Republic of Slovakia
Rating Report

A+ NEGATIVE OUTLOOK

Credit strengths

- EU and euro area memberships
- Strong fiscal framework; moderate debt
- Competitive export-oriented industry

Credit challenges

- Weakening energy security
- External vulnerabilities
- Unfavourable demographics

Rating rationale:

Core euro area member: Slovakia benefits from leeway to cope with external shocks given its institutional strengths, supported by its EU and euro area memberships. The EU Recovery and Resilience Plan contributes to create buffers and to tackle long term challenges.

Strong fiscal framework: Slovakia's strong budgetary framework, as well as moderate public debt levels and favorable dynamic, constitute key credit strengths.

Competitive export-oriented industry: Slovakia has a competitive export-oriented industrial base, anchored by foreign direct investment inflows, among which the automotive industry.

Rating challenges include: i) over-reliance on Russia's energy calling for a swift diversification of supply; ii) high exposure to external demand and global value chains, mostly through the automotive industry; and iii) debt sustainability challenges compounded by adverse demographic trends.

Slovakia's sovereign rating drivers

Risk pillars		Quantitative		Reserve currency	Qualitative*	Final rating
		Weight	Indicative rating	Notches	Notches	
Domestic Economic Risk		35%	bbb	EUR [+1]	-1/3	A+
Public Finance Risk		20%	a		+2/3	
External Economic Risk		10%	ccc		+2/3	
Financial Stability Risk		10%	aaa		+2/3	
ESG Risk	Environmental Risk	5%	a+		0	
	Social Risk	7.5%	bbb+		0	
	Governance Risk	12.5%	bbb		0	
Indicative outcome			**a-**		**+2**	
Additional considerations					**0**	

Note: *The qualitative scorecard adjustments, capped at one notch per rating pillar, are weighted equally with an aggregate adjustment rounded to the nearest integer. The reserve currency adjustment applies to currencies in the IMF's SDR basket. For details, please see Scope's 'Sovereign Ratings' methodology. Source: Scope Ratings.

Outlook and rating triggers

The Negative Outlook represents Scope's view that risks to the ratings are tilted to the downside.

Positive rating-change drivers

- Swift diversification of energy supply and/or larger-than-anticipated EU solidarity mechanisms leads to a sustained, stronger-than-anticipated economic growth
- Sustained fiscal consolidation enables to reduce public debt to GDP beyond current expectations

Negative rating-change drivers

- Major energy rationing and/or weakening of external demand leads to an economic slowdown larger than currently projected
- Lower revenues and/or greater-than-anticipated fiscal loosening leads to a material deterioration of the fiscal trajectory and higher debt ratios
- Rise in political uncertainty leads to a policy shift and/or delays in the reform agenda vis a vis milestones attached to EU funding

Ratings and Outlook

Foreign currency

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

Local currency

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

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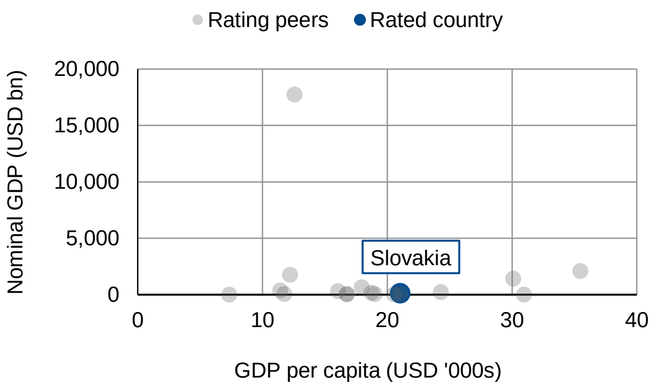
Domestic Economic Risks

