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Research Update:

Ratings On Andorra Lowered To 'A-/A-2' On Weak Economic Growth Prospects; Outlook Remains Negative

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Table Of Contents

Overview

Rating Action

Rationale

Outlook

Related Criteria And Research

Ratings List

Research Update:

Ratings On Andorra Lowered To 'A-/A-2' On Weak Economic Growth Prospects; Outlook Remains Negative

Overview

- We expect Andorra's growth outlook to remain weak, suppressed by declining domestic demand and difficult economic environments in key trading partners.
- We are therefore lowering our long- and short-term sovereign credit ratings on the Principality of Andorra to 'A-/A-2' from 'A/A-1'.
- The outlook on Andorra remains negative, reflecting our view of risks emanating from the difficult internal and external economic environments.

Rating Action

On Dec. 3, 2012, Standard & Poor's Ratings Services lowered its long- and short-term foreign and local currency sovereign credit ratings on the Principality of Andorra to 'A-/A-2' from 'A/A-1'. The outlook remains negative. Our transfer and convertibility (T&C) assessment for Andorra is 'AAA'.

Rationale

The downgrade reflects our view of Andorra's ongoing weak economic growth outlook. We believe further declines in domestic demand, as well as the difficult economic environment in Europe--particularly major trading partners France and Spain--will continue to drag on Andorra's GDP growth.

The government's plans to restart the economy hinge on it adopting legislation aimed at opening the principality to foreign direct investment. Once implemented, we expect it will help diversify the economy, especially as tourism-related growth has waned. In our view, tourism should benefit from a reduced regulatory burden; we anticipate increased labor-market flexibility as well as greater diversification in the geographic origin of visitors and the purpose of visits. Over the long term, we believe the government's policies to diversify the economy will bear fruit; however, progress will be slow given the small size of the economy and the weak external environment.

In 2012 we forecast the economy to contract by 2.7% in real terms--the fifth consecutive year of negative growth--before gradually recovering over the next three or so years. A reflection of the ongoing adjustment in Andorra's economy is the 14% cumulative decline in employment since 2006 resulting from a fall in business activity. The construction sector has been particularly badly hit: it has contracted in value-added terms by more than 30% since 2006. The unemployment rate has only increased by an estimated 3.8% from 2006, to 4.3% in 2012. This is partly explained by a substantial decline in population. In 2011, we estimate it fell by at least 4%, in turn weakening domestic demand. Economic weakening in France and Spain has also dragged on Andorra. This is especially the case for Spain, which has been undergoing a deepening recession and is the source of almost 60% of all tourist arrivals to Andorra.

In our view, the government's broad-based budgetary consolidation strategy should help reduce its debt over the medium term. However, such measures are likely to weigh on domestic demand. On the revenue side, the government is restructuring its tax system by introducing corporate income tax, VAT, and personal income tax (in 2014) as well as raising excise taxes on tobacco. On the expenditure side, it plans to reduce the public-sector wage bill and current transfers, including reforming the transfer arrangement with local authorities as well as reforming the social security system. This also includes the implementation of healthcare and pension reforms.

We expect general government debt to peak at about 40% of GDP in 2013 before declining. Net of substantial social security reserves, mostly placed abroad, we estimate general government debt at just below 3% of GDP in 2012 and 2013 before falling. Central government debt consists mainly of loan facilities with domestic banks, although recently issuance of retail bonds has alleviated the domestic banks' exposure to the sovereign.

The Andorran banking system reported sound capital adequacy and liquidity ratios of about 21% and 67% at end-2011. The sector is large relative to the size of the economy, with banks' aggregate assets about 500% of GDP. Only one of the five banks is foreign owned, by Banco de Sabadell S.A. Andorra's monetary agreement with the European Union officially authorizes it to use the euro and issue euro coins, but does not grant Andorran banks direct access to European Central Bank (ECB) financing facilities. The banks can access the ECB through their subsidiaries in the eurozone.

Outlook

The negative outlook reflects our opinion of ongoing risks emanating from the difficult internal and external economic environments.

We could consider lowering the ratings if the government were to deviate from its strategy of budgetary consolidation or delay structural reforms to restore economic growth potential. The ratings would also come under pressure if the current external environment worsened such that the sovereign's or banking sector's market access to funding was reduced.

The ratings could stabilize at the current level if the government's planned structural reforms are fully implemented and economic growth recovers while correcting budgetary imbalances.

Related Criteria And Research

- Sovereign Government Rating Methodology And Assumptions, June 30, 2011
- Sovereign Government Ratings Methodology Addendum For Sovereigns With Limited External Data, Nov. 7, 2011
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Ratings List

Downgraded

	To	From
Andorra (Principality of)		
Sovereign Credit Rating	A-/Negative/A-2	A/Negative/A-1

Affirmed

Andorra (Principality of)	
Transfer & Convertibility Assessment	AAA

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