S&P Global Ratings

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Autonomous Community of The Basque Country

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This report does not constitute a rating action.

Credit Highlights

Overview

Credit context and assumptions	Base-case expectations
--The Autonomous Community of the Basque Country's special status makes it more exposed to the economic cycle, as it has own tax collection power through its historical territories.	--We forecast budgetary performance to slightly weaken in 2023 owing to slowing economic growth, although we expect operating margins to remain above 5% of operating revenue.
--The region's recent renewal of the agreement with the central government for 2021-2025 supports its predictable institutional framework under which it operates, given there are not any meaningful changes.	-- We estimate operating expenditure to remain high in 2023 because the region will intensify its capital expenditure execution with additional EU grants and the implementation of support measures within its 2023 budget.
--The Basque Country's tax autonomy allows it greater budgetary flexibility if needed.	--We expect management to remain committed to budgetary consolidation and debt reduction while maintaining high liquidity reserves.

S&P Global Ratings expects the Basque Country's operating margins to decline moderately over 2023 due to lower tax revenue growth than in 2022 because of the ongoing economic slowdown. Moreover, high operating expenditure due to inflationary pressures and countercyclical economic policies could add pressure. However, we forecast on average that operating surpluses will remain above 5% of operating revenue through our forecast horizon.

Thanks to the Basque Country's large accumulated surpluses, the region's management has decided to use part of its cash buffer to finance expenditure needs in 2022, primarily associated with personnel expenditure. It also decreased its debt burden in nominal terms thanks to a lower debt intake than expected. We expect the Basque Country to maintain sound liquidity over our forecast, supported by its strong access to external liquidity, and €800 million of liquidity lines.

Our rating on the region can be above that on Spain because, in our view, its credit characteristics would make it more resilient than the sovereign in a stress scenario. However, we believe that the Basque Country is highly sensitive to Spain's country risk, and therefore can rate it no more than two notches above the sovereign. Our rating on the region is at the same level as the 'aa-' stand-alone credit profile (SACP). The SACP is not a rating, but a measure of the intrinsic creditworthiness of a local or regional government before accounting for any constraint from the sovereign rating.

Outlook

The stable outlook on the Basque Country mirrors that on **Spain** (unsolicited; A/Stable/A-1) and our view that the region will maintain positive operating balances over our forecast horizon, while continue its deleveraging path. The outlook also reflects our view that the Basque Country will continue to have a strong access to external funding through capital markets, supporting its exceptional liquidity position.

Downside scenario

We could lower our rating on the Basque Country if we downgraded Spain or we believe the region no longer meets our conditions to be rated above the sovereign. We could also downgrade the Basque Country if the region's budgetary performance deteriorates significantly beyond our expectations, whether because of management's lack of commitment to gradually stabilize its budgetary outcome or because of a weaker economic scenario over our forecast horizon.

Upside scenario

We could raise our ratings on the Basque Country if we took the same action on Spain and the region posted structural surpluses after capital accounts higher than 5% of its total revenue, with a lower debt burden.

Rationale

The Basque Country's special status makes it more exposed to the expected economic slowdown in 2023, although its strong and export oriented economy will mitigate the impact

Basque Country and Navarre have their own tax administrations that collect the bulk of taxes. Therefore, special-status regions do not participate in the regional financing system, which is based on advances from taxes collected, allowing the central government to soften the impact of economic cycles on regional revenue. The framework under which the Basque Country operates makes it more vulnerable to economic shocks, but also allows for a faster recovery. The region benefited from a more immediate recovery from the pandemic over 2021 and 2022, although will feel in its accounts more rapidly the expected economic slowdown in 2023.

The Basque Country renegotiated its agreement with the central government in November 2022 for 2021-2025. The agreement does not include any meaningful changes to the calculation of the "cupo" (transfer that the Basque Country must give the central government for services provided), so we do not expect any impact on the region's budgetary performance. The new agreement formalizes the responsibilities given to the Basque Country over the past year such as the management of prisons, management of minimum vital income benefits, and taxes related to environmental purposes.

