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Research Update:

Spain Outlook Revised To Negative On Rising Fiscal Deficits And Risks Posed By Macroeconomic Adjustment

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Overview

- We are revising the outlook on the Kingdom of Spain to negative from stable, and affirming the 'AA+' long-term and 'A-1+' short-term sovereign credit ratings.
- Compared to our expectations when we lowered our rating on the sovereign in January 2009, we now believe that Spain will experience a more pronounced and persistent deterioration in its public finances and a more prolonged period of economic weakness versus its peers.
- In our opinion, reducing Spain's sizable fiscal and economic imbalances requires strong policy actions, which have not yet materialized.

Rating Action

On Dec. 9, 2009, Standard & Poor's Ratings Services revised its outlook on the Kingdom of Spain to negative from stable, and affirmed its 'AA+' long-term and 'A-1+' short-term sovereign credit ratings.

Rationale

The change in the outlook stems from our expectation of significantly lower GDP growth and persistently high fiscal deficits relative to peers over the medium term, in the absence of more aggressive fiscal consolidation efforts and a stronger policy focus on enhancing medium-term growth prospects.

The ratings on Spain reflect our view on its modern and relatively diversified economy and its manageable though fast-increasing general government debt burden projected at 67% of GDP in 2010. The ratings also benefit from Spain's membership of the Eurozone, which we believe provides the economy with monetary and exchange rate stability and has insulated the country from some of the pressures stemming from the recent global financial turmoil.

Compared to its rated peers, we believe that Spain faces a prolonged period of below-par economic performance, with trend GDP growth below 1% annually, due to high private sector indebtedness (177% of GDP in 2009) and an inflexible labor market. These factors, in turn, suggest to us that deflationary pressures could be more persistent in Spain than in most other Eurozone sovereigns, which we expect would further slow the pace of fiscal consolidation in the medium term.

Rapid credit growth and large current account deficits, averaging 9.5% of GDP in the three years to 2008, highlight to us that the Spanish economy had been overheating for some time before it entered recession. At the same time, we see that Spain has built up a sizable net external liability position with the rest of the world, at 224% of current account receipts in 2008, similar to that in lower-rated Portugal (A+/Negative/A-1; 204%) and Greece (A-/Watch Neg/A-2; 254%).

In our view, reducing this imbalance between external and domestic demand will likely entail prolonged private sector financial deleveraging. Labor and product market rigidities, weak export competitiveness, and the relatively closed nature of the Spanish economy are also likely to impede recovery from the current recession. For example, we forecast Spain's real GDP per capita growth to average 0.1% in 2009-2012, compared with 2% for the 'AA' median. We also project that unemployment is likely to remain close to 20% in the medium term.

Against this backdrop, we expect that downward pressures on the tax base and upward public spending pressure will result in general government primary deficits, averaging around 6% of GDP for the next three years. Such deficits are well above our estimate of Spain's debt-stabilizing primary surplus of 2% of GDP (assuming that the average long-term nominal interest rate on Spain's debt stock will be about 2.5 percentage points higher than nominal growth over the forecast horizon). We envision that general government primary deficits could edge even higher in the absence of more aggressive actions by the authorities and given our expectations of sluggish economic growth and rising real interest rates. In this event, we expect that the ratio of general government debt to GDP could increase from 40% in 2008 to over 90% by the middle of the next decade, which would likely be one of the most rapid increases in public debt as a share of GDP in the Eurozone.

Outlook

The negative outlook reflects the risk of a downgrade within the next two years in the absence of more aggressive actions by the authorities to tackle fiscal and external imbalances. However, given the relatively strong starting position of the public finances, we believe that there is time for the government to forge a political consensus supporting a credible fiscal consolidation that is consistent with the current rating. If the government announces concrete fiscal measures that we believe could credibly achieve annual primary surpluses of 2% or higher by the end of the forecast period in 2012, downward pressure on the ratings may abate.

Related Research

- Standard & Poor's Takes A Closer Look At Its Stress Test Exercise On Spain's Financial System And The Implications For The System's Financial Strength, Sept. 15, 2009
- Kingdom of Spain Full Analysis, Aug. 14, 2009

- Sharper Expected Decline In Spanish Regions' 2010 Revenues Could Mean Record Deficits And Negative Rating Actions, Aug. 11, 2009.
- Spanish Regions' New Financing System Will Help, But Not Heal; Cost Cutting Is Now The Key Rating Driver, July 17, 2009.
- Kingdom of Spain Long-Term Ratings Cut To 'AA+' On Structural Weakness; Outlook Stable, Jan. 19, 2009
- Sovereign Credit Ratings: A Primer, May 29, 2008

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Kingdom of Spain		
Sovereign Credit Rating		
	AA+/Negative/A-1+	AA+/Stable/A-1+

N.B.--This list does not include all ratings affected.

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Complete ratings information is available to RatingsDirect on the Global Credit Portal subscribers at www.globalcreditportal.com and RatingsDirect subscribers at www.ratingsdirect.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow (7) 495-783-4011.