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
• Concerns on 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 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 to deliver fiscal consolidation post energy crisis and early legislative elections.

Competitive export-oriented industry: Slovakia has a competitive export-oriented industrial base, anchored by foreign direct investment inflows. The automotive industry is among the largest contributors to exports and is well placed for the transition to electric vehicles.

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 trajectory exposed to 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%	cc		+2/3	
Financial Stability Risk		10%	aaa		+2/3	
ESG Risk	Environmental Factors	5%	a+		0	
	Social Factors	7.5%	bbb+		0	
	Governance Factors	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
• Stronger than anticipated growth prospects due for example to a swift diversification of energy supply and/or a robust reform momentum
• More favorable than currently anticipated evolution of public debt to GDP based on sustained fiscal consolidation post elections

Negative rating-change drivers
• Material decline in GDP growth prospects due for example to a disorderly energy supply transition and/or a weakening of external demand
• Larger than anticipated rise in public debt to GDP ratio due for example to sustained delay in fiscal consolidation
• Persistent political uncertainty and/or a shift in policy priorities weaken the reform agenda and relations with the EU

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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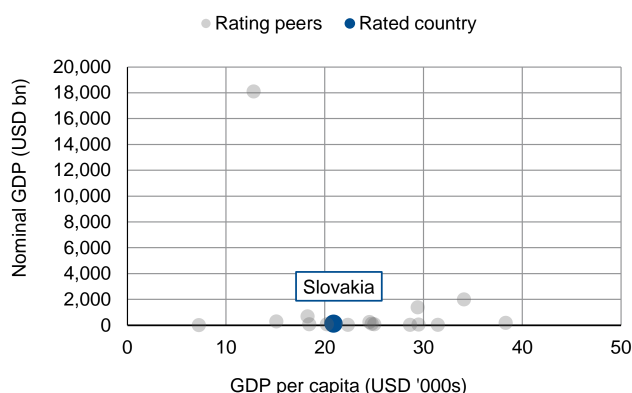
Domestic Economic Risks

- **Growth outlook:** GDP growth rate is expected to decelerate at 1.4% in 2023 (1.7% in 2022) because of lower but persistent concerns on energy security, real wage decrease, and weaker demand from European trade partners (78% of exports). The temporary shutdown of energy intensive factories and lower domestic demand amid tighter financing conditions weigh on near-term growth prospects. Still, gas storage facilities (currently filled at 59%), measures introduced to mitigate the impact of the energy crisis, such as the general energy-price capping, and the support of EU funds (up to 3 % of GDP in 2023) provide a cushion against lower growth. The authorities also announced recently that a complete stop of Russian natural gas imports will be manageable for the winter 2023/2024. In 2024, GDP growth rate is expected to pick up at 2.4% as domestic economic activity benefits from efforts made to strengthen energy supply, including via greater diversification and the gradual ramp up of domestic production capacities. Recovery in external demand and in the automotive industry, as supply bottlenecks ease, are expected to support investment and exports as the main growth drivers. In longer run, potential GDP growth is estimated at 2.5% per year.
- **Inflation and monetary policy:** Inflation declined to 14.8% YoY in March (15.4% in February) and is expected to average 10% in 2023 (12.1% in 2022), which is still close to its record high over the past two decades and one of the highest in the euro area and in the CEE. However, inflation forecast has been revised downward compared to the previous projection (15% as of October 2022) based on the moderation of energy prices on international markets, ECB's monetary policy tightening, subsidised energy prices, and the reduction of VAT on selected good and services. In 2024, inflation is expected to decline further around 5-6%, although the phasing out of budgetary measures and wage indexation could sustain inflationary pressure.
- **Labour markets:** The unemployment rate stood at 5.9% in Q3 2022, which is close to the pre-Covid average of 5% in 2019 but it is expected to peak above 6% in 2023 because of the deterioration of the economic outlook. Moreover, skill mismatches and labour shortages are structural challenges.

