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Political transition will test Honduras' weak institutions

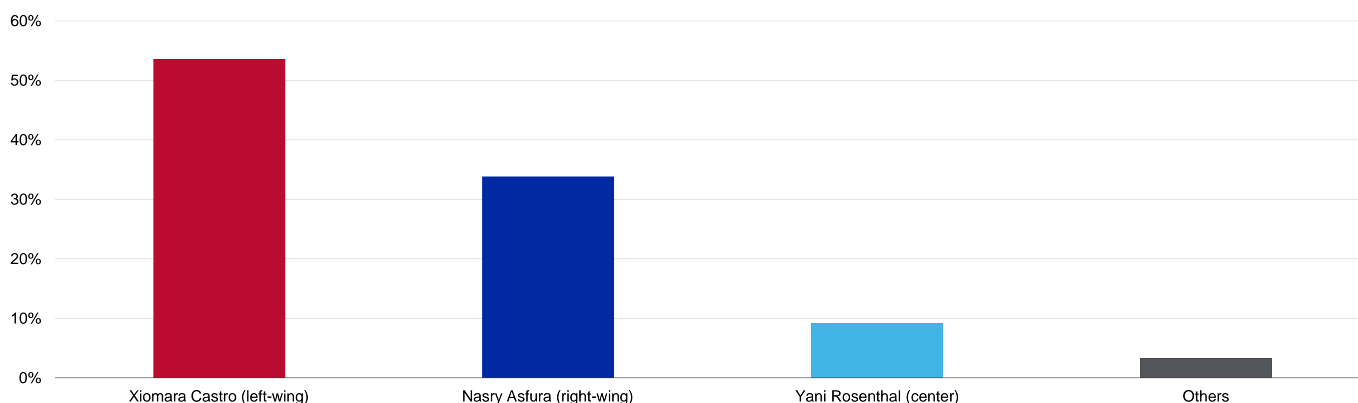
Originally published on 01 December 2021

On 30 November, early returns for Honduras' (B1 stable) presidential and legislative elections two days earlier showed Xiomara Castro of the left-wing Partido Libertad y Refundición (Libre) party comfortably led incumbent Nasry Asfura of the right-wing Partido Nacional (PN) in the winner-take-all presidential contest. Asfura conceded defeat that night, all but confirming Castro's victory.

Considering the country's institutional shortcomings and history of political upheaval, this transition of political power is likely to raise political risks and weigh on Honduras' credit profile. The forthcoming transition of power will be the first since the PN assumed power in 2009 after forcibly ousting former president (Castro's husband) José Manuel Zelaya and a 2017 presidential election marred by allegations of fraud and subsequent social unrest.

With 53.2% of the votes counted as of 30 November, Castro's Libre party garnered 53.3% of the vote compared to Asfura’s 34.2% (see exhibit). Castro's victory ends the PN’s 12-year grip on the country. The transition and shift of political power to Libre from PN will test the country’s institutions.

Xiomara Castro takes a commanding lead in the winner-take-all presidential contest
Vote share (%)



Results are with 53.2% of the vote counted.
Sources: Consejo Nacional Electoral and Moody’s Investors Service

Given that the 68% voter turnout was the highest since 1997, the electorate’s endorsement of Castro likely reflects widespread dissatisfaction with the economy and distrust of the government amid numerous allegations of corruption. Notably, US prosecutors earlier this year charged Honduran Congressman Tony Hernandez, brother of current President Juan Orlando Hernandez Alvarado, with state-sanctioned drug trafficking and sentenced him to life in prison.

Although it is not yet clear whether Castro will have a legislative majority, a shift to more leftist policymaking under her administration will face barriers. Notably her husband's presidential legacy would likely temper any support from conservatives in congress or the business community. A Castro-led initiative to reduce poverty would also have to overcome the rigid constraints of the country’s fiscal responsibility law for non-exceptional years, which targets narrowing the nonfinancial public-sector fiscal deficit to no more than 1% of GDP in 2023 from an average deficit ceiling of 5.5% in 2020-21. Reports indicate that Castro would be open to negotiating with the IMF for a lending program, however, on terms that allow for a more gradual fiscal consolidation. The fiscal challenges facing the next government will be compounded by political uncertainties.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.

In addition to testing institutions' capacity to manage an orderly transition from one administration to another, it remains to be seen how the next government will address corruption, the rule of law and weak governance. The deeply structural nature of such problems and considerable challenges entailed in institutional building will likely limit headway, leaving weak institutions in place and a key credit challenge for Honduras.

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FIRST READS

Violent protests highlight Solomon Islands' elevated social and political risks, a credit negative

Originally published on 30 November 2021

On 26 November, Australia (Aaa stable) announced that it would send a peacekeeping mission to the Solomon Islands (Caa1 stable), where on 24 November rioters set fire to dozens of buildings, including government and police property, and widespread looting targeted the Chinatown area of the capital Honiara, in particular. In response, the Solomon Islands government declared a lockdown, deployed police to disperse crowds and eventually invited defense personnel from neighboring countries to help contain the unrest. Protests of this magnitude have been rare in recent years in the Solomon Islands; business and other activity in Honiara has effectively been brought to a halt.

The protests are credit negative because we expect them to weigh on the Solomon Islands' growth and fiscal revenue in 2021. The Central Bank of the Solomon Islands has estimated the economic loss to the country at SBD$227 million ($28 million), or 2% of GDP. The protests could also affect foreign investment at a time when the country is struggling to recover from the economic impact of the coronavirus pandemic.

A rising debt burden has limited the government's ability to increase spending in response to social demands. The unrest has abated but if it recurs, it could hamper the authorities' ability to implement policies to address structural social and economic issues, particularly because of the Solomon Islands' weak institutions and governance framework. The implications of the protests have not been fully felt, but we do not expect these events to derail infrastructure projects that the government is currently implementing. We assess the Solomon Islands' political risk as "ba" — which, along with government liquidity risk, drives our assessment of susceptibility to event risk — and social risk as highly negative.

We expect social tensions to persist until the next elections, which are scheduled for 2023. Prime Minister Manasseh Sogavare was democratically elected in 2019 but presides over a minority coalition government. The fragmented political landscape and patronage politics also drive our assessment of political risk.

The protests began in Malaita province, the country's largest, most populous island — which is also home to the political opposition — and quickly spread to Honiara on the island of Guadalcanal. Protesters demanded the resignation of Sogavare over long-standing economic and social issues that the pandemic has exacerbated, including high levels of poverty, with 21% of the employed population living below $1.90 per day on a purchasing power parity basis, according to the Asian Development Bank (Aaa stable), and poor access to basic services and infrastructure. Protesters also highlighted perceived corruption and China's (A1 stable) perceived increased involvement in the country.

