Republic of Slovenia
Rating Report

A STABLE OUTLOOK

Credit strengths	Credit challenges
• Euro area membership	• High debt burden
• Fiscal and external buffers	• Skill shortages
• Strong market access	• Ageing population
• Favorable debt profile	• Rising political uncertainty

Rating rationale:

Euro area membership: Slovenia is a member of the euro area, benefitting from a highly credible monetary policy, and rigorous financial sector oversight through the ECB.

Small open economy: Slovenia enjoys a robust external performance thanks to its manufacturing sector, supported by a deep integration with European trade partners. Yet, limited diversification and reliance on European trade expose the economy to external shocks.

Effective fiscal policy management: Slovenia has demonstrated effective fiscal policy making, building on a very strong fiscal policy framework. Conditional upon the waiving of the exceptional circumstances clause, this framework is expected to enable a gradual reduction of fiscal deficits and public debt in a baseline scenario, where GDP growth is broadly in line with its potential.

Strong market access and favorable debt profile: Slovenia benefits from a strong market access, which allowed the government to diversify debt instruments (incl. through sustainability bonds) and deliver proactive liability management operations to smooth its debt profile and lower the interest burden. A higher interest rate environment is not expected to significantly affect the debt dynamics.

Rating challenges include: i) the preservation of fiscal sustainability post Covid-crisis to put the debt-to-GDP ratio back on a firm downward trajectory, in the context of rising political uncertainty and unfavorable demographic trends, and ii) the need for additional reforms to increase the GDP growth potential given low productivity growth, skills shortages, and a heavy regulatory system.

Slovenia's sovereign rating drivers

Risk pillars		Quantitative scorecard		Reserve currency adjustment (notches)	Qualitative scorecard	Final rating
		Weight	Indicative rating		Notches	
Domestic Economic Risk		35%	aa-		-1/3	A
Public Finance Risk		25%	a+		0	
External Economic Risk		10%	a		-1/3	
Financial Stability Risk		10%	aaa		-1/3	
ESG Risk	Environmental Risk	5%	aa+		-1/3	
	Social Risk	5%	bbb		0	
	Governance Risk	10%	a		-1/3	
Overall outcome		**a+**		**+1**	**-2**	

Note: The sum of the qualitative adjustments, capped at 1 notch per rating pillar, is weighted equally and 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 GmbH

Outlook and rating triggers

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

Positive rating-change drivers

- Medium-growth prospects notably improve, supported by structural reforms
- Fiscal consolidation results in a significant debt reduction and/or reduced risks to long term fiscal sustainability

Negative rating-change drivers

- Medium-growth prospects notably deteriorate
- Debt sustainability weakens materially due to a protracted fiscal deterioration
- Policy uncertainty results in lower EU transfers and/or foreign direct investments

