Creditreform Sovereign Rating

Creditreform Rating

Rating Object	Rating Information	
KINGDOM OF SPAIN	Assigned Ratings/Outlook: **A- /stable**	Type: Monitoring, Unsolicited with participation
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 15-07-2022 “Sovereign Ratings” “Rating Criteria and Definitions”

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Rating Action

Neuss, 15 July 2022

Creditreform Rating has revised its outlook on the Kingdom of Spain to stable from negative 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-”

The outlook revision on the Kingdom of Spain reflects

(i) growing confidence that scarring effects from the Covid-19 crisis will be limited and overall favorable medium-term growth prospects backed by government support measures, advancing implementation of initiatives and reforms envisaged in the Recovery, Transformation and Resilience Plan (RTRP) and recovering tourism;

(ii) our expectation of a declining public debt ratio this year and next, followed by a stabilization over the medium term, albeit on a still high level; and

(iii) ongoing reform progress and the government’s demonstrated ability to reach consensus despite some challenges owing to the fragmented political landscape.

Key Rating Drivers

1. Large, wealthy and competitive economy; we expect economic growth to be driven by revived household spending, the ongoing recovery of tourism, and by expanding investment; while to some extent mitigated by government support, high energy and commodity prices as a result of the attack on Ukraine, compounded by global supply shortages, weigh on GDP growth
2. Advancements in terms of investment and initiatives set out in the RTRP continue to render constructive the medium-term economic growth outlook; strengthening labor market conditions, alongside expectations of improvements regarding structural deficiencies of the labor market on the back of last year’s reform add to this
3. Strong institutional framework, including advantages associated with EU/EMU membership; progress in terms of implementation of the RTRP measures and launch of a number of strategic projects suggests timely follow-through on key announced initiatives so far
4. Better-than-anticipated fiscal performance last year on the back of rebounding tax revenue; we expect the public debt ratio to stabilize on a high level after a continued decline

this year and next, emphasizing pronounced uncertainty due to the present global risk environment

5. Comparatively low cost of debt outstanding and increasing average life of debt mitigate risks to fiscal sustainability to some extent; potential fiscal relief from the labor market reforms remains to be monitored, as are net effects from the pension reform; banking sector remained largely resilient as illustrated by stable asset quality
6. Vulnerabilities related to Spain's stance as net international debtor; however, persistent current account surpluses have contributed to narrowing large negative net international investment position; we expect the current account to remain in surplus, with recovering tourism receipts more or less offset by higher energy prices' effects on imports

Reasons for the Rating Decision and Latest Developments[1]

Macroeconomic Performance

The Kingdom of Spain's credit rating is underpinned by its large, competitive and prosperous economy, which makes for an overall favorable macroeconomic profile. The growth trend is set to remain strong, with the pandemic having only resulted in a brief, albeit sharp, economic contraction. The recent GDP growth rebound was partly driven by the recovery of the pivotal tourism industry amid advancing vaccination campaigns, flanking strong investment and employment growth. While structural challenges on the labor market continue to weigh somewhat on our assessment, prospects for meaningful improvements have brightened on the back of last year's labor market reform. While direct effects stemming from the Russian invasion should be contained, headwinds posed by high commodity prices and supply bottlenecks due to the war in Ukraine and China's pandemic policy constitute downside risks to the short-term growth outlook and could, if lasting for longer, also cloud the otherwise favorable medium-term growth prospects. Progressing roll-out of the measures and initiatives included in the Recovery, Transformation and Resilience Plan generally bodes well for the macroeconomic picture in the medium-term.

Having experienced one of the strongest real GDP declines in the euro area (EA) in the first year of the Covid-19 pandemic (2020: -10.8%, EA: -6.3%), Spain's economy regained some of its lost ground last year, with GDP expanding by 5.1%, slightly less than we had expected in our last review. Similarly, despite increasing by 9.4% to USD 41,839 in 2021 (PPP terms, IMF data), GDP per capita did not reach its 2019 level (USD 42,600). Nevertheless, at this level Spain's GDP per head remains in line with that of its A-rated peers in our rating universe.

The economic recovery in 2021 was broad-based, but mostly driven by rebounding private consumption in light of the easing of social distancing requirements, contributing 2.6 p.p. to the expansion of economic output, although not yet making up for the decline in household expenditure in the preceding year. Investment, net exports and government consumption also delivered positive contributions to GDP growth last year.

