MOODY'S
INVESTORS SERVICE

CREDIT OPINION
23 January 2024

Update

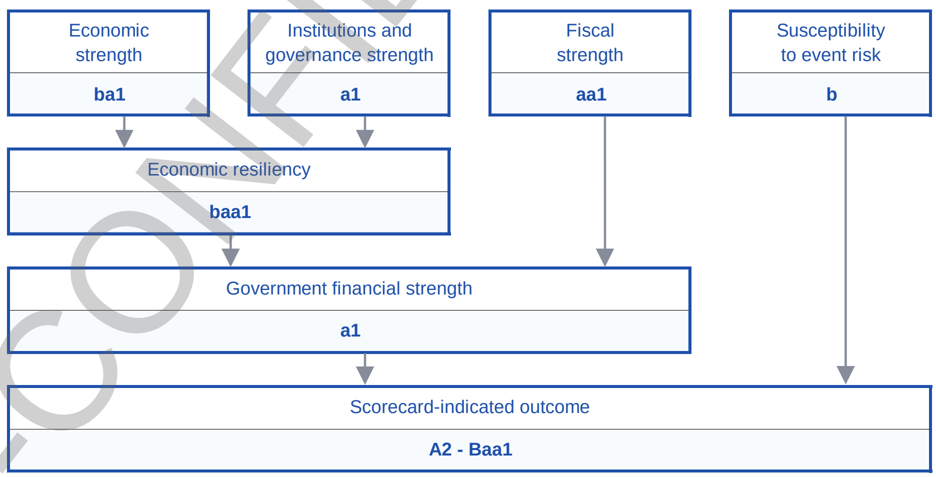
Government of Andorra – Baa1 stable

Update following upgrade to Baa1

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 very small, exposure to a large banking sector and absence of a central bank.

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 central bank
- Potential contingent liabilities stemming from a very large financial sector

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Rating outlook

The stable outlook reflects balanced risks at the Baa1 rating level. Andorra's strong institutions and very affordable debt metrics point to a potential faster improvement in credit metrics than currently assumed by Moody's. Conversely, the country's small size and significant exposure to event risk driven by the very large (albeit profitable) banking sector (with banking assets at 544% of GDP), point to potential downside risks in the event of economic and/or banking sector shocks.

Factors that could lead to an upgrade

The adoption of further reforms in the areas of pensions and healthcare limiting ageing-related spending, and evidence that the implementation of the Association Agreement with the EU leads to significantly higher economic growth, would put upward pressure on the rating. A reduction in the size of the banking sector and further evidence that the system poses lower risk to the Andorran sovereign would also be credit positive.

Factors that could lead to a downgrade

The outlook could be changed to negative were Andorra's medium-term growth prospects to worsen compared to Moody's baseline scenario. Weaker growth and higher economic volatility would negatively affect public finances, potentially prompting government intervention which would put upward pressure on the country's borrowing needs and, eventually, public debt. A reversal of the reform momentum would also be credit negative, as it would indicate a weaker institutional setup than currently assessed by Moody's. Finally, a weakening of the Andorran banking sector that threatened growth and the health of public finances would put downward pressure on the rating.

Key indicators

Andorra	2018	2019	2020	2021	2022	2023E	2024F	2025F
Real GDP (% change)	1.6	2.0	-11.2	8.3	8.8	2.1	2.0	1.5
Inflation rate (% change average)	1.0	0.5	0.1	1.7	6.2	5.6	3.6	1.5
Gen. gov. financial balance/GDP (%)	2.6	2.5	-1.1	-1.2	4.8	1.9	1.8	1.6
Gen. gov. primary balance/GDP (%)	3.0	2.9	-0.5	-0.4	5.5	2.5	2.4	2.2
Gen. gov. debt/GDP (%)	36.3	35.4	46.3	48.6	39.1	36.0	35.6	34.6
Gen. gov. debt/revenues (%)	94.3	92.3	112.2	128.4	98.5	92.3	92.2	88.7
Gen. gov. interest payment/revenues (%)	1.2	1.2	1.5	2.0	1.8	1.5	1.6	1.5
Current Account Balance/GDP (%)	18.0	18.0	15.5	14.1	17.0	17.3	17.7	18.6

Source: Moody's Investors Service

Detailed credit considerations

We assess Andorra's **economic strength** as "ba1", balancing high per-capita GDP and very small size combined with moderate 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. Following the pandemic shock in 2020 (-11%), the economy has rebounded swiftly and we forecast growth to return to its long-term average of 1.5% as of 2025.