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: RESP SCOP

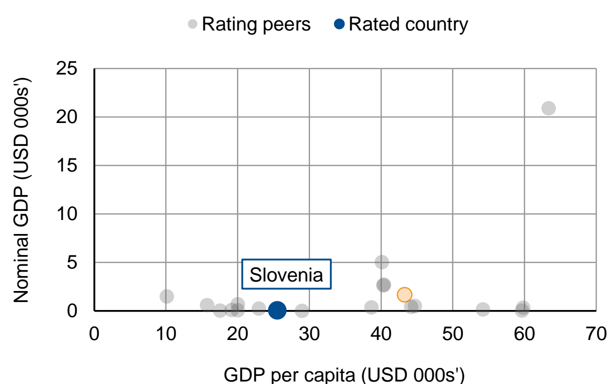
Domestic Economic Risks

- **Growth outlook:** Slovenia's small open economy contracted by 4.2% in 2020 due to the outbreak of the Covid-19 pandemic, which is less than initially expected thanks to the sizable fiscal support measures delivered by the government. In 2021, the economic rebound has been strong with an above consensus GDP growth rate of 8.1%. Looking ahead, we expect the recovery to continue in 2022, although at a slower pace (4.7%), given uncertainties triggered by geopolitical tensions and higher inflation. The recovery will be driven by private consumption, benefiting from a higher real disposable income, and robust investment, supported by the EU, including through the Recovery and Resilience Facility (1.2% of GDP in grants over 2022-23), that will accelerate the green and digital transformations. Exports are also expected to support GDP growth, along with a gradual normalization of external conditions, including the Russia-Ukraine crisis and related international sanctions. The main risks to the economic outlook relate to higher energy prices, an unexpected surge in Covid cases, and longer than expected supply-side bottlenecks. Over the forecasting period, we expect real GDP growth to stabilize at 2.9% in 2026, which is slightly above potential (2.5%). The contribution to potential growth from investment should increase, especially given structural EU funding, while the contribution from labour is set to decline due to the ageing population.
- **Inflation and monetary policy:** Inflation stood at 6.9% YoY in February, a record high driven by higher prices of fuels and energy, alongside heightened geopolitical tensions. We expect inflation pressures to persist in the short term due to a rise in the minimum wage (+4.9%), in response to higher inflation in 2021 (+2.0%) and a tight labour market. Short term inflation will also be driven by higher import prices, domestic demand, elevated unit labour costs, and supportive fiscal policy. The inflation rate should increase to 3.7% in 2022, before progressively decreasing to 1.8% in 2023, a level consistent with the ECB medium-term target.
- **Labour market:** Large public policy support through wage subsidies has mitigated the impact of the Covid-crisis. Employment has reached a record high and unemployment has decreased to 4.5% in December 2021, well below the peak of 10% reached in 2013. We expect the unemployment rate to remain low (around 4.0%), amid persistent labour shortages and unfavorable demographic trends, somewhat mitigated in the short run by strong inflow of foreign workers.

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

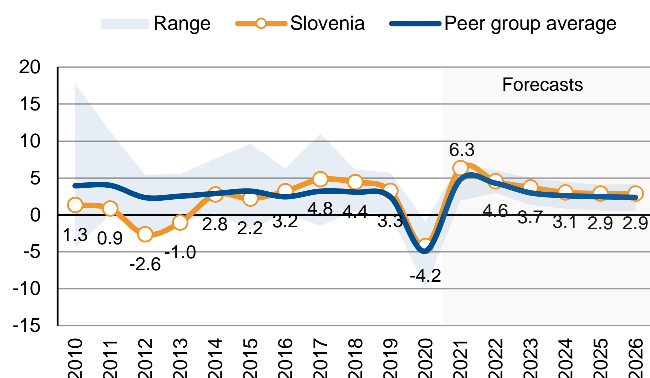
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa-	Growth potential of the economy	Neutral	0	Medium-run growth potential faces challenges from adverse demographic trends; sustained public investment
	Monetary policy framework	Neutral	0	ECB is a highly credible and effective central bank
	Macro-economic stability and sustainability	Weak	-1/3	Limited economic diversification; reliance on external markets

Nominal GDP and GDP per capita, USD thousands



Source: IMF, Scope Ratings GmbH

Real GDP growth, %



Source: IMF, Scope Ratings GmbH

Public Finance Risks

- **Fiscal outlook:** The general government deficit is expected to decline to 5.5% of GDP in 2021 (down from 7.7% in 2020) since the largest emergency measures introduced in response to the Covid-crisis have been progressively removed. We expect the fiscal deficit to decline further in 2022 (-4.7% of GDP) and in 2023 (-2.9% of GDP) on the back of a firm economic rebound, EU disbursements, and proactive fiscal management policy. Without public investment, the budget balance will already be in surplus in 2022 according to the government, which we see as a positive development, especially since the national fiscal rule escape clause still applies in 2022 and the reform of EU fiscal rules is not expected before end-2023.

  Short term risks to the fiscal outlook relate mainly to higher energy prices, for which mitigation measures have been introduced. Public investments are also expected to put pressure on fiscal metrics, although it will be supported by EU funds, estimated around EUR 12bn by 2030. Over the long run, reforming the pension system will be critical to shore up fiscal sustainability, since public pension spending is projected to increase substantially, from 10.0% to 15.7% of GDP between 2019 and 2050 according to the OECD.