In the first quarter of 2022, quarterly GDP growth proved rather modest (0.2% q-o-q) amid renewed Covid-19 containment measures and rising energy prices which restrained household

[1] This rating update takes into account information available until 08 July 2022.

expenditure. With that, the Spanish GDP remained 3.6% below its level prior to the outbreak of the coronavirus (Q4-19), continuing to compare unfavorably against the euro area as a whole (Q1-22 vs. Q4-19: +0.8%).

While direct trade links to Russia and Ukraine are limited, the adverse effects from high energy and commodity prices resulting from the war in Eastern Europe and persistent global supply bottlenecks - the latter also stemming from China's zero-Covid strategy - should weigh on economic developments in the near term. Sentiment indicators have shown mixed signals lately, with sentiment in the service sector holding up well since the Russian invasion in Ukraine and even improving from April, whereas industrial confidence has taken a limited hit and consumer sentiment has clouded significantly over the last few months.

Moreover, some of Spain's key European trade partners are more heavily affected by geopolitical developments, worsening the international trade environment. Given these circumstances, a recovering tourism industry proves vital to economic resilience, and we expect tourism to be a key driver of Spain's economic expansion at this stage, as threats from coronavirus and related mutations seem to ebb and adaptation to life with the virus has improved, including vaccination campaigns.

In the first five months of the current year, the number of international tourists arriving in Spain amounted to about 22.7mn (INE data), corresponding to more than seven times (increase by 609.3%) the number registered in the same period in 2021. However, the cumulative number still falls short of the tourist arrivals in the respective period in 2019, representing 77.7% of the pre-crisis level. On the other hand, tourist spending in the first five months of 2022 reached 87.6% of the respective amount in 2019.

We thus forecast net exports to contribute positively to growth this year, with services exports taking the lead, whereas goods exports are likely to be hampered by supply shortages, e.g. in the important automotive industry. Drawing on the European Commission's (EC) survey relating to factors limiting production in Q2-22, the share of companies reporting on material and/or equipment shortages in the automotive industry shot up to above 80%.

Along with recovering tourism, growing investment in light of rolling out the RTRP should be a stabilizing factor this year, as private consumption is likely to be hampered by soaring energy prices. In June 2022, preliminary figures regarding the HICP inflation rate showed an increase to 10.0% (EA: 8.6%, Eurostat). This said, on 29 March 2022, the government approved the National Response Plan to cushion the economic and social impact of the war. Mobilizing up to EUR 16bn in total, of which EUR 6bn in direct aid and tax cuts, the support was initially intended to remain in place until 30 June 2022. In June 2022, the government announced an extension of the direct support measures to households and companies to the end of 2022, adding about EUR 9.1bn in direct aid to soften the blow from escalating energy prices. In order to further alleviate price pressures, an exceptional mechanism to cap gas prices was introduced, agreed with the EC ('Iberian mechanism', also to apply to Portugal), which is to be in place for one year starting from May-22.

Apart from government support, private consumption should be backed by the improving Spanish labor market, which in the course of the corona crisis benefited from short-time work schemes (ERTEs), and which in the ongoing recovery saw strong employment growth. The annual unemployment rate averaged 14.8% in 2021 (EA: 7.7%, Eurostat), after having risen to 15.5% in 2020. In monthly terms, unemployment fell to 13.1% in May-22, still comparing high

against the euro area, but marking its lowest level since Oct-08. As of Q1-22, total employment exceeded its pre-crisis level (Q4-19) by 0.5% (EA: +1.0%, Eurostat, domestic concept).

Nominal wages could experience limited upward pressure given recent inflationary developments coupled with still prevalent slack in the labor market. We think that the envisaged lifting of the minimum wage to 60% of the average wage by 2023 will be generally supportive to consumers' purchasing power. The still relatively high household saving rate (Q4-21: 11.4%, avg. 2017-19: 6.3%, ECB data) would also point to scope for private consumption to increase markedly, although waning consumer confidence may hint at cautious behavior.

