30 June 2017

Public Finance

Kingdom of Spain
Rating Report

A- STABLE OUTLOOK

Credit strengths

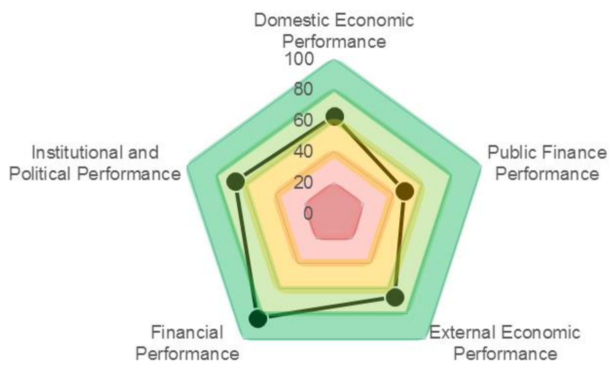
- Euro-area membership
- Large and diversified economy
- Resilient economic recovery
- Commitment to reforms
- Improvements in the banking sector

Credit weaknesses

- High unemployment
- High public deficits and debt
- High external debt
- Political uncertainties

Rating rationale and Outlook: The A- rating is supported by euro-area membership, the size and diversity of Spain's economy, its resilient economic recovery, commitment to structural reforms and ongoing improvements in the banking sector. Persistently high unemployment, high levels of external and public debt, fiscal imbalances and political uncertainty continue to pose challenges. The Stable Outlook reflects Scope's view that the reduction in economic and fiscal imbalances will largely depend on building a durable and sustainable growth model that supports the fiscal adjustment needed to turn around the public debt ratio.

Figure 1: Summary of sovereign rating categories



Source: Scope Ratings AG

Positive rating-change drivers

- Additional structural reforms
- Further fiscal consolidation
- External balance sheet improvements

Negative rating-change drivers

- Sharp GDP growth deterioration
- Fading political commitment to fiscal adjustment
- Rising tensions with Catalonia

Ratings & Outlook

Foreign currency

Long-term issuer rating	A-/Stable
Senior unsecured debt	A-/Stable
Short-term issuer rating	S-1/Stable

Local currency

Long-term issuer rating	A-/Stable
Senior unsecured debt	A-/Stable
Short-term issuer rating	S-1/Stable

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Bloomberg: SCOP

Domestic economic risk

A more balanced economic recovery

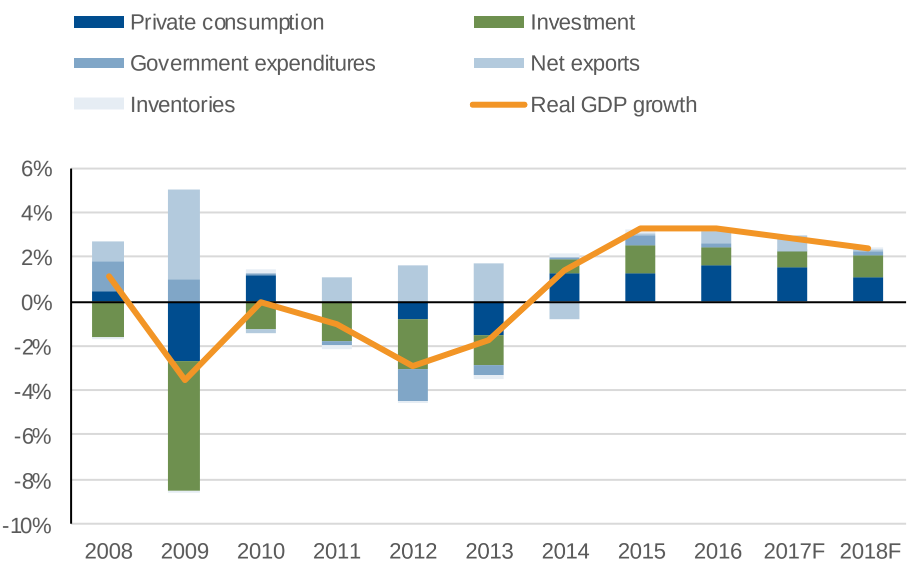
Since 2014, the economy has been recovering from a period of prolonged recession provoked by the global crisis. The external shock revealed heavy imbalances in the Spanish economy and employment, triggering sharp corrections and forcing the country into economic and regulatory reforms. Through wage moderation, greater labour market flexibility and less restrictive market regulations for products and services, the Spanish economy has gained in competitiveness and resilience. The economy is benefiting from the government's structural reform efforts, but also from tailwinds such as low interest rates, a weaker euro, low oil prices, and the economic recovery enjoyed by Spain's main European trading partners.

