EthiFinance Ratings maintains the unsolicited rating of Spain at A- changing the outlook to Under Observation

Despite the conflict between Russia and Ukraine, the European rating agency does not foresee changes in its growth forecasts, which it sets at 5.5% for this financial year 2022, due to the impact of the European funds earmarked for investments to underpin the Recovery, the Transformation and Resilience Plan, as well as the reactivation of the tourism sector and the strength of the foreign sector. It warns, however, of the high uncertainty arising from the effects of the war between Russia and Ukraine, which is leading to an upturn in inflationary pressures.

Sovereign rating of the Kingdom of Spain

The unsolicited credit rating of the Kingdom of Spain of A- Under Observation takes into account the recovery of the Spanish economy and public finances during the last financial year, which allows it to face, for the time being, the uncertainties arising from the conflict between Russia and Ukraine. Thus, EthiFinance Ratings maintains the forecast of growth of the Spanish economy at 5.5%. The European rating agency highlights the positive impact on the economy of the European funds earmarked for investments that are expected to fuel the Recovery, the Transformation and Resilience Plan, as well as the reactivation of tourism and the good performance of the foreign sector. However, despite the fall in the unemployment rate to 12.5%, they also warn of high rates of employment that is temporary in nature as well as high levels of dependence. The report also identifies as a risk the still high levels of deficit and public debt, at around 4.8% and 116.4% at the end of the financial year. All these forecasts are subject to the evolution of the war started by Russia, which is causing an upturn in inflationary pressures due to the increase in the price of raw materials. Indeed, the CPI is expected to rise by year-end to 3.7%, compared to the 2% estimated in the previous review.

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In its march review, **EthiFinance Ratings (formerly Axesor Rating) maintains the credit rating of the Kingdom of Spain at A- Under Observation.**

The credit rating considers the good evolution of the Spanish economy and public finances during the financial year 2021, even considering that pre-pandemic levels have not been reached yet. In addition, a positive impact is expected from investments financed by European Funds which are included in the Recovery, Transformation and Resilience Plan. It takes into account that Brussels is expected to release EUR 18 billion from these funds this year, in addition to the EUR 19 billion received last year.

Added to the above are the prospects of the tourism sector, which is already showing clear signs of recovery according to the first data advanced from the Bank of Spain on the balance of goods and services, which recorded a surplus of EUR 17,1 billion, 130% year-on-year growth. On the other hand, the strength of the external sector is maintained, with an 18% growth in exports —due to improvements in external demand — and a 21% increase in imports — which is largely attributed to the increase in the price of raw materials.

All of this allows Spain, for the time being, to face the uncertainties associated with the conflict between Russia and Ukraine. Thus, EthiFinance Ratings **predicts that the Spanish economy will grow at a rate of 5.5% this year.**

Regarding the labour market, expectations are *“favourable”*, with a fall in unemployment to 12.5%, *which “will contribute to the improvement of the economy as a whole.”* Even so, EthiFinance Ratings insists on the *“high structural unemployment levels”, well above that of other European countries, as well as the high rates of youth unemployment and temporary work. Regarding the latter, we expect a correction after the approval of the new Labour Reform”*, the report points out.

The rating is, however, constrained by another of the structural problems of the Spanish economy, the high dependency rate (which in 2021 stood at 54%), together with the low rate of population growth (3% on average in recent years), *what “may pose a risk to the sustainability of future public finances.”*

Inflationary pressures and the impact of the armed conflict

The rating report highlights the inflationary pressures observed since March 2021, which soared to 7.4% last February due to rising energy prices and bottlenecks in the supply chains. In this regard, EthiFinance Ratings notes *that “an increase of almost two and a half percentage points is observed in underlying inflation (from 0.6% in July 2021 to 3% in February 2022), providing indications that there are already transmission effects to other goods and services.”* Indeed, the financial year 2022 is expected to close with an inflation of 3.7%, compared to the 2% estimated in the previous review.

