The Republic of Slovenia Rating Report

A- STABLE OUTLOOK

Credit strengths

- Euro area membership
- Strong macroeconomic performance
- Strengthening external position
- Progress in fiscal consolidation

Credit weaknesses

- High levels of public debt
- Need for structural reforms
- Ageing population

Rating rationale and Outlook: The A- rating is i) underpinned by Slovenia's Euro area membership, ii) further improvements in macroeconomic performance, iii) continued progress in fiscal consolidation, iv) a strengthening external balance position and v) a strengthening banking sector. The rating remains constrained however by i) elevated debt levels, and ii) the need for comprehensive structural reforms, addressing the country's growth potential and ageing-related impacts.

Figure 1: Sovereign scorecard results

Scope's sovereign risk categories	Slovenia	Peer comparison: Average
Domestic economic risk		
Public finance risk		
External economic risk		
Financial risk		
Political and institutional risk		
Qualitative adjustment (notches)	-1	
Final rating	A-	

AAA AA A BBB BB B CCC CC C

NB. The comparison is based on Scope's Core Variable Scorecard (CVS), which is determined by relative rankings of key sovereign credit fundamentals. The CVS peer group average is shown together with the average result from the entire CVS peer group. The CVS rating can be adjusted by up to three notches depending on the size of relative credit strengths or weaknesses.

Source: Scope Ratings GmbH

Positive rating-change drivers

- Material reduction in public debt
- Structural improvements in potential growth
- Successful pension and health care reforms

Negative rating-change drivers

- Deterioration in economic outlook
- Reversal of fiscal consolidation

Ratings and outlook[1]

Foreign currency

Long-term issuer rating	A-/Stable
Senior unsecured debt	A-/Stable
Short-term issuer rating	S-1/Stable

Local currency

Long-term issuer rating	A-/Stable
Senior unsecured debt	A-/Stable
Short-term issuer rating	S-1/Stable

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[1] This rating report has been updated after the correction on 21 Aug 2018 of Slovenia's short-term rating.

Rating drivers

Overview

Risks to rating are broadly balanced

The A- rating is underpinned by Slovenia's Euro area membership with a large common market, a strong reserve currency, an independent European Central Bank effectively acting as a lender of last resort for the banking sector (ELA), and a sound economic governance and macro prudential framework which supports credible macroeconomic policies. The rating is supported by i) further improvements in macroeconomic performance, ii) continued progress in fiscal consolidation, iii) a strengthening external balance position and iv) a strengthening banking sector. The rating remains constrained however by i) elevated debt levels and ii) the need for comprehensive structural reforms, addressing the country's growth potential and ageing-related impacts.

Domestic Economic Risks

Strong macroeconomic performance supports rating

Slovenia has shown sound macroeconomic fundamentals, with 2017 real GDP growth at 5.0% leading to cumulative real GDP growth from 2014 to 2017 of 13.4%, driven by booming export demand and strong domestic demand buoyed by the employment recovery. In fact, employment in May 2018 increased by 11.6% from Jan 2014 while unemployment, using the ILO definition, after peaking in 2013 at 10.1%, was 5.9% in Q1 2018. With employment increasing, and inflation at moderate levels (July 2018: 2.1%) just slightly above the ECB target level of close to but below 2.0%, real wages should further increase, ensuring solid domestic demand going forward. Scope thus expects economic growth to continue, with real GDP growth in Q1 2018 increasing by 4.6% from Q1 2017, aided by strong growth of gross fixed capital formation (9.1%), which Scope anticipates continuing to grow as also EU structural and cohesion fund absorption increases, reaching 20.1% of GDP in 2018 and 20.6% in 2019 after 19.3% in 2017. Similarly, construction increased for this period by 12.0% and manufacturing grew by 7.2%. Scope anticipates that GDP growth will slow to 4.4% in real terms in 2018 and to 3.5% in 2019, as demand shifts from exports to domestic demand and growth is constrained by a lack of skilled workers. This is evidenced, for instance, by the share of enterprises listing shortages of skilled labour as factors limiting increases in production reaching a new peak in July 2018 at 38%. For this reason, despite current solid fundamentals, Scope expects growth potential in Slovenia going forward to be constrained.

