STANDARD & POOR'S

RATINGSDIRECT®

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Andorra (Principality of)

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Andorra (Principality of)

Major Rating Factors

Sovereign Credit Rating
AA-/Negative/A-1+

Strengths:

- A wealthy economy
- Robust net general government asset position
- A stable political and institutional framework

Weaknesses:

- A moderately diversified economy open to external shocks
- Significant focus on tourism-related activities
- The potential risks posed by the size of Andorra's banking sector, which is large relative to the economy

Rationale

The ratings on the Principality of Andorra are supported by high levels of GDP per capita levels, at an estimated $50,000 in 2008. Meanwhile, political institutions are stable and consensus in favor of fiscal prudence remains strong, which has assisted in the development of a modern and prosperous economy. The favorable tax regime, with very limited direct taxation and low indirect taxes, provides some fiscal flexibility.

Nevertheless, Andorra's economic diversification is constrained by its small size, narrow focus, and limited natural resources. The tourism-related commercial sector is the main contributor to Andorra's economic growth. The decline in the number of visitors by 2.7% on average during the past three years highlights risks specific to Andorra, given its road and air links and the catchment area of its tourists, as well as general risks relating to winter sports, which may suffer disproportionately in an economic downturn.

Andorra's financial sector is large relative to the size of the economy, with domestic credit to GDP expected at close to 260% of GDP in 2008. This raises concerns about asset quality in the event of an economic slowdown, particularly as the banking system has neither deposit insurance nor a lender of last resort. Of the six banks in the system, only one is foreign owned, by Banco de Sabadell S.A. (A+/Stable/A-1). None of the indigenous banks are rated by Standard & Poor's. Although the use of the euro removes foreign exchange risk from the principality's credit profile, any funding pressure on the banks would accentuate Andorra's economic downturn. A large share of the system's deposits is held by nonresidents. In addition, Andorra needs to bring supervision of its Andorran insurance sector up to international standards following the surge in savings-linked life insurance policies since 2005.

Andorra's tax regime, with limited direct taxation and low indirect taxes, provides some fiscal flexibility. Nevertheless, a significant increase in capital expenditure over the period 2006-2007, along with rising current expenditure and interest costs, has led to a sharp rise in the central government deficit, with general government debt to revenues rising to a projected 137% at year-end 2008, from 90% in 2005.

Outlook

The negative outlook reflects downside risks to public finances emanating from the country's narrow economy and the banking system's reliance on external funding. In this context, continuing recession in the tourism sector or a sustained deterioration in banking sector asset quality would raise the government's contingent liabilities, and in turn place downward pressure on the ratings. The ratings could stabilize at this level if Andorra's financial sector proves resilient and evidence emerges of a recovery in the Principality's competitiveness.

Table 1

Principality of Andorra Selected Indicators

	2003	2004	2005	2006	2007	2008e	2009f	2010f	2011f	Median AA (2008e)
GDP per capita ($)	29,571	33,501	36,388	38,010	42,514	49,959	49,614	50,018	47,555	39,338
Real GDP (% change)	6.4	6.1	7.8	6.4	2.0	1.9	1.6	2.0	2.4	4.2
Real GDP per capita (% change)	(1.1)	(0.2)	5.6	2.9	(0.3)	1.1	1.0	1.4	1.8	2.2
General government balance (% of GDP)	1.7	2.2	1.0	(1.0)	(2.2)	(0.8)	(0.8)	(0.9)	(0.5)	(0.4)
General government debt (% of GDP)	18.0	16.9	16.4	18.6	22.4	23.9	25.0	26.2	26.8	21.6
Net general government debt (% of GDP)	(9.7)	(10.9)	(12.1)	(10.4)	(6.7)	(5.4)	(4.5)	(3.7)	(3.2)	1.5
General government interest expenditures (% of revenues)	2.8	2.3	2.0	2.8	4.8	6.0	6.5	6.9	72.9	2.7
Domestic credit to private sector and NFPEs (% of GDP)	159.6	184.0	209.2	230.5	251.1	258.6	264.9	268.7	269.9	140.6
Consumer price index (average; % change)	2.9	3.3	3.1	3.2	3.9	4.2	3.0	2.8	2.9	4.1

f--Forecast. e--Estimate. NFPEs--Nonfinancial public enterprises. CARs--Current account receipts.

Comparative Analysis

- Andorra's small economy has a high level of prosperity, with GDP per capita above the 'AA' median, albeit lower than the level in most small 'AAA' rated jurisdictions.
- The Principality's general government balance has worsened in comparison with the 'AA' median.
- The introduction of a tax on nonresident deposits in 2005 had no noticeable impact on the banking system, but led to a significant increase in savings-linked life insurance products.

