Ratings On Spain Lowered To 'BBB+/A-2' On Debt Concerns; Outlook Negative

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- We believe that the Kingdom of Spain's budget trajectory will likely deteriorate against a background of economic contraction in contrast with our previous projections.
- At the same time, we see an increasing likelihood that Spain's government will need to provide further fiscal support to the banking sector.
- As a consequence, we believe there are heightened risks that Spain's net general government debt could rise further.
- We are therefore lowering our long- and short-term sovereign credit ratings on Spain to 'BBB+/A-2' from 'A/A-1'.
- The negative outlook on the long-term rating reflects our view of the significant risks to Spain's economic growth and budgetary performance, and the impact we believe this will likely have on the sovereign's creditworthiness.

NEW YORK (Standard & Poor's) April 26, 2012--Standard & Poor's Ratings Services today said it lowered its long-term sovereign credit rating on the Kingdom of Spain to 'BBB+' from 'A'. At the same time, we lowered the short-term sovereign credit rating to 'A-2' from 'A-1'. The outlook on the long-term rating is negative.

Our transfer and convertibility (T&C) assessment for Spain, as for all European Economic and Monetary Union (EMU or eurozone) members, is 'AAA', reflecting Standard & Poor's view that the likelihood of the European Central Bank (ECB) restricting non-sovereign access to foreign currency needed for debt service of non-euro obligations is low. This reflects the full and open access to foreign currency that holders of euro currently enjoy and which we expect to remain the case in the foreseeable future.

The downgrade reflects our view of mounting risks to Spain's net general government debt as a share of GDP in light of the contracting economy, in particular due to:

- The deterioration in the budget deficit trajectory for 2011-2015, in contrast with our previous projections, and
- The increasing likelihood that the government will need to provide further fiscal support to the banking sector.

Consequently, we think risks are rising to fiscal performance and flexibility, and to the sovereign debt burden, particularly in light of the increased contingent liabilities that could materialize on the government's balance sheet.

These concerns have led us to conclude a two notch downgrade is warranted in accordance with our methodology (see "**Sovereign Government Rating Methodology And Assumptions**," June 30, 2011).

Under our revised base-case macroeconomic scenario, which we view as consistent with the downgrade and the negative outlook, we have lowered our forecast for GDP to contract in real terms by 1.5% in 2012 and 0.5% for 2013. We had previously forecast real GDP growth of 0.3% in 2012 and 1% in 2013.

We believe that negative drags on GDP include:

- Declining disposable incomes;
- Private-sector deleveraging;
- Implementation of the government's front-loaded fiscal consolidation plan; and
- The uncertain outlook for external demand in many of Spain's key trading partners.

In our opinion, the Spanish economy is rebalancing, and the measures the government has taken should facilitate this process. Spain's current account deficit (CAD) is on a narrowing trajectory, significantly supported by the Spanish economy's strong export performance, especially since 2009. The CAD was 3.5% of GDP at year-end 2011, compared with 10.0% in 2007. Excluding the income deficit, the current account is in balance. The income deficit, which reflects net interest and dividend payments on Spain's net liabilities to the rest of the world, widened in 2011 on the back of increased external funding costs. We expect the current account to broadly balance in 2013-2014, before posting a higher surplus thereafter. In contrast to 2008-2010, the Bank of Spain--through Target2 overdrafts with the ECB (exceeding €250 billion in March 2012, from around €150 billion at the end of 2011)--has now become the major source of financing Spain's CAD. In our opinion, this reflects the extent to which Spain's commercial banking system has sharply increased its dependency on official funding sources to a considerably higher level than we anticipated in January, when we last revised our rating on Spain (see "**Spain's Ratings Lowered To 'A/A-1'; Outlook Negative**," Jan. 13, 2012).

Despite the unfavorable economic conditions, we believe that the new government has been front-loading and implementing a comprehensive set of structural reforms, which should support economic growth over the longer term. In particular, authorities have implemented a comprehensive reform of the Spanish labor market, which we believe could significantly reduce many of the existing structural rigidities and improve the flexibility in wage setting. Even if, in our opinion, the reform is unlikely to eliminate the structural duality in the Spanish labor market, we believe it will ultimately benefit employment growth once a sustainable recovery sets in. In the near term, increased labor market flexibility is likely to accelerate the necessary wage adjustment and reduce the pace of job-shedding. At the same time, we do not believe the labor reform measures will create net employment in the near term. As a consequence, the already high unemployment rate--especially among the young--will likely worsen until a sustainable recovery sets in.

