

Rating Action: Moody's downgrades Spain's government bond ratings to A1, negative outlook

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London, 18 October 2011 -- Moody's Investors Service has today downgraded Spain's government bond ratings to A1 from Aa2. This rating action concludes the review for possible downgrade that Moody's had initiated for Spain's rating on 29 July. The ratings carry a negative outlook.

The main drivers that prompted the rating downgrade are as follows:

(1) Spain continues to be vulnerable to market stress and event risk. Since placing the ratings under review in late July 2011, no credible resolution of the current sovereign debt crisis has emerged and it will in any event take time for confidence in the area's political cohesion and growth prospects to be fully restored. In the meantime, Spain's large sovereign borrowing needs as well as the high external indebtedness of the Spanish banking and corporate sectors render it vulnerable to further funding stress.

(2) The already moderate growth prospects for Spain have been scaled back further in view of (i) the worsening global and European growth outlook and (ii) the difficult funding situation for the banking sector and its impact on the wider economy. Specifically, Moody's now expects Spain's real GDP growth in 2012 to be 1% at best, compared with earlier expectations of 1.8%, with risks mainly to the downside. Over the following years, the rating agency continues to expect a very moderate pace of growth of around 1.5% on average per annum.

(3) Lower economic growth in turn will make the achievement of the ambitious fiscal targets even more challenging for Spain. Moody's expects the budget deficits for the general government sector to be above target both this year and next. In particular, Moody's continues to have serious concerns regarding the funding situation of the regional governments and their ability to reduce their budget deficits according to targets.

These were the main reasons for placing the ratings of the Kingdom of Spain under review on 29 July 2011 and the key areas that Moody's considered during the review period. Since that time, funding challenges for sovereign-related credits as well as uncertainties about the specifics of future euro area support, and about near-term economic growth (and hence the likelihood of further deficit reduction) have increased rather than abated. The credit strengths, on the other hand, have been largely unchanged.

Today's rating action on Spain follows Moody's recent rating actions on the sovereign ratings of Italy (A2, negative outlook) and Belgium (Aa1, rating on review for possible downgrade), which were driven by similar concerns.

Moody's is maintaining a negative outlook on Spain's rating to reflect the downside risks from a potential further escalation of the euro area crisis. The rating agency expects that the next government to emerge after Spain's parliamentary elections on 20 November will be strongly committed to continued fiscal consolidation. Spain's rating would face further downward pressure if this expectation did not materialise. On the other hand, the implementation of a decisive and credible medium-term fiscal and structural reform plan coupled with a convincing solution to the euro area crisis would trigger a return to a stable outlook.

In Moody's view, Spain's sovereign rating is more adequately placed in the A rating category than the Aa category given the potential for contagion from further shocks and the domestic fragilities. Long-term economic strength -- a key input into Moody's sovereign methodology -- is no longer considered to be very high but only moderate given the expectation of a lengthy economic rebalancing process. Moody's also notes that most sovereign issuers with a Aa3 rating have much stronger fiscal and external positions than Spain, including very low public debt, sound public finances and a net creditor status vis-à-vis the rest of the world. This constellation renders them far less vulnerable to a confidence-driven funding crisis than Spain.

At the same time, Moody's acknowledges that Spain has significant fundamental credit strengths when set against its close peers. Even when accounting for the missed deficit targets, Spain's public debt ratio will likely peak at around 75% of GDP, implying a lower vulnerability to growth and interest rate shocks than some of its lower rated peers. Despite a slow start, there is now a clear track record of policy action in Spain which encompasses not only fiscal consolidation but also labour market and pension reforms as well as recapitalisation of the weak parts of the banking sector. The recent constitutional amendment which was supported by the main opposition party is a clear indication that there is a broad consensus on the need for further fiscal consolidation. Despite the downward rating action, Moody's notes that the risk of a default by Spain is remote.

Moody's has today also downgraded the rating of Spain's Fondo de Reestructuración Ordenada Bancaria (FROB) to A1 with a negative outlook, in line with the sovereign rating action. The FROB's debt is fully and unconditionally guaranteed by the government of Spain. FROB's Prime-1 short-term rating is unaffected by today's rating action.

RATIONALE FOR DOWNGRADE

The first driver of Moody's decision to downgrade Spain's sovereign rating is the continued vulnerability of Spain to market stress and, as a result, to elevated funding costs and event risk. Moody's believes that, even if policy action at the euro area level were to succeed in the short term in returning some degree of normality to bank and sovereign debt markets in the euro area, the underlying fragility and loss of confidence is deep and likely to be sustained. High debt and/or deficit countries with large annual funding needs are thus considerably more susceptible to event risk in the form of a loss of market access at affordable rates. Moody's believes that these event risks are better reflected by ratings within the A category rather than the Aa category (see also Moody's recent Special Comment on "Rating Euro Area Governments Through Extraordinary Times -- An Updated Summary" for a broader assessment of the euro area sovereign rating outlook). Nonetheless, Moody's points out that Spain's new A1 rating reflects its view that the risk of default by Spain remains remote. While the Spanish sovereign can sustain higher funding costs for an extended period, the impact on liquidity and funding conditions for regional governments and the banking sector is more severe, with negative implications for the economic outlook.

The weakened growth outlook is the second driver for Moody's rating action. While GDP forecasts for 2011 were already very moderate, the rating agency has now reduced its forecast for 2012 to a real GDP growth rate of only 1%, down from 1.8% previously. The risks to this growth forecast are to the downside. Moody's acknowledges that the necessary rebalancing of the economy is progressing, with positive signs from the export sector. Spain's trade balance with the EU is in surplus for the first time since records began, and international competitiveness is

gradually being recovered through lower labour cost increases than in key competitor countries. However, the necessary adjustment of the economy will likely take several more years, and, in the short term, the slowdown in Spain's key export markets will negatively affect growth. This is already evident in the moderation of export growth over the past several months compared to earlier in the year. The situation on the labour market is severe and will remain so unless further reforms are enacted. The banking sector continues to be fragile as the difficult funding and economic conditions put further pressure on asset quality and profitability. House prices are expected to decline further. At the same time, Moody's acknowledges that the Spanish authorities have made progress with the restructuring of the weak parts of the banking system.

Thirdly, the more moderate growth prospects in turn complicate the already difficult outlook for Spain's public finances. In particular, Moody's expects that the regional governments as a whole will miss this year's deficit target of 1.3% of GDP by a full percentage point of GDP. While the rating agency acknowledges that most of the regional governments are now adopting expenditure-focused fiscal adjustment policies, Moody's points out that achieving the deficit targets would require a significant acceleration of the cost-cutting measures. In June 2011, Moody's had already warned about fiscal slippage among Spain's regional governments, not only for the remainder of 2011 but also in 2012 (see Moody's Special Comment entitled "Spanish Regions: Continued Fiscal Slippage Would Have Negative Ratings Impact").

Despite the additional fiscal measures implemented by the central government in August (amounting to approx. 0.3% of GDP), it will be difficult for the central government to fully compensate for the deviation by the regional governments. Moody's expects the budget deficit for the general government sector to amount to 6.5% of GDP in 2011, half a percentage point above the government's target for the year. For 2012, the rating agency expects a deficit of 5.2% of GDP (revised upwards from 4.8% of GDP previously), well above the government's commitment to reduce the deficit to 4.4% of GDP. This forecast already includes substantial adjustments in most discretionary and mandatory expenditure categories.

PRINCIPAL METHODOLOGY

The principal methodology used in this rating was Sovereign Bond Ratings published in 2008. Please see the Credit Policy page on www.moody's.com for a copy of this methodology.

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