Research Update:

Andorra Outlook To Positive From Stable On Expected Recovery And Budgetary Consolidation; 'BBB/A-2' Ratings Affirmed

January 14, 2022

Overview

- Andorra's consistent record of fiscal prudence supports our view that it will resume budgetary consolidation in 2022, after posting a modest general government deficit estimated at 1.5% of GDP in 2021.
- The resilience of the country's budgetary position over the past two years mitigates the downside risks relating to the evolution of the pandemic.
- We do not expect Andorra's economy to return to its pre-pandemic size until 2023, partly because rising infection rates across Europe could restrict the ski season in 2021-2022.
- We revised our outlook on Andorra to positive from stable and affirmed our 'BBB/A-2' long- and short-term ratings.

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Rating Action

On Jan. 14, 2022, S&P Global Ratings revised its outlook on Andorra's long-term sovereign credit rating to positive from stable. At the same time, we affirmed our 'BBB/A-2' long- and short-term foreign and local currency sovereign credit ratings on Andorra.

Outlook

The positive outlook indicates that we expect Andorra's accelerating economic recovery and steady fiscal consolidation to put government debt-to-GDP on a downward trajectory from 2022 onward. This will restore a degree of fiscal flexibility. Contrary to our original expectation, the Andorran regulator's intervention in the case of Banca Privada d'Andorra in 2015 has had no direct impact on the country's public finances.

Downside scenario

We could revise the outlook to stable if the economic impact of COVID-19 is more severe or prolonged than we anticipate, or if Andorra's budgetary position comes under pressure. Heightened financial sector risks, or a reversal of authorities' ongoing alignment toward international financial standards could also trigger an outlook revision to stable.

Upside scenario

We could raise the ratings within 12-24 months if Andorra's fiscal and economic performance surpasses our projections.

Rationale

We revised the outlook to positive from stable because we expect Andorra's accelerating economic recovery and budgetary consolidation to put debt-to-GDP on a downward trajectory. We also anticipate that the country's prudent fiscal stance during 2020 and 2021 mitigates downside risks regarding the pandemic's evolution.

Andorra's creditworthiness remains constrained by large contingent liabilities from its outsized financial sector, persistent data gaps, the country's lack of an independent monetary policy, and the absence of a lender of last resort.

Our ratings on Andorra are supported by high GDP per capita; steady improvements of the macroprudential environment in which the country's banking sector operates; Andorra's recent membership of the IMF; and our expectation that the sovereign is in the process of improving both its fiscal and its external (monetary reserve) buffers.

Institutional and economic profile: Risks to a robust recovery persist, given the high concentration of Andorra's economy in pandemic-sensitive sectors

- We expect the economy to grow by 4.5% in 2022 (5.2% in 2021), which is broadly in line with Spain and France.
- The high concentration of the Andorran economy in a few sectors and toward a handful of trading partners renders it vulnerable to external shocks.
- Further alignment toward international macroprudential standards in the banking sector will strengthen the institutional framework.

The Andorran economy is concentrated in relatively few sectors and exposed to relatively few trading partners, rendering it vulnerable to external shocks. Andorra has a services-dominated economy that relies mostly on tourism and trade (40% of GDP in 2020), real estate (16%), and finance (12%). As a landlocked country bordering France and Spain, Andorra depends heavily on its neighbors. Most of its inbound tourists come from Spain and France; in addition, 80% of its exports and 82% of its imports in 2020 came from these two countries.

The economic recovery accelerated in 2021, reaching an estimated real GDP growth of 5.2%. The rebound was mainly driven by base effects, following the sharp pandemic-related contraction of 11.2% in 2020. The easing of containment measures locally, continued fiscal support measures

(1.6% of GDP excluding loan guarantees of 3.6% of GDP), and progress on vaccinating the population also boosted private consumption. The construction sector grew by an average 31% year-on-year during the first three quarters of 2021, while financial services grew by 11%, services by 5%, and trade by 3%.

Tourism rebounded during Andorra's summer season in 2021, partially offsetting the poorer ski season. Although the flow of tourists in the first quarter of 2021 was muted, by the third quarter, arrivals had recovered to close to 2019 levels as France and Spain eased mobility restrictions. The new wave of coronavirus cases across Europe in the fourth quarter of 2021 is likely to affect the 2021-2022 ski season. However, we expect the impact to be moderate because containment measures in France and Spain were much milder than in 2020.

