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CREDIT OPINION
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Update

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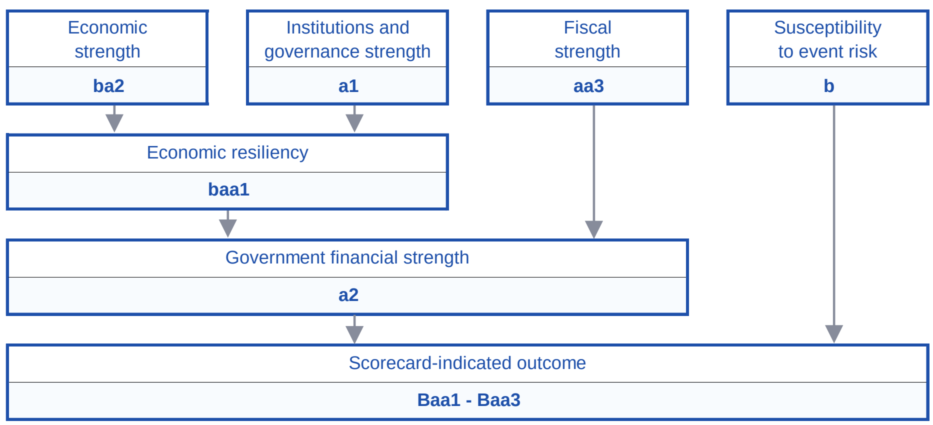
Government of Andorra – Baa2 stable

Regular update

Summary

Andorra's credit profile reflects high wealth, solid institutional and governance capacity and robust fiscal metrics. This is balanced by credit challenges such as Andorra's constrained growth potential, exposure to a very large banking sector and absence of a lender of last resort.

Exhibit 1
Andorra's credit profile is determined by four factors



Source: Moody's Investors Service

Credit strengths

» Wealthy economy with high activity and employment rates

» Solid institutional and governance capacity

» Low government debt and strong debt affordability

Credit challenges

» Very small and volatile economy

» Absence of a lender of last resort

» Potential contingent liabilities stemming from a very large financial sector

Rating outlook

The stable outlook reflects our expectations that Andorra's credit profile in terms of economic and fiscal strength will remain resilient to the pandemic environment. The stable outlook considers the intrinsic strengths of Andorra's institutions and fiscal metrics, with prudent policymaking underpinned by low political risk. This is balanced by credit challenges that relate to the economy's very small size and volatile nature, as well as to the country's very large banking sector (600% of GDP in 2020) and fundamental limitations such as the absence of a lender of last resort.

Factors that could lead to an upgrade

Upward pressures on the ratings might develop over time should Andorra lift its economic trend growth in a sustained manner. Further diversification of the economy would be credit positive, broadening the sources of growth and making the country more resilient to shocks. A stronger banking system helping to limit the sovereign's potential contingent liabilities would also be credit positive.

Factors that could lead to a downgrade

Downward pressures on the ratings might result from an increase in the general government's public debt. This would reflect a deterioration in the fiscal balance stemming from unfinanced new measures and/or a permanently weaker economic environment due to larger than expected scarring from the pandemic. Given the sector's very large relative size, any deterioration in the quality of Andorra's banking system would also be credit negative.

Key indicators

Exhibit 2

Andorra	2016	2017	2018	2019	2020	2021E	2022F	2023F
Real GDP (% change)	3.7	0.3	1.6	2.0	-11.2	8.9	3.5	2.0
Inflation (CPI, % change, Dec/Dec)	0.9	2.4	0.3	1.1	-0.2	3.3	5.8	3.2
Gen. gov. financial balance/GDP (%)	4.4	3.3	2.8	2.3	-1.1	-1.2	0.4	1.7
Gen. gov. primary balance/GDP (%)	5.0	3.8	3.2	2.7	-0.6	-0.6	1.2	2.5
Gen. gov. debt/GDP (%)	39.8	37.9	36.3	35.4	46.3	48.6	45.5	43.2
Gen. gov. debt/revenues (%)	103.5	99.7	94.5	93.0	112.6	129.0	121.4	115.8
Gen. gov. interest payment/revenues (%)	1.6	1.4	1.2	1.2	1.2	1.6	2.0	2.1
Current Account Balance/GDP (%)	--	--	--	--	15.5	15.9	12.0	14.6

