The Slovak Republic Rating Report

STABLE OUTLOOK
A+

Credit strengths

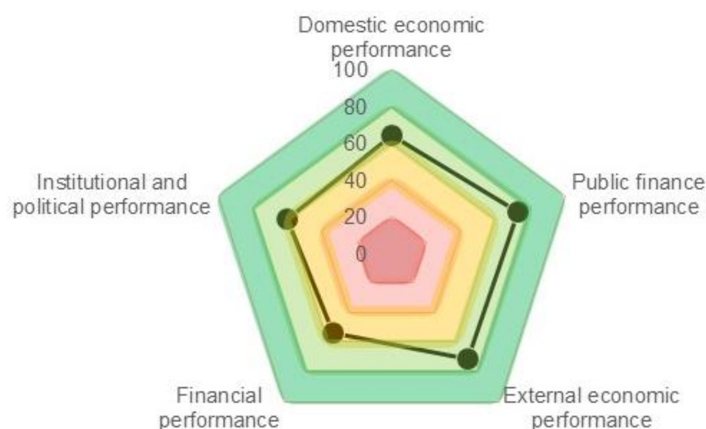
- Euro area membership
- Robust economic performance
- Moderate levels of indebtedness
- Commitment to fiscal consolidation

Credit weaknesses

- Adverse demographic trends
- Strong regional disparities
- Labour market rigidities

Rating rationale and Outlook: Slovakia's A+ rating is underpinned by the country's euro area membership, robust economic growth and commitment to fiscal consolidation. Slovakia's public-debt dynamics are adequate, supported by a moderate public debt stock of 52% of GDP in 2016, favourable financing conditions and supportive growth rates. However, adverse demographics pose a challenge. Broad regional disparities between the Bratislava region and eastern/central regions, a segregated labour market and shortages of skilled labour negatively affect growth potential. The Stable Outlook reflects Scope's assessment that the challenges faced by Slovakia are broadly balanced.

Figure 1: Sovereign rating categories summary



Positive rating-change drivers

- Increasing growth potential via implementation of structural reforms
- Further fiscal consolidation

Negative rating-change drivers

- Policy reversal weighing on investor sentiment
- Sharp deterioration in growth outlook
- Weakening fiscal consolidation effort

Ratings and outlook

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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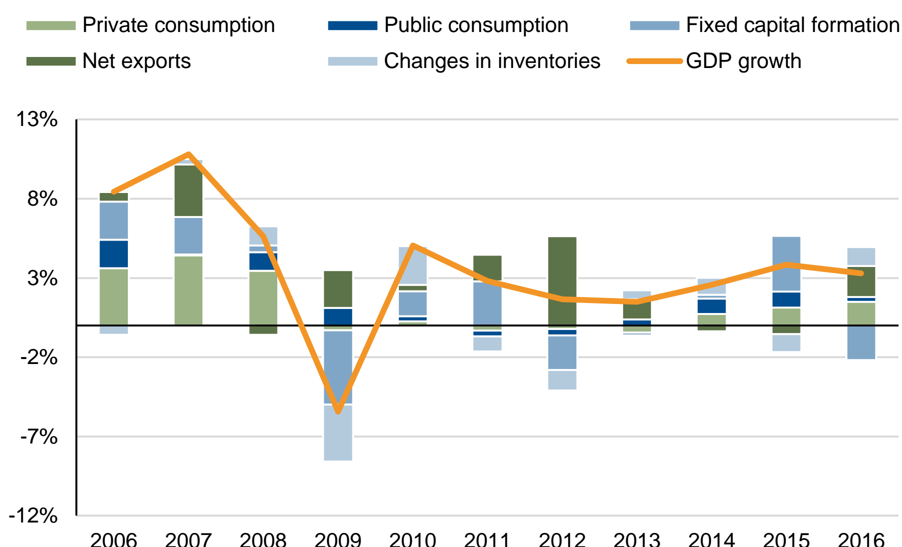
Bloomberg: SCOP

Domestic economic risk

Strong economic growth despite broad regional disparities

Slovakia is one of the fastest-growing economies in the EU. Slovakia's GDP growth, which has picked up since 2014 with the support of a high absorption of EU funds during the 2007-2013 programming period, remained strong in 2016 at 3.3%. The main driver of this growth has been private consumption buoyed by favourable labour market developments and a rise in household disposable income. Supportive financial conditions backed by the ECB's accommodative stance have also contributed via private-sector credit growth. Scope expects Slovakia's GDP to continue growing strongly in 2017 and 2018, by 3.3% and 3.7% respectively, due to strong private consumption alongside investments in the automotive industry. Developments in key trading partners in Europe (e.g. the Volkswagen emissions scandal in Germany) alongside the United Kingdom's exit from the EU increase uncertainty in the medium-term outlook.

