S&P Global Ratings

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Research Update:

Andorra 'A-/A-2' Ratings Affirmed; Outlook Positive

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Overview

- Once approved, mostly likely in 2025, Andorra's association agreement with the EU will benefit the economy by expanding and diversifying exports.
- The country uses the euro without being a member of the Eurosystem and does not have access European Central Bank liquidity. This constrains its flexibility in the event of a future external shock, despite major enhancements to liquidity management in Andorra's financial sector in recent years.
- The upcoming technical assistance mission from the IMF is helping authorities improve the granularity of external data, especially regarding external debt levels, thereby benefiting transparency and economic risk surveillance.
- Therefore, we affirmed our 'A-/A-2' ratings on Andorra. The outlook is positive.

Rating Action

On Nov. 8, 2024, S&P Global Ratings affirmed its 'A-/A-2' long- and short-term foreign and local currency sovereign credit ratings on Andorra. The outlook is positive.

Outlook

The positive outlook reflects our view that the long-term economic benefits of the EU association agreement, the deepening liquidity options for the financial sector, and further enhancements to external data could support an upgrade within the next 18 months.

Downside scenario

We could lower the rating if there is a reversal of recent progress in Andorra's liquidity management and financial supervision standards, or if a shift in budgetary policy results in an increase in government debt.

Upside scenario

We could raise the ratings if Andorra were to further enhance liquidity management for the financial sector or make additional progress on external data transparency.

Rationale

The affirmation reflects our view that Andorra's potential to finalize an EU association agreement would support economic growth, especially since the country is currently constrained by its small domestic market. In our view, further liquidity enhancements for banks will limit systemic risks in the event of future financial sector shocks and allow them to operate under similar conditions as European peers. This will be critical in the negotiations following the association agreement, which entails an integration of the financial sector into the European common market. Finally, an upcoming shift to the regular publication of more detailed external data, especially on external debt, would provide us with more comprehensive information on Andorra's external liquidity metrics, making them more comparable to those of peers. Andorra's high current account surpluses and net asset position imply external liquidity risks may be contained. Nonetheless, we also think non-resident deposits in Andorra's financial system could be vulnerable to flight in the event of a banking sector shock, although they represent just 20% of total deposits.

Institutional and economic profile: The EU association agreement will benefit the economy and institutional framework, but further banking sector evolutions will likely take time

- The EU association agreement will benefit Andorra's exports, although the integration of Andorra's banking system into the EU will be gradual.
- In the absence of regular access to ECB liquidity and as a country that uses the euro without being part of the Eurosystem, the financial sector's access to liquidity remains a systemic weakness.
- GDP per capita is lower than that of peers due to large population flows.

As a microstate landlocked between Spain and France, Andorra's economy is mostly outward looking, dependent on tourism, trade, and financial services. With a population of 85,101 inhabitants as of year-end 2023, Andorra's domestic market is tiny, and consequently, the economy is more concentrated relative to other European sovereigns. Despite recent improvements, the country remains difficult to access. Straddled between both sides of the Pyrenees, its closest airport is 30 kilometers from the capital, located across the Spanish border in Catalonia, at La Seu d'Urgell, with limited--albeit improving--flight connections. For this reason, Andorra has built itself as an attractive shopping and tourism destination for its neighbors thanks to competitive ski resorts and an attractive value added tax. Also, like other microstates striving to tap into broader markets, Andorra's financial sector is far larger than the domestic economy, with consolidated assets worth 5.5x GDP. These are concentrated in three banks, focused on private banking, and with a significant presence abroad in the EU and the U.S. In view of its landlocked position, the principality imports most goods, including energy, from Spain and France, which is largely offset by robust services exports.

Accessing the European common market by 2027, thanks to the EU association agreement, will further benefit Andorra's exports and economic expansion. After years of negotiations, Andorra--along with San Marino--reached an agreement with the EU end-December 2023. They are currently fine-tuning the text prior to the final signature, which is expected by the end of the year. Then, it will be submitted to a referendum in Andorra in 2025. At this stage, it is uncertain whether the text will go through every member state's parliament or just the European Parliament. Either way, we consider the process will likely be relatively smooth and take effect in approximately 2027. Tapping into the single market will expand Andorra's export horizons since some goods cannot be homologated under current regulations. Also, it is likely to boost activities, especially in the construction and financial services sectors.

However, the large financial sector faces a longer process since it lacks the same liquidity mechanisms as its eurozone counterparts. According to the agreement, Andorra's large financial system will have 15 years to fully align with EU regulations and adjust before it fully opens to the EU's internal market. We understand this process is particularly sensitive because the financial sector still does not have access to the same liquidity tools as its European counterparts, making full integration and competition in Andorra difficult. The country already benefits from liquidity lines through its subsidiaries in Spain and Luxembourg, as well as from a small repo line at the ECB since the pandemic. Additionally, the government has built a lender of last resort proxy through a mechanism financed by its foreign reserves. But it still does not equate to a central bank's support for banks' liquidity on a daily operational basis and in the event of a banking shock. We understand a key element in the negotiations, which will take place on the fringes of the association agreement, will be the oversight and regulation of the Andorran financial sector.

