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Research Update:

Spain's Balearic Islands 'BBB+' Rating Affirmed; Outlook Remains Negative

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Overview

- The Balearic Islands have received strong support from the central government again in 2021, sustaining budgetary performance.
- The region will likely face budgetary deterioration in 2022, however, as support is phased out, with continued pressures on expenditure, but could improve its performance in 2023 if tourism fully recovers.
- Tourism flows, on which the region's economy depends, are recovering, thanks to high vaccination rates in Europe, but such recovery is still only partial, and vulnerable to the evolution of the pandemic.
- We have therefore affirmed our 'BBB+' long-term issuer credit rating on Balearic Islands and maintained the negative outlook.

Rating Action

On Nov. 12, 2021, S&P Global Ratings affirmed its 'BBB+' long-term issuer credit rating on Spain's Autonomous Community of the Balearic Islands. The outlook remains negative.

Outlook

Our negative outlook indicates that over the next few years the region's high exposure to the tourism sector could weigh on its economic and budgetary performance beyond our current estimates.

Downside scenario

We could lower our rating on the Balearic Islands in the next 12 months if we consider that the consequences of the pandemic for the tourism sector will be more severe or prolonged than we currently forecast, or if the region's management failed to maintain a check on expenditure in the face of lower revenue. This would cause the region's budgetary performance to deteriorate further, while constraining its liquidity and increasing its already high debt burden.

Upside scenario

We could revise our outlook on the Balearic Islands to stable in the next 12 months if downward pressure on its budgetary performance eases. This could occur if the region's economy recovers sufficiently, enabling a stronger budgetary performance than we currently project, with management maintaining a tight grip on expenditure.

Rationale

Strong support from the Spanish central government during the COVID-19 crisis bolstered the Balearic Islands' budgetary performance in 2020, and continuing support is having the same effect in 2021. As the support is discontinued, we expect more pressure on the region's budget in 2022. The region will receive lower central government support and lower revenue through the financing system, while maintaining elevated operating expenditure, in a context of suspension of fiscal rules, with non-binding deficit targets.

Moreover, the region's exposure to the tourism sector makes it more vulnerable to the pandemic. In our view, the Balearic Islands' economy will likely take longer to recover than that of other non-tourism-exposed regions. This could translate into slower budgetary recovery and a higher debt accumulation.

Management's commitment to budgetary consolidation will be key as central government support is phased out.

After large central government support in 2020, regions are once again receiving extraordinary transfers in 2021, which is helping sustain their budgetary performance. However, central government support will decrease in 2022, and in our view the economic recovery and resulting higher tax collection will not be sufficient in most cases to replace lost revenue, which the government transfers did during 2020 and 2021.

In 2021, the central government once again created a fund, worth €13.5 billion (lower than the €16.0 billion of 2020), to shore up regional budgets. The fund was transferred to regions based on adjusted population, instead of COVID-related variables. The Balearic Islands have received about €330 million in 2021, versus the €439 million in 2020.

Fiscal rules remain suspended for 2021 and 2022, and therefore deficit reference rates are not binding. The reference rate for 2022 is 0.6% of GDP, down from an effective reference of 1.1% in 2021. While nonbinding, reference rates serve as a reference for debt financing that is made immediately available by the state. Excess deficits will also be financed, but with a delay.

In the current scenario of decreasing government support, and while the economic recovery gathers sufficient strength to substitute revenue, we believe that prudence and responsibility in financial management when controlling expenditure will weigh more heavily on our assessment. In particular, we expect social pressure will make structural some of the excess spending arising from the pandemic, in key budget areas such as health care and education. Regions may also face pressure on public worker wages, which they cannot directly control, because wage increases are defined by the central government.

The region's economy has suffered significantly from the economic shock of the pandemic. Its GDP fell by about 24% in 2020. Nevertheless, we continue to view its economy as strong, in line with that of Spain. Historically, the region's GDP per capita has exceeded the national average and its unemployment levels have been just below the national level. During other economic crises, the region even benefited from its higher exposure to the service sector, because of its exposure to international tourism.

During the pandemic, by contrast, tourism has been the sector that suffered the most because of travel restrictions worldwide. Unemployment figures in the Balearic Island are highly seasonal, being lowest typically in the third quarter, thanks to the summer tourism season. The unemployment rate jumped to 13.3% in the third quarter of 2020 from 8.2% of eligible working population in the same period of 2019, and has recovered to 10.6% in third-quarter 2021. This highlights that the recovery of tourism and its impact on economic activity and employment is still incomplete. The number of visitors to the Balearic Islands in 2021 through August is 2.6 times higher than the same period in 2020, but still represents only 38% of that same number in 2019. However, looking only at June-August 2021, tourism had recovered to nearly 50% of the same period in 2019, showing a positive trend.

The central government has provided indirect support to the Balearic Islands by providing support to small and midsize enterprises (SMEs) and self-employed workers, through a fund worth €855 million. Although this does not directly benefit the regional government's budgetary performance, it does help to sustain economic activity and moderate pressure on public expenditure needs. Additionally, the region benefits from EU transfers that will help support its economic recovery over our forecast period through 2023.

Budgetary performance will deteriorate in 2022 as central government support eases, increasing the pressure on the region's already high debt burden

After a relatively strong performance in 2020, we expect the Balearic Islands will post a slightly lower operating balance in 2021, at about 7.4% of operating revenue, compared with 9.6% in 2019. In our view, this is the result of lower central government support, coupled with continued pressure on operating expenditure, because the pandemic has dragged on for longer than expected.