We do not expect protests to threaten the continuity of technical and financial support from external donors in the short term, but this could occur over time along with shifting geopolitical allegiances. Chinese businesses in Honiara have been the target of violence in the past, notably following elections in 2006 and 2019. More recently, tensions between residents of Malaita and Guadalcanal have been exacerbated by increased geopolitical risk in the region, specifically that the Solomon Islands could become a focus for rising tensions between China and Western countries. The conflict took an international dimension following the Solomon Islands' recognition of China over Taiwan, China (Aa3 positive) in 2019, though Malaita province does not recognize China.

The historical conflict between Malaita and Guadalcanal, which largely revolves around distribution of land and resources, erupted into ethnic unrest in 1999-2003 that resulted in the deployment of the Regional Assistance Mission to the Solomon Islands (RAMSI) by Australia, New Zealand (Aaa stable) and other regional countries. RAMSI officially ended in June 2017 after the security situation stabilized, and the mission was replaced by a bilateral security treaty, under which Australia has deployed security personnel in response to this most recent unrest.

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Church & Dwight's TheraBreath acquisition will increase leverage, but metrics can be restored quickly

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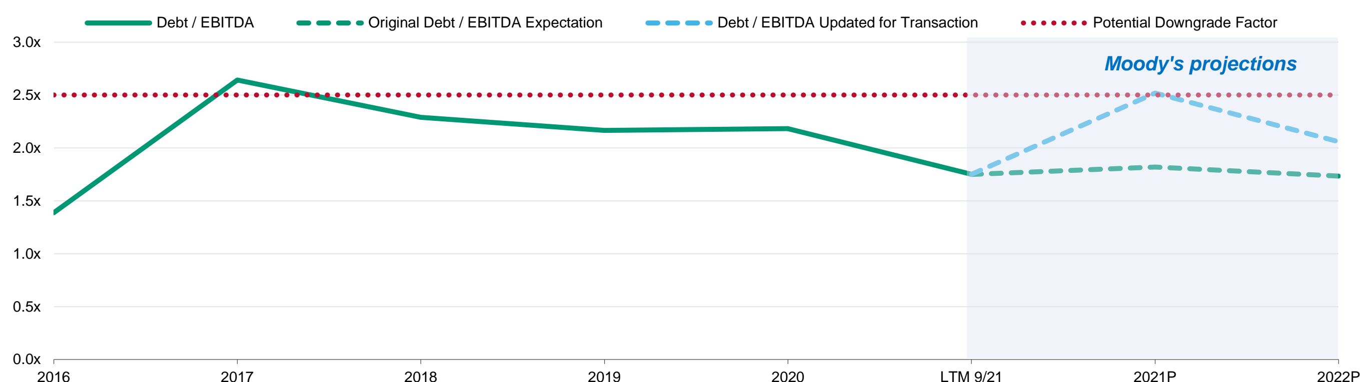
On 29 November, Church & Dwight Co., Inc. (A3 stable) announced plans to acquire the TheraBreath oral care brand for $580 million in cash (before about $85 million in tax benefits). The acquisition is credit negative because it will increase debt/EBITDA leverage.

Pro forma for the acquisition, we expect Church & Dwight's Moody's-adjusted debt/EBITDA to increase to around 2.5x at year-end 2021 from about 1.9x as of June 2021 (see exhibit). The increased leverage is still within our expectations for the A3 rating although at the high end of guidance. Furthermore, we believe that the company will repay debt and reduce leverage to near 2x by year-end 2022. Church & Dwight expects to add about $36 million of EBITDA after around $4 million in synergies.

TheraBreath will lift leverage to the high end of the acceptable range for the A3 rating, but deleveraging will occur swiftly in 2022



All figures incorporate Moody's standard analytic adjustments. Moody's Projections (P) are Moody's opinion and do not represent the views of the issuer. (LTM) = Last twelve month periods are financial year-end unless indicated.
Sources: Moody's Financial Metrics™ and Moody's Investors Service projections

TheraBreath provides premium priced non-alcohol-based bad-breath treatments, predominantly mouthwash, but also sprays and lozenges. The companies believe that the fast-growing brand holds the #2 position domestically in the non-alcohol oral rinse sector. The addition complements Church & Dwight's existing oral care businesses including ARM & HAMMER toothpaste, Spinbrush, Waterpik and Orajel. TheraBreath has had double-digit sales growth in recent years and the company expects to grow at least 15% in 2022 as distribution expands. Other avenues for growth include expansion in international markets, which currently account for only 10% of TheraBreath's sales. TheraBreath's gross margins are higher than those of Church & Dwight's company average, making the deal margin accretive.

Church & Dwight will fund the cash deal with incremental debt. We expect that the company will curtail share repurchases in 2022 and repay debt through cash flow until leverage is reduced to closer to pre-acquisition levels. Church & Dwight plans to utilize TheraBreath's existing co-packing relationships but to also supplement production using its own manufacturing.

Church & Dwight, headquartered in Ewing, NJ, designs and markets a broad portfolio of branded household and personal care consumer products. Brands include Arm & Hammer, Trojan, First Response, Nair, OxiClean, Orajel, Waterpik, and Zicam among others. The publicly-traded company generates roughly $5.0 billion in annual revenue. TheraBreath is expected to generate $100 million of sales in 2022.

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Doosan Heavy's planned equity raise is credit positive for Doosan Bobcat

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On 26 November, Doosan Heavy Industries & Construction Co Ltd (DHIC), the parent company of Doosan Bobcat Inc. (DBI, Ba3 stable), announced plans to raise KRW1.5 trillion ($1.3 billion) in equity during the first quarter of 2022. DHIC plans to use KRW700 billion of the proceeds to reduce debt and the remainder to fund other cash needs including investment.

This measure, if it proceeds, will be credit positive for DBI because the equity proceeds will help improve DHIC's liquidity and capital structure, which will in turn reduce DBI's risk related to DHIC. DBI's credit quality and ratings are constrained by the risk of DBI providing financial support to DHIC and other Doosan group affiliates because of the weaker credit quality of DHIC and other affiliates compared with DBI.

DHIC faced an acute liquidity risk at the onset of the coronavirus pandemic in 2020 because of its weak liquidity, high debt and volatile operating performance. Its earnings weakened significantly in 2020 because of restructuring charges and declining revenue from nuclear and coal-fired power plant construction.

The related risk has subsequently declined and will continue to decline in the next year because of DHIC's self-rescue measures to improve its liquidity and capital structure. DHIC raised new equity of KRW1.2 trillion in December 2020 and sold its stake in Hyundai Doosan Infracore Co., Ltd. (Infracore) for KRW850 billion in August 2021. The planned equity raising will mark DHIC's largest self-rescue measure so far.

Assuming that DHIC uses a total of KRW1.0-1.5 trillion from the planned equity raising and the Infracore stake sale to reduce debt, we project the company's leverage – measured by adjusted debt/EBITDA – will be 6-7x over the next 12-18 months, down from around 16x in 2020 and around 7x in 2019.