Other sectors benefit from a longer transition period. The telecom sector, which is dominated by a state-owned entity, Andorra Telecom, will have seven years to open up to the common market. The increase in competition could limit the dividends that Andorra Telecom pays to the state in the long term, although the company has already started to adjust through agreements with French and Spanish operators. The tobacco sector has also proven to be a sensitive area, with prices in Andorra significantly lower than those in peer countries, and it will have a 30-year transition period. The energy sector, which is also a state monopoly, will not be subject to the agreement.

Economic growth is comparable to that of its peers. GDP growth is forecast to average 1.4% in 2024, driven by strong economic activity in Spain (2.7%) and to a lesser extent in France (1.1%). This will be supported by robust tourism receipts, accelerated construction from numerous real estate projects, and good financial sector performance. This follows years of record-high growth levels following the pandemic, but Andorra is likely to continue to grow at a steadier pace. This growth will be driven, as it is in the rest of the EU, by a decline in inflation boosting private consumption. On the other hand, projects aimed at increasing the number of connection flights to the country, developing a special economic zone for high-end products, upscaling Andorran tourism, and other infrastructure projects will support idiosyncratic economic growth.

On a per capita basis, however, economic growth is below that of its peers. Historically, this metric has been relatively erratic due to the large population flows caused by Andorra's reliance on seasonal workers and limited unemployment benefits. The latter means that workers tend to leave Andorra in case of economic downturn and come back when activity is buoyant. This acts as an adjustment mechanism for the labor market and explains the exceptionally low unemployment levels. That said, such population flows tend to weigh on GDP per capita growth.

Flexibility and performance profile: Strong fiscal and external positions

- Greater granularity in external data would allow us to assess Andorra's external position with more confidence.
- The government is in a net asset position and committed to the prudent management of public finances, which is appropriate given the economy's lack of monetary flexibility.
- The banking sector is robust, although its size represents a risk in the event of a banking shock.

We do not yet have sufficient data to fully understand the details of Andorra's external accounts. Data dissemination has improved tremendously in the past few years, transitioning from a lack of balance of payments and international investment position data to historical estimates starting in 2019. But updates are scarce--as is our last historical data from 2022. Additionally, we do not have a full breakdown of short- and long-term external debt, which makes it harder for us to calculate gross external financing needs, a key measure of external liquidity. We expect the upcoming technical assistance with the IMF may lead to rapid improvements. This would allow us to better understand what we consider to be a strong external position, with current account surpluses hovering about 15% to 18% of GDP and a net asset position exceeding 300% of GDP. This is mostly thanks to Andorra's large financial sector compared to the size of its economy.

The budgetary trajectory is set to remain sound, albeit slightly less so than in previous years. We expect the government to post a surplus of 1.2% of GDP in 2024. This is mostly due to strong government revenues from VAT and duties on products such as tobacco, as well as stronger economic growth than initially anticipated. In 2025, we expect additional measures for wages, education social benefits, and stronger investments will bring the central government balance into a small deficit of 0.5% of GDP. But the latter will be offset by dividends from Andorra Telecom and the energy company Forces Elèctriques d'Andorra, which should resume dividend payments after having halted them when the 2022 energy availability issues began. Small local government and social security accounts will also contribute to the general government surpluses over 2024-2027.

Social security accounts will be stronger than expected thanks to higher population flows contributing to the system's finances. This may potentially delay the incentive to pass a pension reform. However, the government still aims to pass reforms before the end of its term in 2027. The proposals could include gradually increasing both employers' and employees' contributions (which are low compared to those of peer countries); raising the retirement age to 67 years from 65 years; and increasing the replacement rate (the individual's net pension entitlement divided by net preretirement earnings). Although the specifics of the reform have yet to be defined and debated in parliament, we currently assume the social security balance deterioration will halt in 2025.

Andorra's highly competitive tax regime may be subject to scrutiny over the next few years. The country's minimum effective tax rate is 3%, which is an improvement compared to 2023, when some firms did not pay taxes due to existing deductions and compensations. The maximum corporate tax rate is 10%, which is below the global minimum of 15% recommended by the Organization for Economic Co-operation and Development (OECD) for companies that turnover more than €750 million. That said, turnover at most firms established in Andorra falls below this threshold--the few that exceed it are subsidiaries, mainly of Spanish companies. Their head offices will compensate for the tax difference in their home country to align with the OECD agreement. Although we consider the effect of the minimum effective rate to be negligible at this stage, Andorra's tax regime could become the focus of further political pressure from tax watchdogs, if the scope of the OECD agreement were to broaden.