Figure 2: Percentage point contribution to real GDP growth



Source: National Bank of Slovakia, Calculations Scope Ratings AG

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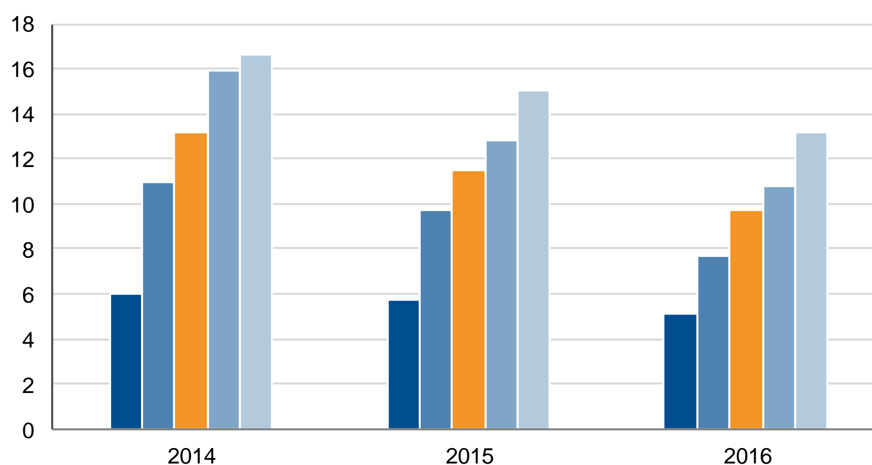
Slovakia's economy is deeply embedded within global supply chains through its competitive automotive and electronics industries. Currently, the country is home to four car manufacturers: Volkswagen, Peugeot-Citroën, Kia, and Jaguar Land Rover (the latter entered the market in 2016). Car production makes up around 40% of industrial product and one-third of overall exports.

Productivity growth in manufacturing helped the average income in Slovakia converge towards that of the EU, with real GDP per capita rising to 77% of the EU average in 2016 from 57% as of 2004, when Slovakia joined the EU. However, since 2011, the economy has witnessed some slowdown in productivity growth. In Q1 2017, labour productivity per hour worked remained unchanged relative to Q1 2016.

Labour market conditions have steadily improved with the unemployment rate falling under 10% in 2016, representing a 4.5 percentage point improvement from 2013. Scope expects the unemployment rate to decline further in the near term, reaching 7.4% in 2018. However, a segregated labour market, relatively weak labour mobility and skilled labour shortages (particularly in manufacturing) pose material challenges.

Figure 3: Regional unemployment rates (%)



Source: Eurostat

Segregated labour market, but reforms underway

Regional disparities between the Bratislava region and eastern/central regions, where employment rates and per-capita incomes are much lower, remain a central issue. These disparities are the result of less-developed infrastructure alongside lower educational attainment in these areas, which negatively affect growth potential and have centralised investment in the Bratislava region.

Despite recent favourable adjustments in the labour market and a steady downward trajectory in the long-term unemployment rate since a peak in late 2013, the latter remains one of the highest in the EU at 5.4% as of Q4 2016 (EU average: 3.8%). The eastern and central areas of Slovakia are the most underrepresented in the labour market, with low participation rates and high long-term unemployment among the young. Recognising this, Slovakia's government has launched numerous labour market measures to tackle these issues, including the Law on Support of Lagging Regions (Act No. 336/2015 Coll.) to bolster regional development. Initially, this law focuses on 12 of the 79 districts with the highest unemployment rates.

Scope notes that Slovakia is meeting or making substantial progress towards meeting Europe 2020[1] objectives on employment, R&D intensity, and renewable energy use. However, the mismatch between labour supply and the specific needs of the car industry continues to constrain economic potential. One reason for this mismatch is the weak link between the education system and labour market demands.

Slovakia is a major beneficiary of EU funds, and is expected to receive up to EUR 15.3 bn by 2020 from the European Structural and Investment Funds.

[1] The European Union's ten-year jobs and growth strategy, launched in 2010.

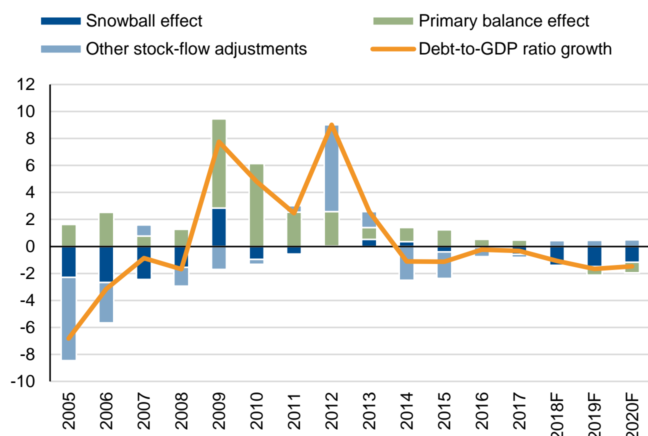
Public finance risk

Slovakia has progressed with its fiscal consolidation. The headline fiscal deficit fell to 1.7% of GDP in 2016, a 1 pp improvement over the previous year (the primary balance improved to 0.0% of GDP from -1.0% in 2015). The improvement was mostly driven by a reduction in expenditure, reflecting the drop in capital spending at the end of the EU programming period as well as savings in interest expenses. On the revenue side, labour market improvements have helped to increase personal income tax and social contribution collections. In addition, corporate tax collections have improved. Scope expects the headline deficit to further decrease to 0.6% of GDP by 2018 supported by budget consolidation including revenue-enhancing measures like a higher levy on regulated business and tobacco and a new levy on some insurance policies. Furthermore, the government has launched a 'value for money' venture aimed at examining and improving efficiency of government spending in transport, healthcare and IT. The second review of this initiative will cover education, environment, labour market and social policies.

