S&P Global Ratings

RatingsDirect®

Research Update:

Basque Country Rating Affirmed At 'AA-'; Outlook Remains Negative, Mirroring That On Spain

March 26, 2021

Overview

- The COVID-19 pandemic hit the Basque Country's budgetary performance in 2020 strongly, and we expect budgetary stress to remain in 2021 before the region gradually returns to a balanced budget by 2023.
- The region has expanded its debt borrowing to further strengthen its very strong cash position.
- 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.
- Therefore, we affirmed our 'AA-' rating on the Basque Country; the outlook remains negative, mirroring that on Spain.

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Rating Action

On March 26, 2021, S&P Global Ratings affirmed its 'AA-' long-term issuer credit rating on Spain's Autonomous Community of The Basque Country. The outlook is negative.

Outlook

The negative outlook reflects that on Spain (unsolicited; A/Negative/A-1).

Downside scenario

We could lower our rating on the Basque Counry in the next 18 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 downgrade 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 weaker cash position.

Upside scenario

We could revise our outlook to stable in the next 18 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 starting in 2022 and a continuing very strong liquidity position.

Rationale

Despite the pandemic, the Basque Country posted a stronger budgetary performance in 2020 than we anticipated, with a small operating surplus and a deficit after capital accounts of 9.2% of total revenue. We now believe the performance recovery will be delayed to at least 2022, given that 2021 will be marked by an expansion of expenditure. While vaccination has started across Spain, the pandemic continues and will require extra expense at least during the first half of the year. Moreover, the Basque Country's government has opted for countercyclical measures to stimulate its economy.

While our tax-supported debt ratio for the region will peak in 2021 and decline thereafter, we expect the Basque Country to maintain a very strong liquidity cash position, supported by the region's overfinancing in 2020 and strong access to external liquidity.

Our rating on the Basque Country can be above that on Spain 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 as 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 accounting for any constraint from the sovereign rating.

The Basque Country's special status will allow the region to recover faster, although its receipt of central government support is limited

In contrast with normal status regions, the 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.

In 2020, the Basque Country and Navarre partially participated in the special fund set up by the central government to compensate regions for the impact of COVID-19. The Basque Country received support to mitigate extraordinary expense in health care and education. However, it did not receive compensation for lost tax revenue, because of its own responsibility and flexibility to manage its resources as needed.

Given the one-off and voluntary nature of central government support, its moderate impact on revenue (5.6% of operating revenue), and the lack of any conditionality, we do not believe it interfered with special status regions' ability to maintain a rating above the sovereign if their credit profiles continue to warrant this. Similarly, we do not believe the central government's temporary measure would imply a change in our institutional framework assessment, which we see as evolving and balanced. However, should this type of support become a recurrent feature of special status regions' financing standing or this type of resources not fit under the "Cupo Law" of the Basque Country, we might reconsider our assessment of the institutional framework, as well as our approach to rating these entities above the sovereign.

The Basque Country's economy is wealthier than that of Spain per capita, and more export oriented. The region's GDP per capita is the highest among Spanish regions, and is 130% of that of Spain, at €34,000 as of year-end 2020. According to the Basque Country's regional statistics, GDP for the region contracted by 9.5% in 2020 due to the pandemic, slightly better than Spain's 11.0% drop. The region's unemployment is also better than the national average, with fourth-quarter data showing 10.0% compared with 16.1% in Spain.

The Basque Country relies more on its industry, which represents 22% of gross value added, compared with Spain's 16%. This, in our view, makes the region more resilient to external shocks. In fact, early data for 2021 indicate that the region's industry is recovering quickly and is close to achieving growth, according to regional management.

We view the Basque Country's financial management as strong. Management is aware of the importance of its continued conversations and agreements with the central government, and we expect this to continue over our forecast period and throughout the pandemic. Moreover, the region's financial management actively monitors its cash levels and debt repayments while complying with the central government deficit targets to avoid any sort of supervision from the central government and maintaining its fiscal autonomy.

The region's budgetary performance will be pressured in 2021 before gradually returning to balance by 2023

The Basque Country posted stronger budgetary results in 2020 than we anticipated, and surpassed its reference deficit target for the year. The region had a small operating surplus of 0.6% of operating revenue and a deficit after capital accounts of 9.2% of total revenue, reflecting the impact of the pandemic. Operating revenue declined 5.3%, including a drop of 9.8% of tax collection and the €568 million in extraordinary central government support. At the same time, operating expense increased 5.7%. The region managed to reorient part of its ordinary expense to cover COVID-19 costs.

In 2020, the Basque Country executed most of its planned investment for the year, to stimulate the economy. It also increased capital transfers to public entities as a one-off COVID-19 offset.

