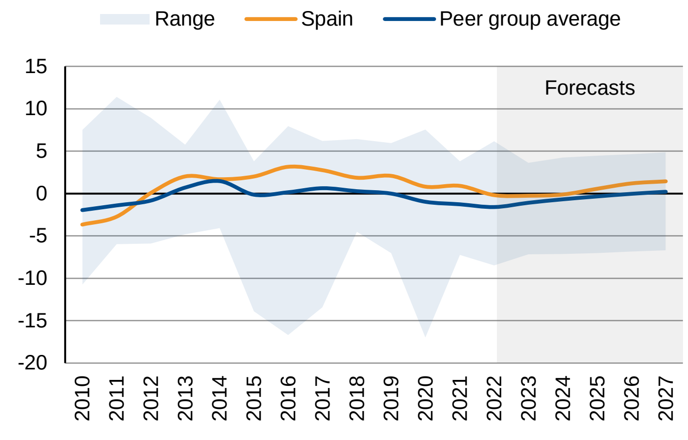
External Economic Risks

- **Current account:** Spain's external balance had strengthened materially in the period leading up to the pandemic, generating comfortable surpluses averaging around 2% of GDP over 2012-19. The current account surplus declined to 0.8% in 2020, as a result of falling tourism exports. The return of international travel only allowed for a partial recovery, as the rebound in net services exports only partially compensated for adverse developments impacting the trade of goods balance, related to weaker exports resulting from global supply chain disruptions as well as to soaring nominal energy imports. The current account surplus amounted to 0.8% of GDP in the year to 2022 Q2. Looking ahead, we expect it to remain subdued compared to historical averages, in line with high global energy prices and with the weakening of the growth outlook among Spain's key trading partners.
- **External position:** Spanish gross external debt had stabilized at a rather elevated level in the decade prior to the crisis, averaging around 170% of GDP between 2010-19, before rising above 200% in 2021 Q1, primarily owing to the fall in economic output. The economic recovery has allowed for a partial reversal of this increase, down to about 183% in 2022 Q2. The composition of external debt has improved in recent years, with lengthy maturities, a high share of public sector debt (54%) and a moderate share of financial sector liabilities (21%). The net international investment position stood at -65% of GDP as of 2022 Q2, having decreased materially from 2014 peaks of above 95%.
- **Resilience to shocks:** Spain, along with all euro area members, benefits from the euro's status as a global reserve currency, significantly mitigating risks to external shocks.

Overview of Scope's qualitative assessments for Spain's *External Economic Risks*

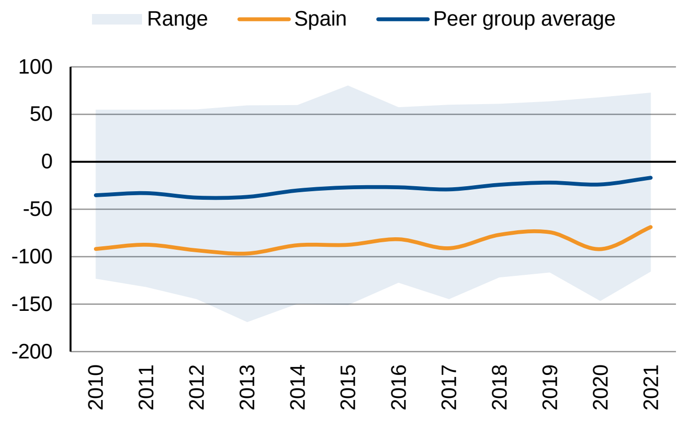
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
b	Current account resilience	Neutral	0	Strong recovery in tourism exports; resilience in non-tourism and non-energy trade surplus
	External debt structure	Neutral	0	Elevated debt stock, with meaningful shares by the government and central bank
	Resilience to short-term external shocks	Neutral	0	Euro area membership shields against short-term external shocks

Current account balance, % of GDP



Source: IMF WEO, Scope Ratings

Net international investment position (NIIP), % of GDP



Source: IMF, Scope Ratings

Financial Stability Risks

- **Banking sector**: The resilience of the Spanish banking sector is supported by comfortable capitalisation and liquidity metrics, as reflected in tier-1 and liquidity coverage ratios of 14.5% and 205.8% as of 2022 Q2, respectively. Profitability is strong following a swift recovery from the Covid-19 shock, with an aggregate sector return on equity of 10.3%, above the EU average (8.4%). Looking ahead, the worsening of the economic outlook is likely to weigh on asset quality, leading to potential increases in provisions and weighing on banking sector profitability, although interest margins should benefit from monetary policy tightening.