Andorra's government is in a net asset position and its financing needs are covered until 2027. In 2024, net government assets are about 24% of GDP and are set to remain relatively stable. Government debt is low compared to peers, at below 35% of GDP, and Andorra benefits from large government assets in its social security fund. Andorra has no financing needs until 2027 since it will be using its cash buffers constituted following its primo issuance of €1.2 billion Eurobonds in 2021. The average debt maturity is about six years in 2024. We expect Andorra's interest-to-revenue ratio to be stable at well below 2%, given its large cash reserves and limited financing needs until 2026. The contingent liabilities associated with Andorra's large financial sector are unlikely to fall directly on the government's balance sheet, given the limited size of the budget. For example, the Andorran regulator's 2015 intervention in the case of Banca Privada d'Andorra had no permanent effect on the country's public finances.

Bank liquidity has improved in recent years. Andorra uses the euro but is not part of the eurozone. As a result, the country does not have a central bank that has monetary reserves or the ability to act as a lender of last resort, nor can it pursue an independent monetary policy. This presents risks to its financial stability, given that the banking system's consolidated assets represent about 550% of GDP. The banks' combined off-balance-sheet assets under management represent about 2,000% of GDP. In 2022, the country created an emergency liquidity mechanism that has bolstered the banking sector's resilience by offering temporary liquidity to solvent and viable entities. The facility would be directly financed by Andorra's international reserves, which this year amount to 12% of GDP. In addition, the ECB has provided Andorra with a temporary repo line since 2020, which improves liquidity risk management. Implementing the full EU association agreement could allow Andorran banks' subsidiaries in the EU to indirectly access greater liquidity.

Key Statistics

Table 1

Andorra--Selected indicators

(Mil.€)

Economic indicators (%)	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Nominal GDP (bil. LC)	2.7	2.8	2.5	2.8	3.2	3.4	3.6	3.8	3.9	4.1
Nominal GDP (bil. $)	3.2	3.2	2.9	3.3	3.4	3.7	4.0	4.4	4.6	4.8
GDP per capita (000s $)	42.3	40.7	37.1	41.8	41.4	43.8	46.2	49.8	51.7	53.0
Real GDP growth	1.6	2.0	(11.2)	8.3	9.6	1.4	1.8	2.0	1.5	1.4
Real GDP per capita growth	(0.3)	0.2	(11.7)	6.2	6.8	(2.7)	0.3	0.5	0.0	(0.1)
Exports/GDP	N/A	N/A	5.7	5.0	11.4	6.9	10.6	10.4	10.2	10.0
Unemployment rate	1.8	2.1	3.0	3.3	2.1	1.6	1.5	1.5	1.5	1.5

Table 1

Andorra--Selected indicators (cont.)

