

### Research Update:

# Long-Term Rating On Spain Lowered To 'AA-' On Economic Growth And Banking Sector Risks; Outlook Negative

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## Research Update:

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## Overview

- Despite signs of resilience in economic performance during 2011, we see heightened risks to Spain's growth prospects due to high unemployment, tighter financial conditions, the still high level of private sector debt, and the likely economic slowdown in Spain's main trading partners.
- The financial profile of the Spanish banking system will, in our opinion, weaken further, with the stock of problematic assets rising further, as highlighted by the recent revision in our Banking Industry Country Risk Assessment on Spain to Group 4 from Group 3.
- As a consequence, we are lowering our long-term sovereign credit ratings on Spain to 'AA-' from 'AA'.
- The outlook on the long-term rating is negative.

## Rating Action

On Oct. 13, 2011, Standard & Poor's Ratings Services lowered the long-term rating on the Kingdom of Spain from 'AA' to 'AA-', while affirming the short-term ratings at 'A-1+'. The outlook is negative. The transfer and convertibility assessment remains 'AAA', as it does for all members of the eurozone.

## Rationale

The lowering of Spain's long-term rating reflects our view of:

- Spain's uncertain growth prospects in light of the private sector's need to access fresh external financing to roll over high levels of external debt amid rising funding costs and a challenging external environment;
- The likelihood of a continuing deterioration in financial system asset quality as reflected in the recent revision of our Banking Industry Credit Risk Assessment score for Spain to group 4 from group 3 (see "Spain Banking Industry Country Risk Assessment Revised To Group 4 From Group 3 On Heightened Economic Risk", published Oct. 11, 2011);
- The incomplete state of labor market reform, which we believe contributes to structurally high unemployment and which will likely remain a drag on economic recovery.

Under our recently updated sovereign ratings criteria, the "economic" score was the primary contributor to the lowering of Spain's long-term rating. The scores relating to other elements of our methodology--political, external,

fiscal, and monetary--did not directly contribute.

While in our view the factors impeding a potential recovery of domestic demand are not unique to Spain, they impact Spain with particular force given its high level of private sector leverage, much of which is funded externally. This is reflected in Spain's negative net international investment position, estimated at 94% of GDP in Q2 2011. A key component of this is short-term external debt, which, at around 50% of GDP in Q2 2011, we view as high. Spanish monetary and financial sector institutions accounted for slightly over one-half of total external debt at the end of Q2 2011, 57% of which is short-term debt. In our opinion, this leaves the economy vulnerable to sudden shifts in external financing conditions.

External leverage at such levels increases uncertainty about the trajectory of the economy, as much depends upon the access of these Spanish borrowers to international markets, as well as the state of external demand. We believe that these factors, in turn, will be influenced by the direction of policy decisions made by eurozone institutions, including the ECB, and Spain's eurozone partners. In 2011, we expect the Spanish economy to grow around 0.8% in real terms, while for 2012, we expect real GDP growth to be around 1%, weaker than the 1.5% we estimated in our February 2011 research update (see "The Specter Of A Double Dip In Europe Looms Larger", published Oct. 4, 2011).

These forecasts are, of course, estimates and subject to various factors, including:

- The possibility that the private sector's protracted deleveraging process may accelerate due to a further tightening of credit conditions. This could hinder any recovery in private investment, even though real fixed investment has already declined by nearly 30% cumulatively between 2008 and end 2010.
- Harsher repricing in the real estate market particularly for new housing, to which the banking sector remains particularly exposed, which may result in a higher-than-previously-expected accumulation of problematic assets in the financial system. This, in turn, could slow the flow of financial resources to more productive sectors of the economy and weigh on the recovery (see "Spain Banking Industry Country Risk Assessment Revised To Group 4 From Group 3 On Heightened Economic Risk", published Oct. 11, 2011).
- High unemployment, expected at around 20%-21% in 2011-12, which will remain a drag on private consumption. Although the government has implemented some labor market reform measures, their impact on reducing labor market rigidities remains to be seen.
- Economic growth in Spain's main trading partners could slow further or contract, which may result in more subdued external demand for Spanish exports (see "The Specter Of A Double Dip In Europe Looms Larger", published Oct. 4, 2011). Since 2009, exports have underpinned the economy's modest growth and contributed to a sharp reduction in the current account deficit, which we expect to decline to 3.8% of GDP in 2011 from 10% of GDP in 2007.

We have adopted a revised base-case macroeconomic scenario, which we view as consistent with the downgrade and the negative outlook. Compared with the February 2011 base-case (see "Kingdom of Spain 'AA/A-1+' Ratings Affirmed On Budgetary Consolidation And Structural Reforms; Outlook Negative " published Feb. 1, 2011), we expect GDP growth in 2011-13 will be weaker, with the stock of domestic credit to the private sector, estimated at around 165% of GDP in 2011, to decline somewhat faster. At the same time, we expect the strength of net exports to cushion the impact of a further tightening of fiscal policy.