Scope assesses Slovakia's fiscal space as adequate underpinned by moderate indebtedness. However, broadening the tax base through more progressive property taxation (to be based on market value rather than surface area) and raising environmental tax collection would provide further fiscal space.

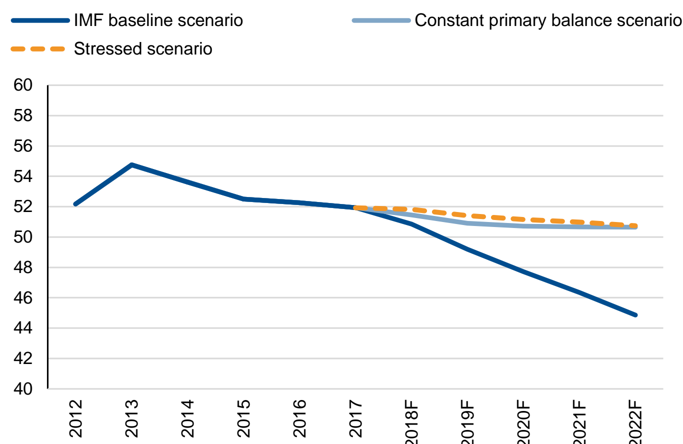
Despite progress on tax administration and reduction of tax fraud (the percentage of companies with no corporate income tax liability declined from 59% in 2013 to 6% in 2015[2]), the VAT gap (measured as the difference between VAT collected and total VAT liabilities) remained the fourth-highest in the EU at 30% or EUR 2.2bn, suggesting specific challenges to tax compliance remain.

Figure 4: Contribution to gov't debt changes, % of GDP



Source: IMF, Calculations Scope Ratings AG

Figure 5: Government debt, % of GDP



Source: Calculations Scope Ratings AG

Challenges to debt sustainability from adverse demographic trends

Scope assesses Slovakia's public-debt dynamics as adequate, the result of relative robustness across several plausible scenarios over the projection period to 2022 (Figure 5). In 2016, gross debt as a share of GDP stood at around 52%, well under the Maastricht criterion. Scope expects the ratio to steadily decrease over the medium term, to around 45% by 2022, supported by robust economic growth and favourable financing costs. The current level of public debt is slightly over a national limit of 50% of GDP (set by the Fiscal Responsibility Act (FRA)), but within a 'tolerance' band of up to 55%.

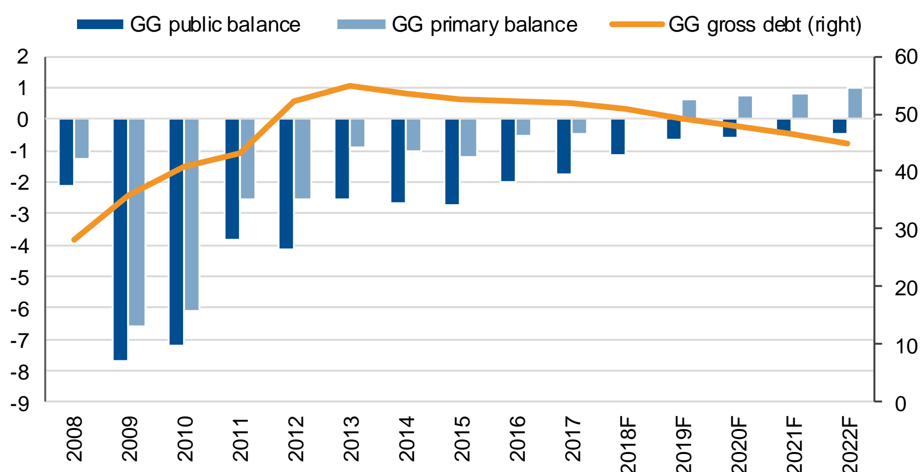
[2] European Commission, Country Report February 2017, p.14.

Presently, authorities are considering revisions to the FRA that include a shift of debt ceilings from a gross to a net debt basis and support for higher infrastructure spending to reduce regional disparities. These revisions will provide fiscal space, more flexible debt management, and some modernisation to fiscal policy in the face of adverse demographic trends.

Slovakia benefits from a favourable debt structure reflected in an increasing average maturity (the weighted average maturity of debt stood at 7 years at the end of 2016 compared to 6.7 years at the end of 2015), which mitigates potential refinancing risks. The debt is mainly in local currency, with only around 6% in foreign currency. Securities make up 85.3% of total debt, with only 13.9% of debt in the form of loans.