Since 2013, employment has increased by more than 1.481 million contracts. In 2016 employment growth has been widespread across all sectors and was quite pronounced in manufacturing and the wholesale and retail trade. The recovery, which has hinged less on temporary contracts and more on open-ended and part-time contracts, has been assisted by labour market reform tackling the main shortcomings of the Spanish labour market: high structural unemployment, high youth unemployment, duality, high employment volatility and wage indexation which limit gains in competitiveness.

The 2015 tax reform aims at reducing taxation on labour in order to strengthen competitiveness, promote saving and investment, modernise personal and corporate income tax as well as to reinforce the fight against tax fraud.

Although Scope considers the Spanish economy to be more resilient now, important challenges remain. Spain's construction boom-and-bust cycle, which echoed the bursting of the global credit bubble, has left the Spanish sovereign with a public-debt burden that nearly equals nominal GDP. Recent adjustments have helped to make Spanish GDP growth more sustainable – an important precondition for a lasting reversal of the public debt trajectory.

Figure 2: Real GDP growth components



Source: IMF, Calculations Scope Ratings AG

Table of Content

Domestic economic risk 2
Public finance risk 3
External economic risk 4
Financial stability risk 4
Institutional and political risk 5
I. Appendix: CVS and QS results 6
II. Appendix: CVS and QS results 7
III. Appendix: Peer comparison 8
IV. Appendix: Statistical tables 9
V. Regulatory disclosures 10

Public finance risk

Decline of deficit ratio to date more cyclical than structural

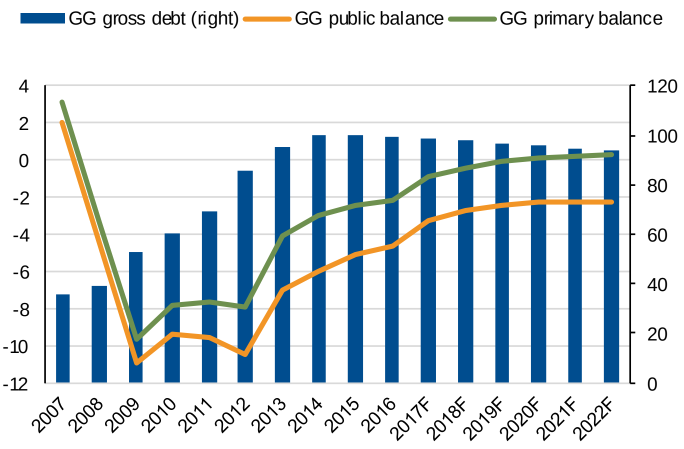
General government budget imbalances are still large. With the outbreak of the global crisis, Spain's deficit ratio reached double digits and averaged around 10% from 2009-2012. Since then the deficit has remained largely above the Maastricht 3% ceiling, moving from 7% in 2013 to 4.33% in 2016. This contrasts sharply with a number of European peers. Italy, for example, did not undergo a damaging boom-bust cycle and therefore managed to return quickly to primary surplus in 2010 and has kept general government deficit ratios in line with European standards since 2012.

In 2016, regional governments managed to halve their deficit ratio to 0.8%, and local governments achieved a surplus of 0.6%. However, the European Commission reports that the Spanish government's structural deficit has increased to around 3.5% of GDP in 2016 due to recent expansionary fiscal policies. It is set to improve marginally in 2017 before stabilizing in 2018.

The Spanish government expects to achieve a primary surplus in 2018 and beyond. The plan is to control public expenditure growth by implementing a rule that requires primary expenditure growth excluding cyclical factors to rise below a medium-term GDP growth reference rate. The government also expects unemployment benefits to have a lower impact on government expenditure due to an improved labour market position.