- **Growth outlook:** GDP growth rate is expected to decline at 1.8% in 2022 (3.0% in 2021) and 0.5% in 2023 as energy security concerns and inflation take a toll on private demand. Domestic economic activity would also suffer from the sharp slowdown of the European Union, accounting for 78% of Slovakia's total exports. In the longer run, persistent energy supply disruptions affecting energy-intensive industries could lead to permanent output losses that would reduce Slovakia's potential GDP growth that is currently estimated at 3% per year.
- **Inflation and monetary policy:** Inflation rose to 14.2% YoY in September 2022 – a record high over the past two decades. It is expected to increase to about 12% in 2022 and peak at around 15% in 2023, or one the highest in the euro area and Central and Eastern Europe. Government measures concerning gas and electricity prices should help to bring inflation down, alongside lower GDP growth, although Slovakia's high exposure to commodity price volatility would likely make the decline in inflation very gradual.
- **Labour markets:** Unemployment rate stood at 6.1% in Q2 2022, which is close to pre-Covid level (around 5%). Still, this trend is unlikely to persist in the near-term, with the unemployment rate expected to hover around 6.5% to 7%, because of the sharp deterioration of the economic outlook. However, skills mismatches and labor shortages could somewhat contain the rise in unemployment.

Overview of Scope's qualitative assessments for Slovakia's *Domestic Economic Risks*

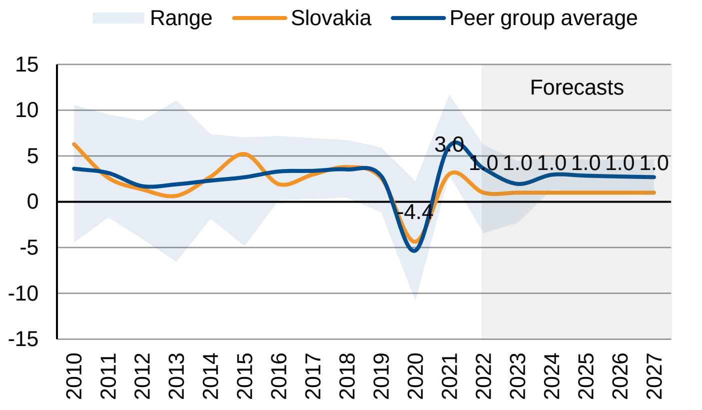
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb	Growth potential of the economy	Neutral	0	Medium-run growth potential in line with peer average, but moderate productivity growth
	Monetary policy framework	Neutral	0	ECB is a highly credible and effective central bank; effective policy framework and transmission over the cycle
	Macro-economic stability and sustainability	Weak	-1/3	Rising energy supply risks; competitive manufacturing industry but challenges for medium-term dynamics in automotive production

