Kingdom of Spain Long-Term Ratings Cut To 'AA+' On Structural Weakness; Outlook Stable

LONDON (Standard & Poor's) Jan. 19, 2009--Standard & Poor's Ratings Services today said it had lowered its long-term sovereign credit ratings on the Kingdom of Spain to 'AA+' from 'AAA', as we believe that current economic and financial market conditions have highlighted structural weaknesses in the Spanish economy that are inconsistent with a 'AAA' rating. At the same time, the 'A-1+' short-term ratings on the Kingdom were affirmed. The outlook is stable. With these actions, Standard & Poor's removed the ratings from CreditWatch negative, where they were placed on Jan. 12, 2009.

Standard & Poor's will hold a telephone conference call on Monday, Jan. 19, 2009, at 1:00 pm U.K. time, 2:00 pm CET to discuss the rating action on Spain (see below for full details).

"The downgrade of the sovereign reflects our expectations that public finances will suffer in tandem with the expected decline in Spain's growth prospects, and that the policy response may be insufficient to effectively counter the related economic and fiscal challenges," Standard & Poor's credit analyst Trevor Cullinan said.

Spain's membership of the European monetary union protects the economy from exchange rate crises, but also puts greater onus on microeconomic and fiscal policies. We expect the necessary correction in Spain's unsustainably high current account deficit of about 10% of GDP in 2008 through the deleveraging of household and corporate sector balance sheets to take place over the medium term, leading to a potential growth rate of about 2%, well below Spain's 2003-2007 average GDP growth of 3.5%. In our view, at one-quarter of GDP, the export capacity of the Spanish economy is insufficient to provide an immediate channel to offset this fall in domestic demand, especially since Spain has no monetary or exchange rate flexibility in the current global environment.

With a relatively strong starting position, Spain has the fiscal flexibility to run a counter-cyclical fiscal policy, with the general government deficit rising to 6.6% of GDP in 2009 before falling back to 4% of GDP by 2011. Over the medium term, we expect public finances to be put on a more sustainable footing commensurate with the weaker growth outlook. Under our baseline scenario, we anticipate that net general government debt will rise by some 18% of GDP over the next four years. However, that figure would rise significantly should recapitalization needs of the banking system rise toward our worst case estimate of over 4% of GDP.

The stable outlook balances the significant challenge of rebalancing the economy with the flexibility provided by the fiscal surpluses and reserves built up during the boom years, and the government's commitment to fiscal consolidation once near-term economic pressures moderate.

"Significant progress in bringing government debt-to-GDP back to the 2008 level, alongside liberalization of labor and product markets in order to increase productivity growth, improve competitiveness, and reduce unemployment, could put upward pressure on the ratings," Mr. Cullinan said. "The ratings would likely decline, however, should the correction in economic imbalances proceed slowly, or should large fiscal imbalances extend beyond what is necessary for countercyclical measures."

The downgrade also applies to those institutions with ratings linked to the sovereign. As a result, the 'AAA' long-term ratings on Instituto de Credito Oficial (ICO), Sociedad Estatal de Participaciones Industriales (SEPI), and Corporacion de Reservas Estrategicas de Productos Petroliferos (CORES) have been lowered to 'AA+' from 'AAA'. The 'A-1+' short-term ratings have been affirmed, and the outlook is stable.

The 'AAA' long-term ratings on two Spanish regions, Autonomous Community of the Basque Country and Autonomous Community of Navarre, remain on Creditwatch with negative implications. We are awaiting further information from the regional governments as to the extent of decoupling between their economies and public finances, and those of the sovereign.