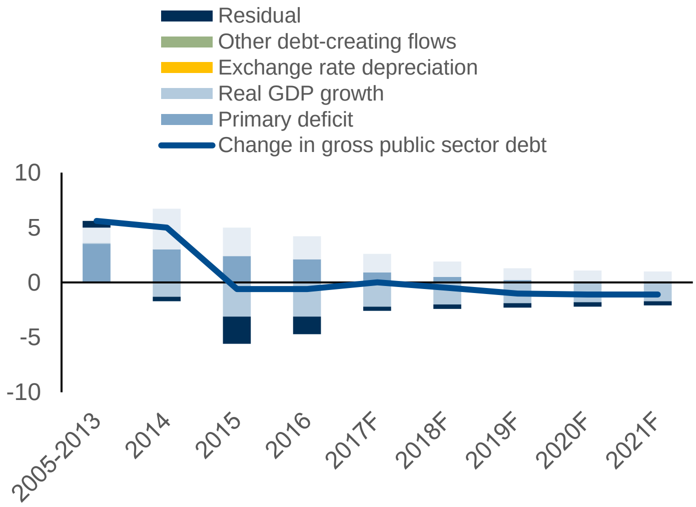
The 2011-2013 pension reforms, which raised the effective retirement age and introduced a sustainability factor, are also expected to enhance public debt sustainability. The debt-to-GDP ratio has been declining slowly since 2014, when the general government-debt ratio peaked at 100.4%. It is projected to fall to slightly below 99% by the end of 2017.

Figure 3: Fiscal developments, % of GDP



Source: IMF

Figure 4: Debt-creating flows, % of GDP



Source: IMF

Spain's government-debt ratio remains vulnerable to cyclical changes in the economy. It has remained high despite a strong cyclical recovery and very moderate refinancing costs. Scope expects the ratio to decrease only gradually to 98.5% of GDP by 2018, as a result of relatively strong nominal GDP and provided there are no adverse shocks. In the meantime, the relatively long debt maturity profile of seven years helps to reduce rollover risk.

External economic risk

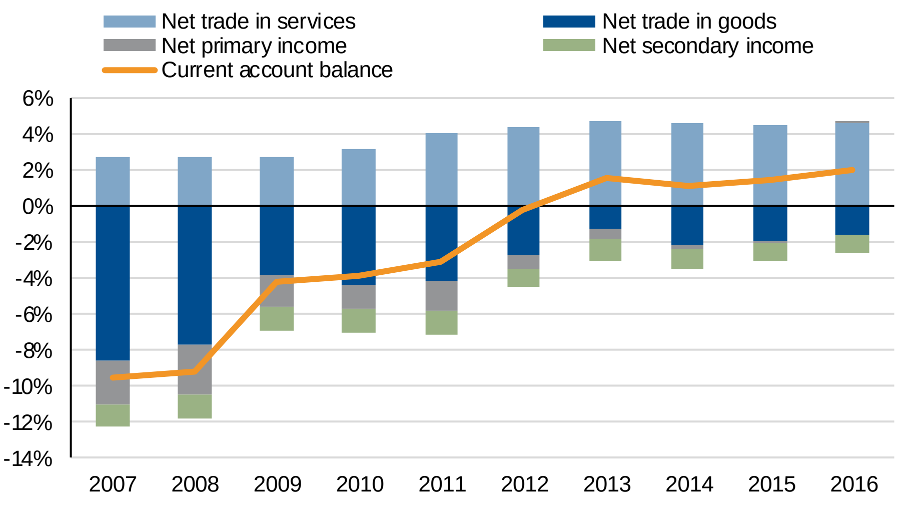
Net international investment position still high but declining

Spain's still-negative net international investment position is high at around 86% of GDP in 2016. This means the sovereign is exposed to shocks or sudden shifts in market sentiment, with net marketable debt accounting for about 77% of GDP in 2016. Since 2013, Spain has registered 4 consecutive years of current account surpluses. Nevertheless, the trade balance in goods remains negative.

The proportion of exports of goods & services in GDP has increased from 21.9% in 2009 to 35.3% by the first quarter of 2017. Exports of goods have increased by 61% and exports of non-tourism services by 39%. Export destinations and market shares are also more widely diversified. Overall, the recent trend is a reflection of improved competitiveness and Spanish firms' increased propensity to export as well as the wider geographical diversification of exports. Service exports have helped to raise the current-account surplus whilst tourism services have reached historical highs. Exports of services other than tourism, such as services to firms, consultancy and IT-related services are also expanding.