Long-term challenges to debt sustainability remain due to adverse demographics. According to the European Commission's 2015 Ageing Report, the old-age dependency ratio is projected to increase by circa 47% between 2013 and 2060, the fastest such increase in the EU. The share of people aged 65 or above is anticipated to nearly triple, from 13% in 2013 to 35% by 2060. Since 2012, however, the government has undertaken significant reforms to the pension system, including indexing pension hikes to consumer prices and linking the retirement age to life expectancy.

Figure 6: Evolution in gross public debt and budget balance, % of GDP



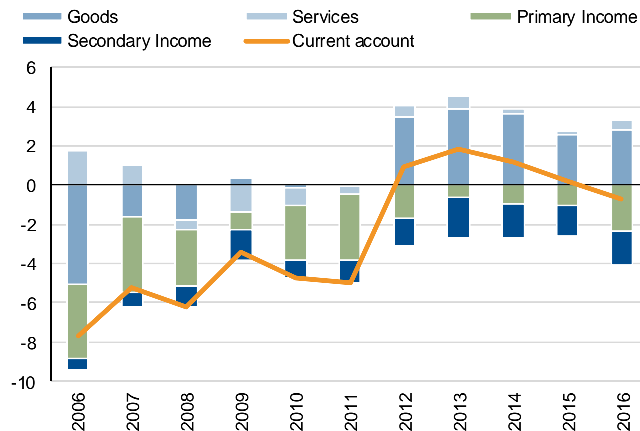
Source: IMF

External economic risk

Deep integration in global supply chains

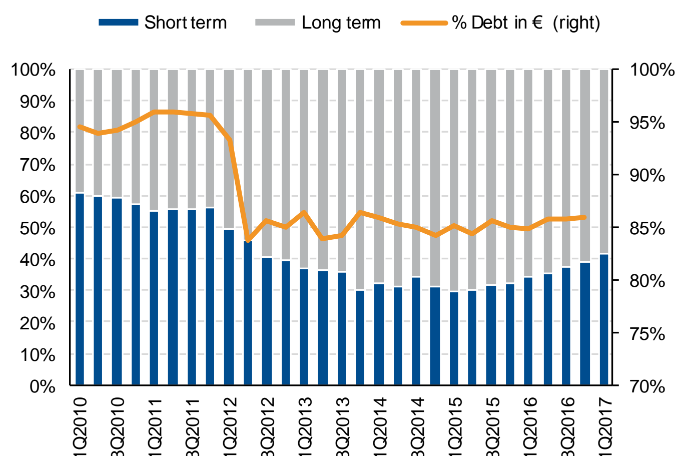
As a small, open economy that is concentrated in the automotive industry, Slovakia is reliant on external demand and vulnerable to external shocks. The country is deeply integrated with both central and western European countries. The openness of the economy, measured by total exports and imports as a percentage of GDP, stood at around 184% in 2016.

Figure 7: Composition of current account balance, % of GDP



Source: Eurostat, Calculations Scope Ratings AG

Figure 8: Breakdown of external debt



Source: National Bank of Slovakia, World Bank, Calculations Scope Ratings AG

Slovakia's current account balance moved into deficit last year for the first time since 2012, at -0.7% of GDP. This was partly driven by a widening of the primary income deficit, due to a worsening of the investment income balance (to around EUR 0.5bn).

The year-on-year depreciation in the real effective exchange rate (REER) amounted to -0.8% in Q2 2017. Scope expects the decline in the REER to support the price competitiveness of domestic producers, bolstering overall export growth in the medium term.

Gross external debt stood at 95% of GDP in Q1 2017, around 10 pp higher than the figure as of Q1 2016. Nonetheless, the ratio is materially under the euro area average of 127% of GDP. Slovakia's external debt is mainly in local currency, with only around 14% of it in foreign currency, bolstering resilience to external shocks.

The net international investment position stood at -57.6% of GDP in 2016, worse than an EU average of +32.3%, reflecting a relatively high dependence on foreign capital inflows. However, almost half of these liabilities are foreign direct investments, which are less prone to flight in times of market volatility.

Financial stability risk

Healthy and well-capitalised banking sector

Slovakia benefits from a healthy and well-capitalised banking sector. The share of non-performing loans in total loans has declined since 2014, standing at 4.4% as of 2016, lower than the Visegrád Group[3] average. According to the National Bank of Slovakia (NBS)'s annual report, bank reserve holdings at the central bank were 2.7 times higher than the reserve requirement in 2016. The credit to GDP gap[4] stood at -3.4%, 0.5% higher compared to in the previous year. This is driven by strong private-sector credit growth, reflecting the financial deepening of the market. The gross debt-to-income ratio of households has continued to increase but remained well under a euro area average (of 93.5%) in 2016.

