FitchRatings

RATING ACTION COMMENTARY

Fitch Revises Spain's Outlook to Positive; Affirms IDR at 'A-'

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Related Content:
Spain - Rating Action Report

Fitch Ratings - Frankfurt am Main - 08 Nov 2024: Fitch Ratings has revised Spain's Outlook to Positive from Stable, while affirming its Long-Term Foreign-Currency (LTFC) Issuer Default Rating (IDR) at 'A-'.

A full list of rating actions is detailed below.

KEY RATING DRIVERS

The revision of the Outlook reflects the following key rating drivers and their relative weights:

High:

Improved Fundamentals: The Positive Outlook reflects improving structural factors that have increased Spain's GDP potential and strengthened its resilience to external shocks. Positive labour market trends boosted by strong net migration and reform, improved competitiveness, and the absence of macro-financial imbalances, underpin Fitch's assessment that Spain will continue outperforming its eurozone peers over our forecast horizon. Fitch projects real GDP growth of 2.9% in 2024, and average growth of 2.2% in 2025-2026 (vs. eurozone's 1.5%). Against the 'A' rating category, Spain's GDP outlook is weaker (A median: 2.7% growth), but its GDP per capita of USD35,350 is above the 'A' median of USD31,307.

Increased Growth Potential: Fitch has revised up its view on Spain's growth potential to close to 2.0% (2024-2028), based largely on stronger growth in the supply of labour. Projections from national statistics (INE) suggest Spain's working-age population grew at least 1.4% in 2023. Net migration contributing to more than half of the increase. Foreign labour will remain an important driver of labour supply growth, helping to offset a natural decline in Spain's population. Migrants from Latin America (accounting for just over half of inward flows) and their familiarity with the Spanish culture, supports their integration into the labour market across a range of skill levels. Current trends support Spain's working-age population expanding at double the projected rate of large European peers.

External Competitiveness: Persistent current account surpluses (10-year average up to end 2023 at 1.8% of GDP) have led to marked improvement in the country's external position with net external debt falling to 52% of GDP as of end-2023, from a 92% peak in 2020. Further, lower unit labour and energy costs than the eurozone average have maintained Spain's price competitiveness, supporting an improvement in the country's economic structure. Growth in the sectors of transportation, financial, information and technology, and telecommunications have led to non-tourism services accounting for 53% of total services exports in 2023, versus 47% in 2018. Since 2019, Spain's global export market share has also increased, while it has declined for Germany and France.

Reduced Imbalances: An absence of macro-financial imbalances is reflected by a sound banking sector and low private sector indebtedness. As of end-2023, corporate sector debt was 66% of GDP and household sector's debt-to-income was at 73% (Eurostat). Prolonged private-sector deleveraging since the 2008-2014 economic crisis has also resulted in substantial correction to Spain's negative net international investment position (IIP). From its 2009 peak, Spain's net IIP has narrowed 45pp to -51.5% of GDP (end-2023); although it is still large relative to the eurozone average (-10.4%) and the 'A' median (-8.9%). We expect further gradual improvement to Spain's net IIP over the medium term. In addition to current account surpluses, stable net FDI inflows and NGEU EU grants will support Spain's net external position.

Declining Debt Ratio: At 105.1% of GDP (2023), Spain's public debt ratio has declined 14pp from its pandemic peak of 119.3% (2020). Under Spain's Medium-Term Fiscal and Structural Plan (MTFP 2025-2028) there is a target to bring debt to below 100% of GDP by 2027, underpinned by primary fiscal surpluses starting from 2025 and high nominal GDP growth. Fitch projects a more gradual debt decline, to 101.2% of GDP by 2027, based on lack of visibility of fiscal consolidation measures. Against peers, Spain's debt ratio is more than double the 'A' median (49.6%), and the fourth highest in the eurozone, after France (109.9%), Italy (134.8%) and Greece (163.9%).

Spain's 'A-' IDRs reflect the following key rating drivers:

Political Fragmentation: Spain's composite governance indicator score (at the 74.0 percentile) is in line with the median percentile of the 'A' category peers (74.7). However, the sub-component on political stability is slightly weaker in comparison, reflecting

Spain's highly decentralised government set-up, which at times can lead to heightened political fragmentation.

Pedro Sanchez's minority coalition government (PSOE-Sumar) continues to face challenges to push through legislation. Reliance on support from separatist parties adds to policy implementation risks, as delays in the discussions to the 2024 and now 2025 budgets clearly demonstrate. Progress in structural reform necessary for disbursement of EU funds could also be hindered. Although the vast majority of important reforms have already been passed, including the second part of the pension reform and the new Employment Law, progress has yet to be made on the tax reform milestone of the Recovery Plan.