Public Finances Risks

Consolidation of public finances leads to improvements

Scope notes that Slovenia's A- rating is also supported by the successful government consolidation of its public finances over the past few years. The primary balance in 2017 was positive at 2.5%, a significant improvement from -12.1% in 2013. Scope anticipates further positive fiscal adjustments, with the primary balance expected to be in surplus at 2.4% in 2018 and 1.9% in 2019. In addition, Scope notes positively that while outstanding guarantees by the government of Slovenia continue to remain relatively high, they have steadily declined from 22.8% of GDP in 2013 to 14.5% in 2017. Part of these guarantees in the amount of 4.1% are included in the general government debt in line with the ESA methodology.

High levels of public debt constrain rating results

High levels of public debt, incurred during the banking/sovereign crisis, continue to constrain the rating for Slovenia, despite debt ratio reductions resulting from continued buy-backs, GDP growth, and reduction in the government's cash position by EUR 600mn in 2018 (EUR 300mn pre-financing from 2017), approximately 1.3% of GDP. Gross government debt, measured as a percentage of GDP, peaked at 82.6% in 2015 but fell to 73.6% in 2017. Scope anticipates that this reduction will continue in 2018 (to 69.3%) and 2019 (to 65.2%). Hence Slovenia remains removed from the Maastricht criteria level of 60%. Debt maturity increased at the end of 2017 to 9.3 years, up from 5.7 years in 2013.

Demographic constraints are significant fiscal challenge

Scope highlights that demographic constraints are a significant fiscal challenge going forward. Costs related to an ageing population (pensions, education, health-care, long-term care and unemployment benefits) are expected to increase government expenditures to 28.8% of GDP by 2050, up from 21.9% in 2016, implying an increase of 6.9 percentage points of GDP. This is driven by a significant increase in the share of the elderly population (over 80 years) from 5.0% in 2016 to 11.4% in 2050. At the same time, the working age population is expected to decrease from 66.4% of the population in 2016 to 54.6% in 2050, with life expectancy at the age of 65 increasing from 20 years in 2016 to 23 years in 2050. Addressing implicit liabilities of the longer-term costs of government pensions and health-care costs for an ageing society will present significant challenges to government expenditures in Slovenia in the years to come. Slower economic growth and, to a lesser degree, the risk of contingent liabilities crystallising through guarantees remain key risks to Slovenian debt sustainability.

External Economic Risks

Strengthening external balances support rating

The rating is also supported by strengthening external balances. The current account surplus in Slovenia reached 7.1% of GDP in 2017, up significantly from a current account deficit of 5.3% of GDP in 2008. Scope anticipates this falling to 6.3% in 2018 and to 5.8% in 2019, reflecting increased domestic demand and higher international energy prices. Net international investment in Slovenia was -32.0% of GDP in 2017. Given further strong current account surpluses going forward, Scope expects the net external position to be largely in balance by 2023. Scope notes positively that gross external debt fell from a recent high of 125.7% of GDP in 2014 to 101.2% in 2017, as did net external debt, from 42.6% in 2013 to 22.4% in 2017.

However, despite this reduction, external debt remains high compared to peers such as Latvia (A-/Stable) and Lithuania (A-/Stable) and the country’s overall strong dependence on foreign trade leaves Slovenia vulnerable to short-term external shocks, as a sharp decline in export demand would disproportionately affect Slovenian growth.

Financial Stability Risks

Banking sector continues to improve

Scope notes that the banking sector in Slovenia, after successfully recovering from the banking/sovereign crisis in 2012-2013, continues to improve. Bank profitability is up, with return on equity reaching 9.58% (8.0%) and return on assets increasing to 1.2% (1.0%) at the end of 2017 (2016). The capital adequacy ratio was 18.1% at the end of 2017, down from the all-time high of 19.1% in 2016. Banks have succeeded in stabilising their aggregate interest rate spread in 2017 at 2.88%. Resolution of non-performing loans held by the Bank Asset Management Company is ongoing and macro-prudential instruments have been put into place. Asset quality continues to improve significantly, with the non-performing loan ratio falling from a high of 15.2% in 2012 to 3.2% in 2017.

Institutional and Political Risks

Structural challenges require comprehensive reforms and policy changes

Slovenia also faces key structural challenges – including an acceleration of privatisation of the large state-owned enterprises, meeting policy goals under tight budget constraints, persistent skills mis-matches in the labour force and relatively low productivity, high health-care costs and long-term care challenges from an ageing population – that will require comprehensive reforms and policy changes. While Slovenia has made some progress with the National Reform Programme for 2018, Scope expects that the implementation of these reforms and policy changes will be lengthy and politically difficult, especially with non-political actors such as public-sector unions.