Despite these measures, DHIC's liquidity will still remain inadequate for the next 12 months because of its large near-term debt maturities. However, this risk is mitigated by DHIC's recovering earnings (including DBI's results) and the continued financial support from Korea's policy banks for DHIC.

DHIC's credit quality will also benefit from its separate plan – announced on 19 November – to raise equity funding at its construction subsidiary Doosan Engineering & Construction Co., Ltd. (Doosan E&C) from a private equity controlled entity. This will dilute DHIC's stake in this financially weak subsidiary to 46% and therefore reduce the potential burden on DHIC to inject further capital into Doosan E&C.

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China General Nuclear Power's $4.8 billion equity placement of wind power arm is credit positive

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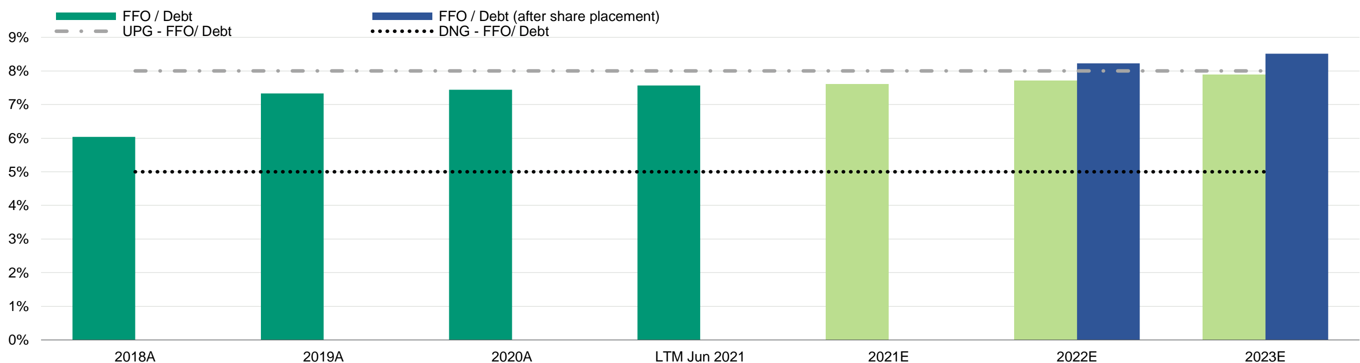
On 26 November, China General Nuclear Power Corporation (CGN, A2 stable) entered a strategic investment agreement with 14 state-owned investors, raising RMB30.5 billion ($4.78 billion) by issuing 33% equity in CGN Wind Energy Limited. The equity placement is equivalent to 3.6% of CGN's reported assets and 12.3% of its reported equity as of end of September 2021.

The transaction will be credit positive for CGN because most of the proceeds will be invested in the development, construction, storage and integrated development of wind and solar power and used to fund the group's capital spending, which will improve our projected financial metrics for the company.

The equity placement is equivalent to 50% of CGN's projected annual capital spending and investment in 2022 at around RMB60 billion, assuming the placement is completed by 2022. Our projected 2022 funds from operations (FFO) interest coverage will improve to 3.15x from 3.06x, and FFO/debt will improve to 8.2% from 7.7%, compared with our previous estimates (see Exhibit 1). We also estimate its debt/capitalization will decrease to 66.7% from 70.5% when the equity placement is completed (see Exhibit 2). The transaction the largest equity fundraising in China's (A1 stable) new energy sector so far and the largest private placement in 2021.

Exhibit 1

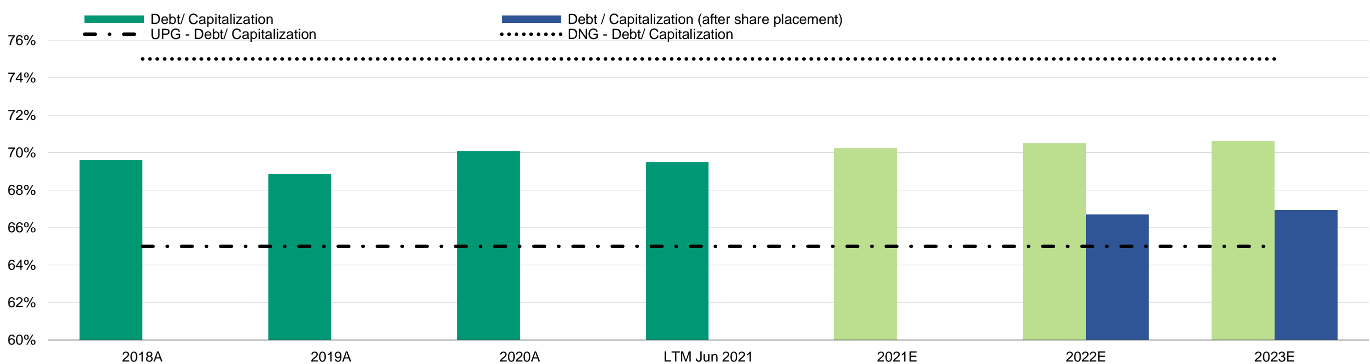
Comparison of key credit metrics with rating change triggers – funds from operations (FFO)/debt



Sources: Moody's Financial Metrics and Moody's Investors Service estimates

Exhibit 2

Comparison of key credit metrics with rating change triggers – debt/capitalization



Sources: Moody's Financial Metrics and Moody's Investors Service estimates

The equity placement meets a number of Chinese government objectives, including carbon transition, state-owned enterprises (SOEs) ownership reform, SOE deleveraging, and synergies across SOEs. The large participation of central SOEs also indicates the high level of government coordination and support.