The situation could be aggravated by the conflict between Russia and Ukraine, **slowing down the country's economic recovery** due to rising prices of raw materials (gas, oil), construction materials such as aluminium, and cereals (corn, wheat, sunflower oil). In turn, this increase will end up being translated to other consumer goods and services and will reduce the purchasing power of consumers and businesses.

The external sector could also be affected by the increase in the price of gas futures, which would negatively impact the current account through imports. However, as noted in the rating report, *“trade relations with both Russia and Ukraine do not represent a high percentage of Spanish international trade.”* One noteworthy fact is that 84% of Russian imports correspond to gas and oil. As for Spanish exports to the aforementioned country, they are specified in machinery and vehicles "but in disaggregated terms, they are not relevant for the global situation of the Spanish external sector."

Budget balance, debt, and liquidity

Despite the improvement in public finances, the rating of A- under observation of the Kingdom of Spain takes into account the high levels of deficit and total public debt, above those recorded in 2019 and which, in addition, are subject to the uncertainty caused by the conflict, putting the process of fiscal consolidation at risk.

EthiFinance Ratings expects the **public deficit** to stand at 4.8% of GDP by the end of 2022, which is 1.8 percentage points above the ceiling set in the fiscal rules of the European Commission. However, the Spanish economy will benefit from the extension of the exceptional situation being considered by the European Commission due to the current uncertainty. Moreover, the Government of Spain has announced a package of measures and tax cuts aimed at mitigating the impact of the conflict. In this regard, *"the maintenance of fiscal incentives, combined with a gradual withdrawal, is appropriate to further promote economic recovery."*

Concerning the State accounts for this financial year 2022, *"no structural increase in spending is expected"*, being the increase associated with the actions included in the Recovery Plan.

With regard to **public debt,** the rating takes into account its high levels with new liabilities (ICO loans) and instruments (European debt) that could pose an upside risk to future debt levels. Looking ahead to the end of the financial year, EthiFinance Ratings forecasts that the debt will be reduced to 116.4% of GDP (3.2 percentage points below that of 2021). The report also highlights the fact that Spanish public debt held by foreign investors fell seven points between February 2020 and November 2021, from 50.35% to 43.36%

The rating report assesses the slight improvement in liquidity positions during 2021, with liquid assets of 14.5% this year.

On the other hand, regarding **the Spanish financial sector**, the agency emphasizes its continuing improvement, which is reflected in the increase in the levels of credit granted, which reached 326% of GDP in 2021. **NPL ratio has also fallen to 4.4%.** However, low profitability and a high level of debt to GDP limit the rating of this sector.

ESG and institutional framework

EthiFinance Ratings's rating positively assesses the environmental advances made by Spain in recent years, including the first issue of sovereign bonds worth EUR 5 billion. However, there are *"certain downward biases"*, such as non-compliance with some EU environmental laws and the fact that the country is one of the most exposed to climate change within the EU. Moreover, Spain is the Member State with the highest number of open cases for infringement of environmental laws in the EU, with a total of 26. Likewise, the Global Climate Risk Index 2021 — which measures a country's vulnerability to climate change — indicates that Spain ranks 32nd among all countries in the world.

Furthermore, Spain has a high level of energy dependence, with net energy imports accounting for 67% of total energy consumption, only behind Italy (73%). Despite this, the rating values the high decarbonized electricity *mix* in Spain, where 42% of electricity comes from renewable energies.

On a social level, the European rating agency positively assesses the Spanish welfare state, which grants a series of social guarantees to the entire population. However, the report highlights the increase in inequality between Spain and the rest of the countries of the European Union, due to the greater impact of COVID-19.

With regard to the institutional framework, although, in general terms, it is positively valued for its soundness, the report warns of factors that could affect the country's medium-term evolution *"which detracts efficiency and agility from public policies"* and the fragmentation of the Spanish parliament, *"that make it difficult to approve the reforms needed to receive the European Funds"*.