Overall, we expect real GDP growth to moderate to about 4.1% in 2022, with substantial carry-over effects from the preceding year (3.2 p.p.), and to about 2.9% in 2023. Apart from the risks associated with the geopolitical tensions, we have to highlight that tourism remains potentially vulnerable to new rounds of coronavirus infections, especially if new variants emerge that require updated vaccines.

From a structural perspective, Spain's labor market has long been grappling with challenges. While its employment rate has climbed to 64.4% as of Q1-22, exceeding its pre-crisis level (Q4-19) by 0.9 p.p. (LFS-adj., 15-64y, Eurostat), it remains well below the euro area level (74.4%). Long-term unemployment, which had been on the decline prior to the outbreak of Covid-19, still moves above the pre-crisis level and continues to exceed the euro area level, registering 5.8% in Q4-21 (EA: 3.1%, 20-64y, Eurostat).

However, we think that last year's labor market reforms enacted at the end of Dec-21 should have laid the ground for some structural improvements, putting stronger emphasis on the protection of workers by limiting the use of temporary contracts and tightening regulation for subcontracting. The share of employed persons with temporary contracts, at 21.4% as of Q1-22, remains one of the highest in the EU, but has come down somewhat compared to pre-crisis levels (avg. 2019: 22.5%, 15-64y, Eurostat).

While the reform also reverses some elements of flexibility introduced with the 2012 labor market reforms and concerning collective wage bargaining, other elements concerning flexibility of working conditions remain in place. Apart from that, the agreed measures also introduce a more permanent short-time work scheme (i.e. RED mechanism), in force since Mar-22 and intended to offer a more effective way of dealing with cyclical and sector-specific shocks.

Along with Active Labor Market Policies envisaged in the RTRP, the reform could thus be conducive to reducing structural deficiencies on the Spanish labor market, opening up scope to boost potential growth by enhancing the labor market's resilience to shocks. In this context, a potentially stronger focus on training, re- and upskilling could lift labor productivity, which has underperformed against the euro area as a whole both per hour and per head over recent years.

In addition to expectations of structural improvements on the labor market, medium-term growth prospects remain backed by a raft of measures to foster the green and digital transformation elaborated in the RTRP. The disbursement of the second instalment of the respective EU funds was greenlighted by the EC on 27 June 2022 after confirming that Spain has met the agreed targets and milestones, suggesting that the sovereign remains on course to implement the initiatives in a timely manner. Still, a protracted war in Ukraine and persistent, or even further escalating, repercussions would likely pose some downside risks to a timely and efficient delivery of these measures, as this may entail financial reprioritization. According to EC simulations, the RTRP could increase Spain's GDP by 1.8% to 2.5% by 2024.

On the back of these initiatives, underlying growth is anticipated to re-narrow the gap to the euro area as whole, following a larger deviation over the last two years. With estimated potential growth rates of 1.2% this year and 1.3% next, it would still remain slightly below estimates for the euro area overall, but we expect reforms to translate into higher potential growth rates in this decade, well exceeding those registered in the 2010s (avg 2010-19: 0.5%, EA: 0.9%, AMECO).

While Spain displays a somewhat mixed picture compared to its main European trade partners when it comes to recent developments of real unit labor costs as an indicator for cost competitiveness, its global export market share has ticked up to 1.80% in 2021 (2020: 1.76%), masking a more palpable increase of the respective share in services (2021: 2.02%, 2020: 1.79%) amid recovering tourism.

In terms of its business environment and factors linked to non-cost competitiveness, Spain is viewed as occupying a middle-range position among fellow EU members, being ranked 36th out of 63 economies considered in the 2022 update of the IMD world competitiveness ranking (2021: rank 39 out of 64), indicating some room to improve. In the same vein, given that Spain has been lagging the euro area when it comes to R&D expenditure, especially concerning the private sector (BERD, avg 2015-19: 0.7% of GDP, EA: 1.4%), there remains scope to catch up. With regard to the ambition to further drive its digital agenda, Spain's rank 9 among the EU-27 concerning the EC's Digital Economy and Society Index 2021 seems to suggest a favorable starting point on which to build, with the sovereign performing particularly well in terms of connectivity.