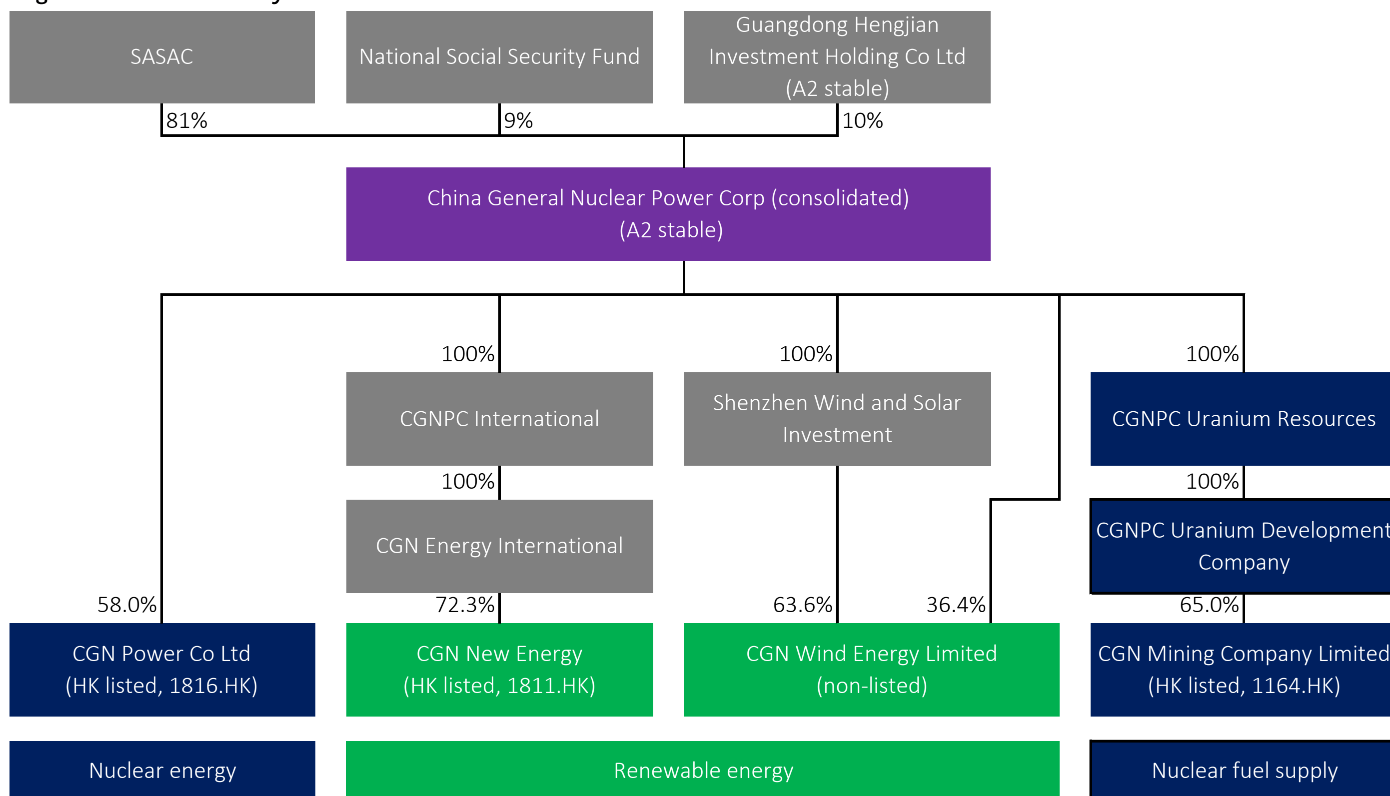
The 14 strategic investors include the National Social Security Fund, State Grid Corporation of China (A1 stable), China Southern Power Grid Co., Ltd. (A1 stable), Guangdong Hengjian Investment Holding Co. Ltd. (A2 stable), Sichuan Provincial Investment Group Co., Ltd. (Baa1 stable), Ping An Life Insurance Company of China (A2 stable), Agricultural Bank of China Limited (A1 stable) and other SOEs and funds. The transaction is likely to close by the first quarter of 2022.

CGN Wind Energy is CGN's key non-nuclear energy arm, ultimately wholly owned by CGN, accounting for 15% of CGN's reported assets and 12% of its revenue.

CGN is a central government-owned clean energy company, which specializes in nuclear, wind and solar power generation. CGN is 81% directly owned by the State-owned Assets Supervision and Administration Commission (SASAC) of China's State Council and 9% owned by National Social Security Fund. The remaining 10% is owned by the Guangdong government through Guangdong Hengjian Investment Holding Co. Ltd. (A2 stable) (see Exhibit 3).

Exhibit 3

Organizational chart as of year-end 2020



Source: The company

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Argentina limits banks' foreign currency holdings, a credit negative

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On 25 November, Argentina's central bank stated that starting 1 December 2021 banks will no longer be able to hold long net spot foreign currency positions. The measure is credit negative for banks because it reduces their ability to protect their capital base amid significant macroeconomic imbalances that lead to high inflation and high volatility in the value of the local currency. However, the measure does not affect banks' creditors directly because it does not change the system's capacity to hold foreign currency positions to hedge foreign currency deposits from customers and other liabilities in US dollars.

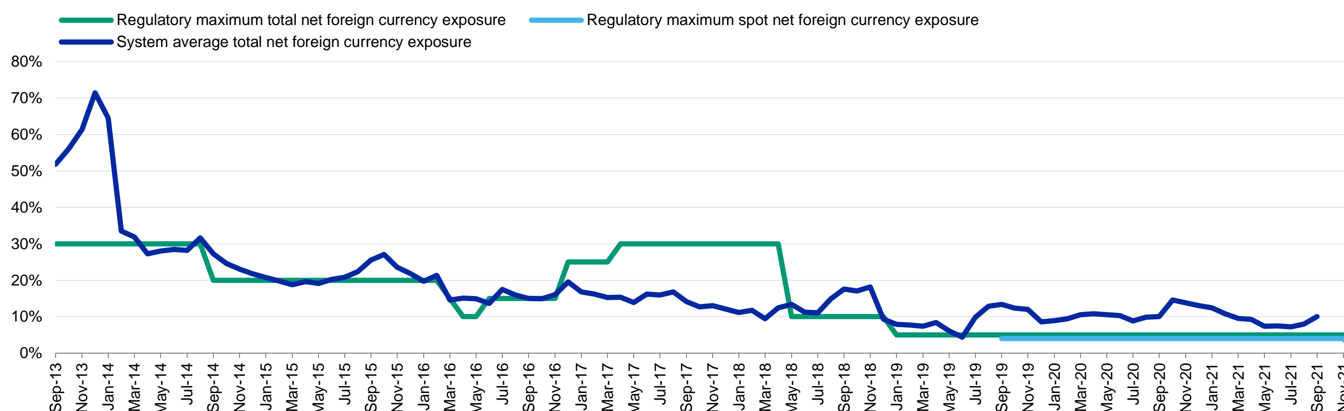
In practice, the new regulation lowers banks' maximum allowed long net spot foreign currency position to 0% of banks' regulatory capital from 4% previously and in place since September 2019. The measure is part of a series of central bank measures in recent years that intend to preserve the country's international reserves, which have been negatively affected by Argentina's currency crisis, particularly since 2018.

This negative credit implication from the measure is mitigated by the comfortable capitalization of Argentine banks that has increased since 2019 because of the contraction in credit markets when adjusted for inflation, relatively stable earnings and the suspension of dividend payments in 2020, which will remain in place at least until the end of 2021. As of June 2021, our preferred capital ratio (adjusted tangible common equity to risk-weighted assets) for the three largest Argentine banks that we rate[1] was a high 13.7% on average. Moreover, these banks' average regulatory Tier 1 capital ratio was 22.6% and their average total capital ratio was 27.0%, also as of last June. As for Argentina's entire banking system, the average total capital ratio was more than double the minimum regulatory requirements.

