EthiFinance Ratings

EthiFinance Ratings maintains Spain's rating at A- but increases the outlook from Under-observation to Stable

- The European credit rating agency expects the Spanish economy to end 2023 with a growth of 1.1%, eight-tenths less than estimated in their September review, due to the impact of inflation and rising interest rates on household consumption and investment.
- The report warns of the weakening of the foreign sector, affected by the increase in the energy deficit, which will result in a contraction of the current account balance to 0.5% of GDP. It also highlights the high unemployment rate related to structural issues in the Spanish labor market.
- On the positive side, in addition to the improved situation in the energy markets and the gradual deceleration of inflationary pressures, the progress of public finances, with the deficit and public debt reduced to -4.5% and 112.5% respectively, is outlined.

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Unsolicited rating of the Kingdom of Spain

Despite lowering the growth forecasts of the Spanish economy to 1.1% due to the impact of price and interest rate hikes on consumption and investment, EthiFinance Ratings confirms the Kingdom of Spain's unsolicited credit rating at A- but increases the outlook to Stable. This change is justified by the more favorable climate presented by the energy markets, as well as by the slowdown in price increases. Despite this improvement, inflation will end at 4.3%, which together with the rise in interest rates and the impact of the drag effect of past months, could be a burden on household consumption and investment. The report also warns of the weakening of the external sector, affected by the increase in the energy deficit, as well as the structural problems of the labor market, that result in a high rate of unemployment which is well above that of their European counterparts. It also highlights the improvement in public finances with a reduction in the deficit and public debt to -4.5% and 112.5%, respectively.

Madrid, February 24, 2023

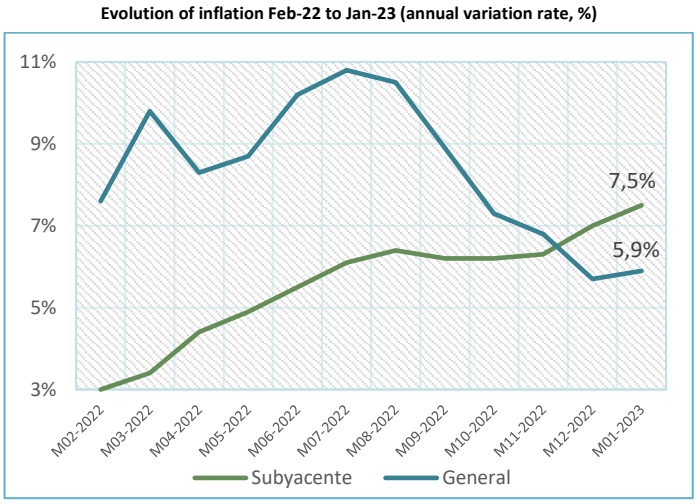
In its February review, EthiFinance Ratings **maintains the unsolicited rating of the Kingdom of Spain at A- with an improved outlook from Under-observation to Stable.**

This change is based on the stronger growth of the Spanish economy during the preceding financial year (5.5% compared to the expected 4.3%), avoiding recession in the last quarter, as well as the slowdown of inflationary pressures and a more favorable situation in the energy markets than expected. However, both factors are closely linked to the geopolitical situation, which is a factor of uncertainty that could put current forecasts at risk.

In line with the foregoing, the report notes that the impact of high prices that occurred during last year, as well as the rise in interest rates, are already beginning to weigh on both household consumption and investment, which represents one of the main constraints on the country's economic growth. In this regard, **the European credit rating agency expects Spain's GDP to end 2023 at 1.1%**, eight-tenths less than in the September review. The 2% barrier will not be reached again until 2024. *"While we point out that the uncertainty of this scenario is high and closely linked to the current geopolitical situation, with significant downside risks, thus, despite the normalization in energy markets that begins to influence prices downward, inflation remains high. Moreover, there are concerns over the persistence of core inflation, remaining in an uptrend, which confirms certain pass-through effect of the increase in prices of certain raw materials during 2021 and 2022".*

In this regard, the inflation forecasts handled by EthiFinance Ratings point to a **price increase of 4.3% at the end of this year, compared to 8.4% in 2022**. And they warn that "the rise in prices is having an

impact on all the countries of the European Union (EU) similarly, so we estimate that it will weigh on domestic and foreign demand, as well as on production".



This is further strengthened by the decision of the European Central Bank (ECB) to maintain the current monetary policy tone, which will imply further increases in interest rates as a tool to contain the rise in prices *"which is another factor limiting growth"*.

The rating assesses the "positive" evolution of employment, favored by the labor reform approved last March, which has boosted permanent contracts, reducing in turn the temporality and improving social security affiliation. Thus, it is expected that the 2023 financial year will conclude with an unemployment rate of around 13%. However, *"it is still very high compared to other large eurozone economies."* This fact is attributed to the persistence of the structural problems presented by the labor market in Spain.

As it has been noted in previous reports, this is further strengthened by the significant dependency rate, which, together with low population growth, represents "one of the main limitations of our rating, in addition to posing a future risk to the sustainability of public finance". This latter fact *"has been exacerbated after the last reform of the pension system, in which they were indexed to the CPI"*.

Risks for the foreign sector but improvement of public finances

As noted in the September report, although the foreign sector will continue to be one of the pillars of the Spanish economy, it is being affected by the general increase in prices and, especially, the deterioration of the energy deficit, "being the increase in exports of services due to tourism insufficient to offset the increase in imports," the report points out. Thus, even though the surplus situation will remain, it will be cut to 0.5% of GDP in 2022 to return to normal in 2023 and 2024, when a three-tenths and five-tenths increase is forecast up to 0.8% and 1%.