A small, prosperous economy

The ratings on Andorra reflect its prudent fiscal policies and high GDP per capita, which offset its small size and relatively narrow economy. Andorra's economy is comparable with that of other small jurisdictions, such as the Grand Duchy of Luxembourg, the Isle of Man, and the Principality of Liechtenstein (all rated foreign currency AAA/Stable/A-1+; all ratings hereafter refer to foreign currency sovereign credit ratings). The higher long-term ratings on these sovereigns, however, reflect greater prosperity and more diversified economies. Andorra can also be compared with Bermuda (AA/Stable/A-1+) and the Republic of Cyprus (A+/Stable/A-1), which are also small, open economies with sizable financial sectors. The Republic of Malta is also a useful comparator (A/Stable/A-1).

Andorra has high GDP per capita, projected at $50,000 in 2008, which is above the 'AA' median ($39,000), but lower than in Andorra's small, but higher rated, peers, which are some of the wealthiest economies in the rated universe (see chart 1). Real GDP per capita growth fell below the 'AA' median in 2006, and is expected to remain weak in comparison with most peers (see chart 2).

Chart 1

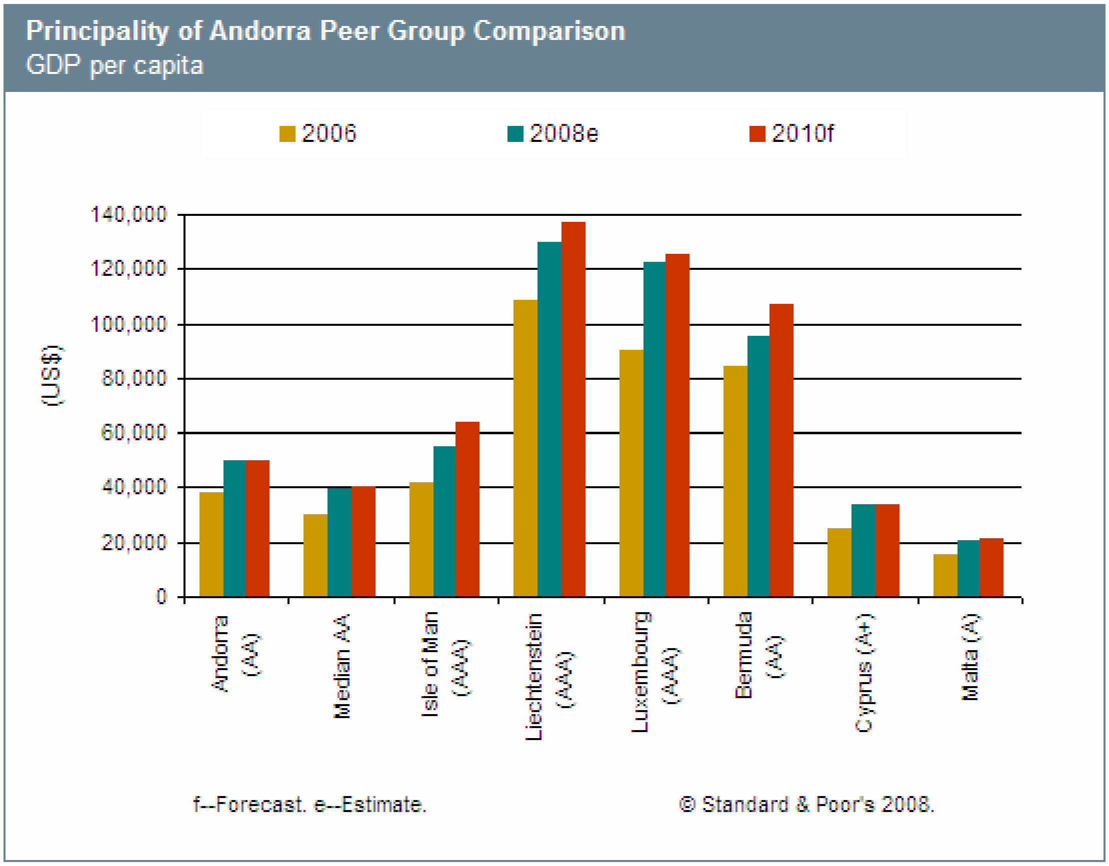
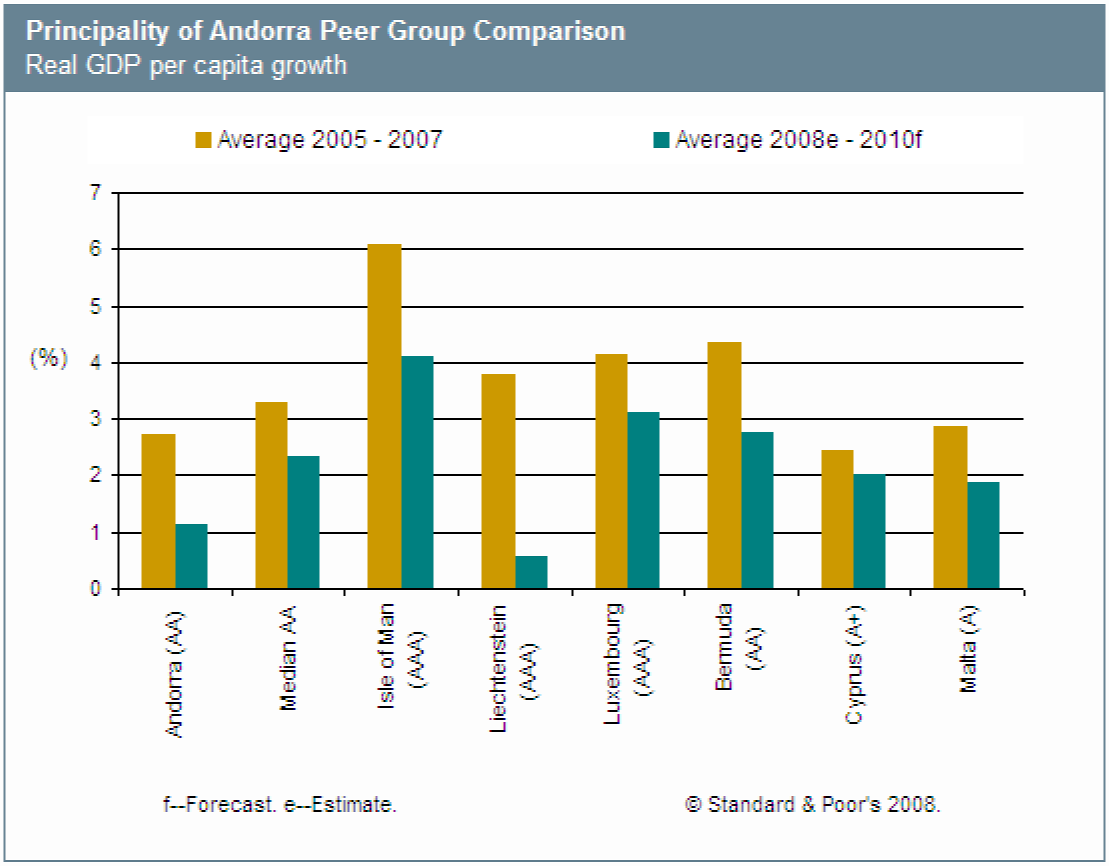