As part of their hedging strategy in recent years, banks have largely used a combination of foreign currency holdings, and investment in inflation-adjusted securities and real assets (mostly real estate) to protect capitalization. However, these hedging tools will now be more limited because banks can no longer be net long in foreign currency. Additionally, alternative investments in the local markets are relatively limited and mostly include sovereign securities. This new measure could therefore increase, albeit slightly, banks' holdings of Argentinian sovereign debt, an exposure that has been consistently increasing since the relaxation of regulatory limits on sovereign exposures in May 2021.

Before 2018, banks benefitted from gains on large net positive foreign currency positions as the local currency endured repeated rounds of depreciations. However, since 2019, gains on foreign exchange positions have been more limited as banks trimmed their dollar exposure to comply with lower regulatory limits. Considering the new cut, the limitations on foreign currency holdings are the most restrictive imposed by the central bank in Argentina in the last decade (see exhibit).

Caps on Argentine banks' foreign currency holdings are at the lowest level of the last decade
Percentage of total regulatory capital



Source: Banco Central de la República Argentina

Despite the subsequent tightening of capital controls in place since 2019, pressure on the country's currency and foreign exchange reserves has persisted. Total international reserves, currently at $42.2 billion, have been broadly stable over the past two years, but usable reserves after deducting an $18 billion swap with the Chinese government and banks' foreign currency deposits held at the central bank are only a fraction of total reserves. At that level, usable reserves provide a limited buffer to meet foreign currency needs in times of financial stress, leading to increasing capital controls and measures on the financial system that aim to limit the drain of the country's reserves.

Endnotes

1 Banco de Galicia y Buenos Aires S.A.U. (Caa2 stable, ca); Banco Macro S.A. (Caa2/Caa3 stable, ca) and Banco Santander Rio S.A. (Caa1 stable, ca). The ratings shown are the banks' domestic deposit rating, senior unsecured debt rating (if available) and Baseline Credit Assessment.

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Burgan Bank's rights issue increases capital buffers and supports profitability

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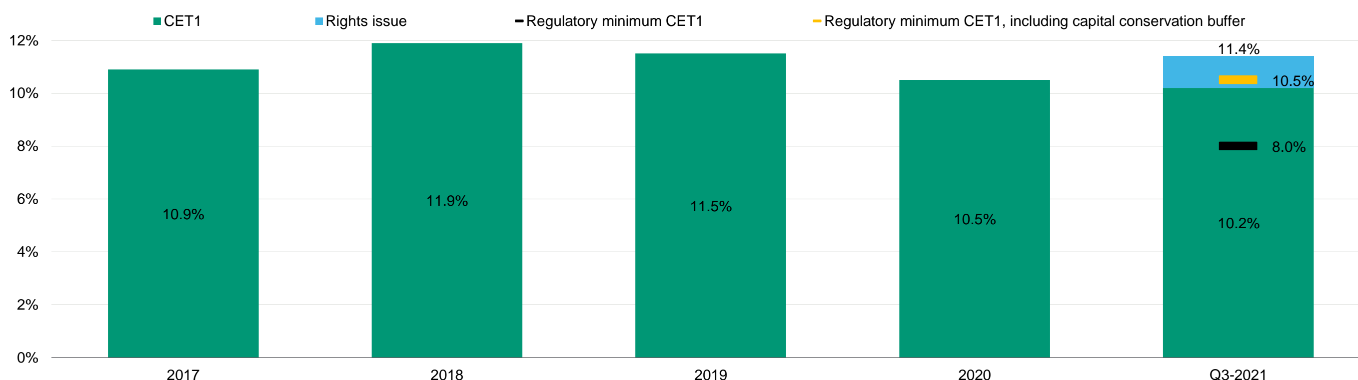
On 28 November, Burgan Bank K.P.S.C. (Baa1 stable, ba2[1]) announced the completion of a KWD71 million ($235 million) capital increase. The capital increase replenishes the bank's equity base, enhances its loss absorption buffers and provides more room for growth, supporting profitability.

The capital increase was subscribed by both of the bank's core shareholders, Kuwait Projects Company (Holding) K.S.C.P. (KIPCO, Ba2 negative), which owns 65%, and Public Institution for Social Security, which holds a 7% stake. By subscribing to the capital increase, both shareholders are confirming their ongoing support to the bank if needed, especially by the majority shareholder that considers Burgan Bank as one of its most valuable assets in its books.

The capital increase was completed via a rights issue that will strengthen Burgan Bank's pro forma Common Equity Tier 1 (CET1) capital ratio to 11.4% from 10.2% as of September 2021, and its total capital adequacy ratio (CAR) to 17.5% from 16.3% as of the same date. The bank's 11.4% CET1 ratio would exceed Kuwait's 8% minimum, which was revised to 9% last October to be effective from January 2022 and includes a 1% buffer applied to domestic systemically important banks.

The capital increase would ensure the bank will be able to meet the increased CET1 minimum requirement of 10.5% by January 2023, in view of the gradual reinstatement of the 2.5% capital conservation buffer by the Central Bank of Kuwait (see Exhibit 1), which was temporarily removed from the regulatory capital requirements for all banks last year as part of the COVID-19 relief measures.

Exhibit 1
Burgan Bank's Common Equity Tier 1 capital ratio



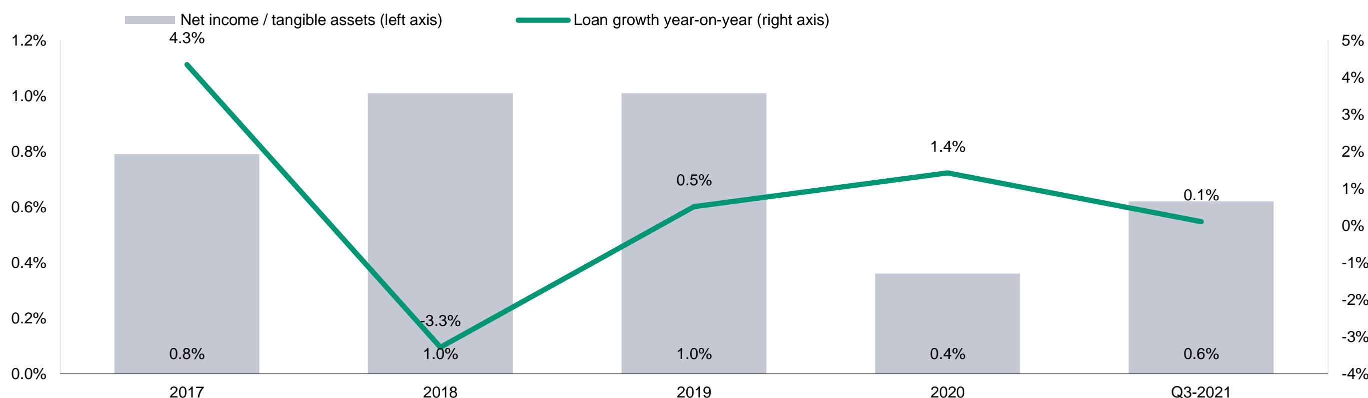
Sources: Burgan Bank and Central Bank of Kuwait

The additional capital reverses the bank's declining CET1 capital ratio since 2018 and provides room for business growth in the post-COVID-19 period. We expect that increased economic growth in 2022-23 will provide more lending opportunities and support the bank's growth strategy in Kuwait, its core market. The increased capital will also shield the bank from credit challenges in its largest foreign subsidiary in Turkey. However, the potential for business growth in Kuwait, where the bank has 76% of its total assets, will also boost core revenue and underlying profitability over the next two years.