After experiencing a very high tax collection in 2022, on economic growth and high inflation, we believe that the general economic slowdown in Europe could hamper the region's operating revenue growth. However, we continue to see the Basque Country's economy stronger than that of the sovereign with above average socioeconomic indicators. As such, the region's GDP per capita was about 129% the national average at year-end 2021 and its unemployment is consistently below that of the national average, at 8.6% (versus Spain's 12.9%) at year-end 2022.

Industry is a much bigger part of Basque country's economy than that of other regions, representing 25.3% of gross value added, compared with Spain's 16.9% (as of year-end 2021). In addition, its industrial sector features high-value added, export-oriented companies. This makes the economy more resilient to external shocks. Furthermore, the Basque Country's economic strength is a positive factor particularly because it boosts its tax base, which it directly benefits from thanks to the institutional arrangements that define its relationship with the central government. We also expect the region's economy to benefit from its countercyclical measures included in its 2023 budget and EU funds, which should allow GDP growth to continue through our forecast. Moreover, the Basque Country's economic strength is a positive factor particularly because it boosts its tax bases, which it directly benefits from thanks to the institutional arrangements that define its relationship with the central government. Spanish normal status regions, on the contrary, do not benefit from this because they participate from a common equalization system.

We view the Basque Country's financial management as strong. Management is committed to budgetary and fiscal consolidation as demonstrated through its compliance of the reference deficit targets agreed with the central government. While these deficit targets are not binding, because fiscal rules remain suspended, the region has complied with them while maintaining its period to payment of suppliers below the maximum limit. Also, the region corrected its overfinancing in 2020 and 2021 and used accumulated surpluses to cover for some 2022 expenditure needs and reduce its debt burden.

The region's budgetary performance will remain stable, while continuing its deleveraging and maintaining a strong liquidity position

The Basque Country's budgetary performance weakened in 2022 as the central government's support funds for COVID-19 expenditure ends and the region increased its operating expenditure by 4.6%, on top of its already-very high operating expenditure from 2021. The region used part of its accumulated budgetary surpluses to pay €236 million of professional career development health care workers from 2019-2021. At the same time, the region's capital expenditure increased significantly owing to its use of EU funds and increased capital transfers to some of its public entities as a measure of support.

We forecast a mild decline in the Basque Country's operating margin in 2023, owing to an expected lower tax collection because of the deceleration of economic activity in 2023. At the same time, the region has budgeted an ambitious operating spending plan in its 2023 budget, covering social measures such as the inclusion of minimum vital income benefits or family subsidies to tackle the demographic issues in the region. We expect the region's operating margin to increase again above 5% of operating revenue from 2024 onward, supported by expected stronger economic growth in Spain, as well as our expectation of the return of fiscal rules, which could put rein in expenditure growth.

We expect the Basque Country's balance after capital accounts to be tied to the evolution of EU grants from the Recovery and Resilience Mechanism. The region received about €830 million up to December 2022, and should receive up to €1.03 billion by the end of 2023. However, Spanish regions have until 2026 to spend the EU funds. This means that the timing upon they will receive this revenue will not perfectly match capital expenditure, so could distort the Basque Country's deficit after capital accounts over the forecast. For example, the region's performance benefited from large EU funds in 2021, while undertaking few projects, creating a surplus after capital accounts. However, we understand that the overall effect of these EU grants shall be neutral for 2021-2026 because regions cannot spend what they don't receive and projects need to be previously approved by the ministry and comply with specific goals and targets set by the EU.

The Basque Country reduced its debt burden in nominal terms in 2022 by about €250 million, using accumulated cash surplus from past years, driven by strong operating performance and overfinancing budgetary needs during the pandemic years. At the same time, the public's sector debt is declining, supporting the region's tax-supported debt ratio, which we estimate to reach about 81.9% of consolidated operating revenue by 2025.

Despite liquidity reserves declining in 2022 due to the use of part of its cash buffers to amortize debt and finance budgetary spending, we expect the Basque Country's liquidity position to remain exceptional over the next year. The region's liquidity position is supported by €800 million of signed credit lines and its strong access to external funding. The Basque Country issued a sustainable bond of €700 million in February 2023 that has been successful in capital markets, given that its demand exceeded its bond amount by 7x. While we believe rising interest rates could further stress the region's budget, about 80% of its debt outstanding is at fixed rates, which in our view limits the immediate impact. Moreover, we expect financial management to maintain low debt intake or continue using its high cash reserves to reduce debt more rapidly.