Source: Moody's Investors Service

Detailed credit considerations

We assess Andorra's **economic strength** as "ba2", balancing high per-capita GDP and very small size combined with modest trend growth. Andorra's diversification away from financial services has broadened the spectrum of economic activities in the country. Our economic strength assessment also incorporates the structurally low unemployment in the context of a fluid labour market. Andorra's attractiveness for foreign workers, customers and investors relies on a favourable tax system as well as modern infrastructure allowing for generalized access to the internet.

Over the last two decades (2001-2019), average real GDP growth reached 1.7%, with a clear declining trend between the first decade (3.4% on average between 2001 and 2009) and the second (0.1% on average between 2010 and 2019) one. In 2020, the initial phase of the coronavirus pandemic had a significant impact on the Andorran economy, with real GDP contracting by 11.2%. With trade and tourism accounting for a fifth of the country's gross value added, Andorra is significantly exposed to travel restrictions. Retail activities are also largely dependent on cross-border flows from commuting visitors.

Andorra's **institutional strength** is assessed to be "a1", with high scores on the WGI indicators and improving policymaking both with regards to fiscal framework and its enhanced banking supervision. However, the country's very small size is a fundamental constraint on key aspects, such as the availability of statistics. From a macroeconomic perspective, we note that the absence of a domestic currency and of a lender of last resort are major constraints for Andorran policymakers.

According to the Worldwide governance indicators (WGI) published by the World Bank, Andorra scores consistently high (80th to 90th percentile) for indicators both related to quality of legislative and executive institutions as well as indicators related to strength of civil society and judiciary[1]. In terms of policy effectiveness, a rules-based fiscal framework has been in place since 2014 setting clear targets for debt, deficit, current spending and direct taxes. As regards, monetary and macro-prudential policy, Andorra has a comprehensive strategy to adopt common European Union (Aaa stable) standards and allow for better supervision. Finally Andorra is no longer considered in the list of non-cooperative tax jurisdictions published by the European Union since 2018.

We assess Andorra's **fiscal strength** as “aa3” to reflect a moderate debt burden, strong debt affordability and the presence of large public sector liquid assets. Prior to the coronavirus pandemic, Andorra recorded seven years of fiscal surpluses between 2013 and 2019, reflecting the government’s willingness to adopt sound fiscal policies. As a result, the general government debt-to-GDP ratio declined from 42.5% in 2013 to 35.4% in 2019. Moreover, debt affordability metrics improved, with the interest payments-to-revenues ratio declining from 3.1% in 2013 to 1.3% in 2019. That said, the pandemic raised the debt burden by over 11 percentage points to 46.8% of GDP in 2020, and continued to increase, albeit more moderately, in 2021 to 48.6%.

Andorra’s fiscal profile is enhanced by the presence of large public sector liquid assets: in 2021, these assets accounted to EUR 2.1 billion, equivalent to 76% of Andorra’s GDP. While mostly earmarked to the social security system and hence not readily available in case of a shock, these accumulated resources will help contain the impact of an ageing population on Andorra’s public finances.

Susceptibility to event risk is assessed as “b”, driven by Banking Sector Risk. The very large relative size of the Andorran banking sector, with total assets accounting for 590% of GDP in 2021, represents a credit challenge for Andorra given the adverse impact a shock to the banking system would have on the economy and the country’s public finances.