Moreover, the rating takes into account the **improvement in the net International Investment Position (NIIP)**, which *"occurred both by the positive effect of GDP growth, as well as by valuation effects and other financial adjustments, improving the valuation of assets abroad",* the report explains.

This same trend is replicated in the levels of gross external debt to 178.9% of GDP in the third quarter of 2022, levels which are almost ten percentage points above those recorded before the outbreak of the pandemic and that pose a *"downside risk"* for the Spanish foreign sector, *"especially if we take into account the tightening of financing conditions"*. Despite this, this debt would be more isolated from exogenous shocks because it was established in the long term, with a fixed interest rate and denominated in euros.

In terms of fiscal positions, the rating positively assesses the fiscal consolidation process carried out by the Spanish Government in recent years, with a gradual improvement in government deficit and debt levels. Even so, "these *remain at high values which* ***make further adjustment measures necessary in the medium term****."*

In terms of the deficit, EthiFinance Ratings improves forecasts by five-tenths respecting the 2022 financial year. Thus, the year will end with a negative rate of -4.5%, both due to the better evolution of the Spanish economy than expected and the effect of the rise in prices on tax collection and the withdrawal of certain fiscal stimulus related to the COVID-19. For this year, a slower pace of correction is expected, down to -4.1%, explained by a greater increase in public spending. This rise is partly due to the indexation of pensions to the CPI, the increase in public sector workers' salaries and other measures for households and enterprises, although this will be partially offset by some extraordinary fiscal measures.

Likewise, the European credit rating agency highlights "the maintenance of **high structural deficits** (-3.6% in 2023 and -3.4% in 2024 by the European Commission), which will make it necessary to adopt greater fiscal adjustment measures in the future". This situation obliges *"the gradual withdrawal of fiscal impulses to avoid conflicting with monetary policy, so that it leads public finances to more sustainable levels, reducing their exposure to external shocks".*

Although **the level of public debt at the end of 2022 is expected to improve to 113.1%,** the report points out that *"debt continues to increase in absolute terms, exposing it to possible fluctuations if falls in GDP occur again".* On the other hand, the rise in interest rates represents a potential risk for the Spanish debt profile through its cost. This would be partially offset by the increase in maturity periods up to eight years and the larger fiscal collection.

Regarding the liquidity profile of Spain, it maintains the September review, with liquid financial assets of 14.8% of GDP and 14.1% in 2022 and 2023 respectively according to the IMF.

The report also mentions the situation of the Spanish financial system, which has managed to contain the increase in the NPL ratio at the level of 3,7%. However, at EthiFinance Ratings, it is clarified that these figures "*are influenced by the state guarantees included in the COVID-19 aid plan, which have subsequently been extended to other sectors that have been more affected by the war between Russia*

and Ukraine, although the grace period of some of them would have already expired ", which could weigh down the good results obtained so far.

On the other hand, both the high level of debt to GDP and the low profitability limit the rating of the financial sector, although the latter is expected to improve due to the impact of rising interest rates on balance sheets.

ESG and institutional framework

EthiFinance Ratings' rating positively assesses the advances made by Spain in the area of ESG (Environmental, Social and Governance) in recent years, including the first issue of sovereign bonds worth EUR 5 billion. Also, the conditions for receiving European Funds include that a large proportion is allocated to green investments, *"which must guarantee a favorable evolution in the country's environmental commitment"*.

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 twenty-six. 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 Spain's highly decarbonized electricity mix, with 42% of electricity coming 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 increased impact of COVID-19. Even so, the new increase of the minimum wage to 15,120 euros gross per year in 2023 approved by the Government of Spain could reduce the income gap between the country and the EU average, and promote equality within the country itself.

Concerning the institutional framework, although it is generally assessed positively for its solidity, the report warns of factors such as political decentralization that may affect the country's evolution in the medium term, since *"they reduce efficiency and agility in public policies"*. At this point, it is expected that the fact that much of the investments of the Recovery Plan Transformation and Resilience are channeled at the regional level "*does not represent a burden for the effectiveness of its implementation*".

In addition, the increasing fragmentation of the parliament "*could make it difficult to approve reforms necessary to meet the requirements of the different disbursements of the NGEU funds*".

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Key figures. International comparison.

	Year	Spain (A-/Est.)	Portugal (BBB/Est.)	Germany	France	Italy
Real GDP (% change)	2022	5.5%	6.7%	1.9%	2.6%	1.7%
GDP per capita (current, €)	2021	25,204	20,673	42,046	35,681	28,910
HIPC (year-on-year variation, %)	2022	8.3%	8.1%	8.7%	2.1%	1.9%
Unemployment rate	2021	14.8%	7.9%	3.6%	6.6%	9.5%
Population (in millions)	2021	47.6	10.3	83.2	67.6	59.6
Population at risk of exclusion	2019	25.3%	21.6%	17.4%	17.9%	25.6%
Dependency ratio (% 20-64 years)	2020	59.2%	64.6%	64.2%	71.6%	65.7%
NPL	2021	4.4%	4.3%	1.2%	2.5%	8.1%
ROA	2021	0.5%	0.4%	0.2%	0.2%	0.4%
Current Account Balance (% GDP)	2021	0.9%	-1.1%	7.4%	-0.6%	2.5%
NIIP (% GDP)	2021	-84.3%	-95.9%	61.3%	-32.7%	5.2%
Fiscal balance (% GDP)	2021	-6.9%	-4.5%	-3.7%	-6.5%	-5.5%
Gross public debt (% GDP)	2021	118.4%	124.4%	69.3%	112.9%	150.8%
Net public debt (% GDP)	2021	104.5%	121.8%	54.4%	103.3%	142.2%
Gross Financing Needs (%GDP)	2021	22.9%	15.6%	13.1%	19.2%	24.7%