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

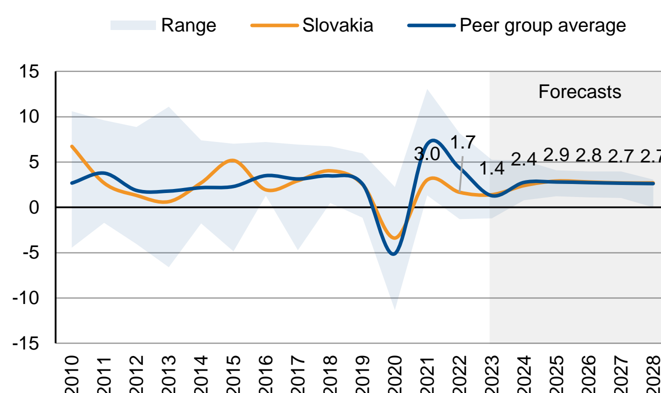
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb	Growth potential of the economy	Neutral	0	Growth potential in line with peer average, but at risk of declining should the energy supply shock have a permanent impact
	Monetary policy framework	Neutral	0	ECB is a highly credible and effective central bank; effective policy framework and transmission over the cycle
	Macro-economic stability and sustainability	Weak	-1/3	Lingering risks on energy supply; competitive manufacturing industry but challenges for medium-term dynamics in the automotive industry

Nominal GDP and GDP per capita, USD



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

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

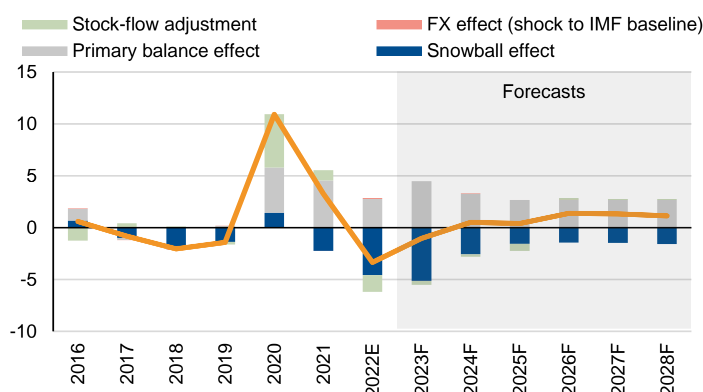
Public Finance Risks

- **Fiscal outlook:** The fiscal deficit is expected to widen to 5.5% of GDP in 2023 (-3.5% in 2022) due to the expansionary policy introduced in response to the energy price shock. One-off measures, for which the cost is estimated at 2.0% to 2.5% of GDP in 2023, deepen the budget deficit. Large public investment required to process non-Russian energy is also expected to weigh on the budget. Still, the worsening is expected to be short-lived given the strength of the fiscal framework that includes a debt brake rule and multi-annual spending limits for the period 2023-2025 under the supervision of the independent Council for Budget Responsibility. In addition, the introduction of the pension reform as of January 2023, as well as European funds, have a positive impact on Slovakia's fiscal trajectory. We expect the gradual reduction of the deficit to start in 2024 (4.5% of GDP) post legislative elections, hovering to 4.0% of GDP by 2025, although political uncertainty is a major risk on the fiscal trajectory.
- **Debt trajectory:** The general government debt is forecasted to stabilise around 58% in 2023 (58.8% in 2022) and slightly increase above 60% of GDP by 2028, which is lower than the peer average (above 70%) although higher than pre-pandemic level (around 50%). The modest rise in public debt results from still robust GDP growth rates, high debt affordability (interest payment around 1% of GDP in 2022), and gradual reduction of primary deficits. The escape clause of the debt brake is set to expire in May 2023, although uncertainty remains on the amendment of the Constitutional Act on Fiscal Responsibility. Without the amendment, the government must present a balanced budget for 2024, which is very unlikely as it would entail significant austerity measures. Large cash buffers also support the government's capacity to limit the impact of external shocks on the debt trajectory. Moreover, the adoption of a pension reform reducing aging related spending should allow for lower debt levels in the longer run.
- **Debt profile and market access:** Slovakia benefits from fair financing conditions compared to non-euro area countries, with 10-year yields trading at 3.7% against 8.6% for Hungary and 6.2% for Poland. Slovakia also benefits from a supportive debt profile with the ECB holding about 40% of government bonds. 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 amount to EUR 12.9bn in 2023, among which EUR 4.6bn of bond amortisation.