By European comparison, private indebtedness does not appear excessive and dropped in 2021 both in terms of NFC debt to GDP (-4.3 p.p. to 80.1%) and private household debt to disposable income (-1.5 p.p. to 92.8%). Having seen a steep increase after the outbreak of the pandemic, outstanding loans to NFCs have risen only moderately in y-o-y terms over the last few months (May-22: 0.9%). The outstanding amount in mortgages to households has seen y-o-y increases since Jun-21, with some slight acceleration more recently (May-22: 1.4%).

As moratoria on declarations of bankruptcy were to expire at the end of Jun-22, we view as positive the Spanish parliament's approval of the draft law overhauling Spain's insolvency framework at the end of June 2022, which includes enhancing efficiency of procedures and introducing special procedures for microenterprises, potentially helping to avoid any cliff edge effects.

Institutional Structure

Spain's high-quality institutional framework, which includes the benefits associated with being a EU/EMU member, continues to buttress our credit assessment of the sovereign and is largely confirmed by the latest set of the World Bank's Worldwide Governance Indicators, notwithstanding some deterioration in this respect. Despite challenges entailed by a fragmented political landscape, the minority government in our view has demonstrated its ability of reaching consensus and following through on envisaged measures and strategic projects as set out in the RTRP. We will continue to monitor further progress in this regard.

Our assessment of Spain's institutional set-up is underpinned by the latest vintage of the World Bank's Worldwide Governance Indicators (WGI) referring to the year 2020. As far as the four dimensions on which we put the highest emphasis are concerned, the sovereign's perceived performance is roughly in line with the median of our A-rated sovereigns, continuing to trail somewhat the respective euro area median rank.

As regards the perceived quality of policy formulation and implementation, i.e. WGI government effectiveness, Spain's relative rank has deteriorated slightly, from 43 to 47 out of 209 economies. Similarly, the sovereign slipped by 6 ranks to 46 out of 209 economies regarding rule of law. Contrary to this, Spain moved up 4 ranks to relative rank 50 when it comes to control of corruption, while it maintained its relative rank of 41 in terms of the extent to which citizens are able to participate in selecting their government and express themselves freely (WGI voice and accountability).

Recalling episodes of reform delays over recent years, partly due to the political fragmentation that comes with challenges to reaching a consensus, or backtracking on past efforts to put the pension system on more solid footing, reform momentum has gained traction more recently. As mentioned above, the EC's positive assessment enabling the second instalment of funds from the EU's Recovery and Resilience Facility to our mind underpins the sovereign's taking ownership in terms of reform as well as responsiveness to policy recommendations.

Authorities' involving the social partners to ensure broad acceptance of such measures strengthens expectations of an effective implementation. In the context of the RTRP, a number of strategic projects (PERTEs) was launched as well, among others relating to electric and connected vehicles, to the transformation of the National Health System, and to renewable energy and hydrogen technology, with further PERTEs to follow.

Moreover, a number of legal reforms have recently been brought on their way to increase the efficiency of the justice system, with regard to which the EC's 2021 Rule of Law Report stressed some remaining challenges. We understand that authorities made headway in terms of the pending renewal of the Council for the Judiciary this June. Apart from this, a wide-ranging overhaul of taxation is envisaged, with the review of the tax system provided by a committee of experts in Mar-22 likely to inform reform proposals. Reportedly, the presented analysis also included corporate, property and environmental taxation. Picking up on the topic of prevention of corruption, GRECO'S second compliance report on corruption prevention regarding members of parliament, judges and prosecutors attests to some further progress.

Spanish policy-makers remain firmly committed to environmental policies and sustainable development, maintaining their objective to reach carbon neutrality by 2050. The sovereign moves in the upper third among the EU-27 with regard to the EC's Eco Innovation Index, underscoring a more advanced stage when it comes to transforming its economy in line with green goals. Further corroborating this, we note that Spain is among the EU members with the lowest greenhouse gas emissions per capita (2020: 5.9 tons of CO2 equivalent, EU-27: 7.5). The overall share of energy from renewable sources was just under the EU-level in 2020 (21.1% vs. EU 22.1%), with the share of renewable energy sources in gross electricity consumption markedly higher compared to the EU as whole, whereas the use of renewables in heating/cooling and regarding transport compares as lower.

