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## Research Update:

# Andorra Ratings Affirmed At 'A-/A-2'; Outlook Remains Negative

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## Research Update:

# Andorra Ratings Affirmed At 'A-/A-2'; Outlook Remains Negative

## Overview

- Andorra's economy continues to contract, and medium-term economic growth prospects are weak.
- Government reforms are focusing on diversifying the economy and reducing the budget deficit.
- We are affirming our long- and short-term sovereign credit ratings on Andorra at 'A-/A-2'.
- The outlook on the long-term rating remains negative, indicating that there is a more than one-in-three chance that we could lower the ratings on Andorra in the next 12 months.

## Rating Action

On Oct. 18, 2013, Standard & Poor's Ratings Services affirmed its long- and short-term foreign and local currency sovereign credit ratings on Andorra at 'A-/A-2'. The outlook is negative.

## Rationale

Our ratings on Andorra incorporate our view of its weak economic growth prospects, its still-limited economic diversification, risks posed by the large size of its banking sector, and its lack of a central bank. The ratings are supported by Andorra's stable political institutions and relatively prosperous economy (we estimate GDP per head at about \$43,500 in 2013), as well as its low net general government debt, despite the rapid increase in gross general government debt in recent years.

The Andorran economy has contracted by more than 20% since 2007 and we estimate real GDP will contract again this year, by about 0.5%, before recovering to subdued growth in 2014 and beyond. Andorra's ongoing economic adjustment can be seen in its 16% cumulative decline in employment between end-2006 and end-2012, resulting from a fall in business activity. Economic stagnation in France and recession in Spain have also dragged on Andorra's economy, as they are its main trading partners.

In order to diversify the economy, the Andorran government adopted a law on foreign direct investment (FDI) in 2012. Since then, it has approved projects worth about 1.2% of GDP, which has helped buck negative trends in employment figures and economic activity. We believe that if FDI continues it will help the economy recover, but we note that progress will be slow given the weak

external environment.

Following the one-off widening of the central budget deficit in 2012--due to investment spending on Andorra's road network--we expect that the government's broad-based budgetary consolidation strategy will now help reduce debt in the medium term. In 2012, despite the recessionary environment, government revenues hit a record high after it introduced new direct taxes, in particular company income tax and tax on economic activities. It also achieved higher indirect tax revenues by increasing excise taxes.

On the spending side the government has exercised restraint in areas such as its wages bill and the purchase of goods and services. Excluding the one-off payment for road works in 2012, this has resulted in lower-than-planned government spending, a trend which we expect will continue. As a result, we forecast the central government deficit will reduce to about 2.0% of GDP in 2013, from 3.5% in 2012.

We expect gross general government debt to peak at almost 41% of GDP in 2013, before stabilizing in 2014 and declining thereafter. Net of substantial social security reserves, mostly placed abroad, we estimate net general government debt will reach just below 3% of GDP in 2013, and will then fall. We expect the government to meet its 2013 borrowing requirements more via bond issuance than by borrowing from domestic banks--a shift away from its previous approach. We anticipate the general government interest burden will average about 7.6% of total general government revenues over 2013-2015 from 4.5% over the previous three years, notably due to the relatively higher interest rate coupled with the higher gross debt stock.

The Andorran banking system reported sound capital adequacy and liquidity ratios, under Andorran accounting standards, of about 20% and 65% at end-2012. Nonperforming loans, however, are still on the rise. The sector is large relative to the size of the economy, with banks' aggregate assets at about 600% of GDP. Only one of the five banks--Banco de Sabadell S.A.--is foreign owned. Andorra's monetary agreement with the European Union authorizes it to use the euro and mint euro coins, but does not grant Andorran banks direct access to European Central Bank (ECB) financing facilities, from their head offices. The banks can access the ECB through their subsidiaries in the eurozone to the extent that the subsidiaries have unencumbered eligible collateral.