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

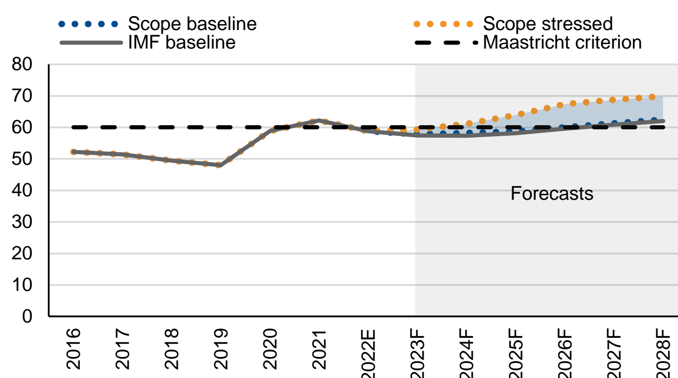
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a	Fiscal policy framework	Strong	+1/3	Credible and flexible constitutional budgetary framework, recently strengthened
	Debt sustainability	Neutral	0	Favourable debt levels and dynamics, although exposed to long term demographic trends and lower GDP growth prospects
	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

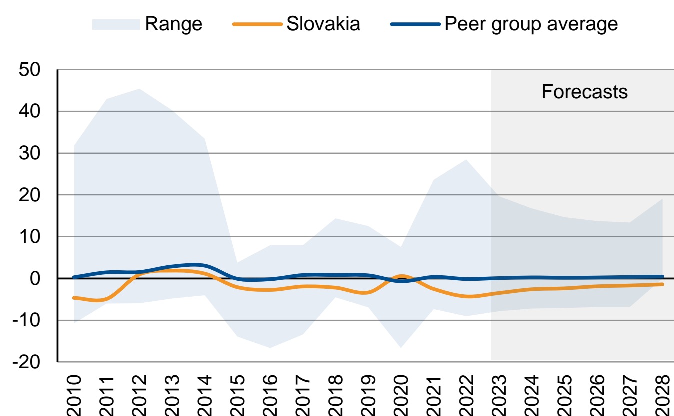
External Economic Risks

- **Current account:** The current account deficit reached a record low of -8.2% of GDP in 2022 according to the Central Bank of Slovakia because of the substantial deterioration of the trade balance that recorded a large deficit (more than EUR 4bn) amid higher energy import bills and lower demand from European trade partners. However, we expect the current account deficit to moderate substantially to 4.0% of GDP in 2023 thanks to the rebound in exports benefiting from the ease of supply bottlenecks in the automotive industry (33% of exports), an improvement in the terms of trade, and a rebound in external demand. Still, the current account deficit is projected to remain larger than historical levels (-1.8% of GDP on average over 2010-2019).
- **External position:** The net international investment position (NIIP) is largely negative (62% of GDP as of Q3 2022) and is one of the largest among peers. Still, around 15% of external debt relate to foreign direct investment (i.e., intercompany lending), mainly long-term spending in the manufacturing industry, among which the green transition of the automotive industry, that is unlikely to reverse in the case of external shocks, which support equity capital and reinvestment of earnings. In our view, Slovakia's external position is sustainable in the medium run given the limited reliance on foreign credit to fund external imbalances (external debt around EUR 113bn as of end-2022, among which 57% issued by the general government and the National Bank of Slovakia) and the support of EU funds, notably under the EU Recovery and Resilience Plan.
- **Resilience to shocks:** Slovakia is a small and open economy with a highly competitive export industry. Reliance on external demand and exposure to international value chains are a source of vulnerability, although the EU and euro area memberships, as well as foreign capital inflows, contribute to strengthen the country's shock absorption capacity.

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

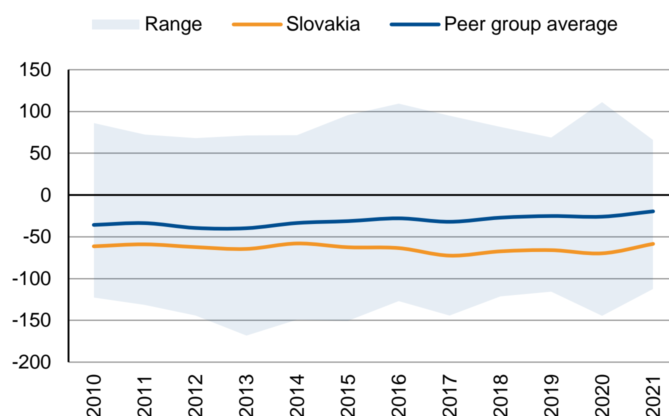
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
cc	Current account resilience	Strong	+1/3	Export-oriented economy with a competitive industry relative to peers and modest current account deficits over the medium term
	External debt structure	Strong	+1/3	Largely negative but 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

