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Research Update:

Kingdom of Spain Long-Term Sovereign Rating Placed On CreditWatch Negative On Economic Weakness

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Table Of Contents

Rationale

CreditWatch

Ratings List

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Rationale

On Jan. 12, 2009, Standard & Poor's Ratings Services placed its 'AAA' long-term foreign and local currency sovereign credit ratings on the Kingdom of Spain on CreditWatch with negative implications. A CreditWatch listing signals a potential but not inevitable change in a rating over the short term. The 'A-1+' short-term ratings were affirmed.

The CreditWatch placement also applies to those institutions with ratings linked to the sovereign. As a result, the 'AAA' long-term ratings on Instituto de Credito Oficial (ICO), Sociedad Estatal de Participaciones Industriales (SEPI), and Corporacion de Reservas Estrategicas de Productos Petroliferos (CORES) have been placed on CreditWatch with negative implications. The 'A-1+' short-term ratings have been affirmed. The 'AAA' long-term ratings on two Spanish regions, Autonomous Community of the Basque Country and Autonomous Community of Navarre, have also been placed on CreditWatch with negative implications.

The CreditWatch placement reflects our view of the significant challenges facing the Spanish economy as it traverses a period of very weak growth, and a sustained period of deleveraging, which we expect to lead to a rebalancing toward traded sectors requiring real exchange rate depreciation. The likely result of such factors will be a much weaker potential growth rate over the medium term than that experienced over the past decade. At the same time, we project a substantial worsening in the Kingdom's public finances.

In our opinion, the credit-driven nature of Spain's strong growth performance in recent years has led to a build-up in imbalances, as evidenced by the sizeable current account deficit (around 10% of GDP in 2008). Due to the need for the private sector to restructure and deleverage balance sheets, we believe that the unwinding of the deficit increases the probability of a protracted economic slowdown. In any case, we expect the rebalancing of the economy towards a more sustainable growth model will lead to weak growth over the medium term. This process will likely be impeded by the restrictive nature of product and labor markets. We believe that Spain's reduced competitiveness will make it challenging to reorient production towards external demand, particularly in the current global environment. Despite a relatively strong starting position, we expect the Kingdom's public finances to deteriorate markedly, with the general government deficit rising well above 3% of GDP until 2011, and peaking above 6% in 2009. Over the medium term, there appears to be a need for a reduction in expenditure to a level more commensurate with lower revenues and a weaker growth outlook.

CreditWatch

A resolution of the CreditWatch action is likely this month pending further information from the Spanish government regarding its response to the deterioration in the structure of both the economy and its public finances. We are in the process of assessing the fiscal consequences of the current recession and reduced growth outlook, which is expected to lead to a medium-to long-term rebalancing of the Spanish economy, and to significantly weaken the government's budgetary position.

Ratings List

	To	From
Spain (Kingdom of)		
Sovereign Credit Ratings		
Long-term	AAA/Watch Neg	AAA/Stable
Short-term	A-1+	A-1+
Corporacion de Reservas Estrategicas de Productos Petroliferos		
Sociedad Estatal de Participaciones Industriales (SEPI)		
Instituto de Credito Oficial		
Issuer Credit Rating		
Long-term	AAA/Watch Neg	AAA/Stable
Short-term	A-1+	A-1+
Autonomous Community of the Basque Country		
Autonomous Community of Navarre		
Issuer Credit Rating	AAA/Watch Neg/--	AAA/Stable/--

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