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Ratings

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Research Update:

Spain's Autonomous Community of the Balearic Islands 'BBB+' Rating Affirmed; Outlook Remains Negative

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Overview

- The Balearic Islands posted a moderate deficit of only 1.9% of total revenue in 2020, thanks to increased support from the Spanish central government through the pandemic.
- We expect its budgetary performance to weaken in 2021 and 2022, partly because it will receive less revenue from the central government, but also because economic recovery in the region is expected to be slow compared with the national average, given the region's high exposure to the tourism sector.
- We therefore affirmed our long-term issuer credit rating at 'BBB+'. The outlook is negative.

Rating Action

On May 14, 2021, S&P Global Ratings affirmed its long-term issuer credit rating on the Autonomous Community of the Balearic Islands at 'BBB+'. The outlook remains negative.

Outlook

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

Downside scenario

We could lower our ratings on the Balearic Islands in the next 18 months if we consider that the consequences of the pandemic for the tourism sector will be more severe or prolonged than we currently forecast. 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 to stable our outlook on the Balearic Islands in the next 18 months if we think that the region is less likely to deviate from our current base case. This could occur if the region's economy recovers sufficiently to prevent it from posting a weaker budgetary performance than we currently project.

Rationale

Strong support from the Spanish central government during the COVID-19 crisis bolstered the Balearic Islands' budgetary performance in 2020; as this eases, we expect deficits to increase in 2021 and 2022. The region will receive lower central government support and slightly lower revenue through the financing system, while maintaining elevated operating expenditure due to ample 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 could take longer to recover than that of other non-tourism-exposed regions. This could translate into a slower budgetary recovery and a higher debt accumulation.

We expect the central government to remain supportive of Spanish regions in the current economic context, but management's commitment to budgetary consolidation will also be key

Consistent budgetary support from the central government throughout 2020 prevented the pandemic from hitting Spanish normal-status regions, including the Balearic Islands, harder. Balearic Islands' resources from the financing system increased by 8.5% in 2020 compared with 2019, despite a significant decline in GDP and tax collection. In addition, the central government put in place a €16 billion fund for the regional tier to cover pandemic-related expenses in health care and education, and to compensate for revenue lost due to lockdown measures. The Balearic Islands received €439 million in grants.

On Sept. 30, 2020, the central government announced the suspension of its usual fiscal rules for 2020 and 2021. The government did establish a nonbinding deficit reference target of 2.2% of regional GDP for 2021, but it also announced that it would create a €13.5 billion fund that would cover half of this target. As a result, the effective deficit reference rate is 1.1% of GDP. The nonbinding nature of the deficit reference implies that there will be no consequences for spending over the target. Moreover, the central government has committed to financing all the regions' deficit needs, although it is encouraging them to take responsibility for managing their budgets over the period.

Given the central government's decision, we anticipate that prudence and responsibility in financial management will weigh more heavily on our assessment. The Balearic Islands incorporated this reference target of 2.2% of GDP in its 2021 budget, implying that it will tolerate higher deficits than those in 2020. That said, we expect regional management will stay within the limits, rather than exceeding the reference rate.

The region's economy has undoubtedly 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 has even benefited from its higher exposure to the service sector, which represents 83% of its gross value added, 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. Consequently, the Balearic Islands' unemployment figures increased to 18.9% in 2020 from 9.9% in 2019. This is well above the national average of 15.3% in 2020.

It is still unclear whether the region will be able to welcome tourists during the summer season. This will largely depend on the evolution of the pandemic, the speed of vaccination, and travel restrictions. Positively, we anticipate that the central government will support small and midsize enterprises and self-employed workers, the Balearic Islands will receive €855 million, and that transfers from the EU will help support economic recovery in the Islands over our forecast period.

Budgetary performance will deteriorate in 2021 and 2022 as central government support eases, increasing the pressure on the region's already high debt burden

In 2020, the region posted an operating surplus of 9.6% of operating revenue and a small deficit after capital accounts of 1.9% of total revenue. Its good performance mainly depended on increased revenue from the financing system and central government support. Together, these sufficiently mitigated the effects of the pandemic on the regional budget.

As these grants shrink in 2021, we expect the Balearic Islands' budgetary performance to deteriorate. The region will receive slightly lower revenue from the financing system and lower budgetary support from the central government. Meanwhile, its debt reference targets will be relaxed. In 2021, we expect the Balearic Islands to receive compensation amounting to half of the reference deficit target from the central government. Although these grants have not been formally announced, they will be smaller than last year, because the fund supplying them is smaller, at €13.5 billion, than the €16 billion fund used to support the Spanish regions in 2020. Revenue from the financing system will be 0.3% lower than in 2020. On average, we expect operating revenue to decline by 2.5% in 2021.