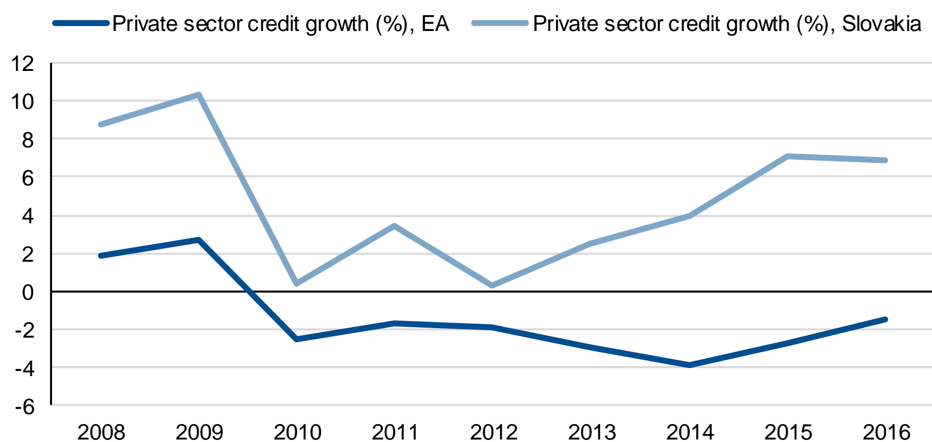
[3] Visegrád Group is a cultural and political alliance of four Central European states – the Czech Republic, Hungary, Poland and Slovakia.
[4] Credit-to-GDP gap is defined as the difference between the credit-to-GDP ratio and its long-run trend. Credit-to-GDP gap could serve as an early-warning indicator for a banking crisis. It points to the build-up of financial vulnerabilities within the economy.

Although the banking sector remains stable, profit growth has declined, partly driven by the extension of a 0.2% bank levy on total receipts exceeding EUR 750m until 2020 and weak net interest income due to the low interest rate environment.

Low mortgage rates for households drove an increase in house prices, with year on year increases at 7% in 2016. While house prices remain below pre-crisis levels, the increase in highly leveraged mortgage loans, with around 90% loan-to-value ratios for new borrowers, is a concern.

To tackle the risk of a credit bubble stemming from household credit, the NBS issued several macroprudential policy measures. Most importantly, it raised the counter-cyclical capital buffer to 0.5%, effective 1 August 2017. All major banks in Slovakia are supervised directly by the ECB though the Single Supervisory Mechanism.

Figure 9: Growth in domestic credit to the private sector



Source: WB, Calculations Scope Ratings AG

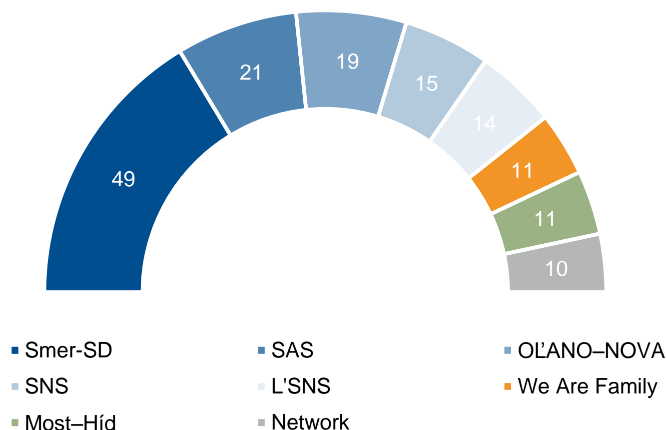
Institutional and political risk

Recent elections followed with new political uncertainty

Slovakia's centre-left governing party (Direction – Social Democracy (Smer-SD)) under Prime Minister Robert Fico lost its parliamentary majority in elections on 5 March 2016. Smer-SD’s seats fell to 49, from 83 in the 2012 election. The number of parties represented in Parliament increased from six to eight, including the extreme-right Kotleba – People’s Party Our Slovakia (L'SNS) led by Marian Kotleba. Though risks to political stability in Slovakia remain low, some intra-coalition disputes and regional elections scheduled in November could weaken the present multi-party coalition made up of Smer-SD, the conservative Slovak National Party (SNS) and centre-right parties Network and Most–Híd, potentially leading to new elections.

Scope expects the present government to continue similar policies to those of the previous government. The government’s agenda includes plans to improve public administration, modernise justice and tax collection systems, address issues in the efficiency of healthcare provision, and implement pension reforms. Nevertheless, administrative and regulatory barriers to business and public procurement, alongside government transparency, remain challenges.

Figure 10: Slovak parliamentary election result, 5 March 2016, seats



Source: Voľby

Methodology

The methodology applicable for this rating and/or rating outlook, 'Public Finance Sovereign Ratings', is available at www.scoperatings.com.

The historical default rates used by Scope Ratings can be viewed in the rating performance report on https://www.scoperatings.com/governance-and-policies/regulatory/esma-registration.

Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

A comprehensive clarification of Scope's definition of default and definitions of rating notations can be found in Scope's public credit rating methodologies at www.scoperatings.com.

The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months. A rating change is, however, not automatically ensured.

I. Appendix: CVS and QS results

Sovereign rating scorecards

Scope's Core Variable Scorecard (CVS), which is based on relative rankings of key sovereign credit fundamentals, signals an indicative "A" ("a") rating range for the Slovak Republic. This indicative rating range 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 analysis.