We forecast that Andorra's economic recovery will continue in 2022, with real GDP growth at 4.5%, and 3.0% and 2.1% in 2023 and 2024, respectively. These expectations are broadly in line with expectations for its neighbors. As Andorra, Spain, and France continue to make progress on their vaccination rollouts, we expect this to limit the risk of renewed stringent containment measures in the event of new pandemic waves, supporting Andorran trade and tourism. We expect robust activity in the construction and financial sectors will also contribute to economic activity. However, the size of Andorra's economy will not return to pre-pandemic levels until 2023.

Despite a modest rise in 2020 and 2021, unemployment remained low and should return to pre-pandemic levels in the medium term. Unemployment rose to 2.9% in 2020 from 1.8% in 2019 and is estimated to reach 3.4% in 2021. This is still well below the euro area average of 7.3% (October 2021). The government furlough schemes, combined with the high proportion of foreign seasonal workers, partially cushioned the impact of the recession. We expect employment to return to 2019 levels by 2023 as the economy recovers.

Further integration with the EU could strengthen Andorra's institutional framework. The current monetary agreement with the EU allows Andorra to use the euro as a legal tender in exchange for adopting EU banking regulations. The government has made substantial progress on this front in recent years, and we expect it to pursue this agenda, especially in the context of ongoing negotiations over an association agreement with the EU. We do not expect these negotiations to conclude in the near term.

Flexibility and performance profile: Withdrawal of temporary budgetary measures and economic recovery will drive the reduction in the government debt-to-GDP ratio in the medium term

- We anticipate that budgetary consolidation will resume in 2022--the budget deficit widened in 2020 and 2021--and that this will contribute to a decline in government debt-to-GDP ratio.
- Our assessment of high contingent liabilities from Andorra's large financial sector constrains the sovereign ratings.
- Access to external data remains limited.

The central government deficit widened to 4.8% of GDP in 2021 from 4.1% in 2020. Revenue was hit by muted growth and the diminished tourist season in the first quarter of 2021. Meanwhile, government spending increased because of higher health expenditure, the extension of most support measures until mid-2021, and increased transfers to households and private sector enterprises. Pandemic-related support measures totaled around 2.6% of GDP in 2020 and 1.6% in 2021, excluding loan guarantees worth around 5.5% of GDP in 2020 and 3.6% in 2021. At the general government level, we estimate a deficit of 1.5% of GDP in 2021, supported by dividends from public companies, and surpluses posted by local governments and social security sector.

The authorities' 2022 budget anticipates a deficit of 0.9% of GDP. The budget assumes real GDP growth of 7% and a subsequent boost in revenue will offset a planned increase in expenditure. The government has budgeted for wage increases and higher spending on both health and goods. The budget also includes higher capital expenditure to finance the new air connections for the Andorra-la Seu d'Urgell airport, the development of two free zones, and the start of the concession for the heliport.

We expect the government to pursue budgetary consolidation starting in 2022, but at a slower pace. We forecast that the central government deficit will fall to 2.8% in 2022 and 1.6% in 2023. Our forecast for 2022 is more conservative because we expect lower growth and incorporate the potential impact of a poorer ski season in 2022 on revenue. However, we view the budgetary consolidation trajectory as credible, given Andorra's recent history of very low deficits or surpluses. From 2010-2019, the average balance was -0.6% of GDP. We forecast the general government balance will return to surpluses in 2022.

In our view, Andorra's highly competitive tax regime could come under pressure. The Organization for Economic Cooperation and Development (OECD) removed Andorra from the list of noncooperative tax jurisdiction in 2018, but the country maintains lower tax rates than most European countries. The OECD's agreement regarding a global minimum corporate tax rate, as it stands, is unlikely to substantially shrink Andorra's tax base as only a limited number of companies would be subject to the threshold. In addition, negotiations with the EU over an association agreement do not currently include a chapter on this issue. However, we anticipate that political pressure to increase the tax rates could arise in the longer run, although the budgetary impact remains unclear at this stage.

Andorra's relatively high financing needs are likely to decrease from 2023 onward. The country has historically had a short average debt maturity (2.9 years from 2015-2020) and this has increased its funding needs. The issuance of a €500 million 10-year bond in 2021 allowed the government to increase the average maturity on its debt to an estimated 6.7 years in 2021. The operation also smoothed the government debt repayment profile from 2023, which reduced its medium-term financing needs.