Chart 2



Banking sector looms large in the economy

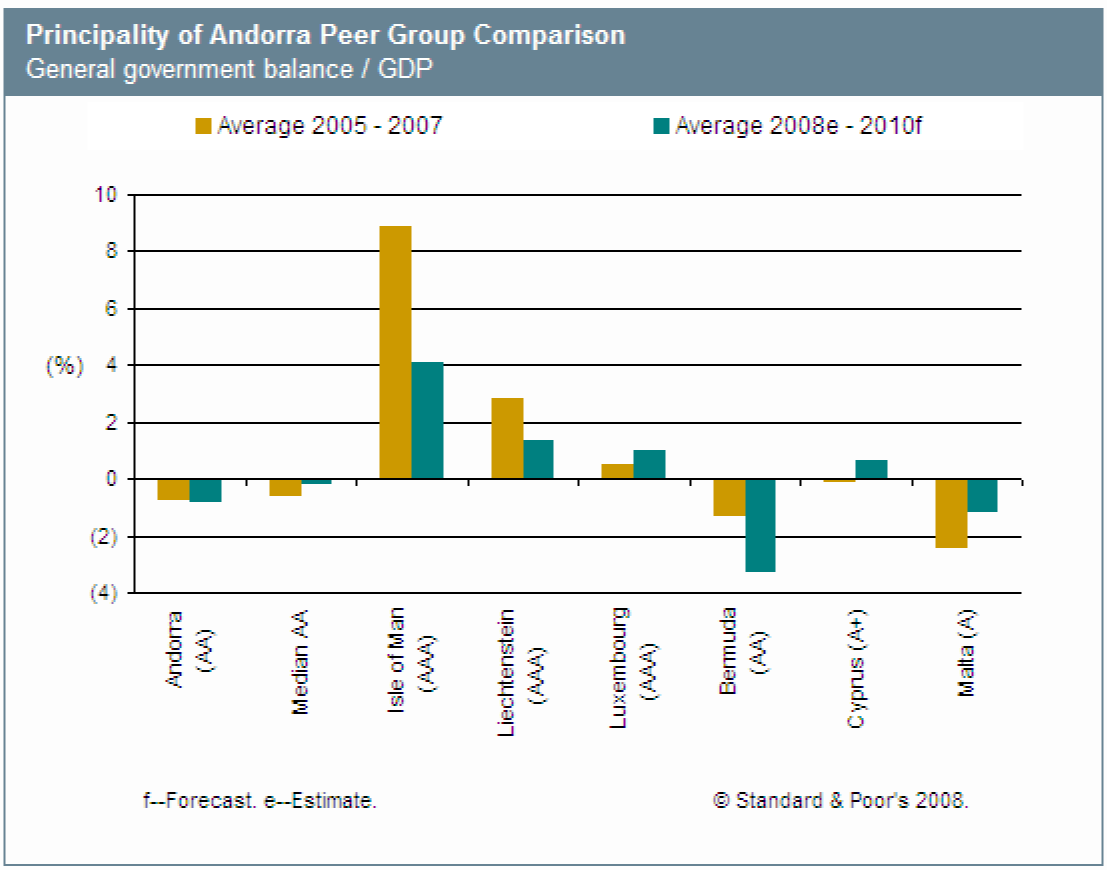
As for most peers, Andorra's favorable tax system and a relatively dynamic tertiary sector have helped it to overcome the economic constraints posed by its small size and limited natural resources. Andorra's economy shares many characteristics with other small jurisdictions, such as not having its own currency. Unlike Luxembourg, however, Andorra is not a member of the EU or EMU, although it adopted the euro and benefits from the macroeconomic stability within the Eurozone. Andorra's favorable tax system is broadly characterized by low indirect taxes and very limited, albeit increasing, direct taxation. This has supported the development of the tourist sector, and a relatively large financial sector, where bank secrecy and the lack of a savings tax, until 2005, attracted significant nonresident savings. The proportion of nonresident deposits is estimated to be similar to the high levels witnessed in certain European peers, such as the Swiss Confederation (Switzerland; AAA/Stable/A-1+) and Luxembourg. Offshore financial activities are limited by legal restrictions on foreign capital in Andorran companies, and although a new law on foreign investment, approved in 2008, will potentially permit foreign capital of up to 100% in certain sectors of the economy, the legislation is not applicable to the Andorran banking sector, where foreign credit institutions are permitted to invest up to 51% of the capital.