For Slovakia, the QS signals relative credit strengths for the following analytical categories: i) growth potential of the economy; ii) market access and funding sources. Relative credit weaknesses are not indicated. Combined relative credit strengths and weaknesses generate an upward adjustment and signal an A+ sovereign rating for Slovakia. The results have been discussed and confirmed by a rating committee.

Rating overview	
CVS category rating range	a
QS adjustment	A+
Final rating	A+

To calculate the rating score within the CVS, Scope uses a minimum-maximum algorithm to determine a rating score for each of the 22 indicators. Scope calculates the minimum and maximum of each rating indicator and places each sovereign within this range. Sovereigns with the strongest results for each rating indicator receive the highest rating score; sovereigns with the weakest results receive the lowest rating score. The score result translates to an indicative rating range that is always presented in lower case.

Within the QS assessment, analysts conduct a comprehensive review of the qualitative factors. This includes but is not limited to economic scenario analysis, review of debt sustainability, fiscal and financial performance, and policy implementation assessments.

There are three assessments per category for a total of 15. For each assessment, the analyst examines the relative position of a given sovereign within its peer group. For this purpose, additional comparative analysis beyond the variables included in the CVS is conducted. These assessments are then aggregated using the same weighting system as in the CVS.

The result is the implied QS notch adjustment, which is the basis for the analysts' recommendation to the rating committee.

Foreign- versus local-currency ratings

Slovakia's debt is predominantly issued in euros. Because of its history of openness to trade and capital flows, and the euro's reserve currency status, Scope sees no evidence that Slovakia would differentiate among any of its contractual debt obligations based on currency denomination.

II. Appendix: CVS and QS results

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

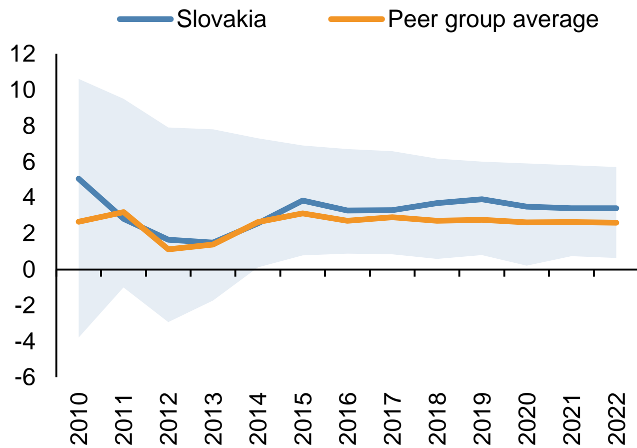
	+2 notch	+1 notch	0 notch	-1 notch	-2 notch
Growth potential of the economy	○ Excellent outlook, strong growth potential	● Strong outlook, good growth potential	○ Neutral	○ Weak outlook, growth potential under trend	○ Very weak outlook, growth potential wel under trend or negative
Economic policy framework	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Macroeconomic stability and imbalances	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Fiscal performance	○ 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 vulnerabilities	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
External debt sustainability	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Vulnerability to short-term shocks	○ Excellent resilience	○ Good resilience	● Neutral	○ Vulnerable to shock	○ Strongly vulnerable to shocks
Perceived willingness to pay	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Recent events and policy decisions	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Geo-political risk	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Financial sector performance	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Financial sector oversight and governance	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Macro-financial vulnerabilities and 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 AG

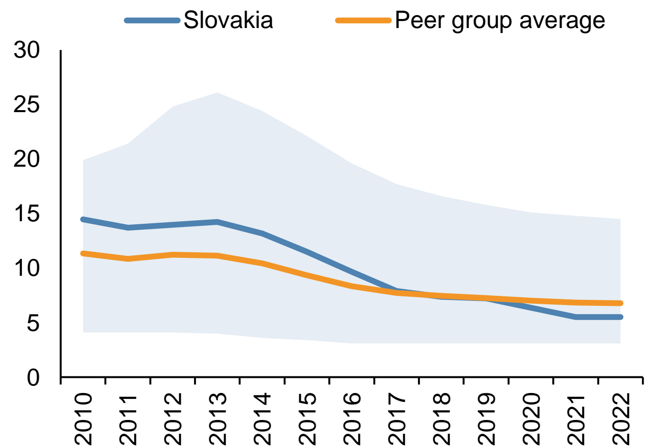
III. Appendix: Peer comparison

Figure 11: Real GDP growth



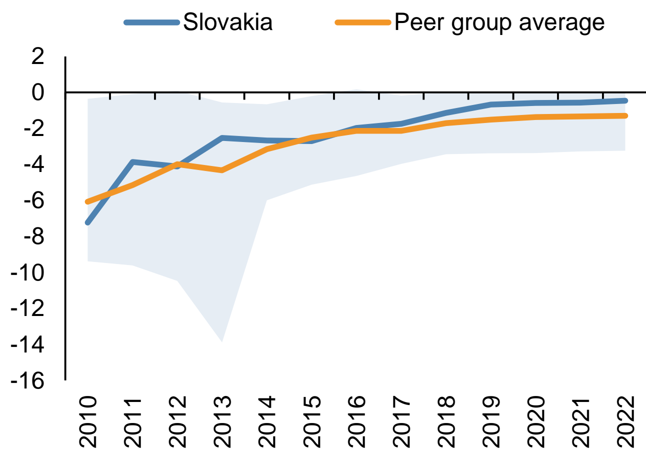
Source: IMF, Calculations Scope Ratings AG