Over the past five years, Burgan Bank's loan book has had a compound annual growth rate of only 0.7%, as the bank was intentionally reducing its exposure in Turkey, with significant devaluation of the Turkish Lira, and classified its subsidiary 'Bank of Baghdad' as held for sale. However, the bank is revamping its retail strategy expecting higher retail business growth and enhanced margins. The additional capital will help finance its strategic initiatives.

Burgan Bank's Moody's-adjusted ratio of net income to tangible assets was relatively solid at around 0.6% in the first nine months of this year, rebounding from 0.4% in 2020, driven by higher noninterest income. Nevertheless, continued pressure on net interest margin (NIM) and elevated loan loss provisions kept profitability constrained below pre-pandemic levels. Burgan Bank reported KWD47.6 million provisions during the first nine months of 2021, with provisioning charges consuming 49% of the bank's pre-provision income, resulting in a bottom-line profit of KWD43.1 million that was 20.3% higher than KWD35.8 million in the first nine months of 2020 (see Exhibit 2).

Exhibit 2
Burgan Bank's profitability and loan growth



Source: Burgan Bank

Endnotes

1 The bank ratings shown in this report are the bank's deposit rating and Baseline Credit Assessment.

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English High Court approval of annuity transfer from M&G to Rothesay is credit positive

Originally published on 26 November 2021

On 24 November, the English High Court approved the transfer of a £12 billion portfolio of annuities to Rothesay Limited (insurance financial strength A3 positive) from Prudential Assurance Company (PAC, insurance financial strength Aa3 negative), a subsidiary of M&G Plc (A2 negative). The ruling is credit positive for the UK life insurance sector because it provides clarity to insurers' ability to manage the risk associated with their legacy annuity books and removes any lingering uncertainty linked to the court's original decision not to approve a transfer.

Additionally, the ruling also supports the growth prospects of specialist acquirers of closed legacy life insurance books of business, such as Rothesay. The approval is also beneficial for M&G because it removes counterparty risk and enables the group to focus more fully on managing its Heritage and Savings & Asset Management businesses, while also keeping open the option for future transfers of annuity liabilities.

Court approval for such transfers is required to ensure that policyholders' interests are not harmed. The High Court initially blocked the transfer of PAC's annuity portfolio in June 2019, following objections from some Prudential policyholders, citing, among other things, a "material disparity" between the external support potentially available for each of PAC and Rothesay. The High Court declined to sanction the transfer despite an independent expert's opinion that there would be no material adverse effect on policyholders, and the absence of objections from both the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA).

The initial ruling by the High Court risked setting a precedent that would have restricted insurers' ability to transfer closed books of life business, including annuities, to more recently established companies such as Rothesay, potentially reducing the number of transactions. This would have likely forced some life insurers to transfer the economic risk of their closed books via reinsurance agreements, which introduce credit risk. Others may have continued to manage their capital consumptive legacy book of annuities, thereby trapping capital which otherwise would have been freed up to support core business lines

Rothesay and M&G subsequently appealed the decision, with the Court of Appeal overturning the decision in December 2020, paving the way for a second transfer hearing. The Court of Appeal described the original ruling as "wrong on a number of issues," including that there was a material disparity between the non-contractual external financial support potentially available to each of PAC and Rothesay.

The transfer of approximately 350,000 annuity policies – the largest transaction of its kind to date – to Rothesay will be completed on 15 December 2021. Rothesay confirmed that there will be a separate court hearing for policyholders who are resident in Guernsey or part of the business carried out from Jersey, which we expect will also be approved.

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Bermuda eases restrictions to support tourism after 2020 GDP contracts 6.9%

On 26 November, Bermuda's (A2 stable) Department of Statistics announced that 2020 GDP contracted 6.9% in real terms versus 2019. On the same day, the country announced that it was loosening pandemic-related restrictions on certain tourism activities to help support the industry, whose gross value added comprised 5% to GDP in 2019.

Bermuda has a high vaccination rate and we expect less restricted conditions, such as allowing more occupancy inside restaurants and accepting rapid covid test results for island entry, to support increased tourist arrivals, which will support economic growth. However, the new omicron coronavirus variant could prompt a retightening of restrictions.

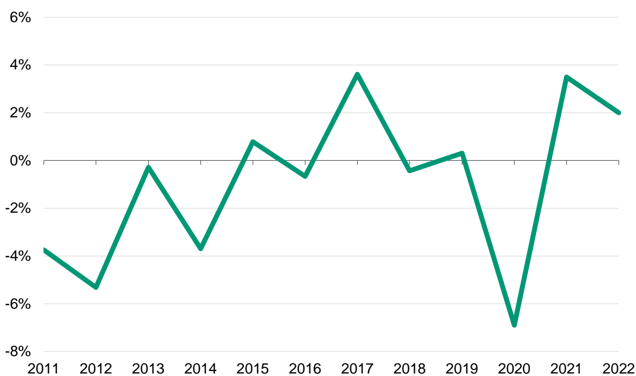
The GDP decline was large (see Exhibit 1) but unsurprising given the circumstances, and less than our forecast 8.5% contraction. It reflects the island's dependence on tourist arrivals. Decreased private consumption led the GDP decline, while government consumption stayed constant at its 2019 levels.

Looser restrictions are critical to the future of Bermuda's economic activity; the large losses in 2020 gross output reflect COVID-19-related restrictions (see Exhibit 2). According to government estimates, tourism-related categories, such as food and lodging, lost 60% of its gross output in 2020 because of pandemic-related restrictions. In fact, all 18 categories that the government monitors showed losses, with 13 of them losing more than 8% in gross output.