Nominal GDP and GDP per capita, USD



Source: IMF World Economic Outlook (WEO), Scope Ratings

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

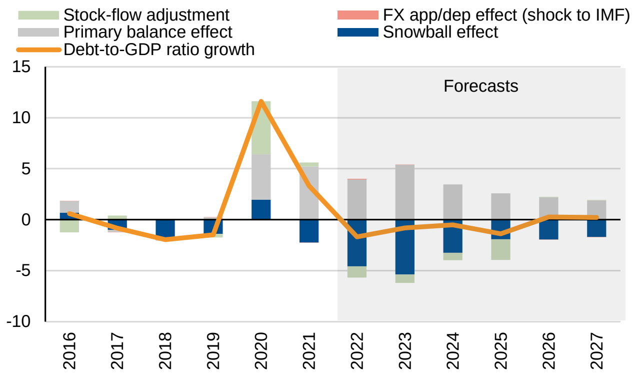
Public Finance Risks

- **Fiscal outlook:** The fiscal deficit is projected at 4.9% of GDP in 2022 and 6.4% in 2023 (-3.2pps compared to the previous estimate) as the inflation aid package is estimated at 1% of GDP in 2023. Those projections are less favorable than the medium-term fiscal consolidation strategy detailed into the Stability Programme in April 2022, which foresees a rapid reduction of the fiscal deficit from 5.1% in 2022 to 2.1% of GDP in 2025. In the longer run, sustained implications of the energy crisis and/or delays on the structural reform agenda would weigh on the fiscal deficit. Still, Slovakia's fiscal framework should enable to reduce the deficit below 3% of GDP by 2027.
- **Debt trajectory:** The general government debt is forecasted to decline from 63.1% of GDP in 2021 to below 60% of GDP by 2027. This is about 3pps of GDP above the previous projections, but still a modest level compared to the euro area average (around 95% of GDP). This gives to the government room of manoeuvre to cope with the energy crisis and long-term public investments. Reforms enhancing the Slovakia's fiscal framework, via the introduction of multi-annual expenditure ceilings, should also enable to reduce public debt in a baseline scenario.
- **Debt profile and market access:** Slovakia benefits from challenging but still fair financing conditions compared to non-euro area countries, with 10-year yields trading at 3.5% against 10.3% for Hungary and 7.9% for Poland. Slovakia also benefits from a supportive debt profile with the ECB holding nearly half of outstanding government securities. The average maturity of the public debt is relatively high (+8 years) and almost all debt carries a fixed coupon and is denominated in euro. Public gross financing needs are estimated at EUR 10bn in 2023 (around EUR 7bn in 2022), among which about EUR 4.5bn of bond amortisation.

Overview of Scope's qualitative assessments for Slovakia's *Public Finance Risks*

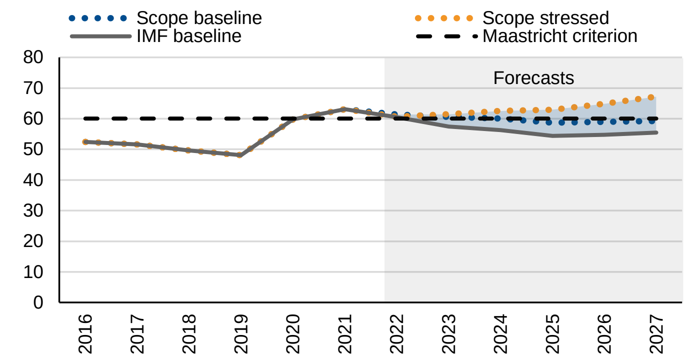
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a	Fiscal policy framework	Strong	+1/3	Credible and flexible constitutional budgetary framework, recently strengthened
	Debt sustainability	Neutral	0	Favourable debt levels and dynamic, although vulnerable to long term demographic trends in a no-policy change scenario
	Debt profile and market access	Strong	+1/3	Favourable debt structure, and significant debt holdings by the ECB

Contributions to changes in debt levels, pps of GDP



Source: IMF WEO, Scope Ratings forecasts

Debt-to-GDP forecasts, % of GDP



Source: IMF WEO, Scope Ratings forecasts

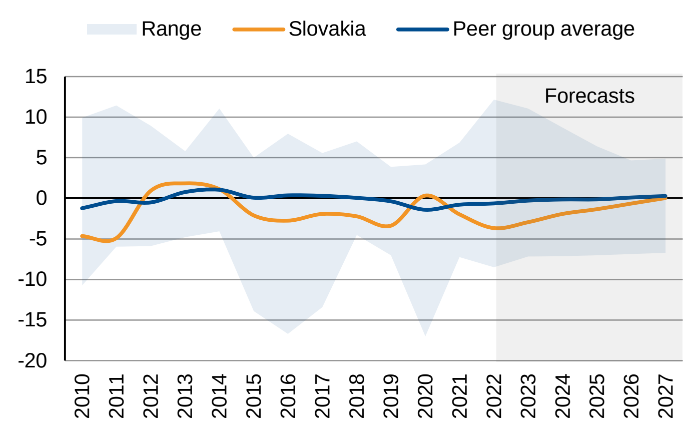
External Economic Risks

- **Current account:** Slovakia's current account turned to deficit in 2021 as imports increased with domestic consumption and supply chain disruptions curtailed exports, particularly in the automotive sector, representing about 48% of the country's industrial production. Direct trade exposure to Russia and Ukraine is limited, as the two countries represents, respectively, only 2.4% and 1.6% of total exports and 6.4% and 0.9% of total imports in 2021. The Slovak economy, however, is exposed to supply chain bottlenecks and lower external demand of manufacturing products from the European Union. The increasing inflow of EU funds, notably under the EU Recovery and Resilience Plan, should help overfund current account deficits that are expected to moderate faster than peer countries by 2027.
- **External position:** The net international investment position (NIIP) stood at -63% of GDP as of Q2 2022, showing some improvements compared to 2020 level. Gross assets and liabilities increased last year, the former driven by higher debt and equity investments, and the later by other investments and financial derivatives. Any moderation of foreign inflows is seen as temporary and long-term external position as sustainable, given Slovakia's structural strengths in the manufacturing sector and additional investments required in the automotive industry for the green and digital transition.
- **Resilience to shocks:** Slovakia is a small and open economy that is mostly specialised in the automotive industry. Reliance on external demand and exposure to international value chains are a source of vulnerability in the current environment, although the EU and euro area memberships, as well as foreign capital inflows, contribute to manage external imbalances.