Spain's net international investment position is set to improve against a background of ongoing GDP growth and current-account surpluses. This appears to represent an important structural change, with GDP growth relying more heavily on exports than on unsustainable domestic activities as in previous growth cycles. The net international investment position, excluding valuation effects, has declined by 16.4 pp since 2013. According to the European Commission, the net international investment position may further decline to around 50% of GDP by 2024, assuming nominal GDP growth and current-account balances at 2016 levels.

Figure 5: Current-account balance, % of GDP



Source: IMF, Calculations Scope Rating AG

Financial stability risk

Ongoing deleveraging in the private sector

Interest rates have continued to converge in the euro area, and the number of new loans to small- and medium-sized enterprises with a turnover of less than EUR 1m has been on the rise since mid-2013. Ongoing deleveraging has modified the composition of liabilities in the private sector, with more equity and fewer loans.

Private-sector deleveraging has continued. Since 2010, companies have reduced indebtedness by EUR 300.5bn and private households by EUR 196.5bn. Corporate indebtedness is now below the euro-area average, at 101.7% of GDP compared to 107.5%. The increase in confidence, employment and economic stability has helped to make private-sector deleveraging compatible with growth in private consumption and investment.

Spain's financial sector is now leaner, more efficient and better capitalised. It is also better-equipped to handle non-performing loans. The exposure ratio declined further to 5.7% in 2016, and the coverage ratio of doubtful loans to households and corporates has increased from 29% in 2008 to around 45% by the end of 2016. There has also been further improvement in the equity-to-asset ratio and the funding gap.

Institutional and political risk

Uncertainty around reform power of minority government

After a 10-month period of political paralysis, including two inconclusive general elections and major political upheavals, the recent formation of a new government has reduced political risk in Spain. The leader of the conservative People's Party, Mariano Rajoy, was returned to office, even though he failed to win an outright majority with 170 of 350 seats in Spain's congress of deputies. Scope believes that the current minority government has less room to manoeuvre. As a consequence, it may be very challenging for the government to formulate and implement further substantial reforms in the current legislative period.

The prospect of Catalonia's independence from the Kingdom of Spain continues to challenge the country's political environment and outlook. Ongoing political tensions could lead to an abrupt separation from Spain or the withdrawal of state support over the medium term, specifically in the light of the potential referendum on Catalan independence scheduled for 1st October 2017 according to the regional government's roadmap plan. Scope does not expect a one-sided secession given the constitutional safeguards in place. A settlement between the national and the Catalan regional government on regional reform and greater autonomy for Catalonia within Spain is increasingly likely to emerge. Reaching an agreement on these points will, nevertheless, prove challenging.

Methodology

The methodology applicable for this rating and/or rating outlook "Public Finance Sovereign Ratings" is available on www.scoperatings.com.

Historical default rates of Scope Ratings can be viewed in the rating performance report on https://www.scoperatings.com/governance-and-policies/regulatory/esma-registration. Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope's definition of default, definitions of rating notations can be found in Scope's public Credit Rating methodologies on www.scoperatings.com.

The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months. A rating change is, however, not automatically ensured.

I. Appendix: CVS and QS results

Sovereign rating scorecards

Scope's Core Variable Scorecard (CVS), which is based on relative rankings of key sovereign credit fundamentals, signals an indicative (a) rating for the Spanish sovereign. This indicative rating can be adjusted by the Qualitative Scorecard (QS) by up to three notches depending on the size of relative credit strengths or weaknesses versus peers based on our qualitative analysis. For Spain the QS signals relative credit weaknesses for the following analytical categories: i) macroeconomic stability and imbalances; ii) fiscal performance; iii) vulnerability to short-term shocks; and iv) financial sector performance.

The QS does not signal relative credit strengths against peers. Combined relative credit strengths and weaknesses generate a downward adjustment and signal a sovereign rating of A- for Spain. The results have been discussed and confirmed by a rating committee.

