Autonomous Community of the Basque Country

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This report does not constitute a rating action.

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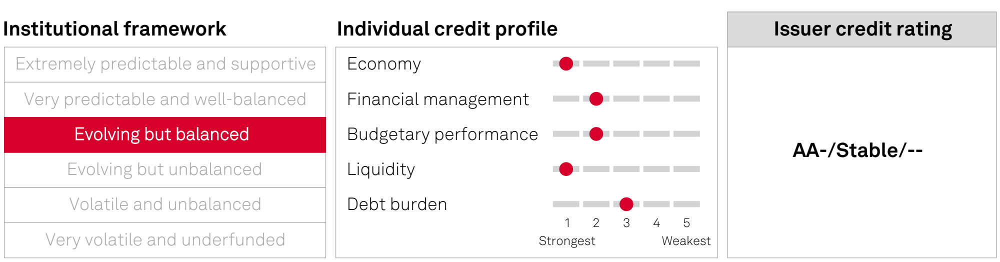
Ratings Score Snapshot



Credit Highlights

Overview

Credit context and assumptions	Base-case expectations
--The Autonomous Community of the Basque Country's special status makes it more exposed to the economic cycle than normal-status regions, since it has its own tax collection power through its three historical territories.	--We expect the Basque Country to maintain operating balance above 5% of operating revenue, and to post minimal deficits after capital accounts.
--The Basque Country's economy is stronger than that of Spain, with low unemployment and above average GDP per capita due to its direct tax collection.	--The Basque Country will likely continue improving its debt burden ratios, which are already among the best of all Spanish regions, fueled by revenue growth and moderation of new debt issuance.
--The Basque Country operates under a predictable institutional framework, with budgetary flows between the region and central government periodically updated and renegotiated in a bilateral way	--We expect liquidity reserves will remain solid, although cash levels may gradually decrease since the region's expense is financed by funds from the EU Recovery and Resilience Facility (RRF)

S&P Global Ratings expects the Basque Country's operating margins to decline only slightly in 2024, due to lower tax revenue growth than in 2023, but should remain comfortably above 5% of operating revenue. We expect inflation levels, which have increased expenditure, to gradually fall. This which should allow the region's financial management to maintain control of expenditure growth.

We expect the Basque Country to continue lowering its debt ratios. The region reduced its direct debt in nominal terms in 2023 and 2022. While we expect that slight deficits from 2024 may lead to an increase in debt in nominal terms, revenue expansion will more than compensate for this increase. We therefore expect the Basque Country's debt ratios to continue their steady improvement over 2024-2026.

Our rating on the region can be above that on Spain because, in our view, its credit characteristics would make it more resilient than the sovereign in a stress scenario. However, we believe that the Basque Country is highly sensitive to Spain's country risk, and therefore can rate it no more than two notches above the sovereign. Our rating on the region is at the same level as the 'aa-' stand-alone credit profile (SACP). The SACP is not a rating, but a measure of the intrinsic creditworthiness of a local or regional government before accounting for any constraint from the sovereign rating.

Outlook

The stable outlook on the Basque Country mirrors that on Spain (unsolicited; A/Stable/A-1) and our view that the region will maintain positive operating balances over our 2024-2026 forecast horizon, while continuing to reduce leverage. The outlook also reflects our view that the Basque Country will continue to have a strong access to external funding through capital markets, supporting its exceptional liquidity position.

Downside scenario

We could lower our rating on the Basque Country if we downgraded Spain or we believed the region no longer met our conditions to be rated two notches above the sovereign. We could also downgrade the Basque Country if the region's budgetary performance deteriorates significantly beyond our expectations, whether because of management's lack of commitment to gradually stabilize budgetary outcomes or because of a weaker economic scenario in 2024-2026.

Upside scenario

We could raise our ratings on the Basque Country if we took the same action on Spain and the region posted structural surpluses after capital accounts higher than 5% of its total revenue, with a lower debt burden.

Rationale

A stronger-than-expected economy in 2023 led to stronger budgetary outcomes

In contrast with Spanish normal-status regions, the Basque Country and Navarre have their own tax administrations that collect the bulk of taxes. Therefore, special-status regions do not participate in the regional financing system, which is based on advances from taxes collected, allowing the central government to soften the effect of economic cycles on regional revenue. The framework under which the Basque Country operates makes it more vulnerable to economic shocks, but also allows for a faster recovery. A stronger-than-anticipated economic performance in 2023 and a more immediate recovery from the COVID-19 pandemic in 2021 and 2022 also led to better tax collection and better budgetary outcomes than we had previously anticipated.