In a bid to promote the shift towards sustainable mobility, the RTRP allocates substantial funds towards electric mobility and respective infrastructure, as well as to railway infrastructure. In addition, significant investment goes towards renovation of buildings to enhance energy efficiency. The development of sustainable financing moves in parallel to such measures. According to the IMF data, Spain issued a total volume of green bonds of USD 5.66bn in 2021, with its first green bond issuance taking place in Sep-21.

Fiscal Sustainability

Risks concerning fiscal sustainability constitute a key factor in our assessment of the sovereign's creditworthiness, with the pandemic prompting a temporary reversal of the gradual downward path of the sovereign's elevated debt ratio. While the threats associated with the coronavirus seem to be receding, the adverse economic repercussions from Russia's war in Ukraine are set to place a burden on public finances. Uncertainty over developments regarding both factors remains pronounced. Even though the pension reform contains elements to encourage a longer work life, relinking pensions to CPI could raise fiscal pressure in the medium to longer term. Developments will have to be monitored here. Risks stemming from the banking sector continue to appear largely contained at this point in time. The favorable debt profile with relatively long average maturity in combination with still low financing costs continues to mitigate fiscal risks to some extent.

After general government net borrowing was reduced to around 3% of GDP prior to the outbreak of the coronavirus, the pandemic caused a sharp increase in Spain's headline deficit to 10.3% of GDP in 2020. However, amid the economic recovery last year and the phasing out of some support measures, public finances witnessed a marked improvement, as the sovereign's deficit narrowed to 6.9% of GDP, primarily driven by higher-than-assumed revenue intake. With that, the 2021 headline deficit came in lower than we had estimated in our last review. Nevertheless, the deficit remained more pronounced than the euro area average (2021: -5.1% of GDP).

Boosted by strong increases in tax receipts and net social contributions in light of the economic rebound and rising employment, total general government revenue soared by 13.2% in 2021. At the same time, total government expenditure grew to a lesser extent than in the preceding year, mainly as social benefits other than social transfers in kind more or less stagnated, contrary to a large increase in the prior year. To be sure, compensation of employees and intermediate consumption grew stronger than in 2020 (2021: 4.9% and 7.0%, respectively), and interest rate payments increased in 2021 by 3.4%, after plunging by 11.0% in 2020. Reflecting the rollout of the RTRP, public fixed investment continued to grow dynamically last year (+8.2%).

While still under the impression of several infection waves, temporary measures to combat the pandemic are estimated to decrease from about 2.8% of GDP in 2021 to 0.4% of GDP in 2022 (EC estimate), as the current year looks set to be shaped by fading Covid-19 support on the one hand and measures to soften the blow from high energy and commodity prices on the other. We gather that measures taken to cushion the adverse economic effects from Russia's aggression against Ukraine are estimated to amount to about EUR 25bn or roughly 2.0% of our estimated GDP 2022, including guarantees. We emphasize that uncertainty both over the epidemiological and geopolitical developments remains considerable.

Having said that, recent figures on tax collection paint a comparatively positive picture. Drawing on the Monthly Tax Collection Report provided by Spain's Tax Agency, total tax revenue in the first five months of the current year (cash basis) rose by 19.1% versus the same period in 2021, boosted partly by increasing VAT and personal income tax receipts. Tying in with this, reportedly for the first time, the number of Social Security affiliates exceeded 20 million as of Q2-22, pointing to limited fallout from the geopolitical tensions at present.

With the fiscal stance likely to remain expansionary, and acknowledging significant uncertainty around estimates, we currently expect the general government deficit to shrink to about 5.3% of GDP in 2022 amid an ongoing economic recovery. For 2023, we anticipate the negative position to narrow further to about 4.5% of GDP. Higher spending on defense, possibly added to by

fiscal pressure through linking pensions to inflation could weigh on public finances further out. On the other hand, we are aware that the government expects the RED mechanism to exert a net positive effect on public finances.

Further afield, authorities expect the headline deficit to decline to 2.9% of GDP in 2025 (Stability Program 2022, SP22), which Spain's Fiscal Council (AIReF) by and large considers feasible. That said, we flag that there is little visibility along the lines of a medium-term fiscal strategy on how to achieve this, pointing to some risks that the medium-term structural deficit may remain more pronounced than currently anticipated by the government.