Rating overview

CVS indicative rating range	a[1]
QS adjustment	A-
Final rating	A-

To calculate the rating score within the CVS, Scope uses a minimum-maximum algorithm to determine a rating score for each of the 22 indicators. Scope calculates the minimum and maximum of each rating indicator and places each sovereign within this range. Sovereigns with the strongest results for each rating indicator receive the highest rating score; sovereigns with the weakest results receive the lowest rating score. The score result is converted into an indicative rating range that is always presented in lower-case rating scores.

As part of QS assessment, the analyst conducts a comprehensive review of the qualitative factors. This includes but is not limited to an economic scenario analysis, review of debt sustainability, fiscal and financial performance and policy implementation assessments.

There are three assessments per category for a total of 15. For each assessment, the analyst examines the relative position of a given sovereign within its peer group. For this purpose, additional comparative analysis beyond the variables included in the CVS is conducted. These assessments are then aggregated using the same weighting system as in the CVS.

The result is the implied QS notch adjustment which forms the basis for the analyst recommendation to the rating committee.

Foreign- versus local-currency ratings

Spain's debt is predominantly issued in euros, or hedged. Because of its history of openness to trade and capital flows as well as the reserve currency status of the euro, Scope sees no reason to believe that Spain would differentiate among any of its contractual debt obligations based on currency denomination.

[1] Editor's note: the CVS indicative rating range notation was initially published incorrectly as "aa" on 30 June 2017. This was amended to "a" on 27 November.

II. Appendix: CVS and QS results

CVS

Rating indicator	Category weight
Domestic economic risk	**35%**
Economic growth	
Real GDP growth	
Real GDP volatility	
GDP per capita	
Inflation rate	
Labour & population	
Unemployment rate	
Population growth	
Public finance risk	**30%**
Fiscal balance	
GG public balance	
GG primary balance	
GG gross financing needs	
Public debt	
GG net debt	
Interest payments	
External economic risk	**15%**
International position	
International investment position	
Importance of currency	
Current-account financing	
Current-account balance	
T-W effective exch. rate	
Total external debt	
Institutional and political risk	**10%**
Control of corruption	
Voice & accountability	
Rule of law	
Financial risk	**10%**
Non-performing loans	
Liquid assets	
Credit-to-GDP gap	
Indicative rating range	**a**
QS adjustment	**A-**
Final rating	**A-**

QS

Maximum adjustment = 3 notches

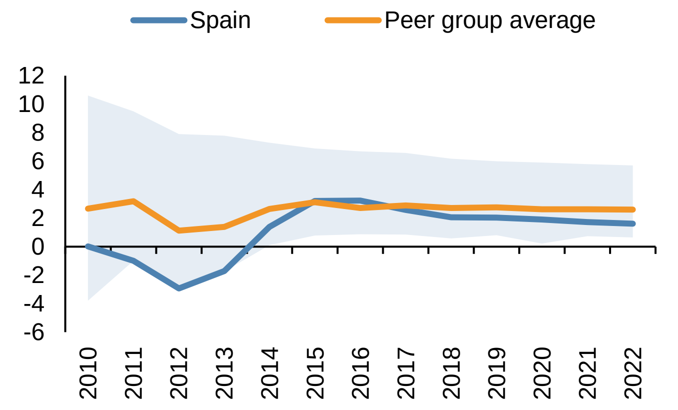
	+2 notch	+1 notch	0 notch	-1 notch	-2 notch
Growth potential of the economy	○ Excellent outlook, strong growth potential	○ Strong outlook, good growth potential	◉ Neutral	○ Weak outlook, growth potential under trend	○ Very weak outlook, growth potential we under trend or negative
Economic policy framework	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Macroeconomic stability and imbalances	○ Excellent	○ Good	○ Neutral	◉ Poor	○ Inadequate
Fiscal performance	○ Exceptionally strong performance	○ Strong performance	○ Neutral	◉ Weak performance	○ Problematic performance
Debt sustainability	○ Exceptionally strong sustainability	○ Strong sustainability	◉ Neutral	○ Weak sustainability	○ Not sustainable
Market access and funding sources	○ Excellent access	○ Very good access	◉ Neutral	○ Poor access	○ Very weak access
Current account vulnerabilities	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
External debt sustainability	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Vulnerability to short-term shocks	○ Excellent resilience	○ Good resilience	○ Neutral	◉ Vulnerable to shock	○ Strongly vulnerable to shocks
Perceived willingness to pay	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Recent events and policy decisions	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Geo-political risk	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Financial sector performance	○ Excellent	○ Good	○ Neutral	◉ Poor	○ Inadequate
Financial sector oversight and governance	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Macro-financial vulnerabilities and fragility	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate

*** Implied QS notch adjustment = (QS notch adjustment for Domestic Economic Risk)*0.35 + (QS notch adjustment for Public Finance Risk)*0.30 + (QS notch adjustment for External Economic Risk)*0.15 + (QS notch adjustment for Institutional and Political Risk)*0.10 + (QS notch adjustment for Financial Stability Risk)*0.10**

Source: Scope Ratings AG

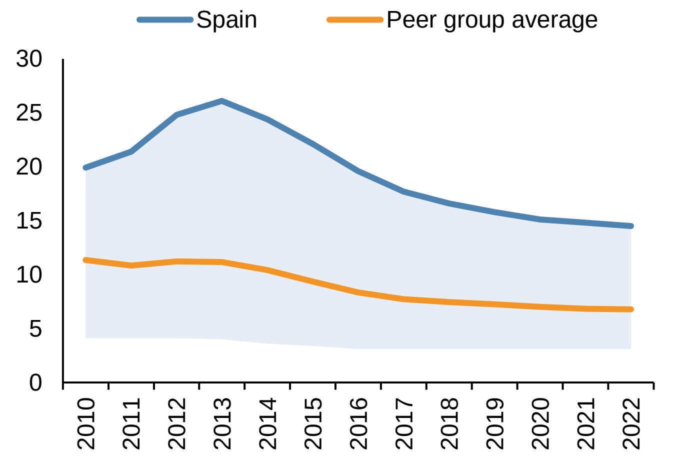
III. Appendix: Peer comparison

Figure 6: Real GDP growth



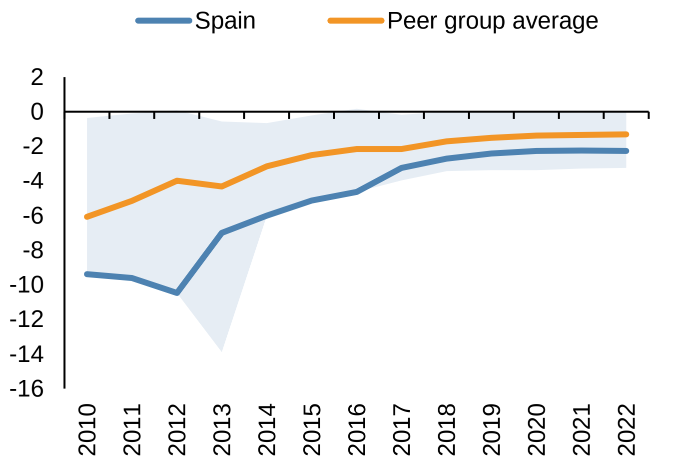
Source: IMF, Calculations Scope Ratings AG

Figure 7: Unemployment rate, % of total labour force



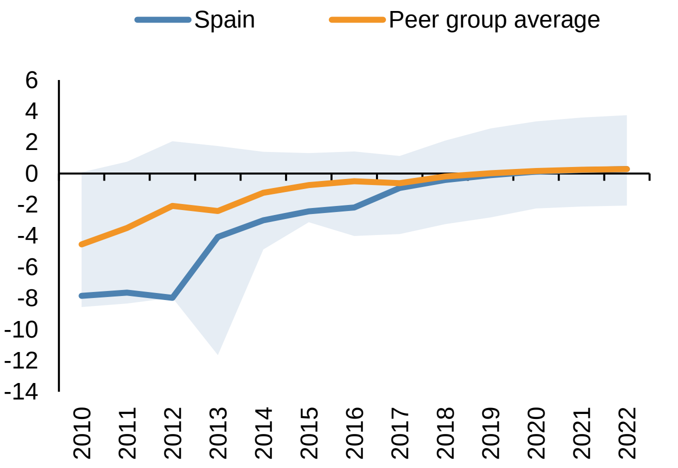
Source: IMF, Calculations Scope Ratings AG