Figure 12: Unemployment rate, % of total labour force



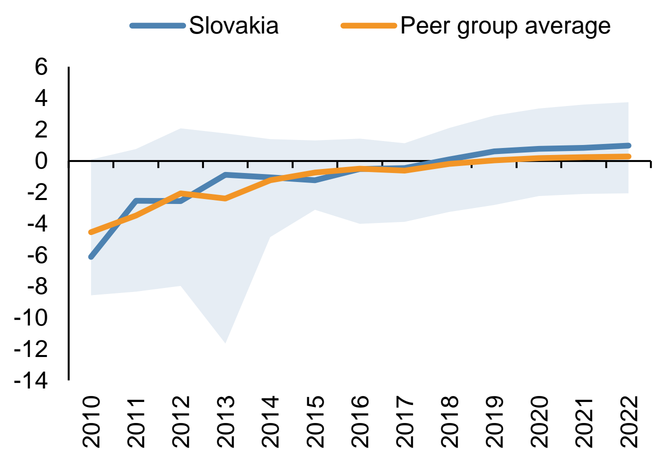
Source: IMF, Calculations Scope Ratings AG

Figure 13: General government balance, % of GDP



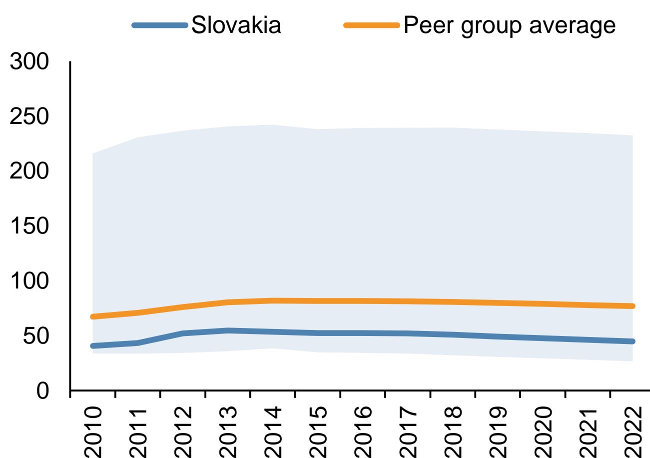
Source: IMF, Calculations Scope Ratings AG

Figure 14: General government primary balance, % of GDP



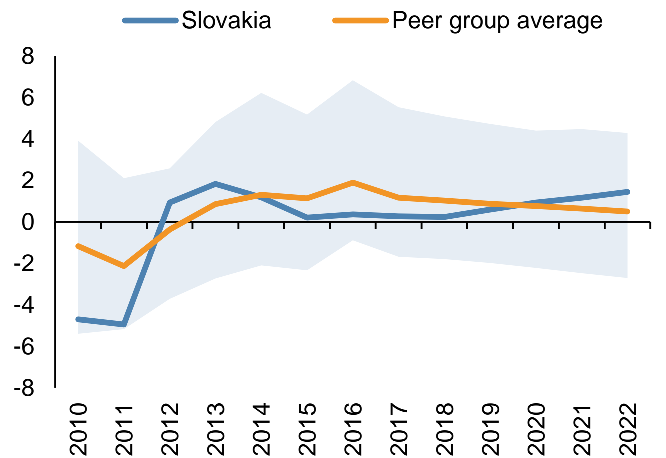
Source: IMF, Calculations Scope Ratings AG