Centre-left minority government coalition established after lengthy delays

After the resignation of PM Cerar on 14 March 2018, elections were held on 3 June 2018, with coalition discussions agreeing on 10 August 2018 to a minority government led by Marjan Šarec (LMŠ) in a five-party centre-leftist government. Scope does not expect any major changes in policy.

Factoring of Environment, Social and Governance (ESG)

Social and governance stability with mixed results

Scope considers ESG sustainability issues during the rating process as reflected in the sovereign methodology. Governance-related factors are explicitly captured in Scope's assessment of 'Institutional and Political Risk', in which Slovenia scores high in the World Bank's Worldwide Governance Indicators, in line with most euro area sovereigns. Qualitative governance-related assessments in Scope's 'recent events and policy decisions' and 'geo-political risk' categories of its QS are assessed as 'neutral' compared with Slovenia's sovereign peers. Socially-related factors are captured in Scope's CVS in Slovenia's moderate GDP per capita (USD 23,654 in 2017), low level of unemployment but weak old-age dependency ratio. Qualitative assessments of social factors are reflected in Scope's 'macro-economic stability and sustainability', which Scope assesses Slovenia at 'neutral'. Slovenia performed well on social scoreboard indicators supporting the European Pillar of Social Rights, with low income inequality and a decrease in social exclusion. However, despite improvements in labour market outcomes, employment rates of older workers and low-skilled workers remain low and old-age poverty prevails. Slovenia is encouraging economic growth while ensuring sustainable natural resources. This is accounted for in the 'growth potential of the economy' and 'macro-economic stability and sustainability' assessments of the QS. Environmental factors are considered during the rating process but did not have an impact on this rating action.

Outlook and rating-change drivers

The Stable Outlook reflects Scope's view that risks to the ratings are broadly balanced over the next 12 to 18 months.

The rating could be upgraded if the sovereign were to: i) achieve a material reduction in public debt, ii) reach structural improvements in potential growth, and/ or iii) implement successful pension and health care reforms. Conversely, the rating could be downgraded if: i) the economic outlook were to deteriorate, ii) fiscal consolidation were to reverse.

Foreign- versus local-currency ratings

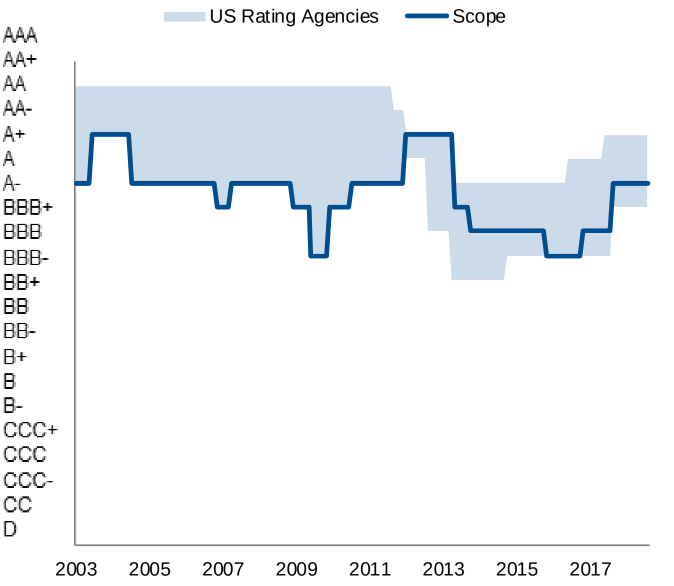
The Republic of Slovenian debt is predominantly in Euro. Because of its history of openness to trade and capital flows, Scope sees no evidence that the Republic of Slovenia would differentiate among any of its contractual debt obligations based on currency denomination.

Summary of Rating Committee

The main points discussed by the rating committee were: i) Slovenia's growth potential, ii) macroeconomic stability, iii) debt dynamics and its drivers, iv) fiscal developments, v) vulnerability to external shocks, vi) demographic challenges, vii) peers consideration.