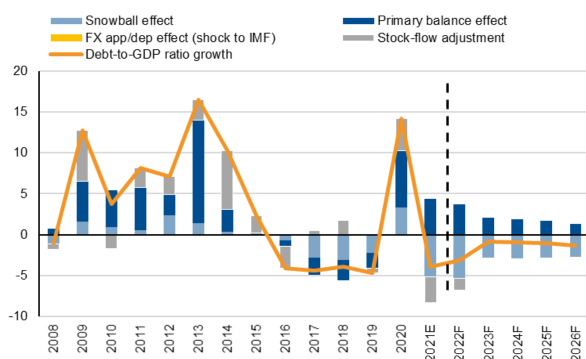
- **Debt trajectory:** Gross public debt soared to 77.3% of GDP in 2021, up from 65.6% in 2019. Even so, risks related to a higher public debt are mitigated by declining but still significant liquid financial assets (+10% of GDP as of Q4 2021), that could be used to cope with external shocks, and by a cautious approach on granting public guarantees. Still-accommodative ECB monetary policy and favourable market conditions have reduced the interest debt burden (1.4% of GDP in 2021). Despite the recent rise of the 10-year government bond yield (0.95%), the interest debt burden is expected to remain low as almost all public debt is under fixed rates. We expect the public debt to gradually decrease from 74.2% of GDP in 2022 to around 70.0% of GDP in 2026.

- **Market access:** Proactive debt management policy has extended the duration of public debt (8.9 years in end-2021), one third of debt having a residual maturity above 10-year. No FX exposure, declining share of debt held by non-resident investors (57% as of 2021), and a large investor base constitute adequate buffers against volatility. We also note that the holdings of public debt by the Bank of Slovenia have increased sizably since 2015 and that GFNs for 2022 are manageable (around EUR 5.0bn). Following the first sustainability bond issuance in 2021, we expect similar transactions over the coming years to fund the national development strategy.

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

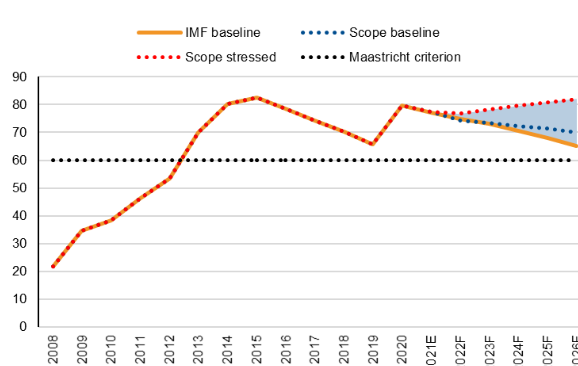
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a+	Fiscal policy framework	Neutral	0	Credible fiscal policy framework; some fiscal space for policy stimulus
	Debt sustainability	Neutral	0	Higher debt burden; positive debt dynamics
	Debt profile and market access	Neutral	0	Low interest-payment burden; substantial public sector liquid assets