Given Andorra's size, the government has limited resources to collect data. Aggregate financial sector data are published by the Association of Andorran Banks annually, usually in the third quarter. The government does not publish a complete balance of payments or data regarding its international investment position. A sovereign's ad hoc publication of economic indicators can influence our credit appraisal more markedly than when dissemination of economic data is more frequent and plentiful.

## Outlook

Given Andorra's five years of economic contraction, we believe that there is a more than one-in-three chance that we could lower the ratings on Andorra in the next 12 months.

We could lower the ratings if economic growth fails to rebound, if central government fiscal deficits do not narrow, if the government's ambitious program of reforms is delayed, or if the periodic release of data suggests greater economic weakness than we currently assume. Moreover, we could lower the ratings if external funding conditions lead to a reduction in the sovereign's or banking sector's market access, or higher funding costs.

The ratings could stabilize at the current level if the economy recovers more robustly than we currently expect and structural reforms as well as budgetary consolidation are fully implemented.

## Key Statistics

Table 1

Principality of Andorra - Selected Indicators											
	2006	2007	2008	2009	2010	2011	2012	2013e	2014f	2015f	2016f
Nominal GDP (US\$ bil)	3.5	4.0	4.1	3.7	3.4	3.5	3.2	3.3	3.3	3.4	3.5
GDP per capita (US\$)	43,163	48,338	48,154	44,176	40,105	44,946	42,285	43,534	43,964	44,801	45,926
Real GDP growth (%)	5.5	1.1	(7.2)	(4.1)	(5.0)	(4.3)	(1.6)	(0.5)	0.4	0.7	1.0
Real GDP per capita growth (%)	2.0	(1.2)	(8.7)	(3.7)	(6.0)	4.1	0.8	0.0	0.4	0.4	0.7
Change in general government debt/GDP (%)	2.9	2.6	6.1	4.4	3.5	1.6	3.0	(0.3)	(0.9)	(1.3)	(1.2)
General government balance/GDP (%)	(0.5)	(2.1)	(5.7)	(1.9)	0.8	0.2	0.0	0.3	0.9	1.2	1.2
General government debt/GDP (%)	16.5	18.2	25.4	30.9	35.4	37.7	41.0	40.4	38.8	36.7	34.5
Net general government debt/GDP (%)	(8.8)	(7.4)	(0.2)	1.7	3.1	3.0	3.1	2.8	1.9	0.6	(0.6)
General government interest expenditure/revenues (%)	2.5	4.4	7.9	4.6	2.9	4.8	6.0	8.0	7.6	7.2	6.7
Oth dc claims on resident non-govt. sector/GDP (%)	202.8	220.0	252.3	258.5	277.0	294.1	294.6	291.7	286.7	283.3	279.7
CPI growth (%)	3.2	3.9	2.0	0.0	1.6	2.5	1.1	1.0	1.3	1.5	1.8
Gross external financing needs/CARs +use. res (%)	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Current account balance/GDP (%)	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Current account balance/CARs (%)	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Narrow net external debt/CARs (%)	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A

**Table 1**

Principality of Andorra - Selected Indicators (cont.)											
Net external liabilities/CARs (%)	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A

Other depository corporations (dc) are financial corporations (other than the central bank) whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private- sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. CARs--Current account receipts.

The data and ratios above result from S&P's own calculations, drawing on national as well as international sources, reflecting S&P's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

## Related Criteria And Research

- Sovereign Government Rating Methodology And Assumptions, June 24, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Sovereign Defaults And Rating Transition Data, 2012 Update, March 29, 2013
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

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 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.

## Ratings List

Ratings Affirmed

Andorra (Principality of)  
Sovereign Credit Rating

A-/Negative/A-2

*Research Update: Andorra Ratings Affirmed At 'A-/A-2'; Outlook Remains Negative*

Transfer & Convertibility Assessment	AAA
Senior Unsecured	A-

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