

Rating Action: Moody's assigns Baa2 rating to Andorra; stable outlook

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Frankfurt am Main, February 04, 2022 -- Moody's Investors Service ("Moody's") has assigned a Baa2 long-term issuer rating to the Government of Andorra and has also assigned a stable outlook

The assignment of the rating balances the following factors:

1. Solid institutional and governance capacity which is supported by greater international openness;
2. Moody's expectation that Andorra's government balance sheet will gradually recover from the pandemic shock;
3. A moderate level of economic strength balancing a wealthy economy with constrained growth potential and exposure to a very large banking sector.

The stable outlook reflects Moody's expectations that Andorra's credit profile will remain resilient to the pandemic environment. Moreover, the stable outlook balances the intrinsic strengths of Andorra's institutions and fiscal metrics with credit challenges that relate to the economy's very small size and volatile nature, as well as to the exposure to the country's very large banking sector (with assets accounting for 600% of GDP in 2020) and fundamental limitations such as the absence of a lender of last resort.

Concurrently, Moody's has assigned Andorra a foreign currency ceiling of A1. The four-notch gap between the foreign currency ceiling and sovereign rating reflects strong predictability of government actions and reliability of key institutions, as well as low political risks and a robust external vulnerability profile. At the same time, data for the government footprint in the economy are not available and the reliance on tourism and retail activities is high (20% of value added in 2020) against the backdrop of a very small economy.

RATINGS RATIONALE

RATIONALE FOR THE Baa2 RATING

FIRST DRIVER: SOLID INSTITUTIONAL AND GOVERNANCE CAPACITY WHICH IS SUPPORTED BY GREATER INTERNATIONAL OPENNESS

The first driver of the action relates to Andorra's solid institutional and governance capacity. According to the Worldwide Governance Indicators (WGI) published by the World Bank, Andorra scores consistently high (80th to 90th percentile) in the indicators Moody's considers for the quality of legislative and executive institutions (government effectiveness, regulatory quality). Andorra also scores highly on indicators related to the strength of civil society and the judiciary (control of corruption, rule of law, voice and accountability).

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. In terms of monetary and macro-prudential policy, Andorra has a comprehensive strategy to adopt common European Union standards and allow for better supervision. Andorra further benefits from a single financial supervisor (AFA), a specialized unit in charge of AML/CFT enforcement (UIFAD) and a bank resolution authority (AREB).

Moreover, from an international perspective, Andorra has followed the Organisation for Economic Cooperation and Development's (OECD) Common Reporting Standard since 2018 and introduced IFRS to the overall financial system reporting in 2019. In addition, Andorra incorporated the Basel III accord requirements in 2018 and the MiFID II/MiFIR regulatory framework in 2020. In terms of tax policy, Andorra is no longer considered in the list of noncooperative tax jurisdictions published by the European Union since 2018. Finally, Moody's considers that Andorra's accession to the International Monetary Fund (IMF) as a member in 2020 is an important milestone.

Moody's believes that the IMF membership has the potential to further strengthen Andorra's institutional capacity and partially mitigate the country's intrinsic limitations due to its size. As noted by the IMF, closing data gaps and publishing statistics according to international standards would allow for better transparency.

From a macroeconomic perspective, Moody's notes that the absence of a domestic currency and of a lender of last resort are major constraints for Andorran policymakers.

That said, building of international reserves will help Andorra cushion the impact in a stress-scenario without a lender of last resort. Finally, the ongoing negotiation with the European Union (EU) on an Association Agreement has the potential to broaden Andorra's access to the single market and foster new business and trade opportunities.

SECOND DRIVER: MOODY'S EXPECTATION THAT ANDORRA'S GOVERNMENT BALANCE SHEET WILL GRADUALLY RECOVER FROM THE PANDEMIC SHOCK

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. In line with several other advanced economies, debt affordability metrics improved, with the interest payments-to-revenues ratio declining from 3.1% in 2013 to 1.3% in 2019.

Furthermore, Andorra's fiscal profile is enhanced by the presence of large public sector liquid assets: in 2020, these assets accounted for almost EUR 1.8 billion, equivalent to 73% 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.

