Slovak Republic
Rating Report

A+ STABLE OUTLOOK

Credit strengths

- EU and euro area memberships
- Still-moderate levels of public debt
- Competitive export-oriented industrial base

Credit challenges

- External vulnerabilities
- Relatively high dependence on car manufacturing sector
- Unfavourable demographics

Rating rationale:

Competitive export-oriented industrial base with high reliance on the car sector: Slovakia is exposed to energy shortages and supply chain disruptions triggered by the Russia – Ukraine conflict. This is expected to weigh on short term economic growth and external outlook, especially because of the significant rise in inflation, one of the highest in the euro area.

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 also to create fiscal buffers and tackle long term challenges. The fiscal and pension reforms under consideration support Slovakia's strong budgetary framework and moderate debt-to-GDP ratios.

Rating challenges include: i) the economy's high exposure to external demand and global value chains; ii) pre-existing public debt sustainability challenges, compounded by adverse demographic trends; and iii) the economy's relatively high reliance on the car industry, exposing it to the acute and structural changes taking place in the sector.

Slovakia's sovereign rating drivers

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

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

- Projected stronger decline in public debt ratios in the medium term, for example, due to sustained fiscal consolidation
- Sustained stronger-than-anticipated economic growth supported by reforms, supporting longer run GDP potential

Negative rating-change drivers

- Material deterioration of macroeconomic stability, for example, due to a prolonged period of energy shortages or sudden halt of energy supply from Russia
- Persistent increases in the government debt ratios in the medium term, for example, because of sustained delay in fiscal consolidation

Ratings and Outlook

Foreign and 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

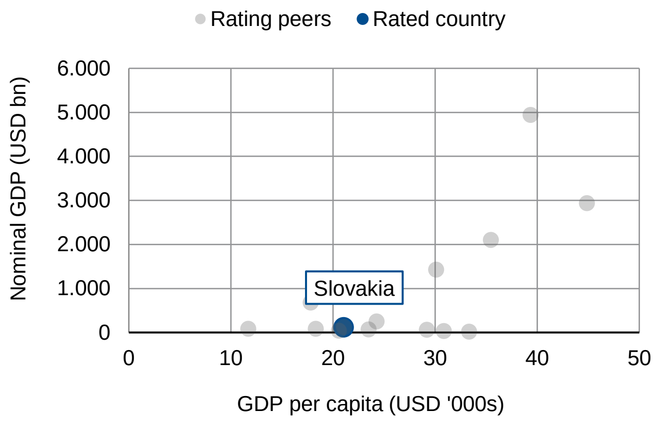
Domestic Economic Risks

- **Growth outlook:** GDP is projected to increase by 2.5% in 2022, down from 3.0% in 2021, and reach 4.8% in 2023. The Slovak economy is highly vulnerable to i) energy supply disruptions that could significantly hurt the industrial production (22% of GDP), and ii) persistent supply chain bottlenecks that could reduce the contribution of net exports to GDP growth, among which the industry-heavy export sectors such as the automotive industry (12% of GDP and 48% of industrial production). On the demand side, geopolitical uncertainties and repercussions on the European energy market weigh on household consumption (57% of GDP), with energy-housing and food representing about 47% of consumption expenditure. Even so, investment resulting from the EU Recovery and Resilience Facility (up to EUR 6.3 billion in grants (7.0% of GDP) over 2021-2026) could support economic activity. In the long term, GDP growth potential (estimated around 2%) is exposed to rapidly ageing population.
- **Inflation and monetary policy:** Inflation rate is expected to reach 8.4% in 2022, up from 2.8% in 2021, and 4.1% in 2023 despite administered energy prices, including electricity. In March, consumer prices surged to 10.4% YoY on the back of rising energy and food prices. We expect inflationary pressures to persist, which reflects the delays for inflation to pass through to administered prices, and the time required to ease supply side constraints related to heavy dependence on Russia's energy imports.
- **Labour market:** Unemployment rate stands at 6.7% in March, which is in line with the euro area average although higher than the pre-pandemic rate (5.7%). Slovakia's main challenges relate to long term unemployment, more than 60% of the unemployed being out of work for more than a year, the automation of the manufacturing industry, among which the automotive sector accounting for around 3.5% of total employment, as well as skills mismatches and shortages in some segments.