Against the backdrop of a narrowing deficit and resuming GDP growth, Spain's general government debt declined to 118.4% of GDP in 2021, and further to 117.7% of GDP as of Q1-22, having leapt by 21.7 p.p. from an already elevated level to 120.0% of GDP in 2020. Spain's public debt ratio hence remains among the highest in the EU-27, highlighting a key credit weakness. Given our expectations for a narrowing deficit and comparatively strong nominal GDP growth, we assume a more marked reduction of the public debt ratio this year, penciling in 116.2% of GDP for 2022. For 2023 we expect a decrease to 114.7% of GDP, with the GDP deflator likely moderating.

With regard to contingent liabilities, we note that public guarantees had declined significantly in 2021, by about EUR 84.4bn to EUR 35.1bn, or roughly 2.8% of GDP (2020: 10.6% of GDP, SP22). More recently, given the burden placed on the Spanish economy from the repercussions of the war in Ukraine, at the end of Mar-22, authorities approved a guarantee envelope over EUR 10bn or 0.8% of 2021 GDP for bank loans.

Having entered the pandemic from a relatively solid position in terms of capital buffers and asset quality after a long phase of deleveraging in the aftermath of the global financial crisis, Spain's banking sector showed resilience throughout the global health crisis, cushioned partly by the application of loan moratoria and public guarantees. As part of the government's Mar-22 support package, state-guaranteed loans were extended by six months.

According to Banco de Espana, 94% of the moratoria related to loans to private households had expired as of Dec-21. The NPL ratio, which moves above the EU level, has remained more or less stable during the pandemic and following the expiry of the moratoria, posting at 3.0% as of Q1-22 (EU: 1.9%, EBA data), pointing to a smooth transition. Having declined by 2.8 p.p. compared to Q1-21, the share of stage 2 loans in total loans and advances outstanding with expired EBA-compliant moratoria stood at 19.7% in this year's first quarter, thus below the EU average of 24.5% (EBA data). While direct credit exposure to Russia via Spanish financial intermediaries is very limited, we closely monitor asset quality in light of the war in Ukraine.

Having been driven up by the increase in total capital and the decrease in risk-weighted assets over the most acute phase of the pandemic, the CET1 ratio edged down to 12.8% in Q1-22, remaining slightly above pre-crisis levels, while continuing to compare somewhat unfavourably against the EU average (Q1-22: 15.2%, EBA data).

The share of government bonds held by Spanish banks further dwindled to 6.7% of banks' total assets (ECB data, May-22), alleviating potential concerns over a resurfacing sovereign-bank nexus. Further to restructuring efforts in the banking sector, we note that, following the completed merger of Bankia and CaixaBank, a new deadline for selling the State's stake (via the Executive Resolution Authority FROB) in CaixaBank was set at Dec-23. In this context, we would also highlight that FROB as of Apr-22 has held the majority of bad bank Sareb's capital, reaching a stake of 50.14%.

Despite rising bond yields in 2022, average cost of debt outstanding has continued to fall, to 1.57% as of Jun-22 (Tesoro data), as maturing bonds had been issued at higher yields, representing a risk-mitigating factor. This said, cost at issuance has gone up to 0.55% as of Jun-22, after having turned negative in 2021, possibly signaling a beginning reversal of the long-term trend of falling interest cost. The yield on 10y Spanish government bonds has climbed to 2.56% as of 24 Jun-22, a level last witnessed in Aug-14 (weekly data). However, the total average maturity of central government debt was lifted to 8.11y over the first six months of 2022 (Tesoro), constituting a new high, and alleviating interest rate risks in the short term. The sovereign thus continues to demonstrate sound debt management.

Apart from boasting a diversified and broad investor base, a considerable share of government debt is held by the official sector, further mitigating risks to fiscal sustainability. Under its PEPP, for which the ECB discontinued net asset purchases at the end of Mar-22, cumulative purchases of Spanish government bonds in the amount of roughly EUR 190.5bn were made, while under the PSPP, for which net asset purchases are discontinued from Jul-22, the ECB had accumulated Spanish government bonds to the tune of about EUR 315.1bn, combined corresponding to about 42% of the 2021 GDP.