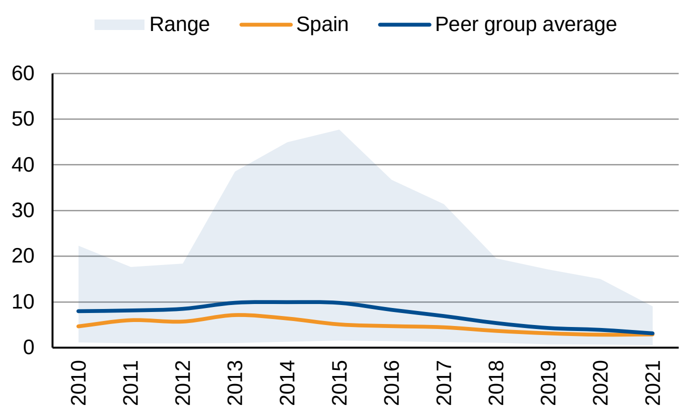
- **Private debt**: Spain entered the Covid-19 crisis in the wake of a period of significant private sector deleveraging, with aggregate private sector debt of around 150% of GDP at end-2019, down nearly 77pps from 2010-peaks. After increasing somewhat during the pandemic, primarily due to denominator effects, private sector leverage moderated again in parallel with the economic recovery. Non-financial corporates indebtedness stood at 101% of GDP as of 2022 Q1, around 8pps above its-end 2019 level albeit below the euro area average (110%). Household indebtedness is moderate, at 57% of GDP (2pp below the euro area average), and the household debt service to gross disposable income ratio is lower than most peers, at 6%. Despite an increase in the share of fixed-rate contracts in recent years, most household mortgage loans remain on variable rate terms, representing a degree of interest rate risk exposure in a context of monetary policy tightening.

- **Financial imbalances**: Spanish housing market activity remained strong in the first half of 2022, with the total number of transactions standing 30% above their 2019 H1 level. Price growth decelerated slightly to 8% YoY in 2022 Q2 (down 0.5pp from the previous quarter) but remains elevated compared to pre-pandemic averages. While growth in housing supply should remain constrained in the medium term, in view of rising construction costs, we expect price dynamics to moderate as rising mortgage rates weigh on demand.

Overview of Scope's qualitative assessments for Spain's *Financial Stability Risks*

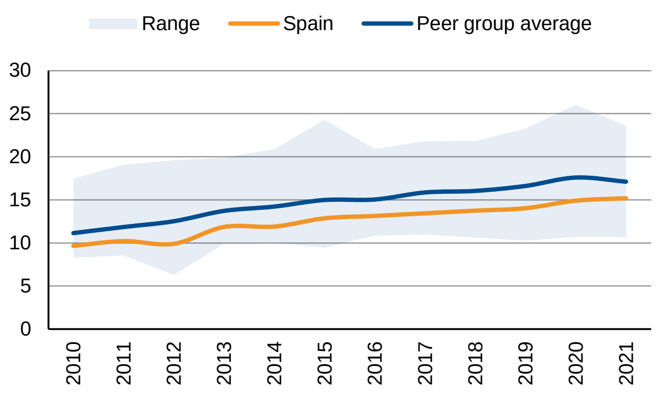
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	Banking-system capitalisation remains sound, but profitability pressures
	Banking sector oversight	Neutral	0	Effective oversight under European Banking Union authorities and the Bank of Spain
	Financial imbalances	Neutral	0	Deleveraging process