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

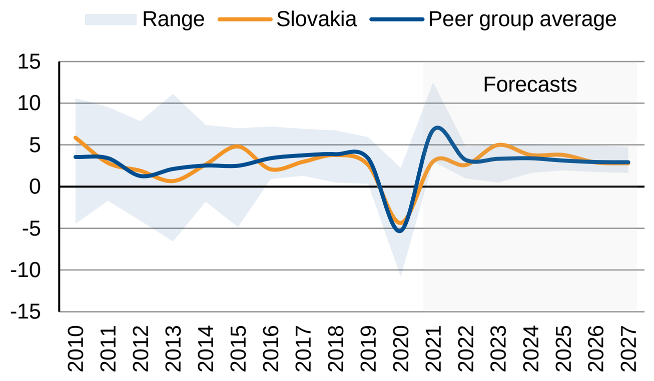
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a+	Growth potential of the economy	Neutral	0	Medium-run growth potential in line with peer average, but moderate productivity growth
	Monetary policy framework	Neutral	0	ECB is a highly credible and effective central bank; effective policy framework and transmission over the cycle
	Macro-economic stability and sustainability	Neutral	0	Competitive manufacturing industry but challenges for medium-term dynamics in automotive production due to rising demand for electric cars

Nominal GDP and GDP per capita, USD '000s



Source: IMF WEO, Scope Ratings GmbH

Real GDP growth, %



Source: IMF WEO, Scope Ratings GmbH

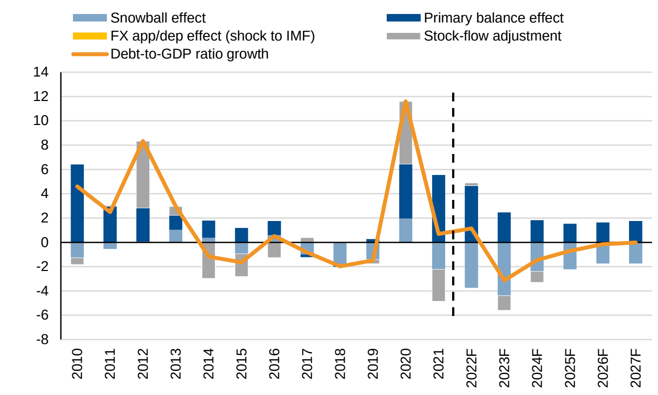
Public Finance Risks

- **Fiscal outlook:** Public deficit could reach 5.5% of GDP in 2022 (up from 6.5% in 2021) and 3.2% in 2023 due to increase spending in response to inflationary pressures. The refugee crisis could also weigh on public expenditures in the short term since about 300 000 people (around 5% of Slovakia's population) crossed the Ukrainian border and will benefit from the package of laws in terms of health, social care, and education. Public investments will contribute to primary fiscal deficits, although the contribution from the EU's Recovery and Resilience Facility, essentially skewed towards climate (43% of spending) and digital (21%), could ease pressures. Amendments to the fiscal framework, including multi-annual expenditure ceilings (covering 80% of spending) and net debt targets (including sanction bands and escape clause), are expected to support flexibility for counter cyclical fiscal policies, without undermining fiscal credibility, thus paving the way for the disbursement under the EU Recovery and Resilience Facility. We see the authorities strongly committed to national and EU fiscal rules, once reactivated.
- **Debt trajectory:** General government gross debt is projected to increase to 61.6% of GDP in 2022 (up from 60.4% in 2021) and decline slightly to 58.4% in 2023. We see the public debt to GDP ratio stabilising around 55-60% of GDP by 2027 in a baseline scenario on the back of Slovakia's recent track record in fiscal consolidation, as illustrated by the primary fiscal surplus reached in 2017 (0.2% of GDP) and 2018 (0.2% of GDP). Importantly, medium-to-long-term fiscal sustainability is vulnerable to a no-policy change scenario with respect to the pension expenditures, as the ratio of retirees to the working-age population will more than double over the next 30 years. A pension reform has been initiated by the authorities, as required under the under the EU Recovery and Resilience Facility, with the aim to realign the effective retirement age on life expectancy.
- **Market access:** Slovakia benefits from favourable financing conditions and a supportive debt profile. The ECB holds nearly half of outstanding Slovak government securities and the average maturity of the debt portfolio is relatively high (8.4 years). Almost all debt is denominated in euros and carries a fixed coupon, a cushion in the context of rising interest rates.