Tax revenue continue to increase, up 6.3% overall in 2023 after very high tax collection in 2022. However, performance was mixed across tax categories. Direct taxes increased strongly by about 11.5%, due to high employment levels that boosted personal income tax bases, and strong corporate results in 2023, which boosted corporate tax receipts. On the other hand, indirect taxes, particularly value added tax (VAT), had a more muted performance. This was partly due to a slowdown in household consumption due to inflation and rising interest rates, but also to the effect of central government measures that lowered VAT on items such as gas, electricity, and food, to prevent higher prices due to the effect of the Russia-Ukraine war being passed on to the population.

We expect a gradual slowdown of economic growth, but Spain's economic trajectory is likely to outperform that of the eurozone, with nominal GDP growth of about 4.2% on average from 2024-2026. This should enable a continued increase in revenue for the Basque Country, particularly if lower interest rates in the second half of 2024 lead to an increase in household consumption.

We continue to see the Basque Country's economy as stronger than that of the sovereign, with above average socioeconomic indicators. As such, the region's GDP per capita was about 127% of the national average at year-end 2022, and its unemployment 6.3% at year-end 2023 was below Spain's national average of 11.8%.

Industry is a much bigger part of Basque Country's economy than that of other regions, representing about 25% of gross value added as of year-end 2022, compared with Spain's 17%. In addition, its industrial sector features high-value added, export-oriented companies. This makes the economy more resilient to external shocks. Furthermore, the Basque Country's economic strength is a positive factor, particularly because it boosts its tax base, which it directly benefits from due to the institutional arrangements that define its relationship with the central government. Spanish normal status regions, on the contrary, do not benefit from this because they participate from a common equalization system.

We view the Basque Country's financial management as strong. Management is committed to budgetary and fiscal consolidation as demonstrated through its compliance with the reference deficit targets agreed with the central government. We believe this places the region in a good position ahead of the return of binding fiscal rules in 2024. We note that budgetary targets for 2024 are not yet official. However, the Basque Country's 2024 budget includes a deficit target of 0.3% of regional GDP, although we believe its performance will likely be stronger.

The region is likely to post stable budgetary performance while continuing to reduce leverage and maintaining strong liquidity

We estimate the Basque Country's operating performance in 2023 was stronger than in 2022, fueled by about 6% increase in operating revenue, while operating expenditure growth moderated to only 3.5%.

We forecast the Basque Country's operating margin will be about 7.5% of operating revenue in 2024, down from about 8.2% in 2023. This is because the region includes an 8% increase in operating expenditure in its budget for 2024, higher than our estimated closing data for 2023. We estimate operating expenditure will increase less than 8%, since, in our view, the Basque Country's estimates tend to be conservative. Moreover, we note that the Basque Country will hold elections in April 2024. Electoral processes typically tend to increase expenditure, but mostly in the year before an election, so we think such an effect would have been seen in 2023 rather than 2024. On the other hand, in the months just before the election, and in the months immediately thereafter, budgetary execution typically slows somewhat as a new government is formed. In our view this supports a moderation in expenditure growth. A return to binding budgetary targets will also induce greater discipline in this regard.

We expect the Basque Country's balance after capital accounts to be tied to the development of EU grants from the RRF. The region has received about €1.1 billion as of Dec. 31, 2023. We do not expect any material additional funds to be assigned to the region, absent any changes in the distribution criteria (which could still happen). However, Spanish regions have until 2026 to spend the EU funds. This means that the timing upon they will receive this revenue will not perfectly match capital expenditure (capex), so could distort the Basque Country's deficit after capital accounts for 2024-2026. For example, the region's performance benefited from large EU funds in 2021, while undertaking few projects, creating a surplus after capital accounts in budgetary accounting terms. In our forecast, we assume capital revenue to decline, reverting back to structural values, while capex will remain high as EU funds are executed, but then gradually decline. However, the overall effect of these EU grants shall be neutral for 2021-2026 because regions cannot spend what they don't receive, and projects need to be previously approved by the ministry and comply with specific goals and targets set by the EU.

The Basque Country reduced its debt burden in nominal terms by about €78 million in 2023 and about €250 million in 2022, using accumulated cash surplus from previous years. At the same time, the public sector debt is declining. Combined with higher revenue than previously expected, we believe this trajectory will allow the region's tax-supported debt ratio to reach about 73% of consolidated operating revenue by 2026, down from about 87% in 2022.

While the central government has made a clear statement on the possibility of Spanish regions benefiting from debt absorption, we believe this will only affect normal-status regions, leaving Navarre and the Basque Country out of scope for this debt write-off. Therefore, we have not included any assumption in this regard in our base case scenario. Additionally, we understand that the central government allocated a €20 billion fund from the RRF in the form of loans for Spanish regions, which will be managed by the European Investment Bank. We have low visibility on how many of these loans the Basque Country could take over the next three years, because the loans' conditions are yet to be defined. Therefore, we have not included any estimates on this front in our assumptions either.