We have also adopted a downside scenario, consistent with another possible downgrade. The downside scenario assumes a return to recession next year, partly as a result of weaker external and domestic demand, with real GDP declining by 0.5% in real terms, followed by a weak recovery thereafter. Under this downside scenario, the current account deficit would decline, but the general government deficit would remain above 5.5% of GDP, at odds with the government's fiscal consolidation targets.

We have also adopted an upside scenario, which, if it occurred, we believe would be consistent with a change in the rating outlook to stable. The upside scenario assumes stronger growth next year, on the back of a pick-up in domestic demand, and supported by an easing in financial conditions and continued strength in exports. For details of all the scenarios, see our analysis on Spain.

Under all three scenarios we expect that Spain's high private sector debt, and in particular the high stock of external debt--largely euro-denominated--will remain the key rating constraint for the foreseeable future. Narrow net external debt would range between 290% and 325% of current account receipts by 2014. Under our sovereign criteria these values would continue to imply an initial external score at the lowest possible level for a country with an actively traded currency, like Spain.

Our macroeconomic analysis also indicates what we consider to be one of Spain's main credit strengths: Even taking into account additional government-financed bank recapitalizations, we do not expect net general government debt to rise much above 70% of GDP, which compares favorably to Spain's peers.

In our view, the introduction of a ceiling for structural deficit and debt in the Spanish constitution underscores the authorities' broad commitment to budgetary discipline. However, in the near term (and under our base-case scenario), we believe the government could miss its fiscal target due to budgetary slippages at the local and regional government levels and in social security, despite a better-than-expected central government deficit. Nevertheless, we expect the general government deficit in 2011 to be around 6.2% of GDP, which is broadly in line with the government target of 6% of GDP. However, we believe that additional measures will be required to meet the 2012 target of 4.4% of GDP (our forecast 5.0% of GDP in 2012). As a result, we project net government debt will increase to around 57% of GDP in 2011 and 60.2% in 2012, from an estimated 50.1% in 2010, despite higher borrowing

costs.

Another sovereign strength is the Spanish government's liquid assets position, currently around 10% of GDP. While further growth in borrowing costs is likely to result in rising interest outlays, the increase in the average interest rate on Spain's outstanding government debt has not in our view been a material additional burden on the budget (3.9% in August 2011, versus 3.7% end-2010, 3.5% end-2009 and 4.3% end-2008). Our current government debt projection does not include the anticipated income from the delayed partial privatizations of the airport operator AENA, or the National Lottery.

As noted above, the application of the other elements of our recently updated sovereign ratings criteria-- political, fiscal, external and monetary--did not directly contribute to the downgrade of the rating. We continue to view Spain as a wealthy sovereign with a high level of political predictability as highlighted by the government's commitment to regular implementation of policy measures, despite weaker economic growth prospects and persistent external imbalances.

Rating actions affecting issuer and issue ratings linked to the Kingdom of Spain's long-term rating will be covered in a separate press release.

## Outlook

The negative outlook reflects our view of the risks to Spain's economic growth linked to private sector deleveraging, external financing pressures, and their impact on budgetary consolidation.

We could lower the ratings again if, consistent with our downside scenario, the economy contracts in 2012, Spain's fiscal position significantly deviates from the government's budgetary targets, or additional labor market and other growth-enhancing reforms are delayed.

Conversely, we could revise the outlook to stable if, consistent with our upside scenario, the government meets its budgetary targets in 2011 and 2012, risks to external financing conditions subside, and Spain's economic growth prospects prove to be more buoyant than we currently assume.

## Related Criteria And Research

- Sovereign Government Rating Methodology And Assumptions, June 30, 2011
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

## Ratings List

Downgraded

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	To	From
Spain (Kingdom of)		
Sovereign Credit Rating	AA-/Negative/A-1+	AA/Negative/A-1+
Senior Unsecured	AA-	AA
Corporacion de Reservas Estrategicas de Productos Petroliferos		
Sociedad Estatal de Participaciones Industriales (SEPI)		
Instituto de Credito Oficial		
Issuer Credit Rating	AA-/Negative/A-1+	AA/Negative/A-1+
Corporacion de Reservas Estrategicas de Productos Petroliferos		
Senior Unsecured	AA-	AA
Fondo de Amortizacion del Deficit Electrico		
Senior Unsecured	AA-	AA
Fondo de Reestructuracion Ordenada Bancaria (FROB)		
Senior Unsecured	AA-	AA
Instituto de Credito Oficial		
Senior Unsecured	AA-	AA

Ratings Affirmed

Spain (Kingdom of)	
Transfer & Convertibility Assessment	AAA
Instituto de Credito Oficial	
Med-term nts ser 391 due 2016	AA-
Commercial Paper	A-1+

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