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

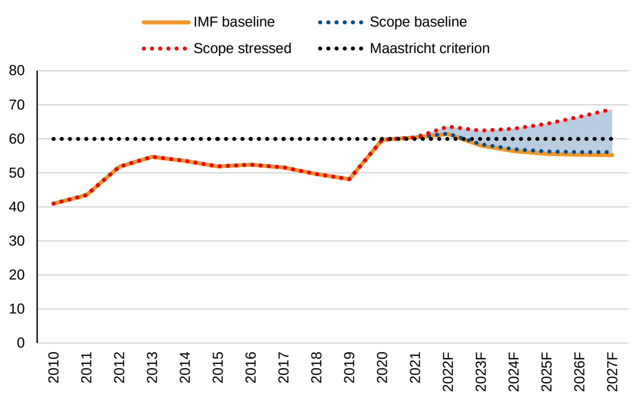
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a-	Fiscal policy framework	Strong	+1/3	Credible and flexible constitutional budgetary framework
	Debt sustainability	Neutral	0	Moderate but rising debt levels over the medium-term in a no-policy change scenario
	Debt profile and market access	Neutral	0	Favourable debt structure, significant debt holdings by the ECB

Contributions to changes in debt levels, pps of GDP



Source: Scope Ratings GmbH

Debt-to-GDP forecasts, % of GDP



Source: IMF WEO, Scope Ratings GmbH

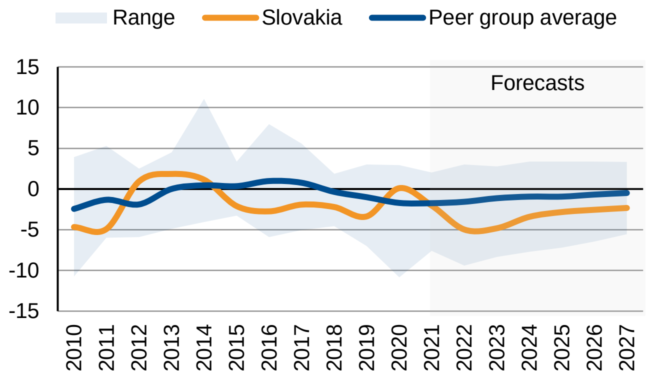
External Economic Risks

- **Current account:** Slovakia's current account is expected to widen to 5.0% of GDP in 2022 (from 2.0% of GDP in 2021) because of the deterioration of terms of trade and moderate foreign investment inflows resulting from geopolitical uncertainties. Trade exposure to Russia is limited (1.6% of exports and 4.6% of imports in 2020) but the Slovak economy is exposed to supply chain disruptions and lower external demand of manufacturing products from the European Union (78% of exports), among which Germany. The increasing inflow of EU funds, notably under the EU Recovery and Resilience Plan, should help overfund current account deficits.
- **External position:** The net international investment position (NIIP) remained broadly stable in 2021 around EUR 60 billion (58.7% of GDP). Inward foreign direct investments (mostly equity capital and reinvested earning) still account for around 75% of the NIIP, reflecting stable capital inflows. 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 (around 24% of total exports). 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 stable foreign capital inflows, contribute to manage external imbalances.

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

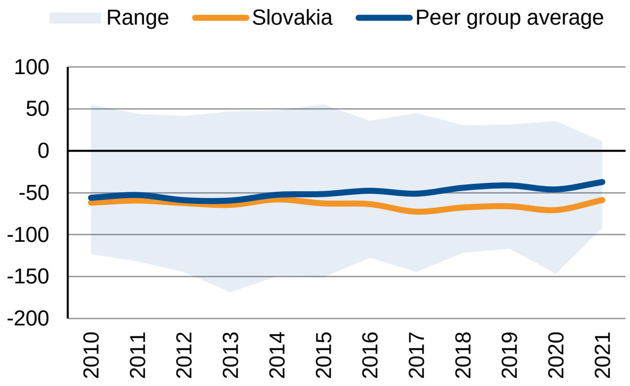
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
ccc	Current account resilience	Neutral	0	Export diversification broadly in line with peer countries
	External debt structure	Strong	+1/3	Substantial share of direct investment in external liabilities
	Resilience to short-term shocks	Neutral	0	Small-open economy; but benefits from EU and euro area memberships

