Research Update:

Basque Country Outlook Revised To Negative From Stable After Similar Rating Action On Spain; Affirmed At 'AA-'

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Overview

- We revised our outlook on Spain to negative from stable on Sept. 18, 2020.
- The Basque Country's budgetary performance will be particularly hit by the COVID-19 pandemic, although we expect the region will absorb the impact and return to balanced budgets by 2022.
- Our ratings on the Basque Country are capped at two notches above our long-term rating on Spain, based on our view that the region's high fiscal autonomy makes it more resilient than Spain in a stress scenario.
- We are therefore revising our outlook to negative from stable and affirming our 'AA-' long-term issuer credit rating on the Basque Country.

Rating Action

On Sept. 25, 2020, S&P Global Ratings revised its outlook to negative from stable and affirmed its 'AA-' long-term issuer credit rating on the Autonomous Community of the Basque Country.

Outlook

Our negative outlook on Basque Country reflects that on Spain.

Downside scenario

We could downgrade the Basque Country in the next 24 months if we downgraded Spain or we believed that the region no longer met our conditions to be rated above the sovereign. We could also lower our ratings on the Basque Country if the region's budgetary performance deteriorated significantly beyond our expectations, whether because of management's lack of commitment to gradually improve budgetary outcomes or a weaker economic scenario over our forecast horizon. This could in turn lead to a higher debt burden and lower liquidity position.

Upside scenario

We could revise our outlook to stable in the next 24 months if we took the same action on Spain provided that the region continues to perform in line with our base-case scenario, which assumes improved budgetary performance already in 2021 and a continuing very strong liquidity position.

Rationale

We revised out outlook on the Basque Country to negative from stable following a similar action on Spain (for more information, see "Research Update: Spain Outlook Revised To Negative From Stable On Mounting Fiscal and Structural Challenges; Affirmed At 'A/A-1'," published Sept. 18, 2020, on RatingsDirect).

Our rating on the Basque Country can be above that on Spain (unsolicited; A/Negative/A-1) because, in our view, the region's 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 than its '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 taking into account any constraint arising from the sovereign rating.

The institutional framework under which the Basque Country operates implies higher exposure to economic shocks, although we expect the region to use one-off central government support

Special-status entities, in particular the Basque Country, have suffered immediate consequences from COVID-19. This is because, in contrast with normal-status regions, special-status entities have their own tax administration that collect the bulk of taxes. They 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. This framework in which they operate make them more vulnerable to economic shocks, but also allows a faster economic recovery. Accordingly, under COVID-19, we expect the Basque Country's budgetary performance to deteriorate due to an expected significant drop in tax collection by the historical territories in 2020, although the recovery in 2021 will also be faster.

As a response to the pandemic, the central government has enacted a recovery fund of up to €16 billion for the regional tier. This support will come in the form of transfers, and regions will not be required to reimburse the fund. This fund is aimed at compensating regions for the extra spending related to health care and education, as well as for the drop in revenue. We understand, based on the published Royal Decree, that the special-status regions, including the Basque Country, will only benefit from the part of the recovery fund related to covering extra health care and education spending, which accounts for €11 billion of the total, while it will not benefit from the part of the fund aimed at compensating for the loss of tax revenue, which accounts for €5 billion. We believe this is because special-status regions are responsible for managing their own revenue and have the flexibility and autonomy to modify their resources as needed.

We estimate that the Basque Country will receive about €550 million in support, which will help mitigate the pandemic's impact on its financial accounts. Given the one-off nature of this support, its voluntary nature, its moderate impact on revenue (about 6%), and the lack of conditions, we do not believe it would interfere with the Basque Country's ability to maintain a rating above the sovereign. Similarly, we do not believe that this temporary measure from the central government warrants a change in our institutional framework assessment. However, should this type of support become a recurrent feature, or should the region avail themselves of this support repeatedly, we might reconsider our institutional framework as well as our approach to rating the Basque Country above the sovereign.

The COVID-19 pandemic has fundamentally changed the economic growth outlook for Spain. We now forecast national nominal GDP will contract 11.0% in 2020, followed by a strong recovery of 9.9% in 2021 and 5.5% in 2022. We expect the Basque Country's economy will suffer in line with that of the sovereign, although it is supported by above-average socioeconomic indicators. The region's GDP per capita represents 130% of that of Spain, at €34,273 at year-end 2019; and its unemployment continues to be below those of the national average at, 8.7% compared with Spain's 15.3% at second-quarter 2020, according to national institute statistics.

Despite a significant deterioration in budgetary performance in 2020, we expect the region to maintain a strong liquidity position and a moderate debt burden

We forecast the Basque Country will post an operating deficit in 2020 of 3.6% of operating revenue and a deficit after capital accounts of about 11% of total revenue, directly because of the pandemic.

While we expect the region to receive about €550 million from the central government recovery fund and €100 million from the EU's European Regional Development Fund, we believe this will only partially mitigate the shock. We expect tax collection from provinces to drop by 12% in 2020 because of the lockdown in first-half 2020 and social distancing measures that have contracted consumption.

At the same time, we expect operating expenditure to increase by 9% in 2020. We believe that most of the region's extra expenditure will come from regional management's support measures to mitigate the pandemic's economic impact. These measures include support to small and midsize enterprises and self-employers, as well as to the health care and education sectors.

While we expect the Basque Country to moderate its capital expenditure in 2020 to absorb part of the impact, we assume a sharp deterioration of its budgetary accounts, and expect a deficit after capital accounts at about 11% of its total revenue, compared with a 2% surplus in 2019. Nevertheless, we expect the region to gradually recover and return to balanced budgets by 2022.