Rating History

Figure 2: Rating history



Source: Scope Ratings GmbH

Figure 3: Recent rating actions

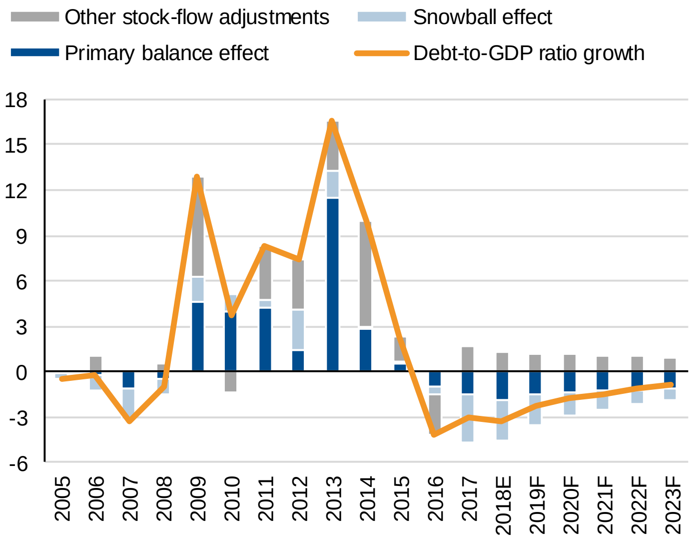
	Rating Action	Outlook
05.05.2017	Under Review	Developing
01.09.2017	Upgrade from BBB to A-	Stable
17.08.2018	Affirmation A-	Positive

Source: Scope Ratings GmbH

Debt Sustainability Analysis

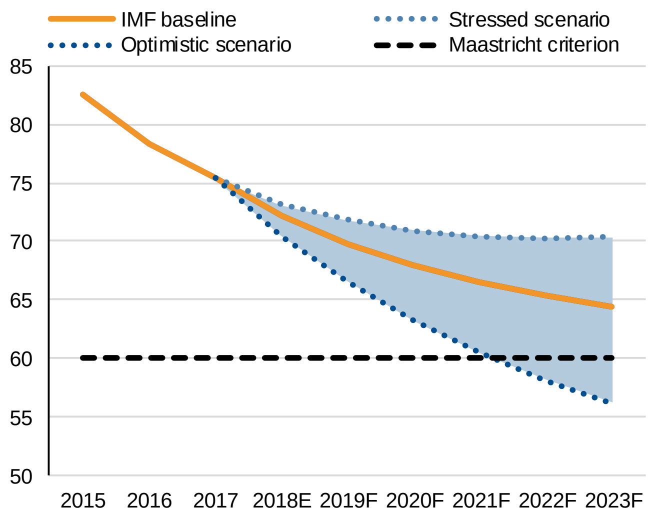
The Republic of Slovenia's debt sustainability metrics have improved over the last several years as the negative effects of the banking and sovereign crisis in 2013 work their way out. The baseline scenario anticipates growth of 2.8%, with a primary balance averaging 1.4% of GDP and 0.7% real effective interest rates. As a result, debt falls to 65.4% of GDP by 2023, broadly driven by stock-flow adjustments, primary balance and snowball effects. Scope executed two scenarios: i) an optimistic scenario with real GDP growth at an average of 3.3%, leading to Slovenian government debt falling to 56.1% of GDP, under the Maastricht criterion of 60%, and ii) a stressed scenario, with growth falling to an average of 1.8% for 2017-2023, a reduced primary balance of 0.9% and an increase in real effective interest rates to 1.9%, which leads to a stabilisation of Slovenian debt at 70.4% of GDP in 2023.

Figure 4: Sources of debt generation



Source: Scope Ratings GmbH

Figure 5: Debt sustainability scenarios



Source: Scope Ratings GmbH

2017-2023 average	Real GDP growth (% change)	Primary balance (% of GDP)	Real eff. interest rate (%)	Debt end period (% of GDP)
Historic values (2013-2017)	2.5	-2.5	2.2	75.4 (2016)
IMF baseline	2.8	1.4	0.7	65.4 (2023)
Optimistic Scenario	3.3	1.4	0.8	56.1 (2023)
Stressed Scenario	1.8	0.9	1.9	70.4 (2023)

Source: Scope Ratings GmbH

I. Appendix: CVS and QS results

Scope's Core Variable Scorecard (CVS), which is based on relative rankings of key sovereign credit fundamentals, signals an indicative (a) rating range for the Slovenian sovereign. This indicative rating can be adjusted by the Qualitative Scorecard (QS) by up to three notches depending on the size of relative credit strengths or weaknesses versus peers based on analysts' qualitative findings. For the Republic of Slovenia, the QS signals relative credit weaknesses for a) the growth potential of the economy and ii) vulnerability to external shocks. The combined relative credit strengths and weaknesses generate a one-notch adjustment and indicate a sovereign rating of A- for the Republic of Slovenia.