Current account balance, % of GDP



Source: IMF WEO, Scope Ratings GmbH

NIIP, % of GDP



Source: IMF WEO, Scope Ratings GmbH

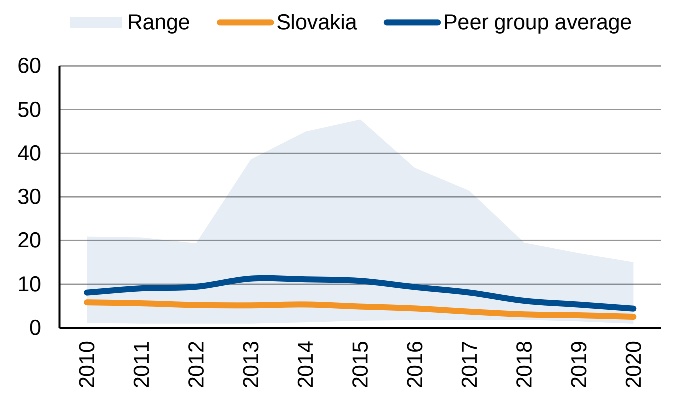
Financial Stability Risks

- **Banking sector:** The banking sector presents a limited contingent liability risk for the sovereign balance sheet, and direct exposure to Russia, Ukraine, and Belarus is low. Slovakia's banking sector is mostly foreign owned by parent banks (located in Austria and Italy) that may have a larger exposure, but this largely refers to stable and well-capitalised banking groups. Slovakia's banking sector is well capitalised and profitable, with a system-wide tier 1 capital ratio of 17.7% and a return on equity of 10.0% as of Q4 2021 according to the European Banking Authority, above the EU weighted average of 17.0% and 7.3% respectively. Non-performing loans stand at 1.6% as of the same quarter, down from 2.0% of total loans in Q4 2020.
- **Private debt:** Household debt ratios (around 50% of GDP) are among the highest in Central and Eastern European countries, driven by strong growth in house prices and associated robust mortgage lending. Although slightly driven by income growth, household debt growth has been significantly outpacing it for the last decade.
- **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.

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

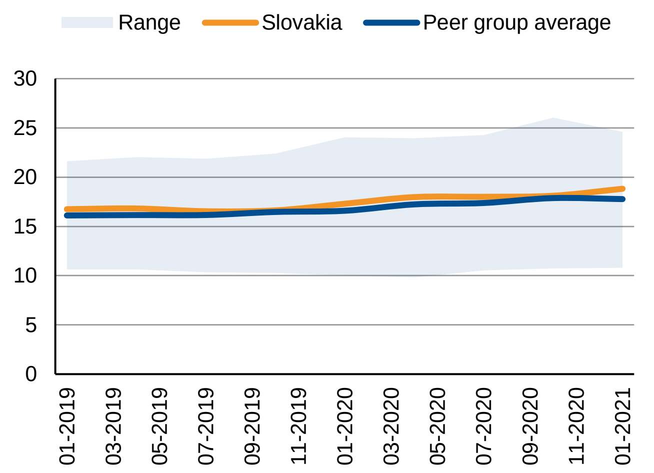
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	Well-capitalized banking sector with a low NPL ratio
	Banking sector oversight	Neutral	0	Oversight under the National Bank of Slovakia and the ECB as part of Banking Union
	Financial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