Due to the economic environment and expected tax shortfall, the Basque Country has agreed with the central government to an individual deficit target of 2.6% of regional GDP in 2020, allowing the region to increase its debt to finance its expected deficit. We expect the region to comply with this deficit target, given that failure to do so could mean higher supervision from the central government. Moreover, we understand from regional management and the preliminary agreement that this deficit target could increase if needed. The final ratification of this agreement will take place in mid-October during the Basque Country's finance committee.

In our opinion, the Basque Country's financial management is sound. Management is aware of the importance of their continued conversations and agreements with the central government, and has done so throughout the COVID-19 outbreak. Moreover, the region's financial management actively monitors cash levels and debt repayments while complying with the central government deficit targets of recent years, avoiding any sort of supervision from the central government and maintaining its fiscal autonomy.

Because of higher deficits in 2020, we now estimate tax-supported debt at 101.1% of consolidated operating revenue in 2020. This changes the debt reduction from the past two years. In 2019, the region early repaid about €510 million, using part of its cash and surpluses from 2018 as obliged by the stability law. Debt from government-related entities also declined by €75 million due to an early debt repayment by housing entity Alokabide in 2019. We believe these operations allow the Basque Country some leeway to increase its debt levels in 2020, without materially deteriorating its debt burden levels. We expect the region will reduce its tax-supported debt ratio to 93.3% of consolidated operating revenue by 2022, returning to 2018 debt levels, thanks to expected declines in deficits and higher operating revenue.

The Basque Country has a very solid liquidity cash position. The region has benefited since 2017 from the agreement with the central government, for which it has been receiving adjustments from the past calculation of the cupo (the portion it needs to pay to the central government as compensation for the services they carry in the region). In 2019 it received €216 million, and for 2020 and 2021, it expects to receive €270 million and €324 million, respectively. The region has also built its cash levels thanks to recent accumulated surpluses, and started 2020 with cash levels of up to €1.4 billion.

The Basque Country has acquired extra credit lines to build a cushion to face potential COVID-19 stress, increasing the total to €1.7 billion from €800 million. The region also has a loan from the European Central Bank of €140 million, which it will use to cover part of its financing needs of the year. The Basque Country has funded €885 million, or about 50%, of its financing needs, of which €500 million corresponds to a sustainable bond issued at the end of March 2020. We expect the region to finance the rest of its needs through marked funding, bank loans, and private placements.

Environmental, social, and governance (ESG) credit factors for this credit rating change:

- Health and safety
- Strategy, execution, and monitoring

Key Statistics

Table 1

The Autonomous Community of the Basque Country--Selected Indicators

	--Fiscal year ended Dec. 31--					
(Mil. €)	**2017**	**2018**	**2019**	**2020bc**	**2021bc**	**2022bc**
Operating revenue	10,158	10,340	10,686	10,060	10,346	10,915
Operating expenditure	9,145	9,272	9,527	10,422	9,799	9,964
Operating balance	1,012	1,068	1,159	(363)	547	951
Operating balance (% of operating revenue)	10.0	10.3	10.8	(3.6)	5.3	8.7
Capital revenue	159	151	82	75	81	84
Capital expenditure	1,008	986	1,013	811	859	902
Balance after capital accounts	163	233	228	(1,098)	(232)	133

Table 1

The Autonomous Community of the Basque Country--Selected Indicators (cont.)

	--Fiscal year ended Dec. 31--					
(Mil. €)	**2017**	**2018**	**2019**	**2020bc**	**2021bc**	**2022bc**
Balance after capital accounts (% of total revenue)	1.6	2.2	2.1	(10.8)	(2.2)	1.2
Debt repaid	654	1,215	1,340	714	768	746
Gross borrowings	975	1,274	870	1,812	999	613
Balance after borrowings	484	291	(242)	0	0	(0)
Direct debt (outstanding at year-end)	9,082	9,134	8,645	9,743	9,975	9,841
Direct debt (% of operating revenue)	89.4	88.3	80.9	96.9	96.4	90.2
Tax-supported debt (outstanding at year-end)	9,885	9,851	9,223	10,321	10,513	10,336
Tax-supported debt (% of consolidated operating revenue)	95.9	93.9	85.1	101.1	100.1	93.3
Interest (% of operating revenue)	1.8	1.7	1.7	1.6	1.7	1.6
Local GDP per capita (€)	32,970	34,079	N/A	N/A	N/A	N/A
National GDP per capita (€)	24,972	25,766	26,532	23,591	25,919	27,473

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. N.A.--Not available. N.M.--Not meaningful.

Ratings Score Snapshot

Table 2

The Autonomous Community of the Basque Country--Ratings Score Snapshot

Key rating factors	Scores
Institutional framework	3
Economy	1
Financial management	2
Budgetary perfomance	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.

Key Sovereign Statistics

- Research Update: Spain Outlook Revised To Negative From Stable On Mounting Fiscal and Structural Challenges; Affirmed At 'A/A-1', Sept. 18, 2020

Related Criteria

- 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

- Research Update: Spain Outlook Revised To Negative From Stable On Mounting Fiscal and Structural Challenges; Affirmed At 'A/A-1', Sept. 18, 2020
- Public Finance System Overview: Spanish Special Status Entities, July 28, 2020
- Comparative Statistics: European Local And Regional Government Risk Indicators, June 30, 2020
- Credit FAQ: How Central Government Support Will Limit COVID-19's Impact On Spanish Regions' Finances, June 24, 2020

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

Ratings List

Ratings Affirmed; Outlook Action

	To	From
The Basque Country (Autonomous Community of)		
Issuer Credit Rating	AA-/Negative/--	AA-/Stable/--