Overview of Scope's qualitative assessments for Slovakia's *External Economic Risks*

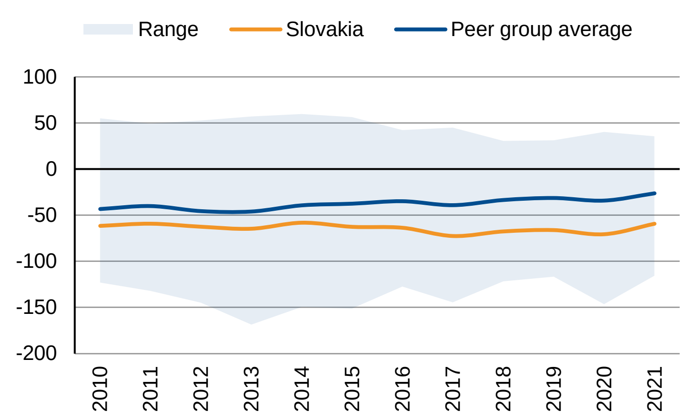
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
ccc	Current account resilience	Strong	+1/3	Export-oriented economy subject to external demand disruptions; current account deficits expected to recover over the medium-term
	External debt structure	Strong	+1/3	Overall stable NIIP; substantial share of direct investment in external liabilities
	Resilience to short-term external shocks	Neutral	0	Small-open economy that benefits from EU and euro area memberships

Current account balance, % of GDP



Source: IMF WEO, Scope Ratings

Net international investment position (NIIP), % of GDP



Source: IMF, Scope Ratings

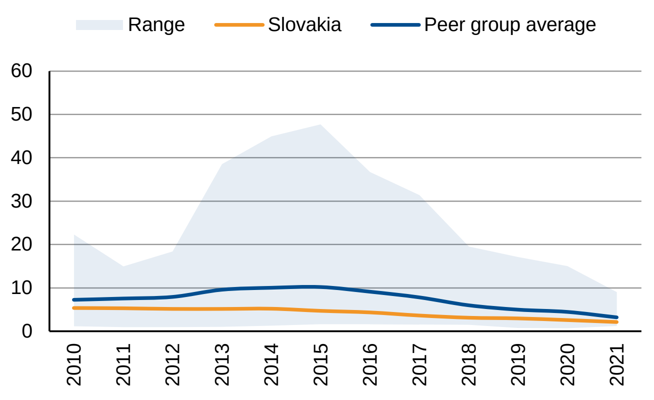
Financial Stability Risks

- **Banking sector:** The banking sector proved resilient during the Covid-crisis and the impact of the Russia-Ukraine conflict has been limited, given banks' low direct exposure. According to the European Banking Authority, liquidity buffers remained at comfortable levels and the NPL ratio has continued to improve despite the gradual unwind of support measures, decreasing from 2.6% in Q1 2020 to 1.5% in Q2 2022, below euro area average of 1.8%. This is also reflected in lower provisioning costs. Capital composition has benefitted from retained earnings during the Covid-crisis and Tier 1 Capital Ratio was at 17.3% in Q2 2022, above the 16.5% EU average. Banks' profitability strengthened in Q2 2022 thanks to higher net interest income and net fee and commission income. Although profitability would continue benefitting from rising interest rates, it could be affected by the heightened geopolitical risks and operating expenses.
- **Private debt:** Household debt ratios (around 50.1% of GDP as of 2021) are among the highest in Central and Eastern Europe, driven by strong growth in house prices and associated robust mortgage lending. Higher inflation and rising interest rates, alongside slower income growth, would further pressure households' indebtedness. NFCs debt was stable at 120.5% in 2021, in line with other Central and Eastern European countries, although their financial situation has not fully recovered from the Covid-crisis, so that they are now more vulnerable to shocks as the operating environment deteriorates.
- **Financial imbalances:** Strong credit growth has led to higher household indebtedness, which made households and banks more vulnerable to a faster-than-expected tightening of financing conditions. Households are topping up their loans and extending the loan maturity because of a sharp increase in housing prices, currently amongst the highest in the EU, bearing the risk of price overvaluation. The European Systemic Risk Board issued a warning and identified the residential real estate sector as a source of systemic risk. However, credit growth and housing market could slow down as interest rates rise, with a gradual price correction more likely in the near term.