Key Statistics

The Autonomous Community of Basque Country--Selected Indicators (Fiscal Year Ended Dec. 31)

Mil. €	2020	2021	2022	2023bc	2024bc	2025bc
Operating revenue	10,125	12,236	12,292	12,618	13,073	13,482
Operating expenditure	10,060	11,044	11,549	12,072	12,395	12,649
Operating balance	64	1,192	743	547	678	833
Operating balance (% of operating revenue)	0.6	9.7	6.0	4.3	5.2	6.2
Capital revenue	119	416	636	432	256	194
Capital expenditure	1,124	1,131	1,767	1,520	1,248	1,220
Balance after capital accounts	(941)	476	(388)	(541)	(314)	(193)
Balance after capital accounts (% of total revenue)	(9.2)	3.8	(3.0)	(4.1)	(2.4)	(1.4)
Debt repaid	687	668	746	778	631	835
Gross borrowings	2,103	1,165	497	850	781	985
Balance after borrowings	475	973	(638)	(469)	(164)	(43)
Direct debt (outstanding at year-end)	10,065	10,597	10,348	10,420	10,570	10,720
Direct debt (% of operating revenue)	99.4	86.6	84.2	82.6	80.9	79.5
Tax-supported debt (outstanding at year-end)	10,622	11,039	10,810	10,878	11,023	11,168
Tax-supported debt (% of consolidated operating revenue)	103.7	89.1	86.9	85.2	83.3	81.9
Interest (% of operating revenue)	1.4	1.2	1.2	1.3	1.3	1.3
Local GDP per capita (single units)	30,401	32,925	N/A	N/A	N/A	N/A
National GDP per capita (single units)	23,620	25,462	28,017	29,596	30,579	31,813

The data and ratios above result in part from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. The main sources are the financial statements and budgets, as provided by the issuer. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario. N/A--Not applicable.

Rating Component Scores

The Autonomous Community of Basque Country--Ratings Score Snapshot

Key rating factors	
Institutional framework	3
Economy	1
Financial management	2
Budgetary performance	2

Liquidity	1
Debt burden	3
Stand-alone credit profile	aa-
Issuer credit rating	AA-

S&P Global Ratings bases its ratings on non-U.S. local and regional governments (LRGs) on the six main rating factors in this table. In the "Methodology For Rating Local And Regional Governments Outside Of The U.S.," published on July 15, 2019, we explain the steps we follow to derive the global scale foreign currency rating on each LRG. The institutional framework is assessed on a six-point scale: 1 is the strongest and 6 the weakest score. Our assessments of economy, financial management, budgetary performance, liquidity, and debt burden are on a five-point scale, with 1 being the strongest score and 5 the weakest.

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- Criteria | Governments | International Public Finance: Methodology For Rating Local And Regional Governments Outside Of The U.S., July 15, 2019
- Criteria | Governments | International Public Finance: Methodology: Rating Non-U.S. Local And Regional Governments Higher Than The Sovereign, Dec. 15, 2014
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 20, 2013
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Institutional Framework Assessments For Local And Regional Governments Outside Of The U.S., March 22, 2023
- Spain, March 20, 2023
- Institutional Framework Assessment: Spanish Special Status Entities, July 21, 2022
- Research Update: Basque Country Outlook Revised To Stable After Similar Action On Spain; 'AA-' Rating Affirmed, March 25, 2022

Ratings Detail (as of March 24, 2023)*

Basque Country (Autonomous Community of) (The)	
Issuer Credit Rating	AA-/Stable/--
Issuer Credit Ratings History	
25-Mar-2022	AA-/Stable/--
25-Sep-2020	AA-/Negative/--
27-Sep-2019	AA-/Stable/--
06-Apr-2018	A+/Positive/--

Ratings Detail (as of March 24, 2023)*

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings credit ratings on the global scale are comparable across countries. S&P Global Ratings credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.