Like other European countries that are not EU members, for example, Isle of Man, Liechenstein, Monaco (not rated) and San Marino (not rated), Andorra introduced a withholding tax on EU residents' deposits in July 2005. Bank secrecy, however, has been maintained, and the new tax only applies to certain assets and solely to individuals' accounts. As a result, so far the new tax has had minimal impact on the level of EU residents' deposits. Nevertheless, the contingent liability of Andorra's banking sector remains an important weakness in the Principality's credit profile. Meanwhile, the withholding tax has resulted in a significant increase in savings-linked life insurance policies, which are not subject to the tax, increasing the importance of the currently less well-regulated insurance sector.

Andorra pursues prudent fiscal policies

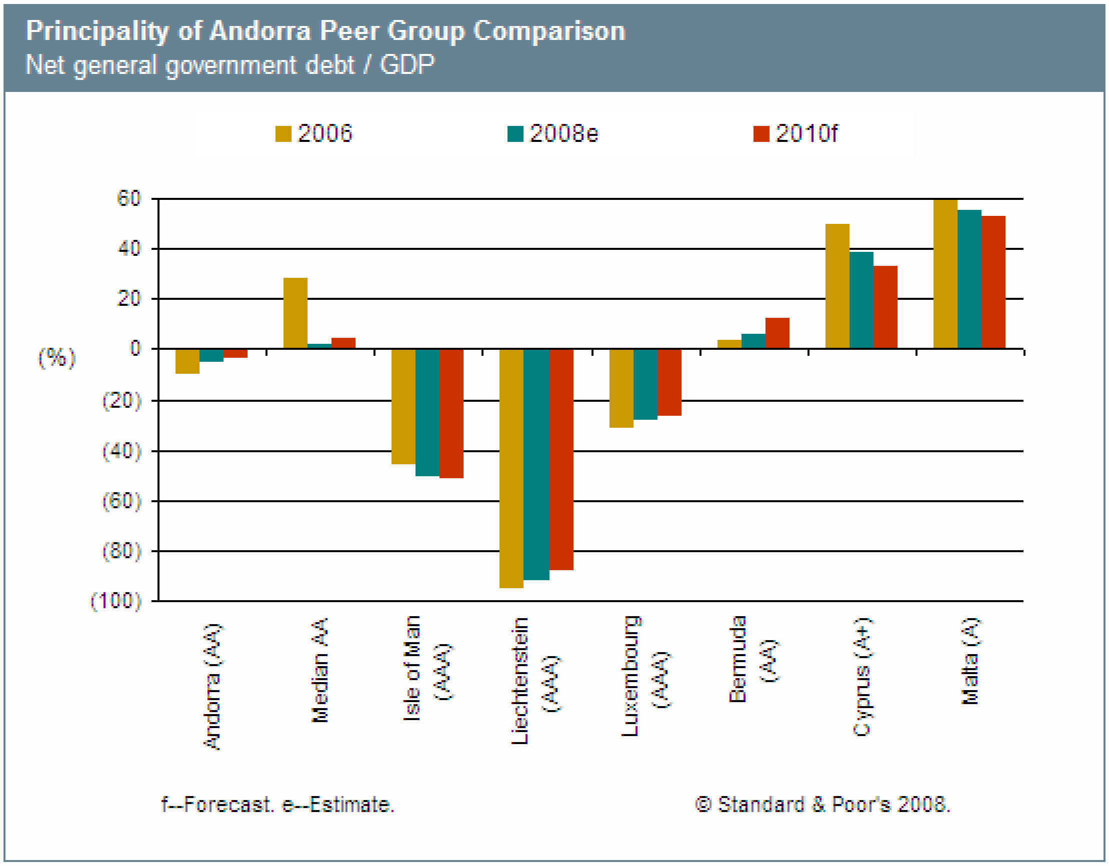
As for many of its peers, limited tax resources have constrained the size of Andorra's government, and ensured prudent fiscal policies. The general government balance had been in surplus since 2001, reflecting moderate central government deficits and local government surpluses coupled with high surpluses posted by the social security sector (see chart 3). Since 2006, however, the general government posted a deficit due to an acceleration in capital investment spending, particularly in 2006, plus stronger current spending and interest costs in 2007.