Non-performing loans, % of total loans



Source: IMF, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

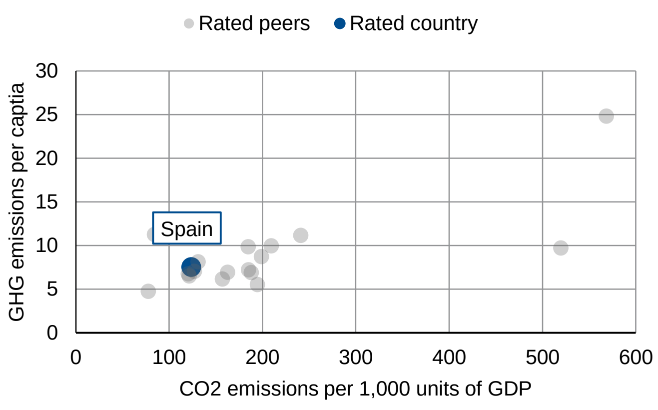
ESG Risks

- **Environment:** The Spanish government aims to reach carbon neutrality by 2050, targeting a 97% renewable energy mix by then. It has made significant progress in its electricity transition, increasing the share of renewables in the electricity mix from 24% in 2009 to 38% in 2019, putting it well on track to attain its 2030 objective (42%). The topography of Spain makes it particularly exposed to the adverse effects of climate change, with increased risks of reduced water resources, coastal erosion, loss of biodiversity and natural ecosystems, and more frequent extreme weather-related phenomena.
- **Social:** Despite achieving improvements in the European Commission Social scoreboard, Spain still faces considerable employment and social challenges. The labour market is characterized by low employment rates and high gender disparities. The percentage of young people neither in employment nor in education and training ('NEETs') is elevated (14.1% in 2020, against a 13.1% EU average). The government aims to take specific steps to tackle these issues, through investments in digital skills, labor market reforms, and a EUR 12.5 bn package aimed at the inclusion of youth.
- **Governance:** The PSOE-UP ruling coalition, led by PM Pedro Sánchez, needs the external support of the Catalan separatist (ERC) to have parliamentary majority. Despite conflicting views on key policy areas within the coalition, it has remained broadly stable since its inception, managing to strike agreements on key reforms as well as on budget bills. The next general elections are expected to take place in December 2023.

Overview of Scope's qualitative assessments for Spain's *ESG Risks*

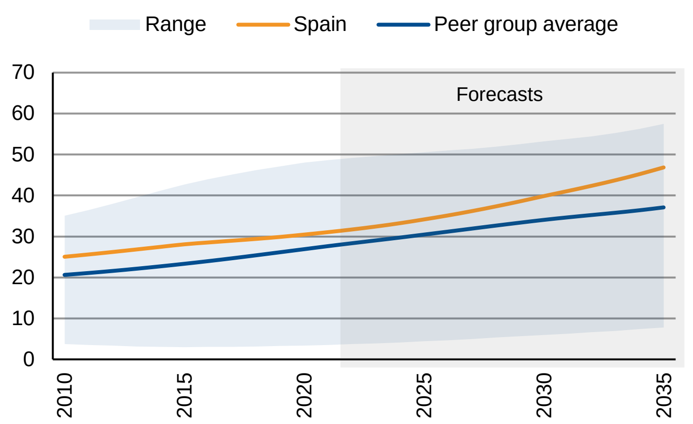
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb+	Environmental risks	Neutral	0	Exposure to natural disasters; ambitious commitment to achieve carbon neutrality by 2050
	Social risks	Weak	-1/3	Adverse demographic trends; high income inequality and risk of social exclusion
	Institutional and political risks	Neutral	0	Some reform momentum on labour market

Emissions per GDP and per capita, $mtCO_2e$



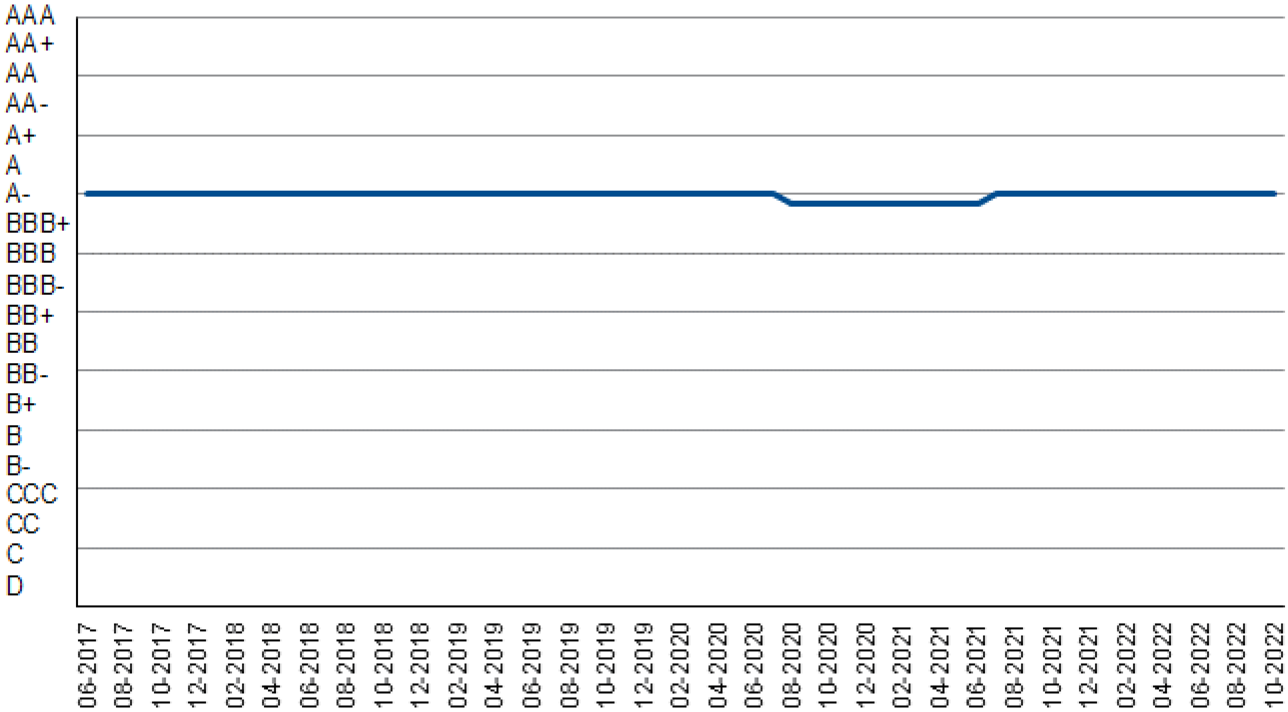
Source: European Commission, Scope Ratings