That said, the share of financial services has halved over the past two decades, from 24% of gross valued added in 2000 to 12% in 2020. In addition, the system exhibits solid profitability and an improved tracked record since the Banca Privada d’Andorra (BPA) scandal in 2015, which had limited spillovers to the rest of banking entities. However, the system’s high reliance on volatile foreign deposits and the geographical concentration in the principality of Andorra are significant risks compounded by the absence of a lender of last resort.

We assess government liquidity risk as “baa”, considering Andorra's elevated borrowing needs in the short run (20% of GDP on average in 2021-2022) and its limited experience with international financial markets. Finally, we assess domestic political risk as “a”, considering the very stable environment in Andorra, and external vulnerability risk as “aa”, reflecting the sizeable current account surplus.

ESG considerations

ANDORRA's ESG Credit Impact Score is Neutral-to-Low CIS-2

Exhibit 3
ESG Credit Impact Score

CIS-2

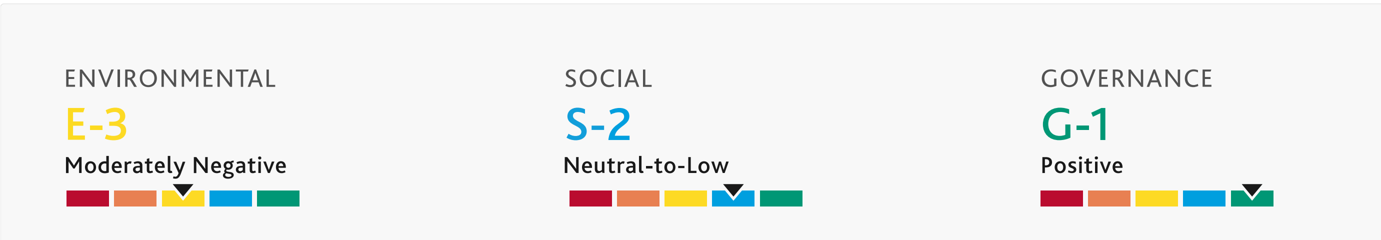
Neutral-to-Low

For an issuer scored CIS-2 (Neutral-to-Low), its ESG attributes are overall considered as having a neutral-to-low impact on the current rating; i.e., the overall influence of these attributes on the rating is non-material.

Source: Moody’s Investors Service

Andorra's ESG Credit Impact Score is neutral-to-low (**CIS-2**), reflecting some exposure to physical climate risk, low exposure to social risks and, like many other advanced economies, strong governance and in general strong capacity to respond to shocks.

Exhibit 4
ESG Issuer Profile Scores



Source: Moody's Investors Service

Environmental

Andorra's overall E issuer profile is moderately negative (**E-3**), reflecting the economic importance of winter tourism, a source of vulnerability in the context of climate change as warmer temperatures reduce the amount of snow available.

Social

We assess Andorra's S issuer profile score as neutral to low (**S-2**). This reflects very high quality of health and safety, as well as strong access to basic services. While Andorra's population is ageing, in line with other advanced economies, high activity and employment rates are credit strength.

Governance

Andorra's high institutions and governance strength is reflected in a positive G issuer profile score (**G-1**). Andorra scores well on global surveys assessing voice & accountability, regulatory quality and government effectiveness. The effectiveness and credibility of fiscal policy is solid.

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moodys.com. In order to view the latest scores, please click here to go to the landing page for the entity/transaction on MDC and view the ESG Scores section.

All of these considerations are further discussed in the "Detailed credit considerations" section above. Our approach to ESG is explained in our report on how the scores depict varied and largely credit-negative impact of ESG factors and our cross-sector methodology General Principles for Assessing Environmental, Social and Governance Risks Methodology.