Slovenia

CVS

Rating indicator	Category weight
Domestic economic risk	**35%**
Economic growth	
Real GDP growth	
Real GDP volatility	
GDP per capita	
Inflation rate	
Labour & population	
Unemployment rate	
Population growth	
Public finance risk	**30%**
Fiscal balance	
GG public balance	
GG primary balance	
GG gross financing needs	
Public debt	
GG net debt	
Interest payments	
External economic risk	**15%**
International position	
International investment position	
Importance of currency	
Current-account financing	
Current-account balance	
T-W effective exchange rate	
Total external debt	
Institutional and political risk	**10%**
Control of corruption	
Voice & accountability	
Rule of law	
Financial risk	**10%**
Non-performing loans	
Liquid assets	
Credit-to-GDP gap	
Indicative rating range	**a**
QS adjustment	**A-**
Final rating	**A-**

QS

Maximum adjustment = 3 notches

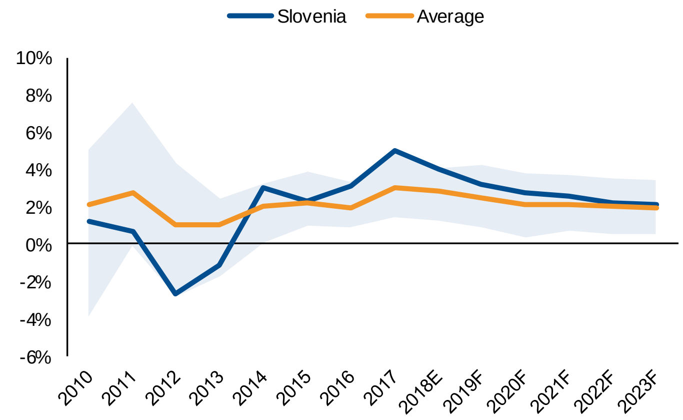
	+2 notch	+1 notch	0 notch	-1 notch	-2 notch
Growth potential of the economy	○ Excellent outlook, strong growth potential	○ Strong outlook, good growth potential	○ Neutral	● Weak outlook, growth potential under trend	○ Very weak outlook, growth potential well under trend or negative
Economic policy framework	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Macro-economic stability and sustainability	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Fiscal policy framework	○ Exceptionally strong performance	○ Strong performance	● Neutral	○ Weak performance	○ Problematic performance
Debt sustainability	○ Exceptionally strong sustainability	○ Strong sustainability	● Neutral	○ Weak sustainability	○ Not sustainable
Market access and funding sources	○ Excellent access	○ Very good access	● Neutral	○ Poor access	○ Very weak access
Current account vulnerability	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
External debt sustainability	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Vulnerability to short-term external shocks	○ Excellent resilience	○ Good resilience	○ Neutral	● Vulnerable to shocks	○ Strongly vulnerable to shocks
Perceived willingness to pay	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Recent events and policy decisions	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Geopolitical risk	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Financial sector performance	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Financial sector oversight and governance	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Financial imbalances and financial fragility	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate

* Implied QS notch adjustment = (QS notch adjustment for domestic economic risk)*0.35 + (QS notch adjustment for public finance risk)*0.30 + (QS notch adjustment for external economic risk)*0.15 + (QS notch adjustment for institutional and political risk)*0.10 + (QS notch adjustment for financial stability risk)*0.10