In addition to terminating net asset purchases under the Asset Purchase Program (APP) in Jul-22, the ECB envisages hiking its key interest rates by 25bp in July, with a further 50bp rise likely to take place in Sep-22. Principal payments from maturing securities purchased under the APP will be reinvested for an extended period of time, whilst principal payments purchased under the PEPP are to be reinvested until at least end-24. Moreover, with the ECB's announced intention to develop a new tool to address resurgent fragmentation risks in the euro area, referred to as Transmission Protection Mechanism, refinancing risks appear set to remain manageable over the medium term.

Foreign Exposure

Spain's external position gives rise to some vulnerabilities, reflected in a large negative net international investment position (NIIP) which constitutes one of the most negative positions among the EU members. However, risks remain somewhat mitigated by the NIIP's composition, and persistent current account surpluses since 2012 - although markedly diminished through collapsing tourism during the most acute phase of the corona crisis and more recently through rising energy prices - have contributed to gradual improvements. Given supply shortages hampering car exports and the reverberations from Russia's war in Ukraine to energy and commodity prices, we expect the current account surplus to remain muted this year, as recovering tourism and wider service exports will likely be offset by an increasing energy bill owing to soaring prices.

Spain's economy managed to retain its current account surplus in 2020/21 amidst adverse conditions. At 0.9% of GDP last year (2020: 0.8% of GDP), Spain's current account surplus remained more moderate compared to the pre-crisis average of 2.4% in 2015-19. While the surplus in the service balance started to recover on the back of revived tourism over the course of 2021, the deficit in the goods balance widened in light of rising energy prices as well as supply bottlenecks affecting car exports in particular.

With these factors remaining in place at the beginning of the present year, the current account surplus narrowed further to 0.6% of GDP as of Q1-22 (four-quarter moving sum). Looking ahead, we expect the current account to post close to a balanced position. We assume that the current

account will shift back into a more comfortable surplus position in 2023, at least to some extent, mirroring a relaxation in terms of energy prices and supply strains.

Driven by sustained current account surpluses over recent years, Spain's position as a pronounced net international debtor has continued to improve. At the end of 2021, the NIIP stood at -70.4% of GDP (2020: -84.9% of GDP) and posted at -66.8% of GDP in Q1-22. Reflecting further improvement in its composition, we note that excluding non-defaultable instruments (NENDI), the position narrowed to -40.2% of GDP at the end of 2021, constituting the smallest negative position since 2005.

Rating Outlook and Sensitivity

Our rating outlook on Spain's long-term credit ratings is stable, as expectations of a comparatively robust medium-term growth outlook, progressing reform implementation and a likely stabilizing public debt ratio as regards the medium term following anticipated declines in 2022 and 2023 outweigh risks related to the growth outlook via geopolitical developments as well as risks to fiscal sustainability. We also continue to emphasize that the assessment and interpretation of economic developments remains more challenging than under normal circumstances, as is the case for other indicators, in particular from the fiscal realm.

We could consider raising the sovereign's ratings if recent signs of resilience in tax revenue continue to firm, on the back of palpable improvement of labor market metrics as a consequence of recent and ongoing labor market reforms, contributing to a downward sloping public debt ratio. Upward pressure on the ratings could, more generally, stem from a stronger-than-expected economic recovery on the back of a timely and effective implementation of RTRP measures which would leave us more confident that the sovereign's public debt ratio will reverse on a sustainable basis.

By contrast, we could reinstate a negative outlook or lower the sovereign's ratings if medium-term growth prospects worsen, with adverse consequences for the outlook on public finances and the debt trajectory. Downward pressure could result from a more protracted Russian aggression against Ukraine than currently expected, calling for enhanced government support, or a conceivable further escalation of geopolitical tensions, possibly exacerbated by renewed adverse pandemic-related developments. A significant slowdown in implementing the RTRP measures could also lead to a less favorable assessment of fiscal sustainability risks, prompting a negative rating action.