Recent developments

Ongoing economic recovery, but inflation is rising

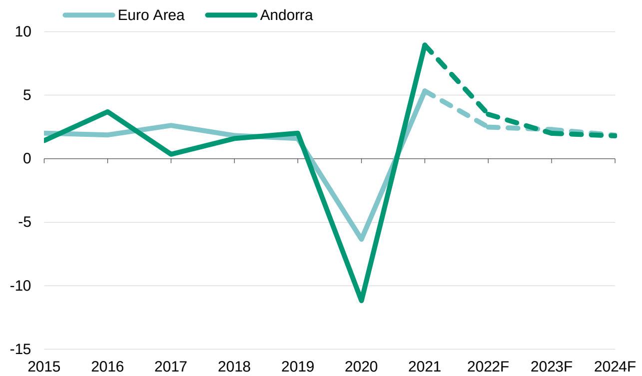
Economic activity in Andorra is proving resilient to the succession of shocks. The number of tourists has exceeded its pre-pandemic level, as travel restrictions have been significantly eased. On the retail side, vehicle registrations were also up by 7.2% in June, year on year, with the increase reaching 11.2% when considering January-June figures.

According to Andorra's statistical office June 2022 update, Andorra's real GDP would reach 5.2% this year, 3.3% in 2023 and 3.2% in 2024 before slowing below 2% as of 2025. The IMF forecasts real GDP to grow by 4.5% in 2022 before 2.7% in 2023 and 2.2% in 2024. We forecast real GDP growth to reach 3.5% this year and 2.0% in 2023 as pandemic-related concerns fade. This is partly offset by the more uncertain environment in the context of the military conflict in Ukraine. Rising inflation across the globe is denting purchasing power and eroding corporate margins.

The Andorran consumer price index (CPI) hit 7.4% in June 2022 on a yearly basis, up from 6.6% in May. This is an all-time high considering the series starting in January 2002. Prices of fuels and other transport items surged to 17.4%, followed by food and non-alcoholic beverages (+9.6%). Services prices such as hotels and restaurants increased at a slower pace (+4.1%). Meanwhile, core inflation, which accounts for 85% of the CPI basket and excludes energy and fresh product prices, reached 3.2%.

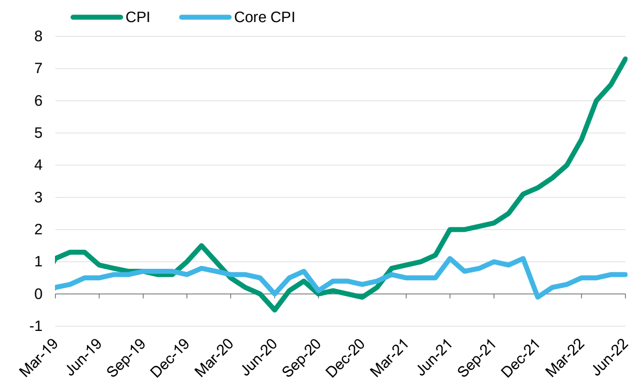
Energy security is currently a key concern in Europe. In terms of electricity supply, Andorra relies primarily on imports, with only 20% of consumed electricity produced in the country. Andorra has two long-term contracts with French Electricité de France (Baa1 negative) and Spanish Endesa (Baa1 stable): taken together, these two contracts ensure 42% of Andorra's total consumption and shield the country from short-term fluctuations in the market. In line with the broader institutional setting governing Andorra on several policies, both France and Spain guarantee Andorra's electricity supply. 37% of Andorra's consumption relies on imports exposed to market prices. Local production is mainly secured via a hydroelectric power station.

Exhibit 5
Growth is slowing in line with the euro area
Real GDP, annual variation, %



Source:Govern d'Andorra Department of Statistics

Exhibit 6
Inflation has accelerated since mid-2021
Annual variation, %



Source: Govern d'Andorra Department of Statistics

Andorra's potential growth is constrained by low investment

In its latest article IV report, the IMF assesses Andorra's potential real GDP growth rate at around 1.5%[2], in line with the euro area's average. The pandemic shock had a significant negative impact on Andorra's economy and public finances, and the IMF estimates that the level of Andorra's potential GDP will be permanently lower by 3.2% due to the large decline in tourism inflows in the 2020-2021 winter season. That said, the IMF believes that the 1.5% potential growth rate will be reached over the medium-term, as economic activity normalizes with the lifting of pandemic restrictions.