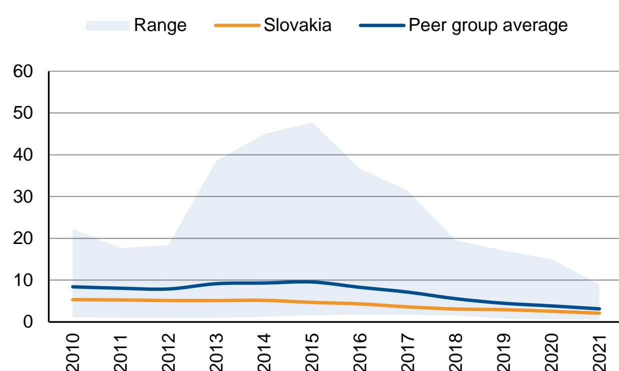
Financial Stability Risks

- **Banking sector:** Slovakia's banking sector, that is mainly owned by Czech banks and highly concentrated (three banks holding 60% of total assets), has the capacity to absorb the pressure resulting from higher interest rates. Inflation erodes retail deposits and households' savings, with loan-to-deposit ratio rising above 100%, although the liquidity coverage ratio is still strong (169.9% in Q3 2022), supported by TLTRO III (around EUR 10bn). Moreover, banks have adequate capital buffers (19.2% vs EU average of 16.5%) to cope with a deterioration in credit quality. After a steady decline, the NPL ratio (1.5% in Q3 2022) is expected to rise, notably for corporates (2.6%) that are more exposed to higher rates than households (1.8%), the latter benefiting from a robust labour market and long-term loan maturity. The upcoming rise of the countercyclical capital buffer rate from 1.0% to 1.5% (effective from 1 August 2023) will reinforce bank's loss absorption capacity. Despite a higher cost of funding, interest margins could somewhat support profitability (RoE of 11.1% in Q3 2022) and strengthen bank's capital.
- **Private debt:** Household debt ratio (50.1% of GDP) is one of the highest in the CEE. Credit to households is expected to slow given higher repayment burden relative to disposable income. Non-financial corporate's (NFCs) debt is stable (120.5% of GDP) and in line with other CEE countries. Still, corporates are more vulnerable to higher interest rates given risk premia and close to 60% of total loans contracted at variable interest rates. The relatively short residual maturities of fixed-rate loans is a risk for NFCs as the access to liquidity tightens. Short-term loans represent 33% of loans to NFCs, against 2% for households.
- **Financial imbalances:** Higher mortgage rates are expected to reduce housing affordability and to contain the rise in residential real estate prices. Housing prices experienced a strong growth rate, peaking in Q2 2022 at a YoY rate close to 26%, but in the second half of the year started to decrease (-1.9% QoQ as of Q4 2022), pointing to a slowdown in the property market. In December 2021, the European Systemic Risk Board issued a warning and identified the residential real estate sector as a source of systemic risk.

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

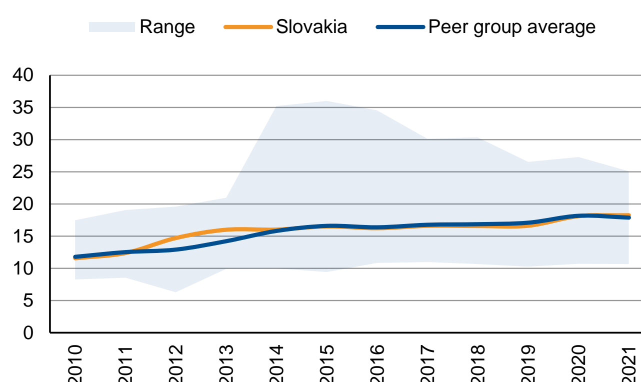
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Strong	+1/3	Well-capitalized banking sector with still-low NPL ratio
	Banking sector oversight	Strong	+1/3	Oversight under the National Bank of Slovakia and the ECB as part of Banking Union
	Financial imbalances	Neutral	0	Elevated private debt balanced by the moderation of real estate prices and macroprudential measures