Contributions to changes in debt levels, pps of GDP



Source: IMF, Scope Ratings GmbH

Debt to GDP forecasts, % of GDP



Source: IMF, Scope Ratings GmbH

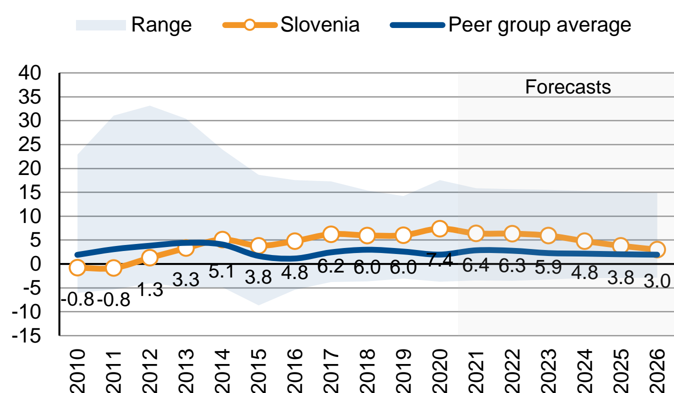
External Economic Risks

- **Current account:** Slovenia is an export-oriented economy recording current account surpluses since 2012, thanks to a strong external demand, gains in unit labour cost competitiveness and a recovery of the export market share. The current account surplus peaked at 7.4% of GDP in 2020 and then declined in 2021 (3.2% of GDP), while the trade balance deteriorated due to a significant growth in imports (+17.4%) that surpassed the rebound of exports (+13.2%). Despite high private sector savings, Slovenia's current account surplus suffered from supply chain disruptions and volatility in the car production (around 40% of exports), as well the slowdown of EU trade. We expect the current account to remain in surplus over the forecasting period, but below its pre-Covid level due to the stepped-up investment required for the green and digital transformations.
- **External position:** The Net International Investment Position (NIIP) stood at -9.3% of GDP in Q3 2021. It is expected to gradually decline towards a more balanced position in the medium term, helped by the deleveraging corporate sector, high FDI inflows and the projected sizeable, albeit declining, current account surplus. After having declined by over 23 percentage points between 2014 and 2019 due to banks deleveraging, gross external debt rose from 91.5% in 2019 to 97.7% of GDP as of end-2021 on the back of higher public debt and lower GDP.
- **Resilience to shocks:** Slovenia's small open economy is highly reliant on external demand and well-integrated in the European supply chains. It supports strong FDI inflows (3.1% of GDP on average over the last three years), which contribute to strengthen resilience against external shocks. However, the local economy is structurally exposed to global trade dynamics, especially among its key EU trading partners such as Germany (20% of total exports) and Italy (12%).

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

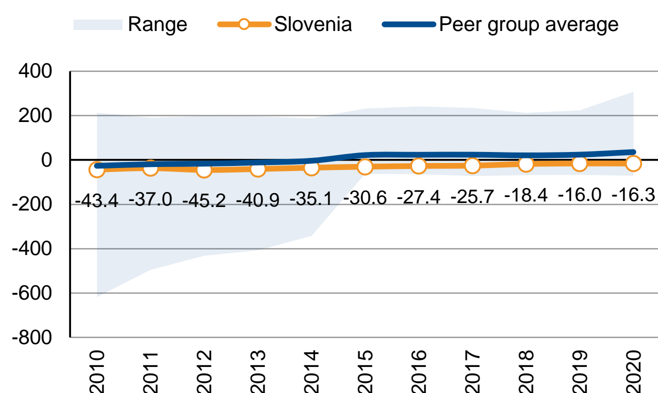
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a	Current account resilience	Neutral	0	Competitive industrial base; strong manufacturing industry
	External debt structure	Neutral	0	Large external debt stock; significant external assets
	Resilience to short-term shocks	Weak	-1/3	Small, open economy; strong reliance on external demand and foreign direct investment

Current account balance, % of GDP



Source: IMF, Scope Ratings GmbH

NIIP, % of GDP



Source: IMF, Scope Ratings GmbH

Financial Stability Risks

- **Banking sector:** Banks benefit from a solid financial situation, as highlighted by the total capital ratio (18.5% as of Q3 2021), common equity Tier 1 capital ratio (17.0%), and liquidity coverage ratio (303.0% in November). However, banks' margins continue to decline (1.4% in November) due to a decreasing net interest income and high competition. In addition, banks' relatively high pre-tax profits resulted mainly from a net release of impairments and provisions, as the Covid-crisis fades progressively.

  Given structural pressures on profitability, two issues deserve close attention currently: First, declarations of bankruptcies increased by 18.8% in Q4 2021 (QoQ), after a decline in previous quarters. However, we expect this to be manageable for bank's exposure since the overall non-performing exposures ratio remains low (1.3% as of November). Second, the Parliament passed in February a law through which banks would have to redefine repayment terms and cap exchange rate losses for borrowers having taken loans in Swiss Franc. Loans denominated in Swiss francs do not constitute a risk to financial stability at present, while emerging contingent risks are expected to have a manageable impact on banks' performance.