Figure 15: General government gross debt, % of GDP



Source: IMF, Calculations Scope Ratings AG

Figure 16: Current account balance, % of GDP



Source: IMF, Calculations Scope Ratings AG

IV. Appendix: Statistical tables

	2012	2013	2014	2015	2016	2017E	2018F
Economic performance							
Nominal GDP (Bil.EUR)	72.7	74.2	75.9	78.7	81.0	83.9	88.3
Population (thous)	5,417.1	5,425.1	5,432.8	5,439.3	5,444.2	5,447.7	5,449.8
GDP-per-capita PPP (USD)	26,647.4	27,897.6	29,020.1	29,907.1	30,632.0	-	-
GDP per Capita (EUR)	13,452.9	13,707.7	14,022.7	14,514.0	14,919.7	15,449.5	16,250.4
Real GDP growth	1.7	1.5	2.6	3.8	3.3	3.3	3.7
GDP growth volatility (10-year rolling SD)	4.4	4.5	4.5	4.4	4.1	3.1	2.9
CPI, % change	3.73	1.46	-0.10	-0.34	-0.47	1.24	1.52
Unemployment rate (%)	14.0	14.2	13.2	11.5	9.7	7.9	7.4
Investment (% of GDP)	20.9	21.0	21.7	23.2	21.5	22.5	23.2
Gross national savings (% of GDP)	21.9	22.8	22.9	23.4	21.9	22.8	23.5
Public finances							
Net lending/borrowing (% of GDP)	-4.3	-2.7	-2.7	-2.7	-1.7	-1.3	-0.6
Primary net lending/borrowing (% of GDP)	-2.6	-0.8	-0.8	-1.0	0.0	0.1	0.8
Revenue (% of GDP)	36.3	38.7	39.3	42.8	40.0	40.3	40.8
Expenditure (% of GDP)	40.6	41.4	42.0	45.6	41.6	41.6	41.3
Interest payments (% of GDP)	1.8	1.9	1.9	1.8	1.7	1.4	1.3
Interest payments (% of revenue)	4.9	4.8	4.8	4.1	4.1	3.5	3.3
Gross debt (% of GDP)	52.2	54.7	53.6	52.5	52.3	51.9	50.9
Net debt (% of GDP)	-	-	-	-	-	-	-
Gross debt (% of revenue)	143.8	141.4	136.4	122.6	130.8	129.0	124.7
External vulnerability							
Gross external debt (% of GDP)	75.5	82.1	90.2	85.4	91.1	-	-
Net external debt (% of GDP)	22.3	23.9	27.5	27.3	26.0	-	-
Current account balance (% of GDP)	0.9	1.9	1.1	0.2	-0.7	0.1	0.3
Trade balance [FOB] (% of GDP)	-	3.7	3.4	2.3	3.0	2.5	2.7
Net direct investment (% of GDP)	-3.2	0.3	0.6	0.0	0.6	-	-
Official Forex Reserves (EOP, Mil.USD)	17.2	54.3	652.1	1,191.6	1,264.9	-	-
REER, % change	0.1%	0.9%	0.2%	-1.8%	0.5%	-	-
Nominal Exchange Rate (EOP, USD/EUR)	1.32	1.38	1.21	1.09	1.05	-	-
Financial stability							
Non-performing loans (% of total loans)	5.2	5.1	5.3	4.9	4.4	-	-
Tier 1 ratio (%)	14.9	16.2	16.0	16.5	16.2	-	-
Consolidated private debt (% of GDP)	70.6	74.0	77.6	81.4	-	-	-
Domestic credit-to-GDP gap (%)	-8.4	-4.3	-1.3	-3.9	-3.4	-	-

Source: IMF, European Commission, European Central Bank, World Bank, United Nations, Scope Ratings AG

V. Regulatory disclosures

This credit rating and/or rating outlook is issued by Scope Ratings AG.

Rating prepared by John Francis Opie, Lead Analyst

Person responsible for approval of the rating: Dr Giacomo Barisone, Managing Director

The ratings/outlook were first assigned by Scope as a subscription rating in January 2003. The subscription ratings/outlooks were last updated on 05.05.2017.

The senior unsecured debt ratings as well as the short-term issuer ratings were assigned by Scope for the first time.

As a "sovereign rating" (as defined in EU CRA Regulation 1060/2009 "EU CRA Regulation"), the ratings on the Slovak Republic are subject to certain publication restrictions set out in Art 8a of the EU CRA Regulation, including publication in accordance with a pre-established calendar (see "Sovereign Ratings Calendar of 2017" published on 21.07.2017 on www.scoperatings.com). Under the EU CRA Regulation, deviations from the announced calendar are allowed only in limited circumstances and must be accompanied by a detailed explanation of the reasons for the deviation. In this case, the deviation was due to the recent revision of Scope’s Sovereign Rating Methodology and the subsequent placement of ratings under review, in order to conclude the review and disclose ratings in a timely manner, as required by Article 10(1) of the CRA Regulation.

Rating Committee: the main points discussed were: (1) the Slovak Republic’s growth potential, (2) macroeconomic stability and imbalances, (3) fiscal performance, (4) public debt sustainability, (5) debt brake mechanism, (6) market access and funding sources, (7) recent political developments, (8) peers consideration.

Solicitation, key sources and quality of information

The rating was initiated by Scope and was not requested by the rated entity or its agents. The rated entity and/or its agents did not participate in the ratings process. Scope had no access to accounts, management and/or other relevant internal documents for the rated entity or related third party.

The following material sources of information were used to prepare the credit rating: public domain and third parties. Key sources of information for the rating include: National Bank of Slovakia, Statistical Office of the Slovak Republic, European Commission, Eurostat, ECB, IMF, WB and Haver Analytics.

Scope considers the quality of information available to Scope on the rated entity or instrument to be satisfactory. The information and data supporting Scope’s ratings originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data.

Prior to publication, the rated entity was given the opportunity to review the rating and/or outlook and the principal grounds upon which the credit rating and/or outlook is based. Following that review, the rating was not amended before being issued.

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