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Research Update:

Andorra 'BBB/A-2' Ratings Affirmed; Outlook Stable

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Overview

- In our view, Andorra's positive real GDP growth and expected economic performance, combined with prudent fiscal policies, will support its net creditor position over the 2018-2019 period.
- Following general elections next year, we expect to see continuity in the government's reform agenda, including continued negotiations with international institutions that upon successful conclusion would support the country's economic resilience.
- We are affirming our 'BBB/A-2' long- and short-term ratings on Andorra.
- The outlook remains stable.

Rating Action

On July 20, 2018, S&P Global Ratings affirmed its 'BBB/A-2' long- and short-term foreign and local currency sovereign credit ratings on Andorra. The outlook is stable.

Outlook

The stable outlook balances our expectation of robust economic activity and sound fiscal performance against risks related to the large size of Andorra's financial sector.

We could raise the ratings if:

- Andorra improves its institutional strength and economic resilience by successfully completing negotiations on its association agreement with the EU or accession to the International Monetary Fund (IMF). These agreements would provide access to emergency funding in case of any future financial crises.
- Greater availability of statistical data were to prompt us to improve our assessment of Andorra's external position.

We could lower the ratings if:

- Andorra's economy performs so far below our expectations that it has structural repercussions for its income levels or fiscal outcomes.
- We perceived heightened risks in the country's financial sector, and we

considered that this could have a material effect on the country's economy and the government's fiscal prospects.

Rationale

The affirmation reflects our view that next year's general elections are unlikely to hinder the steady reform progress Andorra has achieved in converging on global standards of financial reporting and supervision.

It also reflects our expectation that the economy will continue to benefit from the robust economic growth of its main trading partners, Spain and France. We also expect that the Andorran government will retain its net creditor position over the next two years, given our forecast of very low central government fiscal deficits and high level of the government's liquid assets. Our view of these credit strengths is counterbalanced by Andorra's large financial sector compared with the size of its economy and its lack of monetary flexibility.

Institutional and Economic Profile: Steady progress on negotiations with the IMF and alignment with global standards, coupled with robust economic growth

- Andorra continues to make progress on its negotiations with the IMF.
- We expect further progress on the government's reform agenda, which is leading to convergence with international practices in financial supervision.
- We expect Andorra's economy to expand by 1.5% on average over 2018-2019, in real terms, supported by robust economic growth in neighboring Spain and France.

Andorra's stable and mature political institutions support generally effective policy-making in the country.

The center-right party, Democrats for Andorra, led by Prime Minister Antoni Martí, governs the Principality and has an absolute majority. The next elections will take place before the end of March 2019. However, we do not foresee that a potential change in government would delay or disrupt the country's reform agenda. The legislation was supported by a broad consensus in parliament and we consider that the main economic stakeholders support the country's alignment toward global standards of financial supervision and reporting.

The ratings could benefit from the successful completion of the ongoing negotiations for Andorra's association agreement with the EU and accession to the IMF. If concluded on favorable terms, this accession could improve the country's ability to deal with the repercussions of future financial crises. We also believe both processes could have the additional benefit of improving the quality, transparency, and comparability of the country's statistical information.

Policymaking in Andorra has generally been effective in recent years, promoting the sustainable public finances demonstrated by the country's past two years of fiscal surpluses at all government levels. The fiscal sustainability law approved in 2014 limits the fiscal central government deficit to 1% of GDP and the indebtedness level to 40% of GDP.

The government is making progress toward convergence with international financial regulation and supervision practices. In June 2017, the Global Forum (OECD) provisionally graded Andorra "largely compliant" with regard to its exchange of information under request standards; the Global Forum will complete its evaluation on this matter in 2019. The first automatic exchange of information will happen next September 2018.

Economic growth is heavily dependent on Andorra's main trading partners (Spain and France) and follows the same trend--after being subdued over 2014-2016, it started to recover in 2017. For 2018-2019, we forecast average real GDP growth of about 1.5% in Andorra.

Three sectors dominate Andorra's economy: financial services, tourism, and commerce. All are deeply interlinked and correlated. Andorra's dependence on Spain is particularly acute--Spain is the main source of the country's visitors and the key client of its financial services. Additionally, over half of Andorra's exports are to Spain, while 64% of its imports come from this partner.
The government has been active in promoting other sectors of the economy, but significant economic diversification is unlikely to occur in the next two years.