The IMF notes that Andorra's total investment as a share of GDP (13%) is significantly lower than the euro area's average (21%) due to a smaller contribution from private investment. Compared to France, Spain and the euro area's average, Andorra's investment recovery is lagging. In parallel, the analysis points to lower levels of human capital, although the high share of non-resident workers means that raising educational achievements in Andorra would only feed through gradually to economic performance.

To raise potential growth, the IMF calls for a multi-pronged approach focused on diversifying the economy, boosting investment, and building human capital. Interestingly, the Fund advocates for easing immigration requirements in order to raise the supply of highly-skilled workers.

Access to ECB's liquidity line further enhances Andorra's institutional setting

On July 22, the European Central Bank (ECB) and the Andorran Financial Authority (AFA) announced that the Governing Council of the ECB agreed to establish a repo line that will be activated in the event of dysfunctions in the Andorran financial market. The EUR 35 million line will expire on January 15, 2023 and will allow the AFA to meet the exceptional demand for liquidity in euros from Andorran banking entities should such a need arise.

The AFA has the power to carry out all the actions necessary to ensure the correct development of its supervision and control functions for the entities that make up Andorra's financial system (and their consolidated groups), and exercises disciplinary and sanctioning power over these entities. It also provides treasury and public debt management services, manages customer complaints to the agency and is responsible for international relations with central banks and other supervisory authorities. Finally, it submits reports and opinions on financial legislation to the government.

Given the intrinsic limitations of Andorra, with no central bank and no formal lender of last resort, the news further enhances the country's ability to cope with potential shocks. The framework is the first bilateral agreement on a liquidity line between the ECB and the AFA, strengthening Andorra's international integration.

Moody's rating methodology and scorecard factors: Andorra - Baa2 Stable

Factor / Sub-Factor	Metric	Indicator Year	Indicator	Initial Factor Score	Final Factor Score	Weights
Factor 1: Economic strength				**ba2**	**ba2**	**50%**
Growth dynamics	Average real GDP growth (%)	2017-2026F	1.2	b2		25%
	Volatility in real GDP growth (%)	2012-2021	5.5	ca		10%
Scale of the economy	Nominal GDP ($ billion)	2021	3.3	ca		30%
National income	GDP per capita (PPP, Intl$)	2021	58,383.2	aaa		35%
Adjustment to factor 1	*# notches*				0	max ±9
Factor 2: Institutions and governance strength				**a1**	**a1**	**50%**
Quality of institutions	Quality of legislative and executive institutions			a		20%
	Strength of civil society and the judiciary			a		20%
Policy effectiveness	Fiscal policy effectiveness			aa		30%
	Monetary and macroeconomic policy effectiveness			a		30%
Specified adjustment	Government default history and track record of arrears				0	max -3
Other adjustment to factor 2	*# notches*				0	max ±3
F1 x F2: Economic resiliency				**baa1**	**baa1**	
Factor 3: Fiscal strength				**aa3**	**aa3**	
Debt burden	General government debt/GDP (%)	2021	48.6	a3		25%
	General government debt/revenue (%)	2021	129.0	aa3		25%
Debt affordability	General government interest payments/revenue (%)	2021	1.6	aa1		25%
	General government interest payments/GDP (%)	2021	0.6	aa1		25%
Specified adjustments	*Total of specified adjustment (# notches)*			0	0	max ±6
	Debt trend	2017-2022F	7.6	0	0	
	Foreign currency debt/general government debt	2021	100.0	0	0	
	Other non-financial public sector debt/GDP	2021	0.0	0	0	
	Public sector assets/general government debt	2021	0.0	0	0	
Other adjustment to factor 3	*# notches*				0	max ±3
F1 x F2 x F3: Government financial strength				**a2**	**a2**	
Factor 4: Susceptibility to event risk				**b**	**b**	Min
Political risk				a		
	Domestic political risk and geopolitical risk			a		
Government liquidity risk				baa	baa	
	Ease of access to funding			baa		
Specified adjustment	High refinancing risk				0	max -2
Banking sector risk				b	b	
	Risk of banking sector credit event (BSCE)	Latest available	--	ba1-ba2		
	Total domestic bank assets/GDP	2021	--	>=400		
Adjustment to F4 BSR	*# notches*				0	max ±2
External vulnerability risk				aa	aa	
	External vulnerability risk			aa		
Adjustment to F4 EVR	*# notches*				0	max ±2
Overall adjustment to F4	*# notches*				0	max -2
F1 x F2 x F3 x F4: Scorecard-indicated outcome				**Baa1 - Baa3**	**Baa1 - Baa3**	