To date, the coronavirus pandemic has had a negative impact on Andorra's public accounts; following a 1.1% of GDP deficit in 2020, Moody's estimates that Andorra's general government deficit reached 3.0% of GDP in 2021.

In addition, the authorities new issuance strategy is having a -- temporary but significant -- impact on the amount of gross borrowing requirements in 2021 and 2022 (20% of GDP on average). As a result, Moody's estimates that the public debt-to-GDP ratio reached around 50% in 2021. Looking ahead, Moody's forecasts a reduction in the budget deficit in 2022 and 2023, before returning to a surplus as of 2024. While economic activity will lift public revenues, receding of pandemic-related spending will mechanically reduce public outlays.

Under its baseline scenario, Moody's forecasts the debt-to-GDP ratio to fall as of 2022 and return close to its 2019 levels by 2025. Moody's also expects debt affordability metrics to remain strong, with the interest payments-to-revenue ratio to stabilize at around 1.6% of GDP over the next three years.

THIRD DRIVER: A MODERATE LEVEL OF ECONOMIC STRENGTH BALANCING A WEALTHY ECONOMY WITH CONSTRAINED GROWTH POTENTIAL AND EXPOSURE TO A VERY LARGE BANKING SECTOR

With a GDP per-capita of 52,000 (international USD, PPP) in 2020, Andorra is much wealthier than the Baa2 median (22,423). This reflects a mature economy with 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.

At the same time, Andorra's very small economy (USD 2.9 billion) is constrained by the country's size and the modest growth rate of GDP due to its sectoral composition. 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 one (0.1% on average between 2010 and 2019).

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, including the closure of borders by neighbouring Spain (Baa1 stable) and France (Aa2 stable), the country's main economic partners who provide around 90% of the country's annual foreign tourists and are the country's gateways to the rest of the world. Retail activities are also largely dependent on cross-border flows from commuting visitors.

Furthermore, the very large relative size of the Andorran banking sector, with total assets accounting for 600% of GDP in 2020, 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.

Moody's notes that the share of financial services has halved over the past two decades, from 24% of gross value 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.

Looking ahead, Moody's expects Andorra's real GDP growth to reach 4% in 2022, 1.8% in 2023 and 1.5% in 2024. Rising vaccination rates and stronger economic activity in the euro area will support Andorra's gradual recovery, with Moody's expecting Andorra's real GDP to recover its 2019 levels by 2023. A tight labour market will support wages and hence private consumption. The gradual recovery in the tourism sector will also contribute positively to economic growth. Given the recent pandemic developments in Western Europe, risks to the economic outlook are to the downside.

RATIONALE FOR THE STABLE OUTLOOK

The stable outlook reflects Moody's 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.

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

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.

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.

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.

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.

GDP per capita (PPP basis, US\$): 51,989 (2020 Actual) (also known as Per Capita Income)

Real GDP growth (% change): -11.2% (2020 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): -0.2% (2020 Actual)

Gen. Gov. Financial Balance/GDP: -2.8% (2020 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: 14.5% (2020 Actual) (also known as External Balance)

External debt/GDP: [not available]

Economic resiliency: baa1

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 25 January 2022, a rating committee was called to discuss the rating of the Andorra, Government of. The main points raised during the discussion were: The assignment of the Baa2 issuer rating for Andorra balances moderate economic strength, solid institutions and governance strength as well as fiscal strength, and an exposure to susceptibility to event risk driven by the banking sector risk.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATING

WHAT WOULD CHANGE THE RATING UP

Upward pressures on the rating 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.

WHAT WOULD CHANGE THE RATING DOWN

Downward pressures on the rating 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.

The principal methodology used in this rating was Sovereign Ratings Methodology published in November 2019 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1158631. Alternatively, please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

This rating action concerns a new rating for an issuer not previously publicly rated by us at the time that the EU sovereign release calendar was published, and is therefore being released on a date not listed in that publication.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found at: https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

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At least one ESG consideration was material to the credit rating action(s) announced and described above.

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