Source: Scope Ratings GmbH

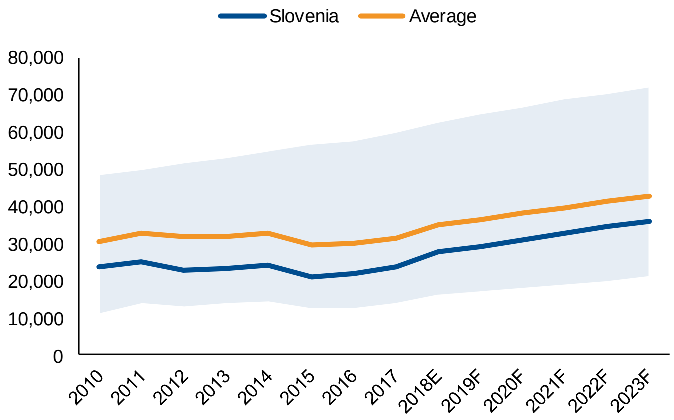
II. Appendix: Peer comparison

Figure 6: Real GDP growth



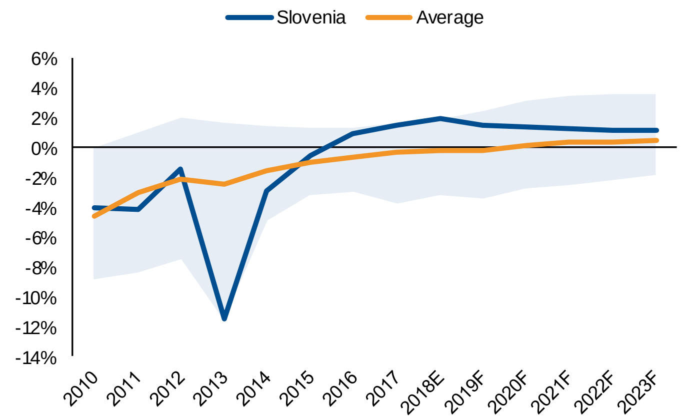
Source: IMF, calculations Scope Ratings GmbH

Figure 7: GDP per capita



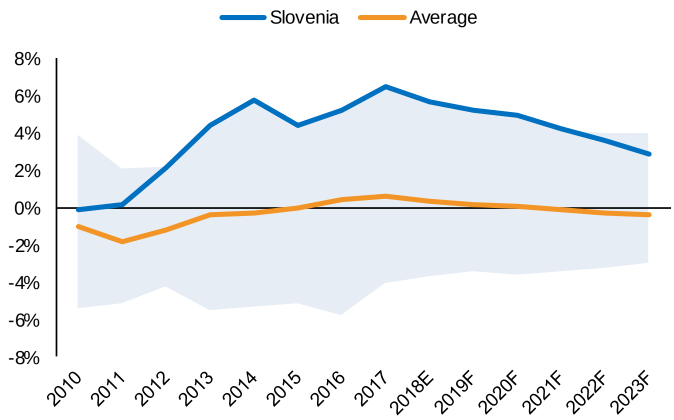
Source: IMF, calculations Scope Ratings GmbH

Figure 8: Primary balance



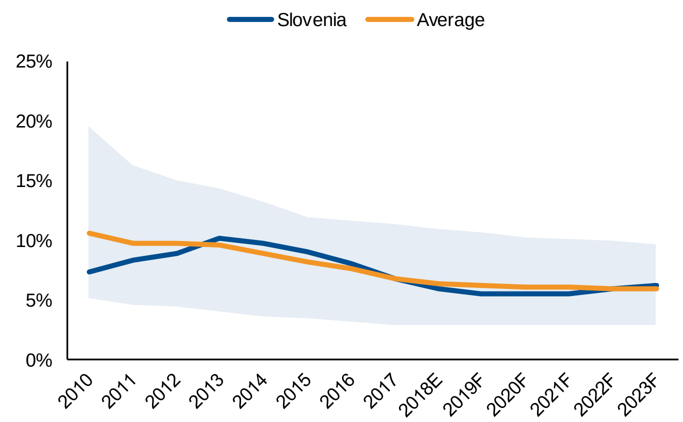
Source: IMF, Calculation Scope Ratings GmbH