On the expenditure side, and based on the regional budget for 2021, we expect operating expense to remain high, especially compared with pre-pandemic levels. The central government set up an ample reference deficit target rate for Spanish regions so that they would have enough room to maneuver during 2021. We believe that, given the pandemic is ongoing in 2021, the region is likely to use this flexibility to reinforce its health care and education system, and to implement social policies to support the region's economy.

In 2022, we expect Spanish regions to face a negative settlement from 2020, which could hamper operating revenue. Moreover, our base case does not incorporate any further support from the central government in the form of additional grants. Although we anticipate that the economic recovery will have already started in 2022, which will support tax revenue growth, we do not expect this to be sufficient to compensate for the lower revenue. At the same time, we expect Balearic Islands to consolidate most of its extraordinary pandemic-related costs, given its limited budget flexibility, and management's struggle to control health care expenditure in the past.

As the economic recovery settles in, we expect to see some budgetary improvement by 2023. However, the tourism sector could take longer to recover entirely. Own tax revenue, such as property taxes, will still be below pre-pandemic levels in 2023, in our view. Therefore, we project only a gradual recovery in budgetary performance from 2023.

Given the increased deficits, we expect our tax-supported debt ratio to peak in 2022, and diminish thereafter, reaching 218% of consolidated operating revenue by 2023. During 2020, the region refinanced €1.5 billion of old loans from the central government, replacing them with new loans from financial institutions that carry lower interest rates. We expect the region to carry out a further €1 billion in refinancing operations over 2021, and to enjoy 0% interest rates as a result.

Over our forecast period, we expect Balearic Islands to make use of its strong access to the central government liquidity mechanisms to finance its debt service and deficits. The liquidity position is also supported by the region's credit lines, which currently stand at €650 million.

Key Statistics

Table 1

The Balearic Islands (Autonomous Community of) Selected Indicators

Mil. €	2019	2020	2021bc	2022bc	2023bc
Operating revenue	3,961.8	4,493.3	4,380.3	4,327.9	4,486.1
Operating expenditure	3,778.1	4,061.1	4,081.3	4,119.5	4,194.3
Operating balance	183.7	432.1	299.0	208.5	291.7
Operating balance (% of operating revenue)	4.6	9.6	6.8	4.8	6.5
Capital revenue	91.0	86.8	191.3	282.0	183.0
Capital expenditure	648.1	605.9	677.9	782.8	688.3
Balance after capital accounts	(373.3)	(87.0)	(187.6)	(292.3)	(213.6)
Balance after capital accounts (% of total revenues)	(9.2)	(1.9)	(4.1)	(6.3)	(4.6)
Debt repaid	990.3	3,002.1	2,188.8	1,237.0	1,207.0
Gross borrowings	1,193.9	3,276.5	2,376.0	1,529.0	1,421.0
Balance after borrowings	(169.7)	187.5	(0.4)	(0.3)	0.4
Direct debt (outstanding at year-end)	8,486.4	8,760.8	8,948.0	9,240.0	9,454.0
Direct debt (% of operating revenues)	214.2	195.0	204.3	213.5	210.7
Tax-supported debt (outstanding at year-end)	8,973.1	9,304.4	9,459.7	9,729.2	9,926.1
Tax-supported debt (% of consolidated operating revenues)	222.1	203.9	212.5	221.2	217.8
Interest (% of operating revenues)	3.2	2.4	2.3	1.7	1.7
Local GDP per capita (single units)	28,143.0	N/A	N/A	N/A	N/A
National GDP per capita (single units)	26,520.0	23,661.8	25,390.4	27,498.1	28,745.9

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. N.A.--Not available. N.M.--Not meaningful.

Ratings Score Snapshot

Table 2

The Balearic Islands (Autonomous Community of) Ratings Score Snapshot

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, April 12, 2021. An interactive version is available at http://www.spratings.com/sri

Related Criteria

- 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, April 13, 2021
- Spain 'A/A-1' Ratings Affirmed; Outlook Remains Negative On Fiscal And Structural Challenges, March 19, 2021
- Research Update: Autonomous Community of The Balearic Islands Outlook Revised To Negative On Expected Weaker Performance; 'BBB+' Affirmed, Nov. 13, 2020
- Public Finance System Overview: Spanish Normal Status Regions, July 16, 2020
- Credit FAQ: How Central Government Support Will Limit COVID-19's Impact On Spanish Regions' Finances, June 24, 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	
Balearic Islands (Autonomous Community of) (The)	
Issuer Credit Rating	BBB+/Negative/--
Senior Unsecured	BBB+