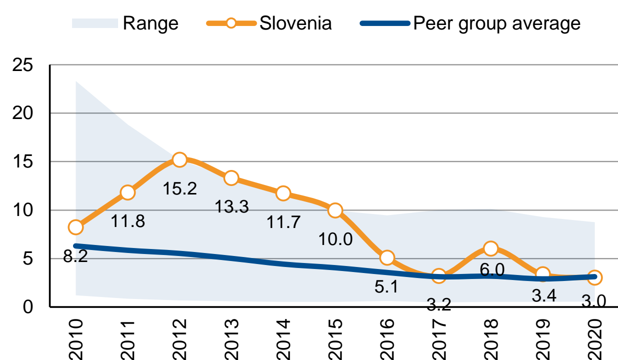
- **Private debt:** The indebtedness ratio of the private sector has decreased significantly since its peak in 2010 (115.2% of GDP), as the deleveraging has been particularly important following the 2013 banking crisis. In 2021, households' and corporates' indebtedness remain low (around 30% and 80% of GDP) and well below the euro area average (70% and 150% of GDP).

- **Financial imbalances:** State ownership in the financial sector decreased substantially in recent years. On the other hand, risks related to the real estate market have been increasing strongly since 2016, including vis a vis peers, with high prices in comparison to economic fundamentals. Even so, banks' exposure to the sector (real estate and construction) remains manageable (14% of total loans to NFC) and the Central Bank has introduced mitigation measures. Large maturity gap between assets and liability in banks' balance sheets constitutes another source of vulnerability.

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

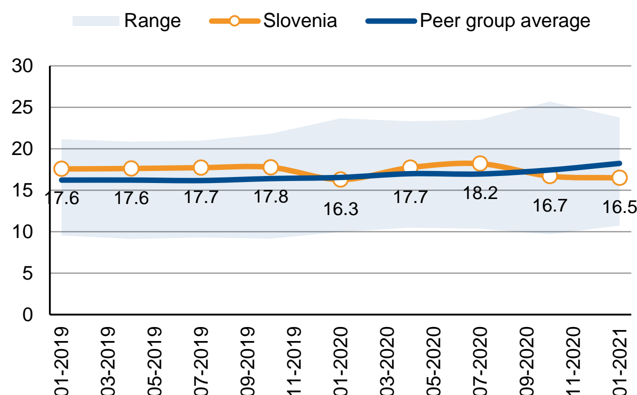
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	High capitalisation levels; emerging contingent risks
	Banking sector oversight	Neutral	0	Rigorous oversight under the ECB
	Financial imbalances	Weak	-1/3	Imbalances in the real estate sector; large maturity gap in banks' balance sheets