Old age dependency ratio, %



Source: United Nations, Scope Ratings

Appendix I. Rating history



NB. Positive/Negative Outlooks are treated with a +/-0.33-notch adjustment. Credit Watch positive/negative with a +/-0.67-notch adjustment.

Appendix II. Rating peers

Rating peers are related to sovereigns with an indicative rating in the same rating category or in adjacent categories per Scope's Core Variable Scorecard, including a methodological reserve-currency adjustment.

Peer group*
China
Croatia
Cyprus
Hungary
Italy
Japan
Latvia
Lithuania
Malta
Poland
Portugal
Slovakia
Slovenia

*Publicly rated sovereigns only; the full sample may be larger.

Appendix III. Statistical table for selected CVS indicators

This table presents a selection of the indicators (24 out of 30 – with the governance indicator reflecting a composite of six indicators) used in Scope's quantitative model, the Core Variable Scorecard, in line with Scope's Sovereign Rating Methodology. The metrics and sources for the data presented here ensure comparability across global peers and may therefore differ from national and other selective international statistics.

Pillar	Core variable	Source	2017	2018	2019	2020	2021
Domestic Economic	GDP per capita, USD '000s	IMF	28,197	30,423	29,576	27,039	30,090
	Nominal GDP, USD bn	IMF	1,312.1	1,421.6	1,393.2	1,280.5	1,426.2
	Real growth, %	IMF	3.0	2.3	2.1	-10.8	5.1
	CPI inflation, %	IMF	2.0	1.7	0.7	-0.3	3.1
	Unemployment rate, %	WB	17.2	15.3	14.1	15.5	14.7
Public Finance	Public debt, % of GDP	IMF	98.6	97.5	95.5	120.0	118.7
	Interest payment, % of revenue	IMF	6.0	5.7	5.3	5.0	4.5
	Primary balance, % of GDP	IMF	-0.8	-0.3	-0.8	-8.9	-5.1
External Economic	Current account balance, % of GDP	IMF	2.8	1.9	2.1	0.8	0.9
	Total reserves, months of imports	IMF	1.7	1.6	1.7	2.3	2.1
	NIIP, % of GDP	IMF	-90.8	-77.6	-75.2	-91.3	-67.3
Financial Stability	NPL ratio, % of total loans	IMF	4.5	3.7	3.2	2.9	2.9
	Tier 1 ratio, % of RWA	IMF	12.8	13.5	13.7	13.7	14.8
	Credit to private sector, % of GDP	WB	105.9	99.6	94.7	108.5	-
ESG	CO_2 per EUR 1,000 of GDP, $mtCO_2e$	EC	152.1	146.2	133.0	125.3	-
	Income share of bottom 50%, %	WID	20.7	21.1	21.0	21.1	21.1
	Labour-force participation rate, %	WB	74.2	74.1	74.2	-	-
	Old-age dependency ratio, %	UN	28.9	29.4	29.9	30.4	31.0
	Composite governance indicators*	WB	0.8	0.8	0.9	0.8	-

* Average of the six World Bank Worldwide Governance Indicators.

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps) as of 10.11.2022	39

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