Overview of Scope's qualitative assessments for Slovakia's *Financial Stability Risks*

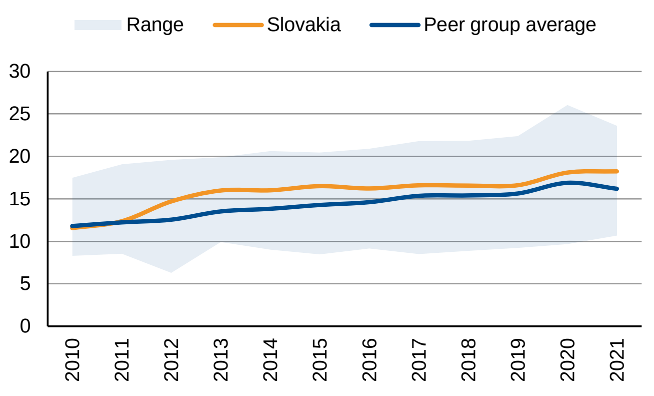
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Strong	+1/3	Well-capitalized banking sector with a low NPL ratio
	Banking sector oversight	Strong	+1/3	Oversight under the National Bank of Slovakia and the ECB as part of Banking Union
	Financial imbalances	Neutral	0	Rapid rise in housing prices and gradual build-up of private sector indebtedness, mitigated by macroprudential measures

Non-performing loans, % of total loans



Source: IMF, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

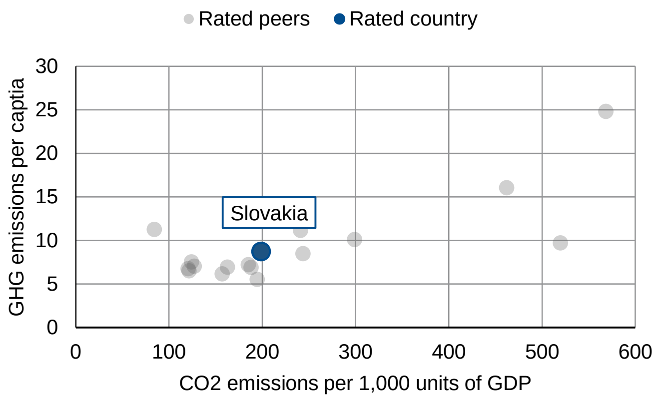
ESG Risks

- **Environment:** Slovakia's energy mix reflects exposure to higher energy prices such as natural gas (25% of energy supply in 2020) – of which Russian gas represents 85% of total – oil (22%), and coal (14%). However, the nuclear energy (25%) constitutes an important cushion against price pressures thanks to nuclear power plants, although nuclear fuel is largely imported from Russia. Slovakia has taken several actions to diversify energy supply sources, such as cross-county agreements, which should mitigate the impact of the shock from Russian natural gas cuts. Renewables represent 17.3% of final energy consumption and the National Energy and Climate Plans (NECP) set a new target of 19.2% by 2030. Current measures in place to reduce GHG emissions are expected to fall short what is needed to attain carbon neutrality by 2050. In this respect, the current long-term EU budget constitutes an opportunity for Slovakia to improve such energy measures and accelerate the pace of GHG reduction.
- **Social:** Slovakia's performance across key social dimensions is mixed. Socially related credit factors are reflected in Slovakia's steadily increasing old-age dependency ratios, high regional inequality (among the highest in the OECD), moderate unemployment rates (6.1% in Q2 2022), gender employment gap (15% in 2020) around EU averages, and below-EU average poverty rates and risk of social exclusion.
- **Governance:** The Slovak government led by prime minister Heger lost parliamentary majority in September 2022 after disputes within the ruling coalition and the withdrawal of the Freedom and Solidarity party ('SaS'). Those recent developments have increased the risk of political instability ahead of the next legislative elections in February 2024, including through a no confidence vote and early elections. A change in policy making is unlikely at this stage but the loss of parliamentary majority reduces policy flexibility to manage the energy crisis and pass reforms agreed under the EU Recovery and Resilience Plan.