Financial sector reform, announced in February 2012, requires banks to allocate additional loan loss provisions and raise capital buffers on exposure to real estate developments and construction projects. We believe these sectors will continue to be the main sources of asset quality deterioration. The reform has also led to further banking sector consolidation. Recent acquirers have benefited from asset protection schemes, with potential losses covered by a partial (80%) guarantee provided by the Deposit Insurance Fund to absorb future credit losses from the acquired banks' legacy portfolios. We estimate that the guarantees related to these schemes, combined with those that will likely be provided in the upcoming sale of three entities currently controlled by the Fondo de Reestructuracion Ordenada Bancaria (FROB), represent a contingent liability for the sovereign in the amount of about 3.75% of GDP. Combined with embedded risks in the rest of the banking sector, public enterprises, and other state guarantees, we now estimate contingent fiscal risks to the sovereign as moderate, as defined in our criteria (see "**Sovereign Government Rating Methodology And Assumptions**," published June 30, 2011).

We believe the ECB's recent long-term repurchase operations (LTROs) have significantly reduced the risks the Spanish banking sector faced in refinancing its medium-term external debt and its short-term interbank liabilities maturing in the first half of 2012. The LTRO also helped banks to finance their government debt portfolios cheaply. Nevertheless, we do not view the provision of liquidity support by the monetary authorities as a substitute for financial sector restructuring and economic rebalancing.

In our view, the strategy to manage the European sovereign debt crisis continues to lack effectiveness. We think credit conditions, and hence the economic outlook for Spain, could now deteriorate further than we anticipated earlier this year unless offsetting eurozone policy measures are implemented to support investor confidence and stabilize capital flows with the rest of the world. Such measures at the eurozone level could include a greater pooling of fiscal resources and obligations, possibly direct bank support mechanisms to weaken the sovereign-bank links, and a consolidation of banking supervision or a greater harmonization of labor and wage policies.

In light of the rapid rise in public debt since 2008, we expect the Spanish government to implement a sustained budgetary consolidation effort--including strengthening fiscal surveillance frameworks at the regional government

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level--aimed at gradually reducing the government's net financing needs. Balancing this commitment to stabilizing public finances with policymakers' clear interest in preventing an acceleration of the economic downturn will be challenging in the absence of fiscal transfers from abroad, or private-sector credit creation at home. At the same time, we believe front-loaded fiscal austerity in Spain will likely exacerbate the numerous risks to growth over the medium term, highlighting the importance of offsetting stimulus through labor market and structural reforms.

Following budgetary slippage of 2.5% of GDP in 2011 beyond the 6.0% target, the government has committed to a target of 5.3% of GDP in 2012 and 3.0% in 2013. In our opinion, these targets are currently unlikely to be met given the economic and financial environment. We forecast a budget deficit of 6.2% of GDP in 2012 and 4.8% in 2013 (our previous forecasts were 5.1% and 4.4%). We also believe the delay to adopting the 2012 budget could reduce the government's capacity to prevent deviations from its budget plans.

Given the significant and regular budgetary slippages at the regional level-–the main contributor to the deviations from the government's targets--the national government's willingness to fully enforce its new budget will likely be tested as we expect the regions to post a shortfall of around 0.4% of GDP in 2012, above their 1.5% of GDP 2012 target. Because of higher-than-previously-expected deficit projections, and other debt-increasing items such as arrears resolutions (estimated at 3.9% of GDP in 2012), we forecast net general government debt at 76.6% of GDP in 2014, against our previous projection of 64.6% of GDP. State guarantees to the European Financial Stability Fund, the European Stability Mechanism, and the Electricity Deficit Amortization Fund, which are included in the government's own debt projections, are not part of our debt estimate and are instead classified with other state guarantees.

In line with the increasing risks we see to Spain's recovery, we have also considered a downside scenario that, if it were to eventuate, could lead us to lower the ratings again. This downside scenario assumes a deeper recession in Spain this year, as a result of weaker external and domestic demand, with real GDP declining by 4% in real terms, followed by a contraction of 1% in 2013 and a weak recovery thereafter. Under this downside scenario, the current account would adjust faster, but the general government deficit trajectory would deteriorate further. The net general government debt ratio would breach 80% of GDP. For details for all our scenarios, see our analysis on Spain.

The negative outlook reflects our view of the significant external and domestic risks to Spain's economic growth and budgetary performance, and the impact we believe this may have on the sovereign's creditworthiness.

We could lower the ratings if we were to see a rise in net general government debt to above 80% of GDP during 2012-2014, reflecting fiscal deviations, weakening growth, or the crystallization of contingent liabilities on the government's balance sheet beyond our current projections. We could also consider a downgrade if political support for the current reform agenda were to wane. Moreover, we could lower the ratings if we see that Spain's external position worsens or its competitiveness does not continue to approach that of its trading partners, a key factor for Spain to return to sustainable economic and employment growth.

We could revise the outlook to stable if we see that risks to external financing conditions subside and Spain's economic growth prospects improve, enabling the net government debt ratio to stabilize below 80% of GDP.

RELATED CRITERIA AND RESEARCH

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

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