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 central bank is a constraint for Andorran policymakers, partly mitigated by the creation of a liquidity emergency provision mechanism in late 2022.

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, and the signature of the association agreement with the EU will further strengthen Andorran institutions.

We assess Andorra's **fiscal strength** as “aa1” to reflect a moderate debt burden, strong debt affordability and the presence of large public sector liquid assets. We expect the debt-to-GDP ratio to reach its pre-pandemic level in 2025, reflecting a swift return to fiscal surpluses after two years of deficit in 2020 and 2021.

Andorra’s fiscal profile is enhanced by the presence of large public sector liquid assets: in 2022, these assets accounted to EUR 2.1 billion, equivalent to 65% 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. As a result, we apply a one-notch positive adjustment to the scorecard-indicated outcome of “aa2”.

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 544% of GDP in 2022[2], 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.

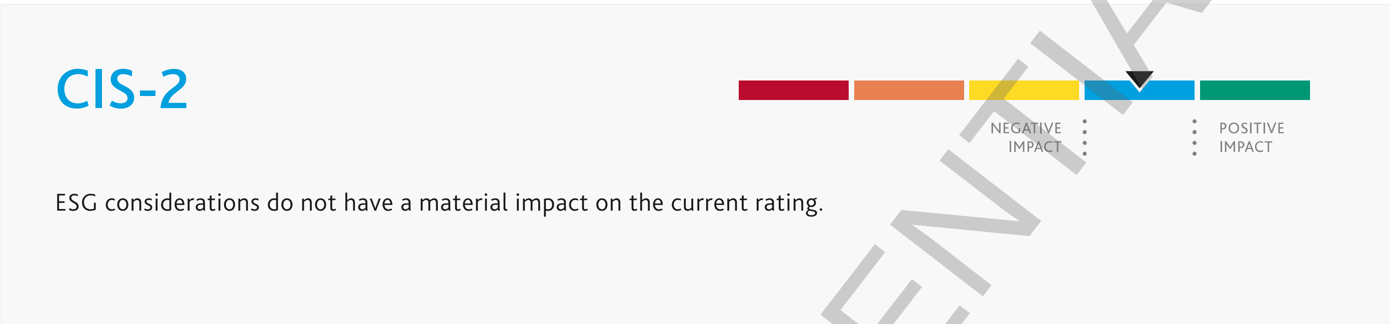
The system exhibits solid profitability and an improved tracked record since the Banca Privada d’Andorra (BPA) scandal in 2015, which had limited spillovers to the rest of banking entities. However, the system’s reliance on volatile foreign deposits and the geographical concentration in the principality of Andorra are risks incorporated in our assessment.

We assess government liquidity risk as “baa”, considering Andorra's limited experience with international financial markets. We assess domestic political risk as “a”, considering the very stable environment in Andorra and consensus-driven policymaking. Finally, Andorra's external vulnerability risk is very low (score of “aa”), reflecting the country's sizeable current account surplus driven by the large services surplus which more than offsets the goods deficit.