Flexibility and Performance Profile: Andorran government will remain a net creditor, but exposed to high contingent risks

Overall, we forecast general government fiscal surpluses of about 1.2% on average for 2018-2021. We expect moderate central government deficits, which we estimate at about 0.5% of GDP for 2017-2021, and which will modestly raise central government debt.

We expect local governments to continue posting surpluses, aided by increased transfers from the central government. This should enable local governments to reduce leverage further.

Furthermore, if the social security system reports further surpluses, they would continue to accumulate in Andorra's retirement pension fund. This supports our expectation that Andorra will maintain its net creditor position at above 14% of GDP through 2021.

Andorra issued €520 million in debt in 2017. The government's financial policy focuses on increasing the average maturity of its debt and lowering its cost. Average debt maturity as of March 2018 had extended to 3.6 years, from 2.9 years in 2016, and the average cost of debt is now around 1.1%. We estimate that the Andorran government's refinancing needs for 2018 amount to about €205 million (7% of GDP), for which the central government will issue additional debt this year to roll over these debt instruments, in line with its debt-management strategy.

The high contingent liabilities from Andorra's large financial sector constrain our debt assessment. As of end-2017, assets under management represented 17.3x our estimated 2017 GDP, while deposits were about 3.6x GDP. Following the collapse of BPA in 2015, the financial sector has stabilized.

In our view, any potential banking crisis could have repercussions for the country's budget and lead to debt accumulation. Moreover, the BPA resolution process remains subject to litigation, which we understand could impose costs on the government in the case of an adverse court ruling.

We still consider that Andorran banks' very large size and international expansion expose the Andorran government to high potential contingent liabilities. Financial institutions' claims on the resident nongovernment sector, at about 1.5x 2017 GDP, are among the highest of the sovereigns we rate. Andorra's financial sector contributes about 20% of total GDP and approximately 5% of salaried employment (at year-end 2016), which highlights the country's vulnerability to any potential turbulence in this sector.

The Andorran authorities and banks continue to improve risk-management policies and oversight, while supervisor Autoritat Financera Andorrana (AFA) and the financial intelligence unit (Unitat d'Intel·ligència Financera d'Andorra; UIFAND) have expanded their resources. Banks are adopting International Financial Reporting Standards 9 (IFRS 9) from 2018 to make their financial reports comparable with international peers.

In our view, convergence with international norms and transparency standards will tend to lower the risk arising from the banking sector. At the same time, we consider that it will test Andorra's banks' current business model--they will have to compete on an even playing field with much larger global players.

Despite improving standards, we still view the international footprint of Andorran banks as a potential source of risk. We estimate the banks' activity outside Andorra continues to grow as a proportion of the total banking sector. Other contingent liabilities are limited, as the sovereign's public companies have consistently reported positive performance, providing additional revenues to the central government instead of requiring transfers.

Our view of Andorra's creditworthiness remains constrained by the country's lack of an independent monetary policy, given its use of the euro as the official currency since 2011. Although Andorra lacks a lender of last resort, we recognize that Andorran banks have indirect access to liquidity from the European Central Bank through their subsidiaries in the eurozone.

Because of a lack of sufficient external data, we evaluate Andorra's external position starting from our view on Spain, the country to which its economy is most closely tied, and then adjust our view to reflect the lack of data. We understand the Andorran government is actively working to address this deficiency, through the approval of a new Statistic Plan for 2018-2021 and a strengthening of the country's statistical services.