Exhibit 1

Bermuda's GDP contracted 6.9% in 2020

Real GDP change, %

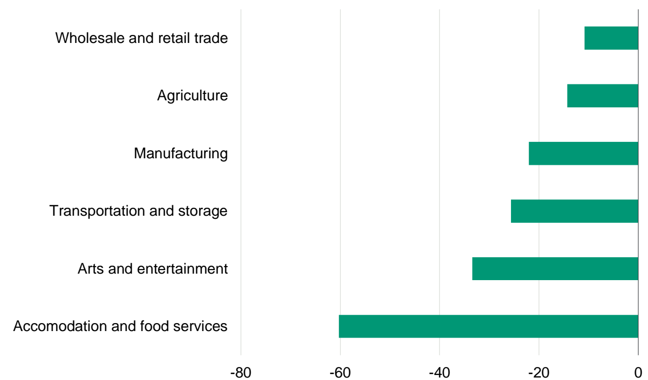


Sources: Government of Bermuda Department of Statistics and Moody's Investors Service

Exhibit 2

... with tourism services leading the contraction

Share of gross output lost in 2020 amid COVID-19 restrictions, %



Sources: Government of Bermuda Department of Statistics and Moody's Investors Service

At the same time, international business activity comprised 27% of 2020 GDP – its single largest contributor – and grew 1%, with insurance growing 28% and reinsurance growing 6%. In 2021, we expect Bermuda's GDP to grow by 3.5% and the sovereign to post a fiscal deficit of 3.5% of GDP. We expect the fiscal deficit to narrow to 1.7% in 2022, with GDP growth moderating to 2% by 2022.

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Spain's 2022 budget focuses on growth-enhancing investment as deployment of European funds accelerates

Originally published on 29 November 2021

On 25 November, Spain's (Baa1 stable) lower chamber of parliament passed the 2022 budget. The Senate still has to approve the bill before it returns to the lower chamber for a final vote, which we expect to take place by the end of the year. The budget targets a general government deficit of 5.0% of GDP for next year and plans for an acceleration of public investment financed by the deployment of EU recovery funds, which will support economic growth without adding significant fiscal pressures.

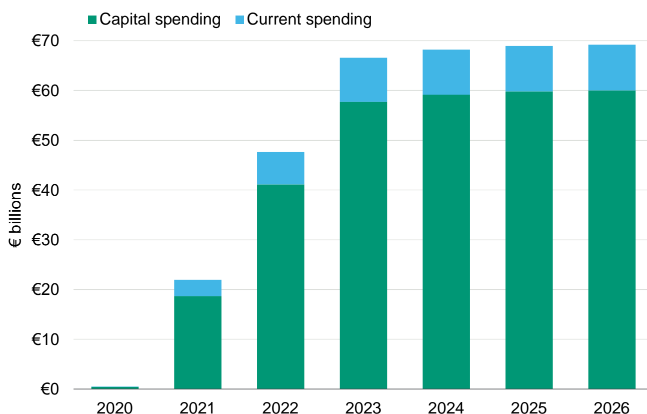
The budget bill passed with 188 votes in favour in the 350-seat Parliament. On top of the two key parties (PSOE, Podemos) supporting the minority coalition government, the bill was approved by nine other regional parties. From a credit perspective, finding a majority on the budget for the second year in a row[1] will ensure political ownership and improve predictability. Nevertheless, risks to budget execution will remain given pandemic-related uncertainties.

The budget assumes that real GDP growth will reach 7.0% in 2022 after 6.5% in 2021. We project 6.3% (European Commission: 5.5%; IMF: 6.4%) considering a lower carry-over effect from 2021 due to weaker-than-expected growth in the first three quarters of the year. In addition, risks are to the downside against the backdrop of surging coronavirus cases in Western Europe and ongoing global supply chain disruptions. In terms of public finances, we forecast a slightly wider 5.5% of GDP deficit next year given our lower growth forecast. Deficit reduction will benefit from tailing off of most pandemic-related support measures.

The successful absorption of EU funds will be key to Spain's longer-term recovery. The budget accounts for the use of 1.9% of GDP in grants next year to increase investment, the largest part of which will be directed to green energy transition and digitalisation projects. These are associated with the authorities' Plan for Connectivity and Digital Infrastructures as well as support for Research and Development and knowledge transfer. The green transition priorities reflect the new Law on Climate Change and Energy Transition and the National Hydrological Plan 2021-2027. The European Commission estimates that usage of the funds has the potential to increase Spain's GDP by between 1.8-2.5 percentage points by 2024. However, as mentioned in previous reports, we believe that reform implementation will face administrative challenges. In this regard, the assessment by the European Commission of

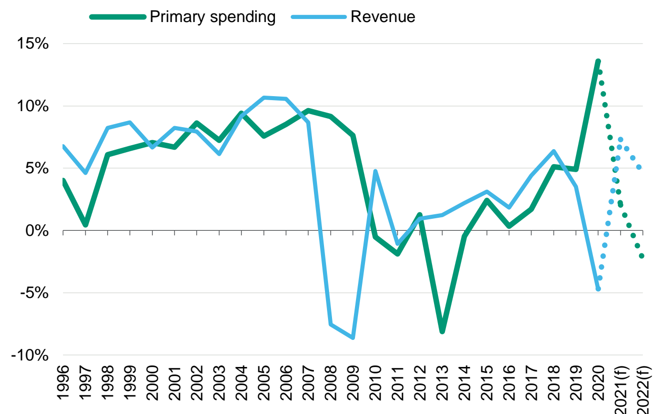
Spain's progress in meeting the targets laid out in the recovery and resilience programme will be an important milestone in 2022.

Exhibit 1
Capital spending to increase notably in 2022
Cumulated allocation of spending, grant component



Sources: Spain's 2022 budget and Moody's Investors Service

Exhibit 2
2022 budget targets an absolute reduction in public spending
Primary spending and revenue year-on-year nominal growth



Sources: Eurostat, Spain's 2022 budget and Moody's Investors Service

The 2022 budget's 5% of GDP fiscal deficit target should allow the debt-to-GDP ratio to decline to 115.1% from 119.5% this year. According to the Commission's estimates, discretionary spending measures would add 0.15% of GDP to the deficit, broadly offset by revenue measures worth 0.13% of GDP.

On the expenditure side, measures include the extension of the short-time work schemes ('ERTEs') and several measures to ensure the financial viability of small and medium-sized enterprises (SMEs) in economic sectors impacted by the pandemic. Overall, the budget targets an absolute reduction in primary spending (-2.3%), which would mean the first decline since 2014.

On the revenue side, the budget includes a two percentage-point increase in income taxes for taxpayers with income above EUR 300,000. As for corporate taxation, the bill limits deductions based on dividends and capital gains generated abroad from 100% to 95% for companies with more than EUR 10 million turnover. Finally, the budget also includes an increase in the tax rate on insurance premiums from 6% to 8%. The rebound in revenues would reach 4.6%, a slower rate compared to nominal GDP (8.6% in the government's scenario).

While we expect Spain's public debt ratio to gradually decline over the coming years, helped by the economic recovery, a materially higher debt burden (we forecast a debt-to-GDP ratio of 117% in 2023) compared to 2019 (95.5% of GDP) will remain a key credit challenge for Spain.