Non-performing loans, % of total loans



Source: IMF, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

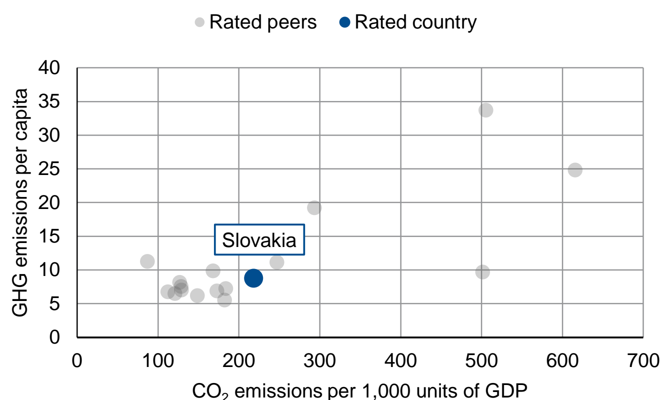
ESG Risks

- **Environment:** The energy mix reflects exposure to higher energy prices such as natural gas (26% of supply), oil (23%), and coal (15%). Slovakia is vulnerable to retaliation measures from Russia in response to military equipment delivered to Ukraine as building new infrastructures able to process non-Russia energy takes time, among which LNG terminal and a new nuclear reactor. However, near-term risks are mitigated by the exemption on European sanctions to import Russian oil that is in force until end-2023 and the reduction of Slovakia's dependence on Russian energy imports that declined to 43% as of October 2022, from 76% in January 2021. It reflects a growing diversification of supply via cross-county agreements, including with Poland for gas, and the ramp up of domestic production, among which the nuclear industry (24% of supply). Investment in green energy also plays a key role to strengthen energy security in the long run with the support of the EU Recovery and Resilience Plan (around EUR 232m), contributing to the transition towards carbon neutrality by 2050.
- **Social:** Slovakia's performance across key social dimensions is mixed. Socially related credit factors are reflected in steadily increasing old-age dependency ratios, high regional inequality (among the highest in the OECD), moderate unemployment rates (5.9% in Q3 2022), and below-EU average poverty rates and risk of social exclusion.
- **Governance:** As the Freedom and Solidarity (Sloboda a solidarita, SaS) left the ruling coalition and the government lost a vote of no-confidence in December 2022, early legislative elections are scheduled for 30 September 2023. Former prime minister Eduard Heger created a centrist political party (Democrats) running around 5% in opinion polls, against 15% to 20% respectively for the Social Democracy (HLAS) and Slovak Social Democracy (Smer) parties led by Peter Pellegrini and Robert Fico. A polarised and fragmented political landscape increases the risk of a policy shift and a weaker reform momentum, potentially with adverse consequences on the fiscal consolidation plans and milestones tied to European funds.

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

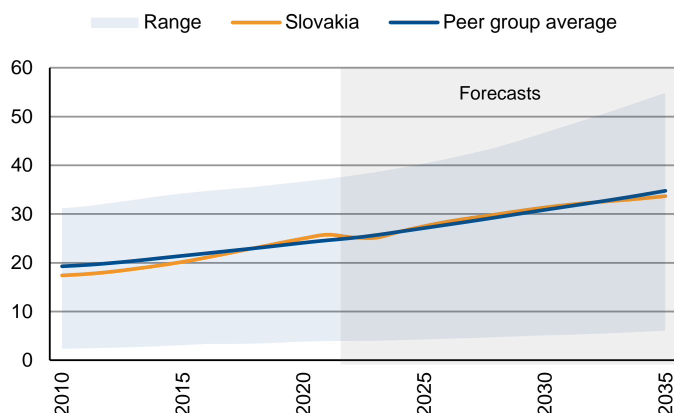
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb+	Environmental risks	Neutral	0	Below-EU-average but increasing share of renewable energy in total energy consumption, transition risks in line with CEE peers
	Social risks	Neutral	0	Unemployment rates around EU-average, 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; rising political uncertainty