ESG considerations

Andorra's ESG credit impact score is CIS-2

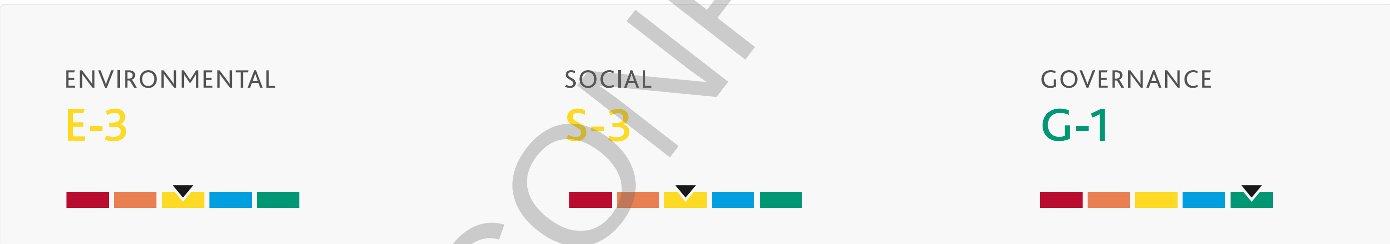
Exhibit 3
ESG credit impact score



Source: Moody's Investors Service

Andorra's ESG Credit Impact Score of **CIS-2** reflects 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 environmental **E-3** issuer profile reflects the economic importance of winter tourism, a source of vulnerability in the context of climate change as warmer temperatures reduce the amount of snow. Against this backdrop, the country has a comprehensive strategy in place to promote renewable energy such as solar and wind and invest in the transition to a more sustainable economic model.

Social

Andorra's social **S-3** issuer profile score reflects the population's ageing, in line with other advanced economies, which will pressure public finances in the coming decade. On the positive side, the score considers high activity and employment rates, as well as the country's very high quality of health and safety. Moreover, Andorra's population benefits from strong access to basic services and modern infrastructure including a complete 5G coverage.

Governance

Andorra's high institutions and governance strength which translates into a **G-1** issuer profile score reflects solid performance on global surveys assessing voice & accountability, regulatory quality and government effectiveness. Andorra has a comprehensive strategy to adopt common EU standards and allow for better financial supervision. The effectiveness and credibility of fiscal policy is solid. Andorra's very small size leads to shortcomings in terms of data reporting, although the country's IMF membership since 2020 is helping to increase transparency and disclosure of information.

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.

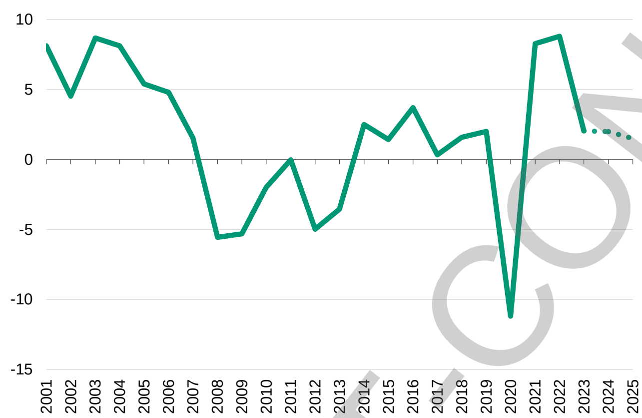
Recent developments

Economy to converge towards trend growth

We expect Andorra's real GDP to have grown by 2.1% in 2023. Domestic demand was supported by private consumption against the backdrop of a tight labour market. Regarding tourism, figures have strongly rebounded in the post-pandemic environment, with 12 million overnight stays in 2023 against 10 million in 2022 and 8.8 million in 2019. Inflation finished the year at 4.6% (year-on-year), down from 7.5% at the beginning of the year, as food and transport prices decelerated, while health and other services prices increased. On hotel and accommodation, the trend is relatively stable at relatively high levels, with a 4.9% increase in December (5.6% in January).

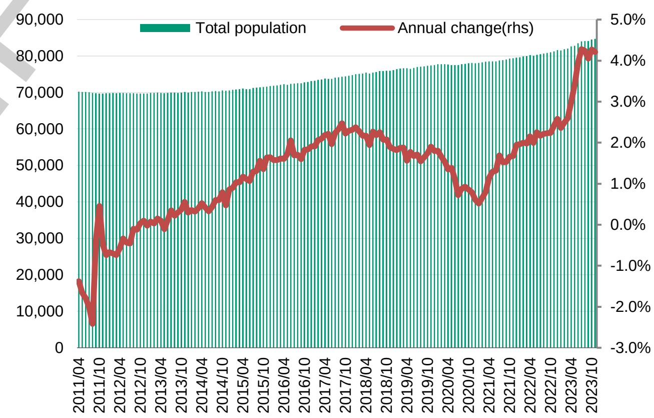
For 2024 and 2025, the latest projections by the statistical institute give 1.8% for 2024 and 2.1% for 2025, before a moderation to around 1.5% for 2026-2028, in line with average trend growth since the beginning of the series in 2001. We forecast 2.0% in 2024, before 1.5% in 2025 and beyond. Growth will be supported by solid tourism demand and construction, given the rising demand for housing against the backdrop of strong population growth.