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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

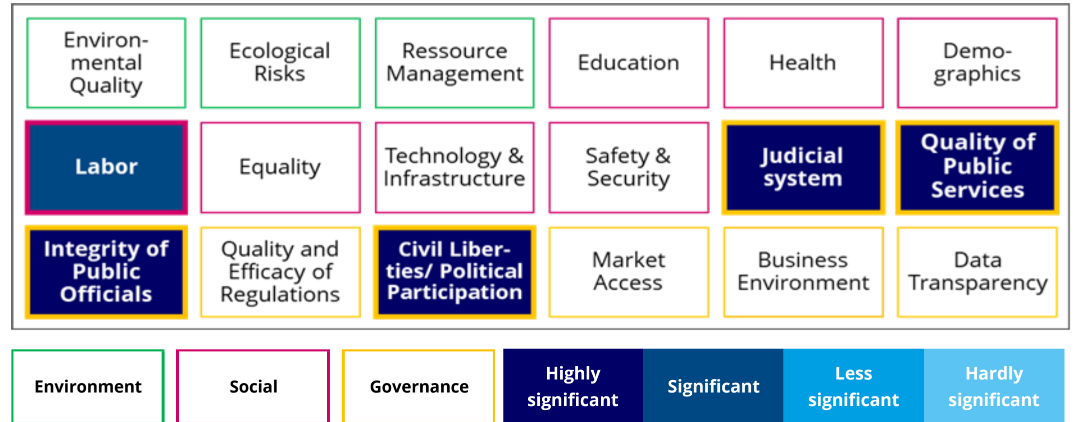
*) Unsolicited

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.

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.

Economic Data

[in %, otherwise noted]	2016	2017	2018	2019	2020	2021	2022e
Macroeconomic Performance							
Real GDP growth	3.0	3.0	2.3	2.1	-10.8	5.1	4.1
GDP per capita (PPP, USD)	37,310	39,626	41,328	42,600	38,244	41,839	46,413
Credit to the private sector/GDP	129.1	120.6	111.2	105.7	121.6	109.1	n/a
Unemployment rate	19.6	17.2	15.3	14.1	15.5	14.8	n/a
Real unit labor costs (index 2015=100)	98.8	97.9	98.1	99.8	104.7	102.7	n/a
World Competitiveness Ranking (rank)	34	34	36	36	36	39	36
Life expectancy at birth (years)	83.5	83.4	83.5	84.0	82.4	83.3	n/a
Institutional Structure							
WGI Rule of Law (score)	1.0	1.1	1.0	1.0	0.9	n/a	n/a
WGI Control of Corruption (score)	0.6	0.5	0.6	0.7	0.7	n/a	n/a
WGI Voice and Accountability (score)	1.0	1.0	1.0	1.0	1.0	n/a	n/a
WGI Government Effectiveness (score)	1.1	1.0	1.0	1.0	0.9	n/a	n/a
HICP inflation rate, y-o-y change	-0.3	2.0	1.7	0.8	-0.3	3.0	7.1
GHG emissions (tons of CO2 equivalent p.c.)	7.4	7.6	7.5	7.1	5.9	n/a	n/a
Default history (years since default)	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Fiscal Sustainability							
Fiscal balance/GDP	-4.3	-3.1	-2.6	-3.1	-10.3	-6.9	-5.3
General government gross debt/GDP	102.8	101.9	100.5	98.3	120.0	118.4	116.2
Interest/revenue	7.2	6.6	6.2	5.8	5.4	5.0	n/a
Debt/revenue	269.3	266.5	256.1	250.4	289.1	270.8	n/a
Total residual maturity of debt securities (years)	6.5	6.9	7.4	7.5	7.8	7.9	n/a
Foreign exposure							
Current account balance/GDP	3.2	2.8	1.9	2.1	0.8	0.9	n/a
International reserves/imports	0.2	0.2	0.2	0.2	0.2	0.2	n/a
NIIP/GDP	-85.5	-85.5	-80.1	-75.0	-84.9	-70.4	n/a
External debt/GDP	168.7	168.2	168.1	169.6	199.1	193.3	n/a

Sources: IMF, World Bank, Eurostat, AMECO, ECB, INE, 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
Monitoring	24.07.2020	A- /negative
Monitoring	22.01.2021	A- /negative
Monitoring	16.07.2021	A- /negative
Monitoring	15.07.2022	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. The rating was not endorsed by Creditreform Rating AG from a third country as defined in Article 4 (3) of the CRA-Regulation.

This sovereign rating is an unsolicited credit rating. The Spanish Treasury participated in the credit rating process as it provided additional information. 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	YES
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, IMD Business School, European Center for Disease Prevention and Control (ECDC), Blavatnik School of Government, Tesoro Publico de Espana, Banco de Espana, Instituto Nacional de Estadistica (INE), 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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