Endnotes

1 In 2019 and 2020, the government had to operate on the previous administration's 2018 budget.

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CREDIT IN DEPTH

Omicron variant poses hurdles to global recovery as new restrictions take effect

Originally published on 30 November 2021

The emergence of the Omicron variant of the coronavirus poses new risks to the global economic growth and inflation outlook, as concerns mount about the variant's health risks and several countries have imposed new travel restrictions in recent days. These restrictions will likely increase over the coming weeks until scientists learn more about the variant. The discovery of Omicron underscores our view that the COVID-19 pandemic remains a health threat, as well as the chief source of uncertainty to the global economy and a driver of financial market volatility. At this time, we are maintaining the G-20 macroeconomic forecasts we published in early November because information about the variant and the policy actions taken to date do not yet support a material shift in our forecasts, which were based on the expectation that the virus will gradually become endemic and that exit from the pandemic will be bumpy and unpredictable.

Threat will depend on new variant's transmissibility and virulence. Just as many countries were moving to a semblance of post-pandemic normalcy, the Omicron variant has injected new uncertainty. However, the experience following the emergence of other variants, notably the Delta variant, and the public health policies put in place to counter successive waves of infections provide some basis for identifying the factors that will determine the economic and credit impact of this latest variant.

Omicron appears to have been identified early, which increases the ability of policymakers to undertake measures to slow its spread. It is not yet known whether this variant is more transmissible or more severe than other virus strains, or to what extent existing vaccines and treatments provide protection against severe disease. Nevertheless, continued progress in global vaccination efforts and public compliance with use of tools such as masks and social distancing will be important factors in determining the economic impact of the new variant. Countries with an assured supply of effective vaccines and delivery systems, and high levels of vaccine acceptance by the public, will remain better positioned.

Virus characteristics will also shape policy and private-sector response. If officials ultimately determine that Omicron poses a high public health risk and if the variant proves difficult to contain with border curbs – similar to the spread of the Delta variant – policymakers in several countries will likely impose renewed mobility restrictions. The severity of restrictions will vary depending on factors including the specific public health situation in each country, public support for restrictions, and the willingness of authorities to bear the economic and political costs associated with restrictions.

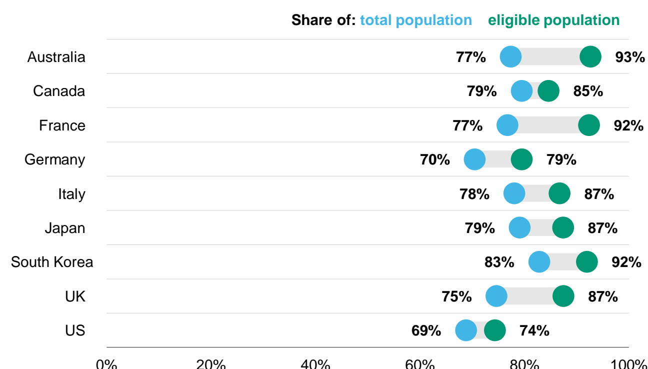
The emergence of the new variant also comes during a period of fragile economic recovery, with stretched supply chains, elevated inflation and labor market shortages. Business disruption resulting from the spread of the new variant could prevent supply chain stresses from easing, dampening productive capacity and stoking further cost pressures in sectors with exposure to global supply chains. On the demand side, fear of infection could prevent a large proportion of individuals from engaging in economic activity that requires close contact. Thus, demand could diminish for services ranging from hospitality to travel, at a time when holiday-related spending would usually ramp up.

Business plans to gradually return to a post-pandemic new normal are now uncertain. Until there is more clarity on the overall pandemic situation, fear of contracting COVID-19, more prolonged uncertainty surrounding schools and child care, and renewed restrictions on international travel will continue to curtail labor supply.

Economies vary in their ability to withstand yet another wave of infections. Should the new variant lead to another rising wave of COVID-19 infections, the hardest-hit economies will be those with lower vaccination rates, higher dependence on tourism and lower capacity to offer additional fiscal and monetary policy support to offset the growth impact of the resurgence in infections. If the variant affects global market risk appetite, it would cause further financial stress for debt issuers with large financing needs. For example, emerging market countries that rely on international markets for borrowing may face heightened refinancing risks.

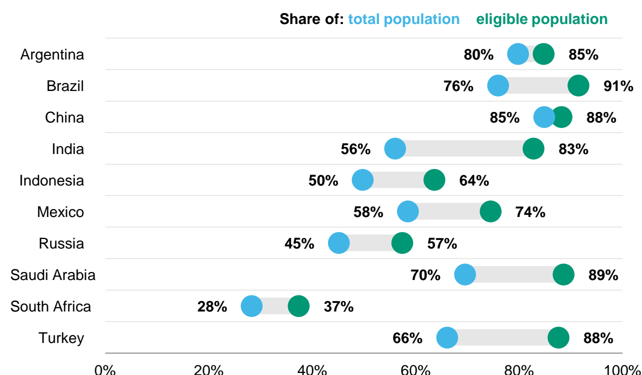
Advanced economies, helped by usage of highly effective vaccines, high vaccination rates and extensive policy support to the private sector, are in a better position to face the challenges that the new variant poses than are emerging market countries. But vaccine hesitancy remains a hurdle to recovery in many places, including in several advanced economies. Exhibits 1 and 2 show differences in vaccination rates across the G-20 countries.

Exhibit 1
Vaccination rates among G-20 advanced economies
Share of population vaccinated with at least one dose



Data as of 26 November 2021 or latest available.
Sources: Haver Analytics and Moody's Investors Service

Exhibit 2
Vaccination rates among G-20 emerging markets
Share of population vaccinated with at least one dose



Data as of 26 November 2021 or latest available.
Sources: Haver Analytics and Moody's Investors Service

European countries including the UK (Aa3 stable), Germany (Aaa stable), France (Aa2 stable), the Netherlands (Aaa stable) and Belgium (Aa3 stable) have detected Omicron cases, prompting new travel curbs. Moreover, the restrictions imposed following a recent rise in Delta infections could now be further extended and expanded.

China's (A1 stable) zero-tolerance COVID-19 policy will further delay relaxation of rules surrounding international travel in the face of the Omicron variant. If the variant is discovered in the country, authorities likely will increase the severity of restrictions.

The economic impact on other emerging market countries will differ, and will depend on a mix of government restrictions, public comfort with social interactions, and the capacity of governments and central banks to provide additional policy support to the private sector, if needed. Emerging market countries facing travel bans, including South Africa (Ba2 negative), as well as those dependent on tourism revenue, face further downside risks.

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Editors

Jay Sherman, Elisa Herr, Andrew Bullard, Julian Halliburton and Phil Macdonald

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