Note: While information used to determine the grid mapping is mainly historical, our ratings incorporate expectations around future metrics and risk developments that may differ from the ones implied by the scorecard-indicated outcome. Thus, the rating process is deliberative and not mechanical, meaning that it depends on peer comparisons and should leave room for exceptional risk factors to be taken into account that may result in an assigned rating outside the scorecard-indicated outcome. For more information please see our Sovereign Ratings Methodology.

Footnotes: (1) Initial factor score: scorecard indicators combine with the automatic adjustments to produce an initial factor score for every rating factor, as detailed in Moody's Sovereign Ratings Methodology. **(2) Final factor score:** where additional analytical considerations exist, initial factor scores are augmented to produce a final factor score. Guidance on additional factors typically considered can be found in Moody's Sovereign Ratings Methodology; details on country-specific considerations are provided in Moody's research. **(3) Scorecard-indicated outcome:** Factor 1: Economic Strength, and Factor 2: Institutions and Governance Strength, combine with equal weight into a construct we designate as Economic Resiliency (ER). An aggregation function then combines ER and Factor 3: Fiscal Strength, following a non-linear pattern where Fiscal Strength has higher weight for countries with moderate ER and lower weight for countries with high or low ER. As a final step, Factor 4, a country's Susceptibility to Event Risk, is a constraint which can only lower the government financial strength as given by combining the first three factors. **(4) There are 20 ranking categories for quantitative sub-factors:** aaa, aa1, aa2, aa3, a1, a2, a3, baa1, baa2, baa3, ba1, ba2, ba3, b1, b2, b3, caa1, caa2, caa3, ca and 8 ranking categories for qualitative sub-factors: aaa, aa, a, baa, ba, b, caa, ca **(5) Indicator value:** if not explicitly stated otherwise, the indicator value corresponds to the latest data available.

Moody's related publications

» **Sector Comment:** Macroeconomics – Europe: Growth in Europe's largest economies will sharply decelerate as energy crisis persists, 25 July 2022

» **Sector In-Depth:** Geopolitical Risks – Cross Region: Fractured geopolitical landscape illustrated by five key risks to credit quality, 6 July 2022

» **Sector Comment:** Macroeconomics – Global: With stubbornly high inflation, central banks will ratchet up monetary policy tightening, 13 July 2022

» **Sector Comment:** Macroeconomics – Global: EU's Russian oil embargo will raise oil prices through summer, 06 June 2022

» **Sector In-Depth:** Sovereigns – Europe: Most are resilient to Russian energy cuts and cyberattacks, but wider military conflict would have major credit effects, 31 May 2022

» **Rating Methodology**: Sovereign Ratings Methodology, 25 November 2019

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Endnotes

1 The number of underlying sources is limited, ranging from 1 for most indicators to 3.

2 The report highlights the challenge of producing such an estimate due to data limitations.

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