NPLs, % of total loans



Source: IMF WEO, Scope Ratings GmbH

Tier 1 ratio, % of risk-weighted assets



Source: IMF WEO, Scope Ratings GmbH

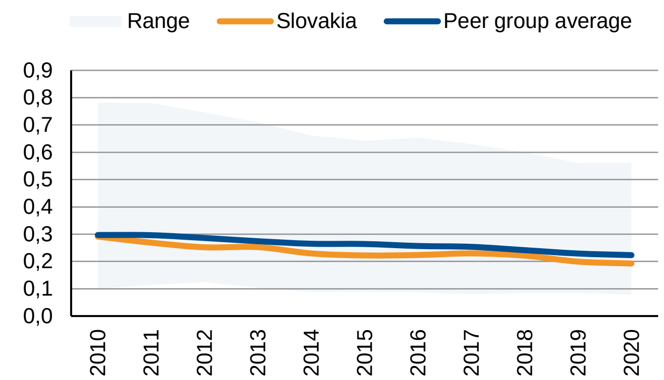
ESG Risks

- **Environment:** Slovakia's energy mix reflects exposure to higher energy prices such as natural gas (25% of energy supply in 2020), oil (22%), and coal (14%). However, the nuclear energy (25%) constitutes an important cushion against price pressures thanks to four nuclear power plants. The development of domestic production capacities could also enhance the capacity of the Slovak car industry for a transition towards electric vehicles. In that respect, the current long-term EU budget constitutes an opportunity for Slovakia to reduce GHG emissions, mostly resulting from steelmakers, and reach carbon neutrality by 2050.
- **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), unemployment rates (6.7% in March) around EU averages, and below-EU average poverty rates and risk of social exclusion.
- **Governance:** Slovakia's performance is weaker than that of other euro area members in Central and Eastern Europe, as assessed using the World Bank's Worldwide Governance Indicators. Nevertheless, the economy's EU and euro area memberships support credible macroeconomic policies and a relatively stable governance framework. Perceived corruption is relatively high, but Scope views positively the government's efforts to undertake judicial and anti-corruption reforms.

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

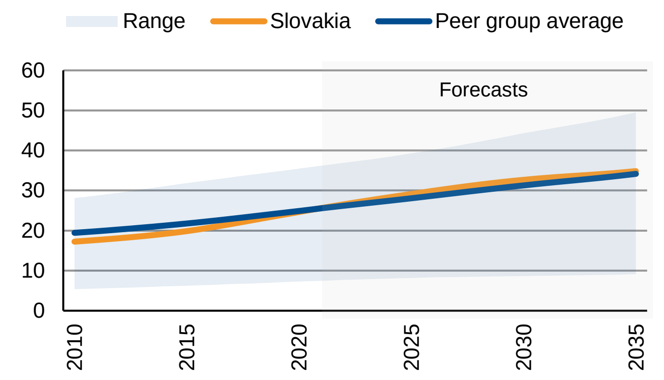
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a	Environmental risks	Neutral	0	Potential pressures from emission standards, below-EU-average but increasing share of renewable energy in total energy consumption, transition risks in line with CEE peers
	Social risks	Neutral	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