Figure 8: General government balance, % of GDP



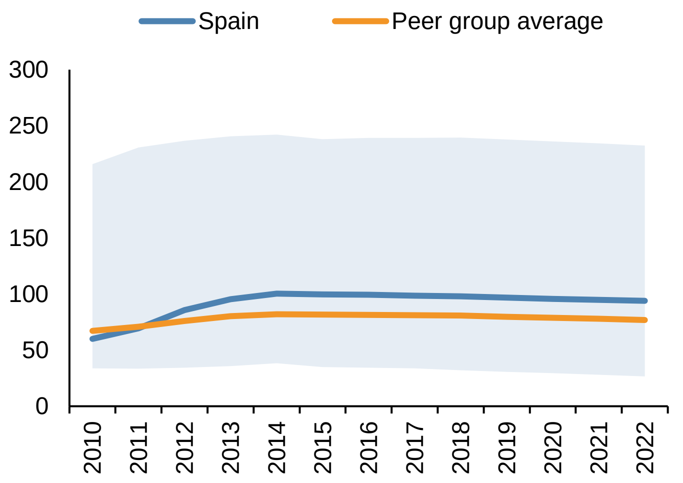
Source: IMF, Calculations Scope Ratings AG

Figure 9: General government primary balance, % of GDP



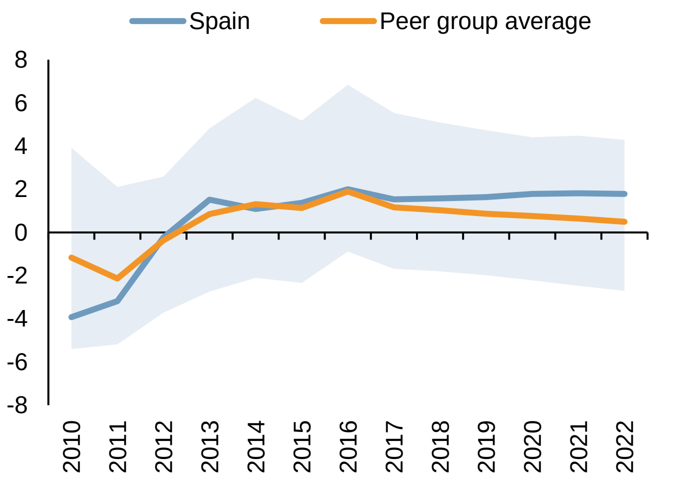
Source: IMF, Calculations Scope Ratings AG