Chart 3



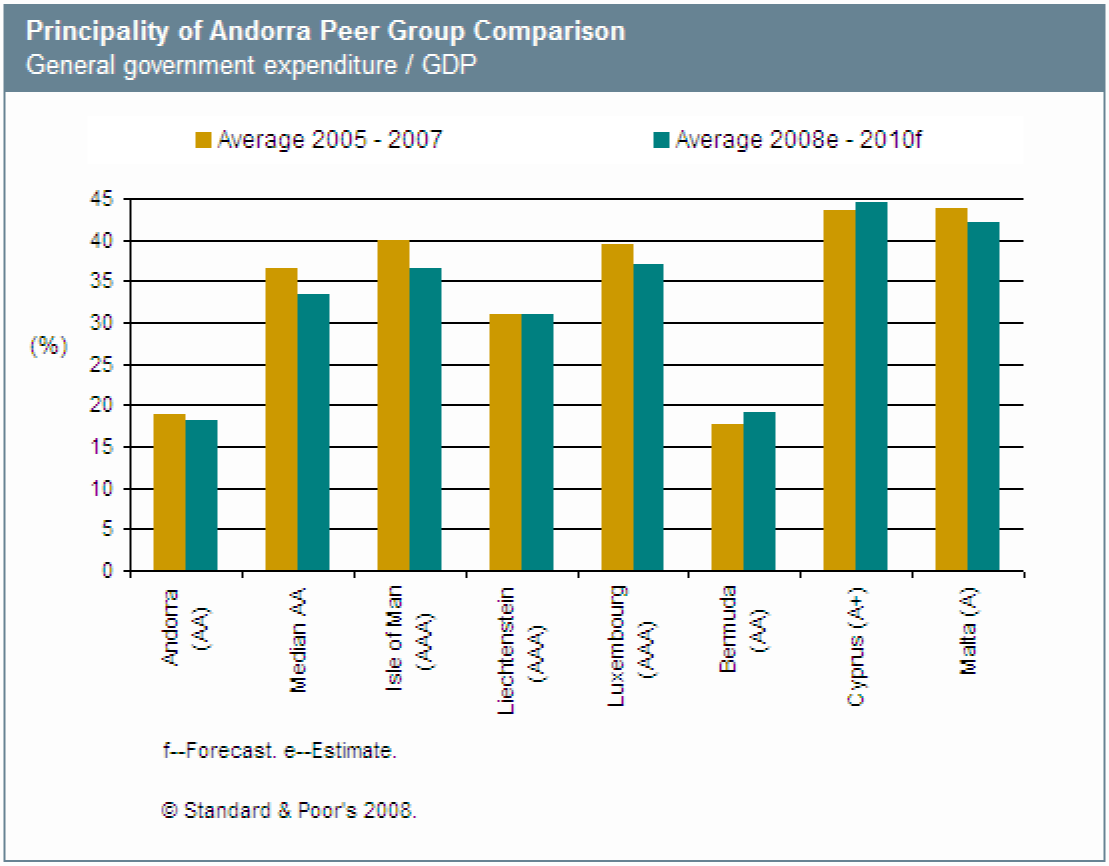
Andorra's general government interest burden posted a significant increase in 2007, and remains high at about 6.0% of general government revenues in 2008. Andorra's debt burden is above that in the Isle of Man, Bermuda, Liechtenstein, and Luxembourg, and rose above that of the 'AA' median in 2007. Andorra's general government is in a net creditor position of about 5% of GDP, although this compares unfavorably with some of its peers--Liechtenstein, Isle of Man, Luxembourg--who stand out among all rated sovereigns on account of their large net asset positions (see chart 4).

Chart 4



In relative terms, Andorra's public sector is the smallest within the peer group, affording the Principality added fiscal flexibility. In 2008, we expect general government expenditures of 18% of GDP (comparable only with Bermuda), almost one-half the ratio of the 'AA' median. The government sectors of Malta, Cyprus, Luxembourg, and the Isle of Man are larger than the 'AA' median, with Liechtenstein in an intermediate position between the median and Andorra (see chart 5).