Exhibit 5
Economy to settle around long-term average
Real GDP growth, in %



Sources: IMF, MIS forecast.

Exhibit 6
Strong population growth is affecting labour supply and housing
Total population in Andorra



Sources: Andorran statistical office, MIS.

The country continues to target sustainable tourism growth, lengthening average stays (3.3 days on average), reducing roundtrip visits from Spain and France and attracting tourists throughout the year. The Andorran Tourism industry has developed a comprehensive offer with cultural, wellness and sport events in complement to the country's natural attractions (hiking, trekking, biking, skiing) partnering with international brands to reach a broad audience (National Geographic…). High-speed internet allows for the development of free-of-charge mobile phone apps to guide visitors throughout the country.

In addition, the government's Digital Transformation Plan 2020-25, which seeks to digitalise public administration and simplify the process of opening up businesses, will continue to attract skilled labour to Andorra. Our growth forecast is based on the assumption that the association agreement with the EU (see below) will not produce an immediate positive impact on the Andorran economy.

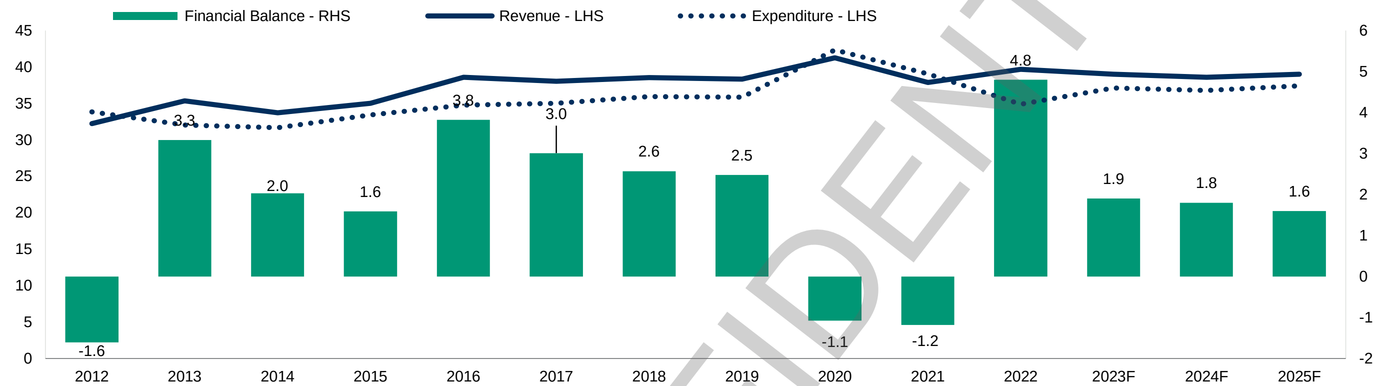
Fiscal surpluses to accelerate debt reduction

Following a 2-year period of modest fiscal deficits (around -1% of GDP in 2020 and 2021) in the wake of the pandemic, Andorra's general government balance returned to a large surplus in 2022 and 2023 (4.8% of GDP and 1.9% of GDP) thanks to solid revenue growth and limited spending progression.

Under our baseline scenario, we expect the surplus to reach 1.8% of GDP in 2024 and 1.6% of GDP in 2025. The forecast is based on the assumption that fiscal policy will remain prudent on the spending side, while allowing for targeted support to improve household's housing affordability. On the revenue side, in addition to the positive impact from economic activity, the measures to raise minimum taxation will support public resources. On the latter, the government has stated its ambition to set an effective 3% effective tax rate on both corporate and personal income taxes. Against this backdrop, the debt-to-GDP would continue to decline from 36.0% in 2023 to 35.6% in 2024 and 34.6% in 2025.

Exhibit 7

Andorra has a track record of fiscal surpluses



Sources: Andorran statistical office, IMF and MIS forecast

From a debt affordability perspective, Andorra's metrics are expected to remain strong, with interest-to-revenues set to stabilize at around 1.5% in 2024-2025. The higher interest rates environment will affect Andorra only to a limited extent given the country's long average debt maturity (7.3 years) and absence of funding needs over the next three years.