Figure 10: General government gross debt, % of GDP



Source: IMF, Calculations Scope Ratings AG

Figure 11: Current-account balance, % of GDP



Source: IMF, Calculations Scope Ratings AG

IV. Appendix: Statistical tables

	2012	2013	2014	2015	2016	2017E	2018F
Economic performance							
Nominal GDP (EUR bn)	1,039.8	1,025.6	1,037.0	1,075.6	1,113.9	1,160.3	1,201.8
Population ('000s)	46,857.4	46,697.6	46,521.8	46,397.7	46,347.6	46,354.3	46,397.5
GDP per capita PPP (USD)	31,986.5	32,631.5	33,687.9	34,727.2	-	-	-
GDP per capita (EUR)	22,233.0	22,012.5	22,323.2	23,176.8	24,045.4	25,082.7	26,016.8
Real GDP growth, % change	-2.93	-1.70	1.38	3.20	3.24	2.76	2.36
GDP growth volatility (10-year rolling SD)	2.9	2.9	2.8	2.8	2.6	2.5	2.5
CPI, % change	2.44	1.41	-0.14	-0.50	-0.20	2.40	1.43
Unemployment rate (%)	24.8	26.1	24.4	22.1	19.6	17.7	16.6
Investment (% of GDP)	20.0	18.7	19.4	20.1	20.4	20.5	20.6
Gross national savings (% of GDP)	19.8	20.2	20.5	21.4	22.4	22.1	22.2
Public finances							
Net lending/borrowing (% of GDP)	-10.5	-7.0	-6.0	-5.1	-4.3	-3.3	-2.7
Primary net lending/borrowing (% of GDP)	-8.0	-4.1	-3.0	-2.4	-2.2	-0.9	-0.4
Revenue (% of GDP)	37.6	38.6	38.9	38.6	38.4	38.3	38.2
Expenditure (% of GDP)	48.1	45.6	44.9	43.8	42.7	41.5	40.9
Net interest payments (% of GDP)	2.5	2.9	3.0	2.7	2.2	2.3	2.3
Net interest payments (% of revenue)	6.6	7.6	7.7	7.0	5.6	6.1	6.0
Gross debt (% of GDP)	85.7	95.4	100.4	99.8	99.3	98.5	97.9
Net debt (% of GDP)	66.0	74.0	78.6	80.2	80.4	80.4	80.4
Gross debt (% of revenue)	227.7	247.3	258.0	258.3	258.5	257.4	256.0
External vulnerability							
Gross external debt (% of GDP)	166.2	159.8	167.7	169.1	167.5	-	-
Net external debt (% of GDP)	95.7	94.3	97.0	93.1	89.0	-	-
Current-account balance (% of GDP)	-0.2	1.5	1.1	1.4	2.0	1.5	1.6
Trade balance [FOB] (% of GDP)	-	-1.4	-2.2	-2.0	-1.6	-1.9	-1.9
Net direct investment (% of GDP)	-2.0	-1.8	0.8	2.7	1.9	-	-
Official forex reserves (EOP, USD m)	28,168.3	28,151.7	32,873.3	38,714.6	46,879.8	-	-
REER, % change	-2.4%	1.8%	-0.4%	-4.2%	0.7%	-	-
Nominal exchange rate (EOP, USD/EUR)	1.3	1.4	1.2	1.1	1.1	-	-
Financial stability							
Non-performing loans (% of total loans)	7.5	9.4	8.5	6.2	5.6	-	-
Tier 1 ratio (%)	9.8	11.9	11.8	12.7	13.0	-	-
Consolidated private debt (% of GDP)	187.8	176.7	165.4	155.5	147.3	-	-
Domestic credit-to-GDP gap (%)	-26.5	-38.6	-46.5	-52.6	-53.5	-	-

Source: IMF, European Commission, European Central Bank, World Bank, United Nations, Scope Ratings AG

V. Regulatory disclosures

This credit rating and/or rating outlook is issued by Scope Ratings AG.

Rating prepared by Dr Giacomo Barisone, Lead Analyst

Person responsible for approval of the rating Dr Stefan Bund, Chief Analytical Officer

The ratings /outlook was first assigned by Scope as subscription rating on January 2003. The subscription ratings/outlooks were last updated on 05.05.2017.

The senior unsecured debt ratings as well as the short term issuer ratings were assigned by Scope for the first time.

As a "sovereign rating" (as defined in EU CRA Regulation 1060/2009 "EU CRA Regulation"), the ratings on the Kingdom of Spain are subject to certain publication restrictions set out in Art 8a of the EU CRA Regulation, including publication in accordance with a pre-established calendar (see "Sovereign Ratings Calendar of 2017" published on 30.06.2017 on www.scoperatings .com). Under the EU CRA Regulation, deviations from the announced calendar are allowed only in limited circumstances and must be accompanied by a detailed explanation of the reasons for the deviation. In this case the deviation was due to the recent revision of Scope's Sovereign Rating Methodology and the subsequent putting the ratings under review, in order to conclude the review and disclose these ratings in a timely manner, as required by the Article 10(1) of the CRA Regulation.

Solicitation, key sources and quality of information

The rating was initiated by Scope and was not requested by the rated entity or its agents. The rated entity and/or its agents did not participate in the ratings process. Scope had no access to accounts, management and/or other relevant internal documents for the rated entity or related third party.

The following material sources of information were used to prepare the credit rating: public domain and third parties. Key sources of information for the rating include: The Ministry of Finance, Bank of Spain, Instituto Nacional de Estadística, Spanish Treasury, European Commission, AMECO, Eurostat, Interational Monetary Fund (IMF), Haver Analytics.

Scope considers the quality of information available to Scope on the rated entity or instrument to be satisfactory. The information and data supporting Scope's ratings originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data.

Prior to publication, the rated entity was given the opportunity to review the rating and/or outlook and the principal grounds upon which the credit rating and/or outlook is based. Following that review, the rating was not amended before being issued.

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