Fiscal Consolidation Challenges: A strong growth outlook and the expiry of inflation support measures will support some narrowing in fiscal deficits from a projected 3.0% of GDP this year to 2.7% in 2025 and 2.9% in 2026 (Fitch estimates), in line with the 'A' category median. For Spain to deliver its fiscal commitments under the new EU economic governance framework, additional fiscal consolidation is needed.

The PSOE-Sumar government is relying mainly on tax reform to achieve its medium-term fiscal targets, but will face expenditure pressures from increasing public pension spending and interest payment costs. According to the European Commission 2024 Ageing Report, Spain is projected to have one of the highest increases in public pension spending, increasing by 1.2% of GDP from 2022-2030, versus the EU average of 0.5%. In the same period, government projections point to interest expenditure on its liabilities to reach 2.9% of GDP, versus 2.4% of GDP in 2023.

ESG - Governance: Spain has an ESG Relevance Score (RS) of '5[+]' for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption. Theses scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model (SRM). Spain has a high WBGI ranking at 74.0, reflecting its long record of stable and peaceful political transitions, well-established rights for participation in the political process, strong institutional capacity, effective rule of law and a low level of corruption.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

-Public Finances: A renewed increase in public debt/GDP, for example, due to larger-than-expected fiscal deficits or weaker growth.

-Structural Features: Heightened domestic political tensions, for example between Catalonia's regional government and the central government, leading to severe deterioration in economic, fiscal policy implementation.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

-Public Finances: Confidence that public debt/GDP remains on a downward path over the medium term, for example, due to implementation of a sustained fiscal consolidation strategy.

-Macro: Continued favourable growth dynamics, for example, supported by the effective use of NGEU funds and implementation of structural reforms.

SOVEREIGN RATING MODEL (SRM) AND QUALITATIVE OVERLAY (QO)

Fitch's proprietary SRM assigns Spain a score equivalent to a rating of 'A' on the LTFC IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM score to arrive at the LTFC IDR by applying its QO, relative to SRM data and output, as follows:

- Public Finances: -1 notch on public finances, reflecting a general government debt ratio still above its pre-pandemic level and far above the 'A' category median, as well as a lack of clarity on a sustained fiscal consolidation strategy that would put debt on a sustained downward path.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centred averages, including one year of forecasts, to produce a score equivalent to a LTFC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the LTFC IDR, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

COUNTRY CEILING

The Country Ceiling for Spain is 'AAA', six notches above the LTFC IDR. This reflects very strong constraints and incentives, relative to the IDR, against capital or exchange controls being imposed that would prevent or significantly impede the private sector from converting local currency into foreign currency and transferring the proceeds to non-resident creditors to service debt payments.

Fitch's Country Ceiling Model produced a starting point uplift of +2 notches above the IDR. Fitch's rating committee applied a further +4 notches qualitative adjustment to this, under the Long-Term Institutional Characteristics pillar, reflecting the sovereign's membership of the eurozone currency union and the associated reserve currency status. The agency views the risk of the imposition of capital or exchange controls within the eurozone as exceptionally low but not negligible.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Spain has an ESG Relevance Score of '5[+]' for Political Stability and Rights as WBGI have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and a key rating driver with a high weight. As Spain has a percentile rank above 50 for the respective Governance Indicator, this has a positive impact on the credit profile.

Spain has an ESG Relevance Score of '5[+]' for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as WBGI have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and are a key rating driver with a high weight. As Spain has a percentile rank above 50 for the respective Governance Indicators, this has a positive impact on the credit profile.

Spain has an ESG Relevance Score of '4[+]' for Human Rights and Political Freedoms as the Voice and Accountability pillar of the WBGI is relevant to the rating and a rating driver. As Spain has a percentile rank above 50 for the respective Governance Indicator, this has a positive impact on the credit profile.

Spain has an ESG Relevance Score of '4[+]' for Creditor Rights as willingness to service and repay debt is relevant to the rating and is a rating driver for Spain, as for all sovereigns. As Spain has a record of 20+ years without a restructuring of public debt, which is captured in our SRM variable, this has a positive impact on the credit profile

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/topics/esg/products#esg-relevance-scores.

RATING ACTIONS

ENTITY / DEBT	RATING	PRIOR
Spain	LT IDR A- Rating Outlook Positive Affirmed	A- Rating Outlook Stable
	ST IDR F1 Affirmed	F1
	LC LT IDR A- Rating Outlook Positive Affirmed	A- Rating Outlook Stable
	LC ST IDR F1 Affirmed	F1
	Country Ceiling AAA Affirmed	AAA
senior unsecured	LT A- Affirmed	A-
Senior Unsecured-Local currency	LT A- Affirmed	A-
senior unsecured	ST F1 Affirmed	F1

VIEW ADDITIONAL RATING DETAILS

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