Chart 5



Political Environment: 2009 General Elections Not Expected To Affect Overall Policy Direction

- Andorra's stable political environment faces few appreciable risks.
- EU membership is not on the agenda, but formal relations with the Union are good.
- There is strong support for a prudent budgetary approach favoring small government.

Andorra is a parliamentary co-principality. The joint and indivisible position of Head of State is held by two princes: the Bishop of La Seu d'Urgell (a small city in north Catalonia) and the President of the Republic of France. The co-princes, who hold their title on a personal basis, do not represent their respective jurisdictions, but abide by the Andorran constitution. The co-princes are not actively involved in governing the Principality, and their role is limited to the political and representative tasks that the constitution assigns them. Their responsibilities include calling general elections, sanctioning and promulgating laws, and appointing the Head of Government, among other things. Their actions, however, have to be countersigned either by the Head of Government or the Head of Parliament. The co-principality arrangement dates back to the thirteenth century and has worked as a tenable formula in supporting Andorra's political and territorial independence, its good relations with neighboring Spain and France, and its integration within Europe.

Only Andorran nationals, who make up slightly more than one-third of the resident population, are entitled to vote in general elections. The next general election is set to take place in March 2009, but there is little to separate the two leading parties with regard to macroeconomic policy and they are only likely to differentiate themselves on local issues, leading to another close run contest. The ruling Liberal Party staved off a strong challenge from the opposition Social Democrats (SDs) in the 2005 election, retaining 14 seats in the 28-seat parliament compared with the SD's (11). As a result, Albert Pintat, head of the center-right government, has required support from two smaller parties to implement various measures in order to regularize the economy in an EU context. This should allow for increased foreign investment and facilitate negotiations with regard to reducing the punitive taxes applied to Andorran exports by key trade partners. One of the first steps along this route involves the introduction of the framework necessary to apply a direct tax on company profits. This should be legislated for in the second half of 2008, but bilateral negotiations are likely to delay the impact of the tax on budget revenues over the medium term. Nevertheless, this development will represent a key change in Andorra's traditional tax structure. The government also began to increase the level and coverage of indirect taxation from 2006 onwards and is expected to introduce a reform to simplify the system in 2008 (see "Fiscal Flexibility" section below).

Andorra's public administration, despite growing fast in recent years, remains relatively small, and its involvement in economic issues is limited largely to the demands of the Principality's business-oriented private sector, reflecting Andorra's traditionally liberal economy.

Political ties with Spain and France were deepened with the signature of tripartite agreements in 2003 that regulate free circulation and mutual preferential treatment of French and Spanish nationals in Andorra, and vice versa. In 2007, the government signed further Memorandums of Understanding with Portugal and Spain. Economic relations with the EU are governed by the Customs Union agreement signed in 1990. Given the independent nature of the Principality it is unlikely to consider EU membership for the time being.

Economic Prospects: Tourism Sector Remains Weak

- Andorra's economy is driven by a relatively competitive and dynamic services sector, with tourism-related services the largest contributor to gross value added.
- Real GDP per capita growth is expected to slow to an average 1% in the medium term, from closer to 4% over the past three years.
- Andorra's banking sector is sound, solidly capitalized, and well managed, but significant nonresident deposits increase its vulnerability to adverse economic shocks.

Table 2

Principality of Andorra Economic & Financial Indicators

	2003	2004	2005	2006	2007	2008e	2009f	2010f	2011f
Nominal GDP (bil. €)	1.9	2.1	2.3	2.5	2.6	2.7	2.9	3.0	3.2
Nominal GDP (bil. $)	2.1	2.6	2.9	3.1	3.5	4.2	4.2	4.2	4.1
GDP per capita ($)	29,571	33,501	36,388	38,010	42,514	49,959	49,614	50,018	47,555
Real GDP (% change)	6.4	6.1	7.8	6.4	2.0	1.9	1.6	2.0	2.4
Real GDP per capita (% change)	(1.1)	(0.2)	5.6	2.9	(0.3)	1.1	1.0	1.4	1.8
Consumer price index (% change)	2.9	3.3	3.1	3.2	3.9	4.2	3.0	2.8	2.9
Domestic credit to private sector and NFPEs (% change)	17.9	26.3	26.1	17.9	14.3	9.3	7.2	6.3	5.8
Domestic credit to private sector and NFPEs (% of GDP)	159.6	184.0	209.2	230.5	251.1	258.6	264.9	268.7	269.9

f--Forecast. e--Estimate.

Economic structure

Andorra is a small but prosperous economy, dominated by the services sector. Tourism and tourism-related commerce (more than 60% of gross value added) is the main driving force behind Andorra's economic performance. However, the Andorran economy's relatively narrow focus makes it vulnerable to economic developments in France and Spain, which account for almost all visitors and tourists (97%), hence the current sharp slowdown in the Spanish economy following the end of the construction boom is likely to have a significant impact on Andorra's growth prospects. Relatively low prices and modern infrastructure, the largest ski complex in the Pyrenees, and the attractiveness of its low indirect taxes are among Andorra's comparative advantages over nearby tourist destinations, but difficult access to the Principality constrains further expansion in the number of visitors.