Key Statistics

Table 1

Andorra Selected Indicators

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. LC)	2	2	3	3	3	3	3	3	3	3
Nominal GDP (bil. $)	3	3	3	3	3	3	3	4	4	4
GDP per capita (000s $)	41.5	43.1	43.6	36.1	36.8	37.7	41.2	44.1	45.2	46.2
Real GDP growth	(1.6)	0.4	2.3	0.8	1.9	1.9	1.5	1.4	1.4	1.2
Real GDP per capita growth	0.8	0.5	1.1	(0.5)	1.6	(0.6)	1.3	1.2	1.2	1.0
Real investment growth	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Investment/GDP	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Savings/GDP	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Exports/GDP	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Real exports growth	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Unemployment rate	6.0	6.5	5.8	4.1	3.6	2.4	2.5	2.5	2.5	2.5
EXTERNAL INDICATORS (%)										
Current account balance/GDP	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
CARs/GDP	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Trade balance/GDP	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Net FDI/GDP	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Net portfolio equity inflow/GDP	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Gross external financing needs/CARs plus usable reserves	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
Narrow net external debt/CAPs	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Net external liabilities/CARs	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Net external liabilities/CAPs	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Short-term external debt by remaining maturity/CARs	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Usable reserves/CAPs (months)	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Usable reserves (mil. $)	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
FISCAL INDICATORS (%, General government)										
Balance/GDP	(0.1)	4.9	3.0	2.4	5.2	4.5	1.7	1.5	1.4	1.4
Change in net debt/GDP	0.2	(3.3)	(1.8)	(2.2)	(4.7)	(4.7)	(1.7)	(1.5)	(1.4)	(1.4)
Primary balance/GDP	1.3	5.9	3.9	3.1	5.9	4.9	2.0	1.9	1.8	1.7
Revenue/GDP	22.5	24.2	22.0	22.7	25.1	21.3	20.8	20.7	20.7	20.6
Expenditures/GDP	22.6	19.3	19.0	20.3	19.9	16.8	19.2	19.2	19.2	19.3

Table 1

Andorra Selected Indicators (cont.)										
	2012	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
Interest /revenues	6.0	4.3	4.1	3.2	2.7	1.8	1.8	1.7	1.7	1.6
Debt/GDP	41.7	41.4	41.0	40.7	40.0	37.7	36.5	35.6	34.7	33.9
Debt/Revenue	185.3	171.2	186.3	179.3	159.5	176.9	175.7	171.6	167.9	164.5
Net debt/GDP	3.2	(0.1)	(2.0)	(4.1)	(8.7)	(13.2)	(14.5)	(15.6)	(16.6)	(17.5)
Liquid assets/GDP	38.5	41.6	43.0	44.9	48.7	50.9	51.0	51.2	51.3	51.5
MONETARY INDICATORS (%)										
CPI growth	1.6	0.5	(0.0)	(1.1)	(0.5)	2.4	1.5	1.4	1.4	1.5
GDP deflator growth	1.1	0.0	(0.1)	(0.5)	0.7	0.9	1.5	1.4	1.4	1.5
Exchange rate, year-end (LC/$)	0.76	0.73	0.82	0.92	0.95	0.83	0.82	0.79	0.80	0.80
Banks' claims on resident non-gov't sector growth	(5.4)	(5.3)	(2.6)	(4.0)	(9.2)	1.0	1.4	1.6	1.6	1.6
Banks' claims on resident non-gov't sector/GDP	220.3	207.8	198.0	189.3	167.5	164.6	162.0	160.1	158.2	156.5
Foreign currency share of claims by banks on residents	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Real effective exchange rate growth	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A

Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository 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. N/A--Not available. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. The data and ratios above result 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.

Ratings Score Snapshot

Table 2

Ratings Score Snapshot	
Key rating factors	
Institutional assessment	3
Economic assessment	2
External assessment	5
Fiscal assessment: flexibility and performance	1
Fiscal assessment: debt burden	3
Monetary assessment	5

S&P Global Ratings' analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). S&P Global Ratings' "Sovereign Rating Methodology," published on Dec18, 2017, details how we derive and combine the scores and then derive the sovereign foreign currency rating. In accordance with S&P Global Ratings' sovereign ratings methodology, a change in score does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the scores. In determining the final rating the committee can make use of the flexibility afforded by §15 and §§126-128 of the rating methodology.

Related Criteria

- Criteria - Governments - Sovereigns: Sovereign Rating Methodology, Dec. 18, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

Sovereign Risk Indicators, July 5, 2018. An interactive version is also available at http://www.spratings.com/sri

- Sovereign Ratings History, July 5, 2018
- Credit Trends: Global Corporate And Sovereign Credit Outlook: Growing Risks Threaten Stable Credit Quality, July 5, 2018
- Banking Industry Country Risk Assessment Update: June 2018, June 20, 2018
- Default, Transition, and Recovery: 2017 Annual Sovereign Default Study And Rating Transitions, May 8, 2018
- Global Sovereign Rating Trends: First-Quarter 2018, April 11, 2018
- Sovereign Debt 2018: Global Borrowing To Remain Steady At US$7.4 Trillion, Feb. 22, 2018
- Credit FAQ: What's New In S&P Global Ratings' Updated Sovereign Rating Methodology? Dec. 18, 2018

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

Andorra	
Sovereign Credit Rating	BBB/Stable/A-2
Transfer & Convertibility Assessment	AAA

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