Andorra's funding diversification strategy further mitigates its refinancing risks. Although the government's reliance on short-term domestic financing has led to high funding needs, the depth of the domestic market and strong demand for government bonds from local investors somewhat mitigated refinancing risks. The recent issuance in international capital markets further widens Andorra's options. In addition, accession to the IMF in 2020 offers the possibility that it could request emergency funding if needed, although we do not expect the government to require any in the medium term.

Andorra's government debt levels remain relatively low despite the recent temporary increase, and are expected to decline. Following an increase to 49% of GDP in 2021, from 44% in 2020 and 33% in 2019, we now expect central government debt to decline to around 45% in 2024, given higher nominal GDP and expected improvements in the budget balance. General government debt has seen a similar trend, rising to 46% of GDP in 2020 and an estimated 52% in 2021. We then forecast that it will gradually decline, in line with central government debt.

In our view, although Andorra breached its national fiscal rule, this has not dented its credibility. The fiscal framework limits central government debt to 40% of GDP and general government debt to 55%. It also caps budget deficits at 1% of GDP and imposes restrictions on revenue and expenditure. We consider the activation of the escape clause in the context of the pandemic-induced recession and the related adverse budgetary impact exceptional. Given the government's record of fiscal prudence, we anticipate that it will strive to comply with the rule after the pandemic shock has eased.

Large contingent liabilities from Andorra's financial sector constrain the rating. Contingent liabilities mainly stem from the banking sector, which had total assets worth about 600% of GDP in 2020. In our view, these are not likely to materialize directly on the government's balance sheet, given the limited size of the government budget. However, a banking crisis would likely have a severe impact on the economy, and would weigh on the country's budgetary position and lead to debt accumulation.

The banking sector's metrics appear relatively robust, but risks to asset quality remain. Tier 1 capital to risk-weighted assets increased slightly to 21.6% at end-2020 from 21.0% at end-2019, because of a few loan losses and the insolvency moratorium. Nonperforming loans (NPLs) remained relatively high at 6.1% at end-2020--most of these are legacy loans from Banca Privada d'Andorra, which has been under resolution since 2015 following a money laundering case.

Our view of Andorra's creditworthiness remains constrained by the country's lack of an independent monetary policy. It has used the euro as its official currency, as part of its monetary agreement with the EU, 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. That said, this support is limited.

Access to external data remains limited and weighs on the rating. The authorities produced an estimate of the current account balance in 2019, which indicated a large surplus of 18% of GDP. However, shortcomings remain on historical data and on the net international investment position. As a result, our external assessment is based on that of Spain, Andorra's main trading partner, and is adjusted to reflect these data gaps. Accession to the IMF could further improve access to external data.

Key Statistics

Andorra Selected Indicators

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Economic indicators (%)										
Nominal GDP (bil. €)	3	3	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 $)	39.6	40.1	42.3	40.7	37.1	40.6	41.5	43.3	44.5	45.1
Real GDP growth	3.7	0.3	1.6	2.0	(11.2)	5.2	4.5	3.0	2.1	1.5
Real GDP per capita growth	1.8	(1.9)	(0.3)	0.2	(11.7)	3.6	3.0	1.5	0.6	(0.0)
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	3.0	1.8	1.5	1.8	2.9	3.4	2.8	1.8	1.8	1.8

Andorra Selected Indicators (cont.)

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
External indicators (%)										
Current account balance/GDP	N/A	N/A	N/A	18.1	N/A	N/A	N/A	N/A	N/A	N/A
Current account balance/CARs	N/A	N/A	N/A	19.2	N/A	N/A	N/A	N/A	N/A	N/A
CARs/GDP	N/A	N/A	N/A	93.9	N/A	N/A	N/A	N/A	N/A	N/A
Trade balance/GDP	N/A	N/A	N/A	(42.7)	N/A	N/A	N/A	N/A	N/A	N/A
Net FDI/GDP	N/A	N/A	N/A	(10.2)	N/A	N/A	N/A	N/A	N/A	N/A
Net portfolio equity inflow/GDP	N/A	N/A	N/A	2.2	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. $)	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Fiscal indicators (general government; %)										
Balance/GDP	4.4	3.3	2.8	2.3	(1.1)	(1.5)	0.8	1.0	1.2	2.0
Change in net debt/GDP	(4.7)	(5.8)	(0.3)	(4.7)	3.8	3.5	(0.1)	(0.5)	(0.7)	(0.5)
Primary balance/GDP	5.0	3.9	3.3	2.8	(0.5)	(1.0)	1.4	1.5	1.7	2.5
Revenue/GDP	38.4	38.0	38.5	38.0	41.1	38.0	38.0	38.0	38.0	40.0
Expenditures/GDP	34.1	34.6	35.7	35.7	42.2	39.5	37.2	37.0	36.8	38.0
Interest/revenue	1.8	1.5	1.4	1.2	1.3	1.4	1.5	1.4	1.4	1.3
Debt/GDP	39.7	37.9	36.3	35.4	46.3	52.0	47.3	46.3	45.7	44.0
Debt/revenue	103.3	99.7	94.3	93.0	112.6	136.8	124.4	121.9	120.3	109.9
Net debt/GDP	(8.8)	(14.4)	(14.3)	(18.5)	(16.9)	(12.2)	(11.6)	(11.5)	(11.9)	(12.0)
Liquid assets/GDP	48.5	52.3	50.6	53.9	63.2	64.2	58.8	57.9	57.6	56.0
Monetary indicators (%)										
CPI growth	(0.4)	2.6	1.3	0.8	0.3	1.8	1.6	1.2	1.1	1.1
GDP deflator growth	0.3	1.1	1.0	1.4	1.1	2.1	1.9	1.6	1.3	1.3
Exchange rate, year-end (€/$)	0.95	0.83	0.87	0.89	0.81	0.88	0.87	0.85	0.85	0.85