Figure 9: Current account balance



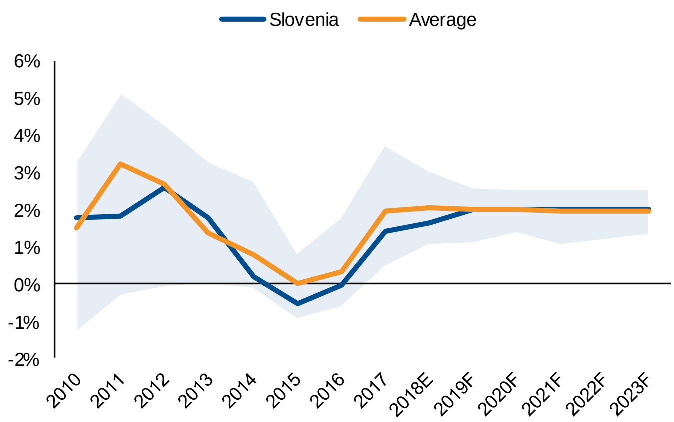
Source: IMF, Calculation Scope Ratings GmbH

Figure 10: Unemployment



Source: IMF, Calculations Scope Ratings GmbH

Figure 11: Inflation



Source: IMF, Calculations Scope Ratings GmbH

III. Appendix: Statistical tables

	2013	2014	2015	2016	2017	2018E	2019F
Economic performance							
Nominal GDP (EUR bn)	36.2	37.6	38.8	40.4	43.3	45.9	48.4
Population ('000s)	2,059.0	2,061.0	2,063.0	2,064.0	2,066.0	2,068.0	2,069.0
GDP per capita PPP (USD)	29,796.8	30,854.1	31,468.4	32,723.1	34,801.6	-	-
GDP per capita (EUR)	17,601.9	18,250.1	18,826.5	19,580.6	20,948.8	22,210.9	23,369.0
Real GDP, % change	-1.1	3.0	2.3	3.1	5.0	4.4	3.5
GDP growth volatility (10-year rolling SD)	4.4	4.3	4.3	4.0	3.7	3.8	2.4
CPI % change	1.8	0.2	-0.5	-0.1	1.4	1.7	2.0
Unemployment rate (%)	10.1	9.7	9.0	8.0	6.6	5.9	5.5
Investment (% of GDP)	19.5	19.6	19.4	18.7	19.3	20.1	20.6
Gross national savings (% of GDP)	23.9	25.4	23.7	23.9	25.8	25.8	25.8
Public finances							
Net lending/borrowing (% of GDP)	14.7	-5.5	-2.9	-1.9	0.0	0.8	0.5
Primary net lending/borrowing (% of GDP)	-12.1	-2.3	0.4	1.1	2.5	2.9	2.5
Revenue (% of GDP)	44.8	44.3	44.9	43.3	43.1	43.5	43.3
Expenditure (% of GDP)	59.9	49.9	47.7	45.3	43.1	42.7	42.8
Net interest payments (% of GDP)	2.6	3.2	3.2	3.0	2.5	2.1	2.0
Net interest payments (% of revenue)	5.5	7.1	6.8	6.9	6.0	4.9	4.6
Gross debt (% of GDP)	70.4	80.3	82.6	78.6	73.6	70.3	68.0
Net debt (% of GDP)	45.5	46.5	50.4	52.1	-	-	-
Gross debt (% of revenue)	157.0	181.2	184.0	181.3	170.8	160.3	155.6
External vulnerability							
Gross external debt (% of GDP)	114.9	125.7	120.1	110.9	101.2	-	-
Net external debt (% of GDP)	42.6	41.4	35.3	28.9	22.4	-	-
Current-account balance (% of GDP)	4.4	5.8	4.4	5.5	7.1	6.3	5.8
Trade balance [FOB] (% of GDP)	2.0	3.1	3.8	3.8	2.5	2.1	0.7
Net direct investment (% of GDP)	-0.1	-1.6	-3.3	-2.1	-1.0	-	-
Official forex reserves (EOP, mil EUR)	210.0	345.0	320.0	232.0	293.0	-	-
REER, % change	1.4	1.1	-1.9	0.5	-0.6	-	-
Nominal exchange rate (EOP, USD/EUR)	1.4	1.2	1.1	1.1	1.2	-	-
Financial stability							
Non-performing loans (% of total loans)	13.4	11.9	9.9	5.5	3.6	-	-
Tier 1 ratio (%)	12.9	17.1	18.0	18.5	17.7	-	-
Consolidated private debt (% of GDP)	107.2	97.3	86.8	80.4	74.9	-	-
Domestic credit-to-GDP gap (%)	-23.6	-29.5	-34.5	-33.8	-29.8	-	-

Source: IMF, European Commission, European Central Bank, Bank of Slovenia, World Bank, Haver Analytics, Scope Ratings

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