In 2022, however, we expect the operating performance to deteriorate sharply. The Balearic Islands will no longer receive extraordinary support from the central government, while resources coming from the regional financing system will decline by over 7%. The central government's decision to absorb negative settlements of the financing system arising from 2020 will not benefit the Balearic Islands, whose settlement remains positive, though sharply reduced. This impact will be only partially compensated by an expected strong performance of the region's own taxes, and the return of one month's worth of value-added tax. Importantly, the region will also benefit from a new source of revenue, following an agreement with the central government to receive a special transfer to compensate it for the additional costs that its geography imposes as an archipelago. This fund will amount to about €183 million in 2022, and €110 million thereafter.

However, overall operating revenue is set to decrease by about 5.4% in 2022 compared with 2021, which, along with continued spending pressures, should lead to an operating balance of only about 1.2% of operating revenue. We believe the regional government has limited flexibility to reduce expenditure and may instead make certain pandemic-driven higher spending structural, to reinforce the quality of public services.

In 2023, we expect economic recovery to continue and tourism to gradually resume, leading to operating revenue growth. If the regional government manages to rein in expenditure growth, as we expect, the operating balance could recover to above 3% of operating revenue.

On the capital side, we expect EU funds to somewhat distort the region's budgetary trajectory. We understand the Balearic Islands have already been receiving EU funds (REACT-EU and Resilience and Recovery Fund) in 2021 but will not be able to spend them all during the year. This means in budgetary terms that the region could post a small surplus after capital accounts for 2021.

In contrast, we expect an increase in investment execution in 2022. Coupled with the weakening in operating performance, this should lead to an increase in deficits after capital accounts as high as 7% of total revenue. We expect budgetary performance to improve in 2023, and advance toward budgetary consolidation thereafter, assuming the economy continues its recovery. We think it likely that fiscal rules will once again become binding in 2023, pushing the regional government to rein in spending.

We note that, in national accounting terms, which the central government uses to measure the Balearic Islands performance, the temporary mismatches in the calendar of EU funds will be neutralized through adjustments, diminishing the variability in official outcomes.

Given the expected deficits in 2022 and 2023, we expect our adjusted tax-supported debt ratio to reach about 224% of consolidated operating revenue in 2023, which we consider very high both in the national and international context. That said, the region has been very active in refinancing its debt, with a total of over €3 billion in central government loans refinanced during 2020 and 2021. This has allowed for substantial interest rate savings, thanks to currently favorable market conditions.

Overall, we view the region's liquidity as adequate. Cash levels during 2021 have sharply increased, mostly thanks to EU funds and the cashing in of funds to support SMEs, which will be transferred out to their beneficiaries before the end of the year. We expect the region to gradually reduce its cash in 2022. The region's liquidity is also supported by its credit lines, which currently stand at €650 million. The region typically uses them only during the first quarter of the year, until central government loans are disbursed. Over our forecast period, we expect Balearic Islands to make use of its strong access to the central government's liquidity mechanisms to finance its debt service and deficits.

Key Statistics

Table 1

Autonomous Community of the Balearic Islands--Selected Indicators

	--Fiscal year ending Dec. 31--				
(Mil. €)	**2019**	**2020**	**2021bc**	**2022bc**	**2023bc**
Operating revenues	3,962	4,493	4,353	4,116	4,240
Operating expenditures	3,778	4,061	4,029	4,067	4,109
Operating balance	184	432	324	49	131
Operating balance (% of operating revenues)	4.6	9.6	7.4	1.2	3.1
Capital revenues	91	87	370	344	351
Capital expenditures	648	606	674	712	717
Balance after capital accounts	(373)	(87)	20	(318)	(235)

Table 1

Autonomous Community of the Balearic Islands--Selected Indicators (cont.)

	--Fiscal year ending Dec. 31--				
(Mil. €)	2019	2020	2021bc	2022bc	2023bc
Balance after capital accounts (% of total revenues)	(9.2)	(1.9)	0.4	(7.1)	(5.1)
Debt repaid	990	3,002	2,706	1,222	1,191
Gross borrowings	1,194	3,277	2,706	1,448	1,450
Balance after borrowings	(170)	187	20	(93)	24
Direct debt (outstanding at year-end)	8,486	8,761	8,761	8,986	9,245
Direct debt (% of operating revenues)	214.2	195.0	201.3	218.3	218.1
Tax-supported debt (outstanding at year-end)	8,973	9,304	9,238	9,398	9,641
Tax-supported debt (% of consolidated operating revenues)	222.1	203.9	208.8	224.5	223.6
Interest (% of operating revenues)	3.2	2.4	1.8	1.6	1.6
Local GDP per capita (single units)	28,213	N/A	N/A	N/A	N/A
National GDP per capita (single units)	26,512	23,703	25,599	27,661	29,007

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. N/A--Not applicable.

Ratings Score Snapshot

Table 2

Autonomous Community of the Balearic Islands--Ratings Score Snapshot

Key rating factors	Score
Institutional framework	3
Economy	2
Financial management	3
Budgetary perfomance	4
Liquidity	3
Debt burden	4
Stand-alone credit profile	bbb+
Issuer credit rating	BBB+

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

- Sovereign Risk Indicators, Oct. 12, 2021. An interactive version is available at http://www.spratings.com/sri

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
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Institutional Framework Assessments For International Local And Regional Governments, Nov. 4, 2021
- Spanish Normal Status Regions: Budgetary Pressures Will Mount As Central Government Support Phases Out, Dec. 17, 2020
- Public Finance System Overview: Spanish Normal Status Regions, July 16, 2020

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

Autonomous Community of the Balearic Islands	
Issuer Credit Rating	BBB+/Negative/--
Senior Unsecured	BBB+

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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