Overview of Scope's qualitative assessments for Slovakia's *ESG Risks*

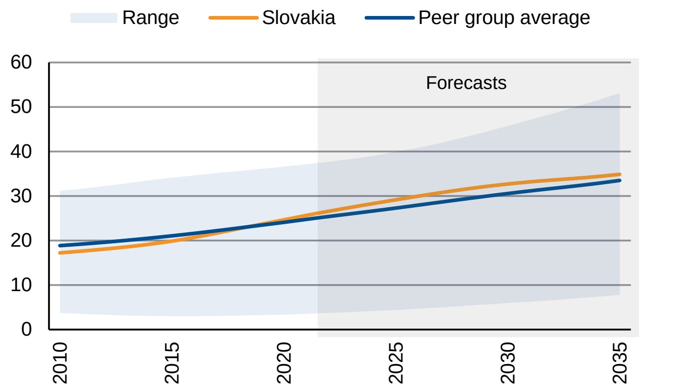
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb+	Environmental risks	Neutral	0	Potential pressures from emission standards, below-EU-average but increasing share of renewable energy in total energy consumption, transition risks in line with CEE peers
	Social risks	Neutral	0	Unemployment rates around EU-average, below EU-average poverty level, negative demographic trends, high regional economic disparities
	Institutional and political risks	Neutral	0	Comparatively stable governance framework, supported by EU and euro area memberships

Emissions per GDP and per capita, $mtCO_2e$



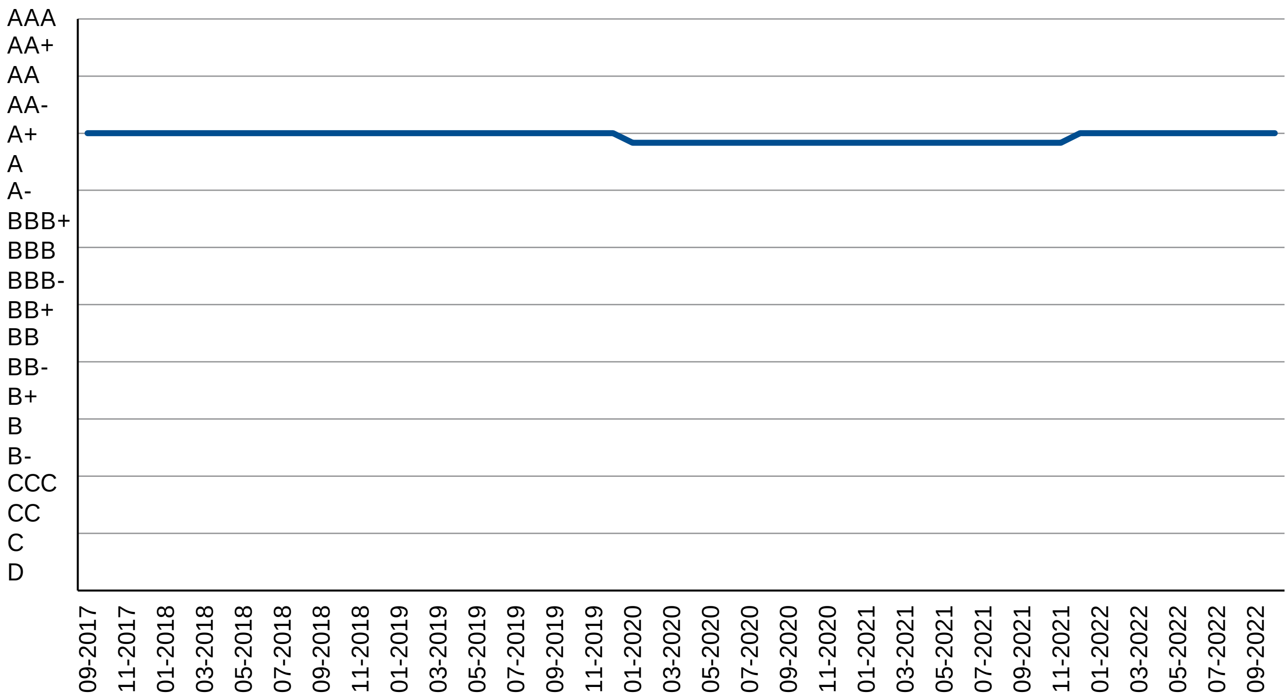
Source: European Commission, Scope Ratings