Nevertheless, there has been a sharp decline in the number of tourists over the period 2005-2007, partly due to increasing competition from nearby winter holiday destinations, but also due to specific factors such as the closure of the French border during the height of the ski season in 2005 due to bad weather, and unseasonably warm weather during the 2006-2007 season, which led to poor skiing conditions. Meanwhile, the number of tourist arrivals stagnated in 2007. The government is attempting, in close collaboration with the private sector, to improve the quality of tourist facilities, widen the scope of tourism activities on offer, and to promote Andorra as a conference and services center. This should go some way toward stemming the decline in visitor numbers over the medium to long term, but the limited offer of the Andorran economy is unlikely to change substantially.

Reflecting very low direct taxation, the set of available statistics on Andorra's economy is limited. Andorra does not produce national accounts, although the government has recently started to produce GDP figures, which are indirectly estimated from labor market data. Andorra has no currency of its own, but uses the euro.

Andorra's second-largest economic sector, its banking system (16% of gross value added), continues to be characterized by healthy macro-prudential indicators. The IMF's assessment of the banking system in 2006 as part of its Offshore Financial Centers assessment program gave the Principality a clean bill of health, and in 2007 attested that Andorra's financial sector supervision is broadly sound and compliance with international anti-money-laundering standards is generally favorable. Foreign participation in the banking system has been reduced in recent years, so that Spanish banks now have a controlling share in the capital of only one of the five Andorran banking groups. Banking secrecy and, until mid-2005, the absence of savings tax have attracted nonresident deposits to Andorra's banks, although data on the share of nonresident deposits is not available. The new savings tax has not resulted in a destabilizing decline of nonresident deposits as the tax only applies to certain assets and individuals, and, more importantly, bank secrecy has been maintained. With the tax not applying to all assets, however, there has been a significant shift to savings-linked life insurance policies. Adverse economic shocks could, nevertheless, affect Andorra's banking sector, which is large relative to the size of the economy. Fast credit expansion in Andorra's private sector in recent years has heightened the risk to the banking sector from any economic slowdown.

Economic growth

Andorra's growth remained relatively strong in 2007, as a result of continued strength in the service sector despite the decline in tourist numbers, while industry and construction sector output also remained buoyant. Andorra's short-term economic prospects have worsened, with real GDP per capita growth estimated at about 1% in the medium term.

Fiscal Flexibility: General Government Debt Continues To Increase

- Measures to broaden the tax burden have increased the government's revenue-raising capacity, although spending has also been ramped up and as a result the general government budget has fallen into deficit.
- The general government maintains a net asset position, reflecting substantial social security reserve assets.
- Contingent liabilities largely reflect Andorra's sizable banking sector, as public companies record profits and healthy financial accounts.

Table 3

Principality of Andorra Fiscal Indicators

	2003	2004	2005	2006	2007	2008e	2009f	2010f	2011f
(% of GDP)									
General government revenues	18.3	18.2	18.3	17.6	18.1	17.5	17.3	17.2	17.0
Of which central government	12.0	11.7	11.1	11.4	12.5	11.9	11.7	11.6	11.4
General government expenditures	16.6	16.0	17.3	18.7	20.3	18.3	18.1	18.1	17.5
Of which central government	13.0	13.3	12.9	14.3	15.1	13.7	13.3	13.3	12.6
General government balance	1.7	2.2	1.0	(1.0)	(2.2)	(0.8)	(0.8)	(0.9)	(0.5)
Of which central government	(1.0)	(1.6)	(1.8)	(2.9)	(2.6)	(1.8)	(1.6)	(1.6)	(1.2)
Of which local authorities	0.3	1.2	(0.3)	(0.7)	(1.2)	(0.9)	(0.8)	(0.9)	(1.0)
General government primary balance	2.3	2.6	1.4	(0.5)	(1.3)	0.3	0.4	0.3	11.9
Central government primary balance	(0.8)	(1.4)	(1.5)	(2.6)	(2.0)	(1.0)	(0.8)	(0.8)	(0.3)
General government balance (% of revenues)	9.5	12.1	5.4	(5.9)	(12.1)	(4.5)	(4.5)	(5.3)	(2.8)
General government interest payments (% of revenues)	2.8	2.3	2.0	2.8	4.8	6.0	6.5	6.9	72.9
Central government interest payments (% of revenues)	2.1	1.9	2.0	3.0	5.2	6.6	7.1	7.4	7.8
General government debt	18.0	16.9	16.4	18.6	22.4	23.9	25.0	26.2	26.8
Of which central government debt	9.8	10.8	11.6	13.6	16.4	17.2	17.9	18.4	18.4
General government net debt	(9.7)	(10.9)	(12.1)	(10.4)	(6.7)	(5.4)	(4.5)	(3.7)	(3.2)
Of which central government net debt	8.9	10.1	10.5	12.7	15.7	16.5	17.2	17.8	17.8

f--Forecast. e--Estimate.