CO2 emissions per GDP, mtCO2e



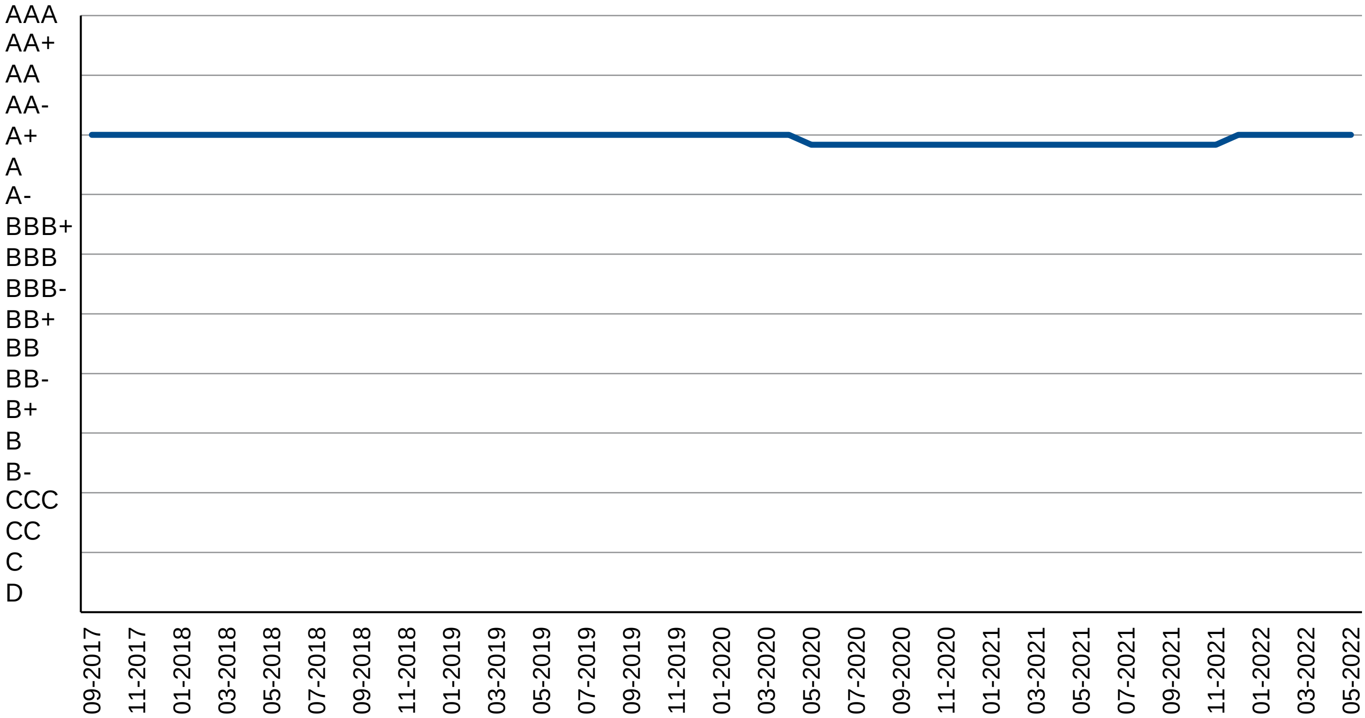
Source: European Commission, Scope Ratings GmbH

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*
Bulgaria
China
Croatia
Cyprus
Hungary
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 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'	16.5	17.5	19.4	19.3	19.3	21.1	21.7	23.9
Nominal GDP, USD bn	89.7	95.4	105.7	105.3	105.1	114.9	118.4	131.0
Real growth, %[1]	2.1	3.0	3.8	2.6	-4.4	3.0	2.5	4.8
CPI inflation, %	-0.5	1.4	2.5	2.8	2.0	2.8	8.4	4.1
Unemployment rate, %[1]	9.6	8.1	6.5	5.7	6.7	6.8	6.8	6.8
Public Finance Risk								
Public debt, % of GDP[1]	52.4	51.6	49.6	48.1	59.7	60.4	61.6	58.4
Interest payment, % of government revenue	3.5	3.1	3.0	2.7	2.6	2.2	1.9	1.7
Primary balance, % of GDP[1]	-1.2	0.2	0.1	-0.3	-4.5	-5.5	-4.7	-2.5
External Economic Risk								
Current account balance, % of GDP	-2.7	-1.9	-2.2	-3.4	0.1	-2.0	-5.0	-4.8
Total reserves, months of imports	0.4	0.5	0.6	0.8	1.2	-	-	-
NIIP, % of GDP	-63.6	-72.6	-67.6	-66.1	-70.7	-	-	-
Financial Stability Risk								
NPL ratio, % of total loans	4.3	3.6	3.1	3.0	2.6	-	-	-
Tier 1 ratio, % of risk weighted assets	16.2	16.6	16.6	16.6	18.1	18.3	-	-
Credit to private sector, % of GDP	57.1	60.2	62.0	62.8	67.2	-	-	-
ESG Risk								
CO^2 per EUR 1,000 of GDP, $mtCO^2e$	223.6	229.5	221.3	199.3	192.5	-	-	-
Income quintile share ratio (S80/S20), x	3.9	3.5	3.8	3.5	-	-	-	-
Labour force participation rate, %	72.0	72.2	72.5	72.7	-	-	-	-
Old age dependency ratio, %	20.7	21.7	22.7	23.7	24.6	25.6	26.6	27.5
Composite governance indicator[2]	0.7	0.7	0.6	0.6	0.7	-	-	-

[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 WEO, World Bank, Scope Ratings GmbH

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps) as of May 5	37.3

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