Andorra's fiscal profile is enhanced by the presence of large public sector liquid assets: in 2022, these assets accounted to EUR 2.1 billion, equivalent to 65% of Andorra's GDP. While mostly earmarked to the social security system (assets under management for the pension system as depicted below) 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.

Ongoing reform momentum is credit positive

Andorra's solid track record of reforms is evidenced by the country's growing global integration, with the adoption of international standards in the areas of financial reporting, banking regulation and the exit of the European Union's (EU) list of non-cooperative tax jurisdictions. The momentum has recently continued, with the achievement of two important milestones.

In December 2022, the creation of a liquidity emergency provision mechanism based on the country's international reserves is a credit positive development which will help Andorra mitigate risks associated with the absence of a central bank. The aim is to provide the government with the necessary liquidity to cope with potential adverse economic shocks, including financial sector stress, natural disasters and pandemics. According to the Ministry of Finance, Andorra currently holds around €340 million (10% of GDP) in international reserves. The scheme is based on the European Central Bank's (ECB) Emergency Liquidity Assistance (ELA) mechanism.

One year later, in December 2023, Andorra signed an association agreement with the EU. The agreement grants Andorran enterprises access to the EU's internal market, which opens new opportunities for Andorra's economic growth. The agreement, which requires the introduction of level-playing field rules for businesses in Andorra and the EU, will further bolster Andorra's regulatory and supervisory framework momentum, particularly in the financial services sector. Nonetheless, uncertainty remains with regards to implementation, as the final draft agreement will be submitted to a referendum expected in late 2024. Furthermore, if adopted, the agreement will require significant implementation efforts for both public authorities and private sector actors.

Looking ahead, we expect the authorities to continue pushing this reform momentum to tackle some of the country's structural challenges. The "State Pacts" ("Pacte d'Estat" involving the majority, the opposition and civil society forces) on ageing and healthcare represent an opportunity to further strengthen Andorra's credit profile by reducing long-term pension and public health costs. A reform of the pension system, for which the government expects the surplus to turn into a deficit in 2027, leading to rising financing needs at the 2040 horizon, would consolidate the authorities forward-looking strategy and improve the country's long-term fiscal sustainability.

Moody's rating methodology and scorecard factors: Andorra - Baa1 stable

Factor / Sub-Factor	Metric	Indicator Year	Indicator	Initial Factor Score	Final Factor Score	Weights
Factor 1: Economic strength				**ba1**	**ba1**	**50%**
Growth dynamics	Average real GDP growth (%)	2018-2027F	1.8	ba2		25%
	MAD Volatility in Real GDP Growth (%)	2013-2022	1.7	ba2		10%
Scale of the economy	Nominal GDP ($ billion)	2022	3.4	ca		30%
National income	GDP per capita (PPP, Intl$)	2022	66,154.5	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				**aa2**	**aa1**	
Debt burden	General government debt/GDP (%)	2022	39.1	a1		25%
	General government debt/revenue (%)	2022	98.5	aa2		25%
Debt affordability	General government interest payments/revenue (%)	2022	1.8	aa1		25%
	General government interest payments/GDP (%)	2022	0.7	aa1		25%
Specified adjustments	*Total of specified adjustment (# notches)*			0	1	max ±6
	Debt Trend - Historical Change in Debt Burden	2014-2022	-2.9	0	0	
	Debt Trend - Expected Change in Debt Burden	2022-2024F	-3.5	0	0	
	General Government Foreign Currency Debt/ GDP	2022	39.1	0	0	
	Other non-financial public sector debt/GDP	2022	0.0	0	0	
	Government Financial Assets including Sovereign Wealth Funds / GDP	2022	0.0	0	1	
Other adjustment to factor 3	*# notches*				0	max ±3
F1 x F2 x F3: Government financial strength				**a2**	**a1**	
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	2022	544.2	>=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**	**A2 - Baa1**	

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.

Endnotes

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

2 This ratio is calculated on a consolidated basis, including domestic and non-domestic activities.

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