External indicators (%)										
Current account balance/GDP	N/A	18.0	15.5	14.1	17.3	17.0	16.8	16.8	16.9	17.1
Current account balance/CARs	N/A	19.2	18.4	15.9	17.6	18.1	18.7	19.2	19.7	20.3
CARs/GDP	N/A	93.6	84.6	88.6	98.2	93.6	90.1	87.1	85.5	84.1
Trade balance/GDP	N/A	(42.6)	(36.4)	(39.9)	(46.9)	(45.6)	(45.6)	(44.6)	(44.4)	(44.8)
Net FDI/GDP	N/A	10.2	4.8	10.4	16.0	15.0	15.0	15.0	15.0	15.0
Net portfolio equity inflow/GDP	N/A	5.9	(13.8)	(9.2)	10.9	5.0	5.0	5.0	5.0	5.0
Gross external financing needs/CARs plus usable reserves	N/A	N/A	281.1	256.9	231.0	197.8	193.2	186.2	181.7	178.1
Narrow net external debt/CARs	N/A	(110.2)	(121.2)	(126.5)	(125.3)	(130.1)	(137.0)	(140.2)	(146.4)	(153.8)
Narrow net external debt/CAPs	N/A	(136.4)	(148.4)	(150.4)	(152.0)	(158.9)	(168.6)	(173.6)	(182.3)	(193.0)
Net external liabilities/CARs	N/A	(328.6)	(445.9)	(441.0)	(346.1)	(348.6)	(358.1)	(359.3)	(368.7)	(381.9)
Net external liabilities/CAPs	N/A	(406.9)	(546.1)	(524.1)	(419.9)	(425.7)	(440.5)	(444.8)	(459.4)	(479.2)
Short-term external debt by remaining maturity/CARs	N/A	N/A	199.5	177.0	159.9	136.1	131.1	124.9	121.8	119.9
Usable reserves/CAPs (months)	N/A	N/A	0.0	0.2	0.7	1.5	1.5	1.5	1.7	1.8
Usable reserves (mil. $)	N/A	0.0	47.9	163.3	356.4	356.4	396.3	439.9	485.9	533.9
Fiscal indicators (general government; %)										
Balance/GDP	2.7	2.6	(1.1)	(1.2)	4.8	2.2	1.2	0.6	0.7	0.7
Change in net debt/GDP	(0.8)	(5.3)	(1.4)	(4.9)	(0.8)	(5.3)	3.4	(0.8)	(0.9)	(0.9)
Primary balance/GDP	3.2	3.0	(0.5)	(0.5)	5.5	2.8	1.7	1.1	1.2	1.2
Revenue/GDP	38.6	38.2	41.3	37.9	39.7	38.6	39.0	39.0	39.0	39.0
Expenditures/GDP	35.9	35.8	42.3	39.0	34.9	36.4	37.8	38.4	38.3	38.3
Interest/revenues	1.3	1.3	1.3	1.9	1.8	1.4	1.2	1.2	1.2	1.2
Debt/GDP	36.3	35.4	46.4	48.6	38.9	36.0	33.7	32.4	31.4	30.4
Debt/revenues	94.2	92.7	112.3	128.3	97.9	93.3	86.5	83.1	80.5	78.0
Net debt/GDP	(18.0)	(22.7)	(26.6)	(28.8)	(26.0)	(29.5)	(24.5)	(24.2)	(24.3)	(24.4)
Liquid assets/GDP	54.3	58.0	72.9	77.4	64.9	65.5	58.2	56.6	55.7	54.8
Monetary indicators (%)										
CPI growth	1.0	0.5	0.1	1.7	6.2	5.6	3.6	2.5	2.0	2.0
GDP deflator growth	1.0	1.4	1.1	2.6	4.2	5.9	3.7	2.6	2.1	2.1

Table 1

Andorra--Selected indicators (cont.)

Exchange rate, year-end (LC/$)	0.9	0.9	0.8	0.9	0.9	0.9	0.9	0.9	0.9	0.9
Banks' claims on resident non-gov't sector growth	3.2	(3.8)	(0.0)	0.8	0.0	0.2	1.0	1.0	1.0	1.0
Banks' claims on resident non-gov't sector/GDP	150.8	140.4	156.3	141.8	124.2	115.9	110.8	106.9	104.2	101.7

Sources: Department D'Estadistica (economic indicators), Autoritat Financera Andorrana, European Central Bank (monetary indicators), and Ministry of Finance (fiscal indicators).
Adjustments: None.
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. LC--Local currency. 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.

Rating Score Snapshot

Table 2

Andorra--Rating 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, the finalization of an association agreement with the EU, reforms to improve liquidity management for the country's outsized financial sector, and improvement of external data dissemination.
Economic assessment	3	Based on GDP per capita (US$) as per Selected indicators in Table 1.
		Volatile and concentrated economy in the financial, trade, and tourism sectors, which together represent more than 40% of GDP.
		Real GDP growth per capita is below that of peers, mostly due to large population flows.
External assessment	2	Based on narrow net external debt (% of CARs) and gross external financing needs (% of CARs and usable reserves) as per Selected Indicators.
		The sovereign's net international investment position is more favorable than the narrow net external debt position by over 100% of CARs, as per Selected Indicators in Table 1.
		Persisting data gaps on the external debt service weigh on the assessment.
Fiscal assessment: flexibility and performance	1	Based on the change in net general government debt (% of GDP) 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.
		Based on liquid assets to GDP, which are greater than 50% as per Selected Indicators in Table 1.

Table 2

Andorra--Rating score snapshot (cont.)

Key rating factors	Score	Explanation
		Contingent liabilities are high. Andorra has a large banking sector, which has consolidated assets worth about 5.5 times GDP.
Monetary assessment	5	Andorra uses the euro, a reserve currency, without being a member of the eurozone.
		Consumer price index is as per Selected Indicators in Table 1.
		Andorra lacks monetary flexibility, in the absence of a central bank acting as a lender of last resort. The buildup of international reserves is a positive development to mitigate liquidity shocks.
Indicative rating	a-	
Notches of supplemental adjustments and flexibility	0	
Final rating		
Foreign currency	A-	
Notches of uplift	0	
Local currency	A-	

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, Oct. 9, 2024
- Sovereign Ratings History, Oct. 9, 2024
- Sovereign Ratings Score Snapshot, Oct. 8, 2024
- Economic Outlook Eurozone Q4 2024: Consumer Spending To The Rescue, Sep 24, 2024

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	A-/Positive/A-2
Senior Unsecured	A-
Transfer & Convertibility Assessment	AAA