We expect the Basque Country's liquidity position to remain exceptional over the next year. The region's liquidity position is supported by €800 million of signed (and fully available) credit lines and its strong access to external funding. The Basque Country has repeatedly issued sustainable bonds (most recently €600 million in February 2024 and €700 million in February 2023) with a demand about 7x higher than the issued amount. The region is experiencing an increase in financial costs, in line with market conditions, but we nevertheless see its interest burden as moderate, reaching about 1.7% of operating revenue in 2024, before gradually abating as interest rates normalize. Also, about 83% the Basque Country's debt is fixed-rate, limiting interest rate risk.

Autonomous Community of the Basque Country Selected Indicators

Mil. EUR	2021	2022	2023	2024bc	2025bc	2026bc
Operating revenue	12,261	12,292	13,024	13,605	14,155	14,741
Operating expenditure	10,813	11,549	11,957	12,592	13,068	13,550
Operating balance	1,448	743	1,067	1,013	1,087	1,191
Operating balance (% of operating revenue)	11.8	6.0	8.2	7.5	7.7	8.1
Capital revenue	419	636	339	319	269	220
Capital expenditure	1,124	1,531	1,756	1,675	1,495	1,420
Balance after capital accounts	743	(152)	(351)	(342)	(139)	(9)

Autonomous Community of the Basque Country Selected Indicators

Balance after capital accounts (% of total revenue)	5.9	(1.2)	(2.6)	(2.5)	(1.0)	(0.1)
Debt repaid	668	746	778	632	835	879
Gross borrowings	1,165	497	700	600	800	800
Balance after borrowings	1,240	(402)	(429)	(374)	(174)	(88)
Direct debt (outstanding at year-end)	10,597	10,348	10,271	10,239	10,204	10,125
Direct debt (% of operating revenue)	86.4	84.2	78.9	75.3	72.1	68.7
Tax-supported debt (outstanding at year-end)	11,132	10,830	10,685	10,651	10,615	10,534
Tax-supported debt (% of consolidated operating revenue)	89.7	87.2	81.2	77.5	74.2	70.8
Interest (% of operating revenue)	1.2	1.2	1.5	1.7	1.6	1.5
Local GDP per capita ($)	38,733.4	37,731.1	--	--	--	--
National GDP per capita ($)	30,498.8	29,889.3	32,877.7	34,618.6	37,667.2	40,029.0

The data and ratios above result in part 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. The main sources are the financial statements and budgets, as provided by the issuer. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario. EUR--euro. $--U.S. dollar.

Autonomous Community of the Basque Country--Rating Component Scores

Key rating factors	Scores
Institutional framework	3
Economy	1
Financial management	2
Budgetary performance	2
Liquidity	1
Debt burden	3
Stand-alone credit profile	aa-
Issuer credit rating	AA-

S&P Global Ratings bases its ratings on non-U.S. local and regional governments (LRGs) on the six main rating factors in this table. In the "Methodology For Rating Local And Regional Governments Outside Of The U.S.," published on July 15, 2019, we explain the steps we follow to derive the global scale foreign currency rating on each LRG. The institutional framework is assessed on a six-point scale: 1 is the strongest and 6 the weakest score. Our assessments of economy, financial management, budgetary performance, liquidity, and debt burden are on a five-point scale, with 1 being the strongest score and 5 the weakest.

Key Sovereign Statistics

- Research Update: Spain 'A/A-1' Ratings Affirmed; Outlook Stable, March 15, 2024

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- Criteria | Governments | International Public Finance: Methodology For Rating Local And Regional Governments Outside Of The U.S., July 15, 2019
- Criteria | Governments | International Public Finance: Methodology: Rating Non-U.S. Local And Regional Governments Higher Than The Sovereign, Dec. 15, 2014
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 20, 2013
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Institutional Framework Assessments For Local And Regional Governments Outside Of The U.S., March 22, 2023
- Spain, March 20, 2023
- Institutional Framework Assessment: Spanish Special Status Entities, July 21, 2022
- Research Update: Basque Country Outlook Revised To Stable After Similar Action On Spain; 'AA-' Rating Affirmed, March 25, 2022

Ratings Detail (as of March 25, 2024)*

Basque Country (Autonomous Community of) (The)	
Issuer Credit Rating	AA-/Stable/--
Issuer Credit Ratings History	
25-Mar-2022	AA-/Stable/--
25-Sep-2020	AA-/Negative/--
27-Sep-2019	AA-/Stable/--

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings credit ratings on the global scale are comparable across countries. S&P Global Ratings credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.