STANDARD
&POOR'S

Global Credit Portal
RatingsDirect®

April 28, 2010

Research Update:

Spain Downgraded To 'AA' On Protracted Economic Adjustment And Risks To Budgetary Position; Outlook Negative

Primary Credit Analyst:
Marko Mrsnik, Madrid +34 913 896 953;marko_mrsnik@standardandpoors.com

Secondary Credit Analysts:
Myriam Fernandez de Heredia, Madrid (34) 91-389-6942;myriam_fernandez@standardandpoors.com
Trevor Cullinan, London (44) 20-7176-7110;trevor_cullinan@standardandpoors.com

Table Of Contents

Research Update:

Spain Downgraded To 'AA' On Protracted Economic Adjustment And Risks To Budgetary Position; Outlook Negative

Overview

- In our opinion, Spain is likely to have an extended period of subdued economic growth, which weakens its budgetary position.
- We are lowering our long-term rating on the Kingdom of Spain to 'AA' from 'AA+'.
- The negative outlook reflects the possibility of a downgrade if Spain's budgetary position underperforms to a greater extent than we currently anticipate.

Rating Action

On April 28, 2010, Standard & Poor's Ratings Services lowered its long-term sovereign credit rating on the Kingdom of Spain to 'AA'. At the same time, the 'A-1+' short-term sovereign credit rating was affirmed. The outlook is negative. Standard & Poor's transfer and convertibility assessment is unchanged at 'AAA'.

Rationale

The downgrade primarily reflects Standard & Poor's downward revision of its medium-term macroeconomic projections. We now believe that the Spanish economy's shift away from credit-fuelled economic growth is likely to result in a more protracted period of sluggish activity than we previously assumed. We now project that real GDP growth will average 0.7% annually in 2010-2016, versus our previous expectations of above 1% annually over this period.

We have also revised our views on the GDP deflator, so that we now expect nominal GDP to regain the 2008 level by 2015; previously, we had assumed that nominal GDP would exceed the 2008 level in 2013. In addition, and while not factored into our base case, we have taken into account the possibility that Spanish public and private sector borrowing costs could remain elevated in 2010-2011 and further slow Spain's recovery from the current recession. Our conclusion is that challenging medium-term economic conditions will further pressure Spain's public finances, and additional measures are likely to be needed to underpin the government's fiscal consolidation strategy and planned program of structural reforms.

We consider the main factors dampening Spain's medium-term growth prospects to be:

- Private sector indebtedness at 178% of GDP, which in our estimation is higher than that of many of Spain's peers;
- An inflexible labor market (we expect unemployment to reach 21% in 2010), which we believe is likely to slow the recovery of external price competitiveness;
- A fairly low export capacity--currently, Spain's exports are close to 25% of GDP--coupled with eroded competitiveness due to past high increases in unit labor costs compared with those of its peers;
- The financial system's asset quality, which in our opinion is under pressure as reflected in the recent revision of our Banking Industry Country Risk Assessment (BICRA) for Spain to group 3 from group 2. Although the degree of possible additional official support for Spanish banks is uncertain, we currently anticipate a cumulative fiscal cost of at least 5% of GDP. This cost relates to the likely financing needs of the Fondo de Reestructuración Ordenada Bancaria (FROB; €34 billion) and the Fondo de Adquisición de Activos Financieros (€19 billion), which we incorporate into our measure of the general government debt burden; and
- An unwinding of the government's fiscal stimulus as part of its current strategy to reduce the general government deficit to 3% of GDP by 2013.

We continue to believe that the 2010 fiscal deficit will be broadly in line with the government's target of 9.8% of GDP. However, over the medium term we anticipate weaker revenue performance and higher spending pressures than what the government envisages, mainly due to our view of more subdued economic growth compared with the government's current estimates. As a result, Standard & Poor's projects that the general government deficit is likely to still exceed 5% of GDP by 2013, significantly higher than the government's official target of 3%. Consequently, we estimate that gross government debt is likely to rise above 85% of GDP in 2013 and continue to trend higher until the middle of the decade. Increases in Spain's borrowing costs, beyond what we factor into our base case, could, in our opinion, also reduce the government's ability to meet its fiscal targets this year and next.

Our general government debt projections assume that banks will not draw more than the €27 billion in funds available and not yet used via the government's FROB vehicle between now and 2013. However, under our current weaker baseline growth scenario, we believe there is a possibility that the banking system's capital needs could exceed this figure.

Outlook

The negative outlook reflects the possibility of a downgrade if Spain's fiscal position underperforms to a greater extent than we currently anticipate. Conversely, we could revise the outlook to stable if the government meets or exceeds its fiscal objectives in 2010 and 2011 and Spain's economic growth prospects prove to be more buoyant than we currently envisage.

Spanish Government Economic Scenarios And Standard & Poor's Updated Baseline

Scenario

Average 2010-2013

	Spain SGP	S&P Baseline
Real GDP growth (% yoy)	1.9	0.6
Nominal GDP growth (% yoy)	3.4	1.4
GG deficit (% of GDP)	6.4	8.1
Gross GG debt (% of GDP, end-2013)	74.1	87.5

SGP--Stability and Growth Program. GG--General government. yoy--Year on year.

Related Criteria And Research

- Spain BICRA Revised To Group 3 From Group 2 On Greater Weight Of Economic Risk; Teleconf. Tuesday March 16, 10:30am CET, March 15, 2010
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009
- Sovereign Credit Ratings: A Primer, May 29, 2008

Ratings List

Downgraded; Ratings Affirmed

	To	From
Spain (Kingdom of)		
Sovereign Credit Rating	AA/Negative/A-1+	AA+/Negative/A-1+
Senior Unsecured	AA	AA+

Ratings Unchanged

Spain (Kingdom of)	
Transfer & Convertibility Assessment	
	AAA

NB--This list does not include all ratings affected.

Additional Contact:
Sovereign Ratings;SovereignLondon@standardandpoors.com

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.