In 2021, we expect budgetary performance to be pressured by high operating expense and lower operating revenue compared with pre-pandemic levels. The region's 2021 budget was built assuming a reference deficit target of 2.2%, which the Basque Country and central government had previously agreed to, and very conservative tax revenue assumptions. We believe management's prudence will allow it to post a smaller deficit than allotted, like in 2020. We therefore estimate a negative operating balance of 2.1% of operating revenue. This reflects our view that the pandemic will continue to weigh negatively on the region's accounts at least until the second half of the year. Also, while we expect tax collection from the historical territories to increase, we do not anticipate any extraordinary government support in 2021.

We believe, however, that budgetary performance will recover gradually from 2022 as the pandemic eases, part of the extraordinary expense related to COVID-19 ends, and the recovery translates into higher tax collection. Therefore, we expect the region to return to a balanced budget by 2023.

We believe that the region's capital accounts will be determined by the React-EU funds, from which the Ministry of Finance says the Basque Country is entitled to receive €426 million. We understand these funds were not included in the regional budget, which might imply higher revenue in the coming years. We expect the region to receive 80% of the funds in 2021 and 20% in 2022, while they will be allowed to certify the expenses until 2023. We are not fully clear on how the region will use these funds, although we believe they can finance direct COVID-19 expense, ongoing investment projects, and new projects.

Accounting for these dynamics, we expect the Basque Country's tax-supported debt ratio to peak in 2021, then gradually decline to 102% of consolidated operating revenue by 2023. We believe the decline in debt in 2018 and 2019 allowed the region more space to increase its debt burden in facing the pandemic. Under our tax-supported debt ratio, we consolidate the government-related entities' debt and guaranteed debt, which together account for about €357 million at year-end 2020.

In 2020, the Basque Country's gross borrowings reached €2.1 billion, and created an excess of financing that increased its cash levels. Of these borrowings, €1.7 billion were bond issuances, demonstrating its access to external liquidity, which we now assess as strong. The region has a solid track record accessing the market, and has bonds outstanding representing about 57% of its direct debt.

The Basque Country's cash position has also been strengthened by its agreement with the central government in 2017, under which it received 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 2020, it received €308 million, and in 2021, it will receive €370 million. Thereafter the agreement will be settled.

At the beginning of 2021, the Basque Country had €1.7 billion in contracted credit lines. We believe the region might return to lower levels of credit lines next year, once the pandemic eases.

Key Statistics

- Spain 'A/A-1' Ratings Affirmed; Outlook Remains Negative On Fiscal And Structural Challenges, March 19, 2021

Ratings Score Snapshot

Table 1

Autonomous Community of the Basque Country--Selected Indicators

	--Fiscal year ended Dec. 31--				
(Mil. €)	**2019**	**2020e**	**2021bc**	**2022bc**	**2023bc**
Operating revenue	10,686	10,125	10,163	10,803	11,290
Operating expenditure	9,520	10,060	10,373	10,259	10,281
Operating balance	1,166	64	(210)	544	1,009
Operating balance (% of operating revenue)	10.9	0.6	(2.1)	5.0	8.9
Capital revenue	83	119	461	211	124
Capital expenditure	1,009	1,124	1,283	1,268	1,129
Balance after capital accounts	240	(941)	(1,032)	(513)	4

Table 1

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

	--Fiscal year ended Dec. 31--				
(Mil. €)	2019	2020e	2021bc	2022bc	2023bc
Balance after capital accounts (% of total revenue)	2.2	(9.2)	(9.7)	(4.7)	0
Debt repaid	1,360	687	768	746	853
Gross borrowings	871	2,103	1,800	1,259	849
Balance after borrowings	(249)	475	0	0	0
Direct debt (outstanding at year-end)	8,645	10,065	11,097	11,610	11,607
Direct debt (% of operating revenue)	80.9	99.4	109.2	107.5	102.8
Tax-supported debt (outstanding at year-end)	9,223	10,622	11,638	12,108	12,104
Tax-supported debt (% of consolidated operating revenue)	85.1	103.7	113.2	110.8	106.0
Interest (% of operating revenue)	1.7	1.4	1.4	1.6	1.5
Local GDP per capita (€)	34,142	N/A	N/A	N/A	N/A
National GDP per capita (€)	26,520	23,662	25,390	27,498	28,746

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. e--Estimate. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario. N/A--Not applicable.

Key Sovereign Statistics

Table 2

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.

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

- Spain 'A/A-1' Ratings Affirmed; Outlook Remains Negative On Fiscal And Structural Challenges, March 19, 2021
- Sovereign Risk Indicators, Dec. 14, 2020. An interactive version is available at http://www.spratings.com/sri
- Basque Country Outlook Revised To Negative From Stable After Similar Rating Action On Spain; Affirmed At 'AA-', Sept. 25, 2020
- Public Finance System Overview: Spanish Special Status Entities, July 28, 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	
Basque Country (Autonomous Community of) (The)	
Issuer Credit Rating	AA-/Negative/--