Andorra Selected Indicators (cont.)

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Banks' claims on resident non-gov't sector growth	(9.2)	(8.6)	(0.3)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Banks' claims on resident non-gov't sector/GDP	166.5	150.1	145.8	141.0	157.0	146.2	137.3	131.2	126.8	123.4
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

Sources:Department D'Estadistica (Economic Indicators), Autoritat Financera Andorrana, European Central Bank (Monetary Indicators), and Ministry of Finance (Fiscal Indicators).
Adjustments: N/A.
Definitions: 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 claims on nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. N/A--Not applicable. 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

Ratings Score Snapshot

Key rating factors	Score	Explanation
Institutional assessment	3	Generally effective policymaking in recent years has promoted sustainable public finances and balanced economic growth, which is reflected in the government's record of fiscal prudence, its accession to the IMF, and the continued negotiations with the EU over an association agreement. Parliament has ensured expedited processes to approve the government's emergency plan in response to the pandemic.
Economic assessment	2	Based on GDP per capita (US$) and growth trends as per Selected Indicators in Table 1.
		Volatile and concentrated economy in the financial, trade, and tourism sectors, which together represent more than 50% of GDP.
External assessment	5	The sovereign has limited external data. Therefore, we assign an initial assessment that is the same as the initial assessment that we could apply to Spain.
		The sovereign's external data lack consistency, as there is a lack of reliable and sufficient external accounts information.
Fiscal assessment: flexibility and performance	1	Based on the change in net general government debt (% of GDP) as per Selected Indicators in Table 1.
		Based on liquid assets/GDP, which are greater than 50% as per Selected indicators in Table 1.
Fiscal assessment: debt burden	3	Based on net general government debt (% of GDP) and general interest expenditure (% of general government revenue) as per Selected Indicators in Table 1.

Ratings Score Snapshot

Key rating factors	Score	Explanation
		Contingent liabilities are high. Andorra has a large banking sector with total assets under management worth around 600% of GDP in 2020.
Monetary assessment	5	The euro is a reserve currency. Consumer price index is as per Selected Indicators in Table 1. Andorra lacks monetary flexibility.
Indicative rating	bbb+	
Notches of supplemental adjustments and flexibility	-1	The notch of flexibility down captures additional factors that have an impact on creditworthiness and are not fully reflected in the indicative rating. These uncertainties relate to downside risks around our baseline scenario, which could affect the economic recovery and fiscal consolidation over the medium term.
Final rating		
Foreign currency	BBB	
Notches of uplift	0	
Local currency	BBB	

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 Dec. 18, 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

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Sovereign Ratings List, Jan. 12, 2022
- Sovereign Ratings History, Jan. 12, 2022
- Sovereign Risk Indicators, Dec. 13, 2021. An interactive version is also available at http://www.spratings.com/sri
- Global Sovereign Rating Trends: Third-Quarter 2021, Oct. 7, 2021
- Default, Transition, and Recovery: 2020 Annual Sovereign Default And Rating Transition Study, April 12, 2021

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; CreditWatch/Outlook Action

	To	From
Andorra		
Sovereign Credit Rating	BBB/Positive/A-2	BBB/Stable/A-2
Ratings Affirmed		
Andorra		
Senior Unsecured	BBB	
Transfer & Convertibility Assessment	AAA	