Emissions per GDP and per capita, $mtCO_2e$



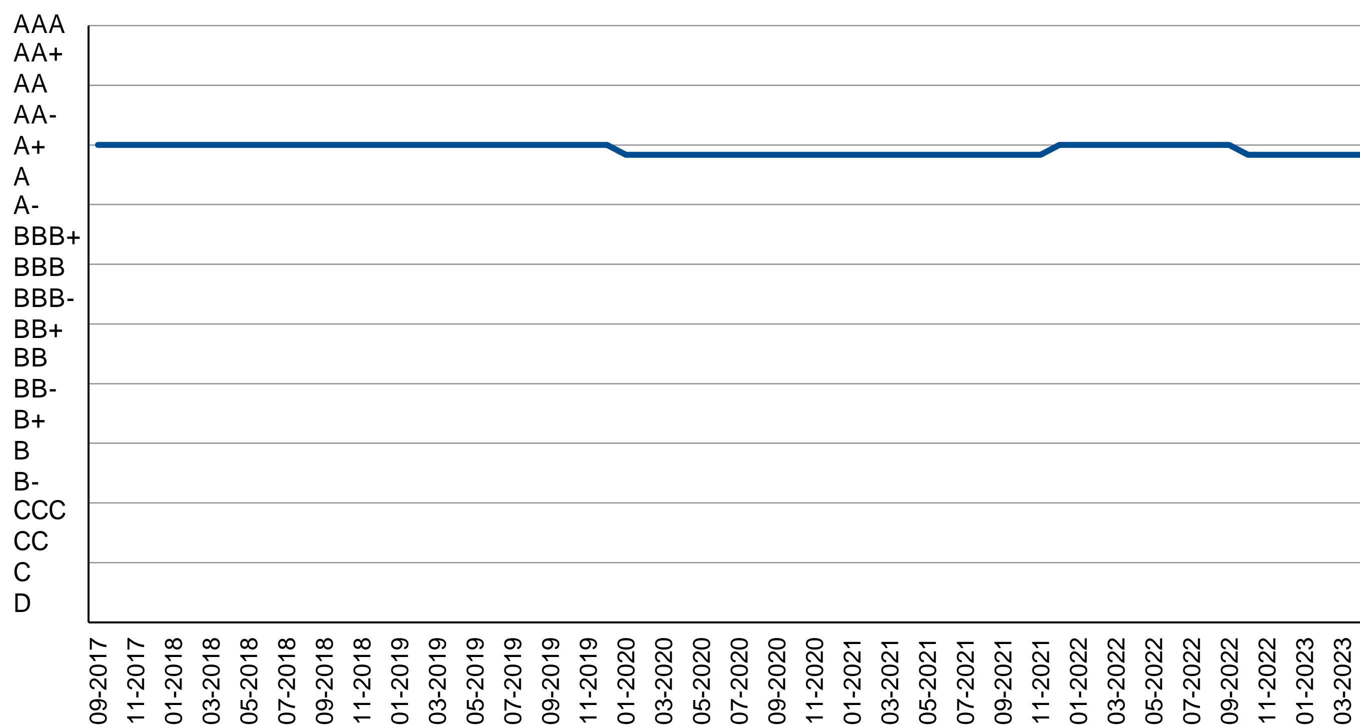
Source: European Commission, Scope Ratings

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*
Croatia
Cyprus
Estonia
Italy
Latvia
Lithuania
Poland
Portugal
Spain
United States

*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	2018	2019	2020	2021	2022
Domestic Economic	GDP per capita, USD '000s	IMF	19,508	19,399	19,534	21,357	20,890
	Nominal GDP, USD bn	IMF	106.2	105.7	106.6	116.6	113.5
	Real growth, %	IMF	4.0	2.5	-3.4	3.0	1.7
	CPI inflation, %	IMF	2.5	2.8	2.0	2.8	12.1
	Unemployment rate, %	WB	6.5	5.8	6.7	6.8	-
Public Finance	Public debt, % of GDP	IMF	49.4	48.0	58.9	62.2	58.8
	Interest payment, % of revenue	IMF	3.0	2.7	2.6	2.2	1.9
	Primary balance, % of GDP	IMF	0.1	-0.2	-4.4	-4.6	-2.8
External Economic	Current account balance, % of GDP	IMF	-2.2	-3.3	0.6	-2.5	-4.3
	Total reserves, months of imports	IMF	0.6	0.8	1.2	1.0	-
	NIIP, % of GDP	IMF	-67.3	-65.9	-69.6	-58.4	-62.9
Financial Stability	NPL ratio, % of total loans	IMF	3.1	3.0	2.6	2.1	1.9
	Tier 1 ratio, % of risk-weighted assets	IMF	16.4	16.7	17.3	18.8	18.1
	Credit to private sector, % of GDP	WB	61.7	62.5	66.2	-	-
ESG	CO_2 per EUR 1,000 of GDP, $mtCO_2e$	EC	218.3	200.0	198.8	218.5	-
	Income share of bottom 50%, %	WID	24.2	24.4	24.6	24.6	-
	Labour-force participation rate, %	WB	72.5	72.7	-	-	-
	Old-age dependency ratio, %	UN	23.0	24.0	25.0	25.8	25.2
	Composite governance indicators*	WB	0.6	0.6	0.7	0.6	-

* 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 April 14, 2023 — 39.88

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