Revenue, expenditure, and balance performance

Budgetary revenues are circumscribed by very limited direct taxation and the associated low fiscal burden on Andorra's residents. The government's main source of revenue, 80% of the total, comes from indirect taxes, particularly a tax on imports and consumption that is ultimately paid by final consumers--mostly tourists. Recent measures taken by the Andorran government have tried to reduce the heavy dependence of fiscal resources on retail activities by creating new taxes and shifting part of the fiscal burden to Andorra's residents.

A tax on the finance and insurance sectors was introduced in 2000 and was widened to cover all domestically produced services in 2006. The government also introduced a tax on production and increased the tax on imports and consumption in the same year. This broadening of the tax base boosted revenues in 2007, which in combination with the introduction of the withholding tax on EU residents' deposits (which is partially retained by the levying country), strengthened the government's revenue-raising capacity. The withholding tax on the interest income of EU residents will be gradually raised to 35% in 2011 from 15% in 2005.

Andorra's expenditure structure largely reflects the need to maintain and upgrade the country's tourism infrastructure. Capital expenditures, including capital transfers to the local governments, are by far the largest expense item--at close to 50% of total expenses in the past two years due to the completion of previously contracted road and tunnel improvement projects--and are the main reason for the worsening in the general government balance. The implementation of further significant infrastructure projects will continue to put pressure on the central government balance in the short term. However, the government expects parliament's 2008 approval of legislation allowing for the increased use of public-private partnerships to structurally improve the budgetary position over the medium term.

The fiscal performance of Andorra's social security sector is characterized by surpluses, averaging 2.5% of GDP in the past five years, and the accumulation of substantial reserves, which in 2007 amounted to €735 million, equivalent to 29% of GDP. The reserves are held by Andorran and foreign banks, with a maximum of 15% invested in variable-rate financial instruments, 10%-25% invested in the money markets, and the remainder in fixed-income instruments. Despite the current favorable financial position of the social security sector, the Andorran government projects that, without reforms, the system will only have a cash surplus up to 2020. The government made a modest improvement in the terms of pension provision for working people in 2006, while a more substantial reform of the Social Security Law to prevent the future emergence of deficits remains under consultation.

Government debt and interest burden

Andorra's central government debt burden remains moderate, at 17% of GDP. Traditionally, the government's debt was nonmarketable and held only by Andorra's banks. This changed in January 2005, when the government issued short-term debt of €56.8 million. This was followed by the issuance of Andorra's first tradable long-term security in December 2005, in order to rationalize the structure of the country's public debt. (For details of the bond issue, see the article titled "Principality Of Andorra's Inaugural €260 Million Long-Term Bond Rated 'AA'," published Dec. 30, 2005, on RatingsDirect.) Interest expenses have increased significantly since 2001, when the government started to pay interest on government debt to Andorra's banks in return for taxing their activities. Meanwhile, the interest burden increased sharply in 2007, reaching about 5% of total central government revenues, due to the relatively high cost of short-term financing plus the additional interest payments resulting from the lease on a new waste management plant, which runs until 2026.

Including the debt of local governments, total general government debt is expected to amount to about 24% of GDP in 2008, and has been on a rising trend since 2006. Central governments efforts to limit local government debt have been less successful than anticipated as ongoing investment needs have resulted in local government debt increasing to 6.1% of GDP in 2007, compared with 5.1% in the previous year. Nevertheless, net of social security assets, the general government will remain in a net creditor position, amounting to about 5.4% of GDP in 2008.

Contingent liabilities

The contingent liability posed by the banking system in a reasonable worst-case scenario is significant and estimated to be well above the 'AA' median of 30% of GDP. There is currently no deposit insurance mechanism in place, nor is there a lender of last resort. However, Andorran financial institutions and the respective financial authorities, the Institut Nacional Andorrà de Finances and banking supervisory authority, the Andorran Bankers' Association, are working on a proposal for the government to set up a deposit insurance scheme in 2008.

Ratings Detail (As Of August 21, 2008)*	
Andorra (Principality of)	
Sovereign Credit Rating	AA-/Negative/A-1+
Senior Unsecured (1 Issue)	AA-
Sovereign Credit Ratings History	
12-Aug-2008	AA-/Negative/A-1+
16-Aug-2007	AA/Negative/A-1+
11-Aug-2004	AA/Stable/A-1+
Default History	
None	
Population	85,000
Per Capita GDP	$50,000
Current Government	
Prime Minister Albert Pintat leads a Liberal Party government. The joint and indivisible position of Head of State is held by the two co-princes: the Bishop of Urgell and the President of the Republic of France.	
Election Schedule	
Parliamentary Last......March 2005 Next......March 2009	

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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