NPLs, % of total loans



Source: IMF, Scope Ratings GmbH

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings GmbH

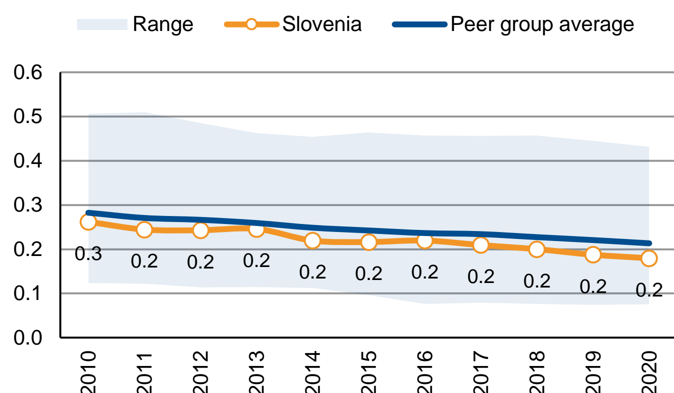
ESG Risks

- **Environment:** Slovenia accounts for 0.5% of total EU GHG emissions and it aims to reach the zero GHG emissions target by 2050. The country faces challenges in the transition process towards a decarbonised energy mix. It remains one of the most carbon-intensive EU member States, despite a significant reduction in coal reliance and achieving its 25% target of energy coming from renewables in 2020. Slovenia set a further target for the share of renewable energy of 27% by 2030, which has been deemed unambitious by the European Commission, being 10 percentage points below the Governance Regulation estimations, due in part to an above EU average share of Natura 2000 areas in the total territory (37.9%) precluding setting more ambitious renewable energy targets. However, private sector initiatives related to renewable energy production could progressively increase the share of renewables in the energy mix, alongside the phase-out of coal in the electricity production that is set for 2033 and accounts for around ¼ of total GHG.
- **Social:** Slovenia benefits from a productive and well-educated labour workforce and one of the lowest income inequalities in Europe in nominal terms. Increasing pressures that weigh on the sustainability of the pension and health systems result mainly from population ageing, which is projected to remain on a rising trend until the mid-2050s due to improved health conditions at older ages and lower fertility rates. Long-term unemployment of older workers constitutes a challenge (63.7% for the 55-64 age group in 2018), as it remains higher than the EU average (58.9%). The old-age-dependency ratio could reach 65% in 2050 according to the OECD.
- **Governance:** Slovenia benefits from strong institutions and the European Union membership. In March 2020, the leader of the Slovenian Democratic Party (SDP), Janez Jansa, was appointed prime minister for the third time. The prime minister runs a governing coalition, in which more than half of ministers come from the SDP, and his party ranks first in voting intentions ahead of the legislative elections due in April 2022. However, uncertainty has risen due to the political fragmentation that may require forming a larger coalition. We also note the adoption of a resolution by the European Parliament in December 2021 regarding fundamental rights and the rule of law.

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

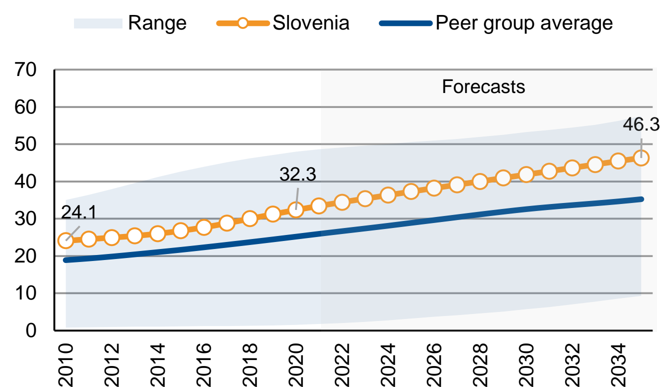
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a	Environmental risks	Weak	-1/3	Energy mix represents transition risks towards gradual decarbonisation
	Social risks	Neutral	0	Well-educated labour force and low levels of income inequality, although rising old-age-dependency ratio
	Institutional and political risks	Weak	-1/3	Rising political fragmentation and uncertainty hampers effective policy making

CO2 emissions per GDP, mtCO2e



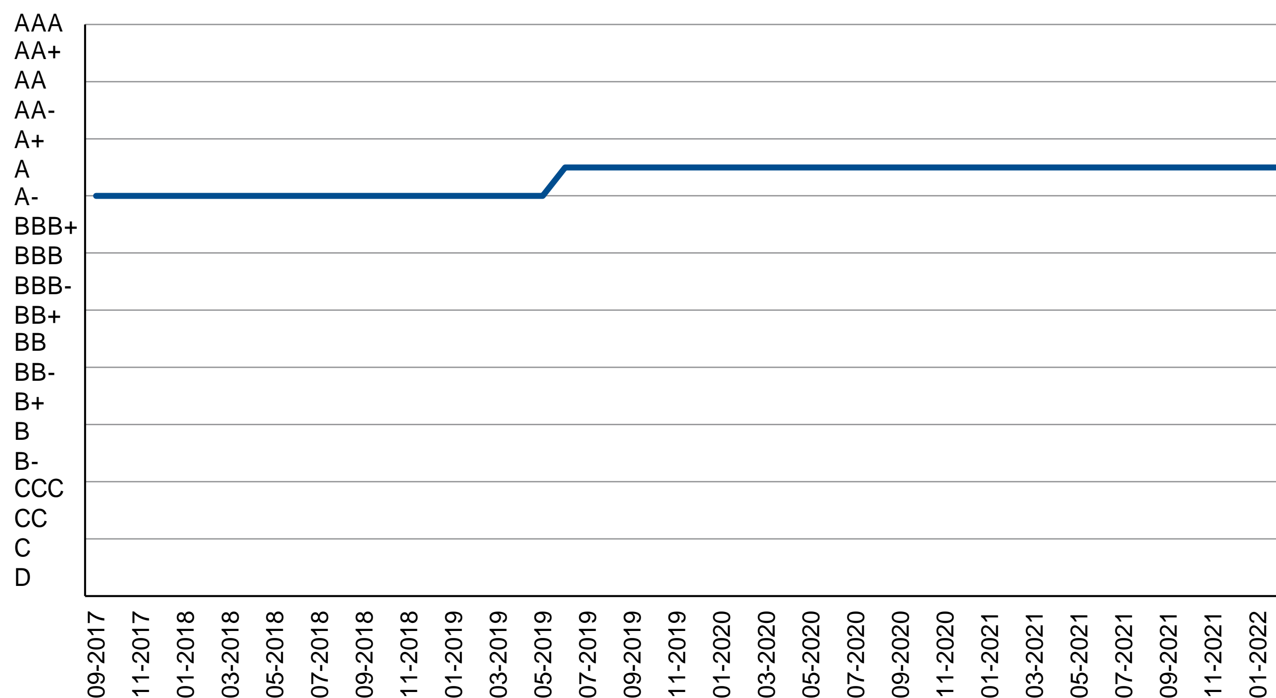
Source: European Commission, Scope Ratings GmbH

