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### **Fitch Affirms the Basque Country at 'A-'; Outlook Stable**

Fitch Ratings, City, 23 January 2019: Fitch Ratings has affirmed the Autonomous Community of the Basque Country's Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDR) at 'A-'. The Outlook is Stable. Fitch has also affirmed the Short-Term Foreign-Currency IDR at 'F1'. The bond issues and senior unsecured ratings have also been affirmed at 'A-'.

The affirmation also takes into account the consolidation of fiscal performance improvement with current balance at November 2018 close to EUR1.27bn (13.9% of operating revenue), in 2017 the operating margin was at 11.3% leading to surplus before debt variation representing 1.1% of total revenue net of new borrowing.

The ratings reflect the Basque Country's special status, strong socio-economic profile, rigidity of its expenditure considering the scope of its responsibility, and relatively volatile debt coverage. The ratings also take into consideration the Basque Country's prudent management and satisfactory financial reporting.

#### **KEY RATING DRIVERS**

##### **Institutional Framework – Neutral / Stable**

There is a specific tax arrangement in the Basque Country under which, its three historical territories have wide fiscal powers and are entitled to levy and collect taxes. Under pre-established agreements a large share of the proceeds need to be redistributed to the regional government.

The Basque Country can be rated higher than the Spanish sovereign, albeit by a maximum three notches, because of its financial and fiscal autonomy as recognised by the Spanish Constitution.

##### **Fiscal Performance – Neutral / Stable**

Under Fitch's rating case scenario, which is stressed, we expect the Basque Country's keeping operating margin above 10% until 2020. The operating margin was negative in 2009-2011, gradually improving to 3.9% in 2016, and unexpectedly jumped to 11.3% in 2017.

The steep improvement over fiscal performance is stemmed from the decision of the Joint Committee of Economic Agreement (half of whose representatives come from the central government and the other half from the Basque Public sector) to review the contribution of the Basque public sector for 2011-2016, and that translated into an important tax compensation to the regional government (the Basque Country) which will reinforce revenue until 2021 by the new agreement of establishment. Additionally, for the medium term, and mainly due to the good performance of the economy and the aforementioned agreements, we have tune revenue up in our rating case scenario.

The 2019 budget was not yet approved, and the regional government was expecting a further increase of revenue leading to an operating margin of 9.4% which was enough to maintain

investments and interest payments by complying with fiscal target of 0 deficit and decreasing the new debt outstanding.

**High Debt but Sound Liquidity - Neutral /Stable**

Under our rating case scenario, the improvement of the budgetary performance indicates the Basque Country would report a surplus in 2019-2020 and therefore debt should stabilize below 90% of current revenue.

Liquidity risk is limited as provincial administrations frequently transfer tax revenue to the Basque Country. Cash reserves increased in 2017 to EUR912 million, from EUR616 million in 2016, covering 82% of the region's 2018 budgeted debt repayment. The Basque government was able to contract debt even during very adverse conditions in 2012-2014. Debt payback improved strongly in the last few years, and we believe that it will remain below 10 years in the short term, from our previous expectation of 20 years.

**Economy – Strength/ Stable**

Under Fitch's rating case scenario, real GDP growth should continue at an average of 1.5% supported by the internal demand until 2020. GDP in 2017 estimated at about EUR71.5 billion and GDP per capita 30% above of the national average, the Basque Country's economy is strong and diversified. According National Statistics, its real GDP growth was negative up until 2013 when it registered its lowest value, but it has consistently grown since following absolute growth of 14% between 2013 and 2017.

The registered population was 2.194 million in 2017 and has gradually increased since 2010 (0.7% rise between 2010 and 2017), in contrast with a decline in population in the other regions located in the north of Spain. Job creation slightly improved in 2018, although at around 954,000 in November 2018 jobs are still well below the 980,000 in 2008. Salaries in the Basque Country are above that of Spain, according to National Statistics Institute on average a 17% above during 2018 .In the last three years, housing sold were 47% to 60% above the national average.

**Management and Administration – Strength / Neutral**

The scope of responsibility of regional governments (healthcare, education university), implies some spending rigidity. The regional government has a strong intention to maintain its level of public services always within the central government framework of compliance in order to avoid any interferences and gain plain autonomy.

The Basque Country's reporting and transparency is very much satisfactory, with accounts of its participation available on its website. Debt management is very prudent. The entity has issued a green bond and the proceeds will be channelled to eligible green and social bond projects specified in the Sustainability Bond Framework adopted by the Basque government in May 2018.

**RATING SENSITIVITIES**

The Basque Country's IDRs could be upgraded due to a confirmation of the recent improvement of its operating performance combined with a stabilisation of its debt level over the medium term.

A downgrade - unlikely at present- could result from an increase in debt to about 120% of its current revenue. A downgrade of the sovereign could also prompt a similar action in the Basque Country's IDR.

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