Old age dependency ratio, %



Source: United Nations, Scope Ratings

Appendix I. Rating history



NB. Positive/Negative Outlooks are treated with a +/-0.33-notch adjustment. Credit Watch positive/negative with a +/-0.67-notch adjustment.

Appendix II. Rating peers

Rating peers are related to sovereigns with an indicative rating in the same rating category or in adjacent categories per Scope's Core Variable Scorecard, including a methodological reserve-currency adjustment.

Peer group*
Bulgaria
China
Croatia
Cyprus
Hungary
Italy
Latvia
Poland
Portugal
Spain

*Publicly rated sovereigns only; the full sample may be larger.

Appendix III. Statistical table for selected CVS indicators

This table presents a selection of the indicators (24 out of 30 – with the governance indicator reflecting a composite of six indicators) used in Scope's quantitative model, the Core Variable Scorecard, in line with Scope's Sovereign Rating Methodology. The metrics and sources for the data presented here ensure comparability across global peers and may therefore differ from national and other selective international statistics.

Pillar	Core variable	Source	2017	2018	2019	2020	2021
Domestic Economic	**GDP per capita, USD '000s**	IMF	17,544	19,412	19,319	19,254	21,053
	Nominal GDP, USD bn	IMF	95.4	105.7	105.3	105.1	114.9
	Real growth, %	IMF	3.0	3.8	2.6	-4.4	3.0
	CPI inflation, %	IMF	1.4	2.5	2.8	2.0	2.8
	Unemployment rate, %	WB	8.1	6.5	5.8	6.7	6.7
Public Finance	**Public debt, % of GDP**	IMF	51.6	49.6	48.1	59.7	63.1
	Interest payment, % of revenue	IMF	3.1	3.0	2.7	2.6	2.3
	Primary balance, % of GDP	IMF	0.2	0.1	-0.2	-4.4	-5.2
External Economic	**Current account balance, % of GDP**	IMF	-1.9	-2.2	-3.4	0.3	-2.0
	Total reserves, months of imports	IMF	0.5	0.6	0.8	1.2	1.0
	NIIP, % of GDP	IMF	-72.6	-67.6	-66.1	-70.6	-59.2
Financial Stability	**NPL ratio, % of total loans**	IMF	3.6	3.1	3.0	2.6	2.1
	Tier 1 ratio, % of RWA	IMF	16.6	16.4	16.7	17.3	18.8
	Credit to private sector, % of GDP	WB	60.2	62.0	62.8	67.2	-
ESG	**CO_2 per EUR 1,000 of GDP, $mtCO_2e$**	EC	230.5	218.3	200.0	198.8	218.5
	Income share of bottom 50%, %	WID	25.1	24.2	24.4	24.6	24.6
	Labour-force participation rate, %	WB	72.2	72.5	72.7	-	-
	Old-age dependency ratio, %	UN	21.7	22.7	23.7	24.6	25.6
	Composite governance indicators*	WB	0.7	0.6	0.6	0.7	-

* Average of the six World Bank Worldwide Governance Indicators.

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps) as of October 28, 2022	65.36

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