Old age dependency ratio, %



Source: United Nations, Scope Ratings GmbH

Appendix I. Rating history



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.

Peer group
Belgium
Czech Republic
France
Japan
Latvia
Lithuania
Malta
Poland
Russia
Slovakia
Slovenia
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 29) used in Scope's quantitative model, the Core Variable Scorecard.

	2016	2017	2018	2019	2020	2021E	2022F	2023F
Domestic Economic Risk								
GDP per capita, USD 000s'	21.7	23.5	26.2	26.0	25.5	28.9	31.0	33.2
Nominal GDP, USD bn	44.8	48.6	54.2	54.2	53.5	60.9	65.5	70.1
Real growth, %[1]	3.2	4.8	4.4	3.3	-4.2	8.1	4.7	3.9
CPI inflation, %	-0.1	1.4	1.7	1.6	-0.1	1.4	1.8	1.8
Unemployment rate, %[1]	8.0	6.6	5.2	4.5	5.0	4.5	4.4	4.0
Public Finance Risk								
Public debt, % of GDP[1]	78.5	74.2	70.3	65.6	79.8	77.3	74.2	73.4
Interest payment, % of government revenue	6.0	4.9	4.0	3.4	3.2	2.7	2.2	1.9
Primary balance, % of GDP[1]	0.7	2.1	2.5	1.9	-6.1	-4.3	-3.7	-2.1
External Economic Risk								
Current account balance, % of GDP	4.8	6.2	6.0	6.0	7.4	3.2	6.3	5.9
Total reserves, months of imports	0.3	0.3	0.3	0.3	0.4	-	-	-
NIIP, % of GDP	-28.8	-24.2	-18.9	-15.9	-15.2	-	-	-
Financial Stability Risk								
NPL ratio, % of total loans	5.1	3.2	6.0	3.4	3.0	-	-	-
Tier 1 ratio, % of risk weighted assets	18.7	17.8	17.6	17.8	16.7	17.0	-	-
Credit to private sector, % of GDP	46.6	45.1	43.3	42.5	43.4	-	-	
ESG Risk								
CO^2 per EUR 1,000 of GDP, mtCO^2e	219.6	209.3	200.0	187.5	179.6	-	-	-
Income quintile share ratio (S80/S20), x	3.6	3.4	3.5	-	-	-	-	-
Labour force participation rate, %	71.6	74.2	75.1	75.1	-	-	-	
Old age dependency ratio, %	27.7	28.8	30.0	31.2	32.3	33.4	34.4	35.4
Composite governance indicator[2]	0.9	0.9	0.9	1.0	0.9	-	-	-

[1] Forecasted values are produced by Scope and may differ from those presented in the charts of the previous sections
[2] Average of the six World Bank Governance Indicators
Source: European Commission, IMF, World Bank, Scope Ratings GmbH

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps) as of 25 February 2022	51.2

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