19 August 2022

Sovereign and Public Sector

Republic of Slovenia
Rating Report

SCOPE A STABLE OUTLOOK

Credit strengths	Credit challenges
• Euro area membership	• Low diversified energy supply
• Strong market access and debt profile	• Moderately high public debt burden
• Sound fiscal policy	• Labour market rigidities
• Fiscal and external buffers	• Ageing population

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.

Strong market access and favorable debt profile: Slovenia benefits from a strong market access and debt management policy that mitigate risks resulting from higher interest rates.

Effective fiscal policy management: Slovenia has demonstrated sound and effective fiscal policy making that should enable a gradual reduction of primary deficits conditional upon structural reforms.

Fiscal and external buffers: Slovenia has elevated cash reserves and comfortable current account surpluses until 2021 that reinforce its capacity to cope with market volatility and external shocks.

Rating challenges include: i) the limited diversification of energy supply amid geopolitical uncertainties which weighs on the economic outlook; ii) a moderately high public debt; iii) labour market rigidities curbing medium-term GDP growth; and iv) adverse demographic trends with a rapidly ageing population which places long-term structural pressures on fiscal sustainability through rising pension and healthcare expenditures.

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%	aa-		0	
External Economic Risk		10%	bbb		-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-term growth prospects notably improve, supported by structural reforms
- Fiscal outlook improves; public debt on a firm downward trajectory

Negative rating-change drivers

- Medium-term growth prospects deteriorate
- Fiscal outlook weakens materially due to a protracted fiscal deterioration
- Political fragmentation and policy uncertainty curtail the implementation of needed reforms

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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Domestic Economic Risks

- **Growth outlook:** Slovenian economy is performing well with GDP growth projected at 5.6% in 2022 – based on strong carry-over from 8.1% growth rate in 2021 – and 2.5% in 2023. However, risks on the economic outlook are exceptionally high given substantial reliance on Russian gas (no storage capacity) that accounts for 81% of imports as of 2020 (against 10-15% for oil) and around 11% of the energy mix. Despite interconnection with the gas transmission networks of EU member states (Austria, Italy, Croatia), uncertainty undermines private consumption – a key growth driver. Disruptions in energy supply, especially for sectors such as metallurgy, and in supply-chains could derail production of the automotive industry, accounting for around 10% of GDP. In addition, economic slowdown of key European partners (Germany, Italy, Austria) is a risk on the short-term growth outlook. Longer term, a sustained rise in GDP growth enabling Slovenia to converge with peers and other EU countries is conditional upon structural reforms to address bottlenecks such as labour market rigidities, limited labour supply, low productivity growth, and still large state-owned sector.

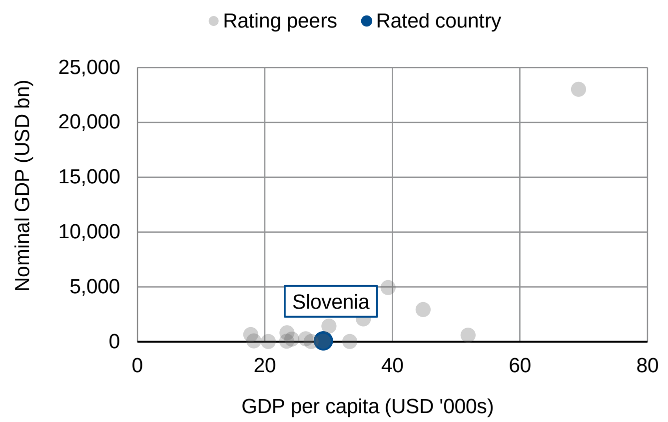
- **Inflation and monetary policy:** Rising food and energy prices led inflation to reach its highest rate since early 2000s at 11% YoY in July 2022. The ECB's decision to hike policy rates by 50bps may help curb inflationary pressures, but a structurally tight labour market makes wage renegotiations in the private sector, and thus more broad-based and sustained inflationary pressures, more likely. We forecast inflation at 8.1% in 2022 and 4.8% in 2023.

- **Labour market:** The unemployment rate is low at around 4% as of June 2022 (well below the euro area average of 6.6%) and in line with pre-Covid levels. Even so, short term dynamics threaten a sustained rise in GDP growth given weaknesses related to an old workforce, low mobility, elevated minimum wage, and high labour tax burden. The green and digital transformations also require massive public investment in domestic skills and incentives to attract high-skilled foreign workers. Still, recent reforms improving labour market flexibility and lowering labour costs for high-skilled workers start to address some of these challenges.

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

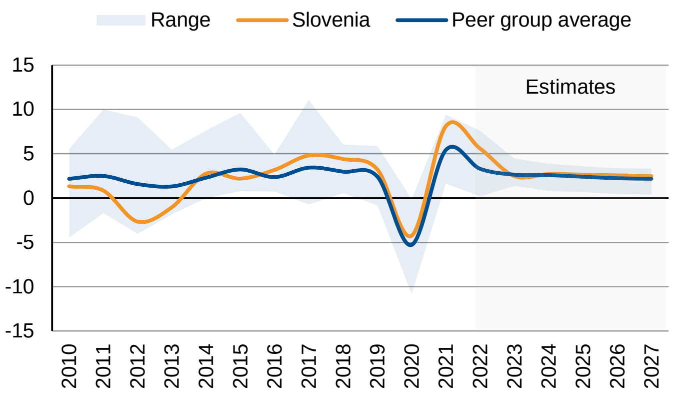
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa-	Growth potential of the economy	Neutral	0	Medium-run growth potential faces challenges from adverse demographic trends; sustained public investment
	Monetary policy framework	Neutral	0	ECB is a highly credible and effective central bank; effective policy framework and transmission over the cycle
	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

Real GDP growth, %



Source: IMF, Scope Ratings

Public Finance Risks

- **Fiscal outlook:** Covid-related measures (more than 10% of GDP in 2020-2022) and one-off measures to offset the impact of higher energy prices (price cap, reduced VAT and excise duties on gas, one-off solidarity allowance – representing about 0.5% of GDP) are set to delay fiscal consolidation. The deficit would gradually decline from 5.2% of GDP in 2021 to 5.0% in 2022 and 4.5% in 2023, as the lack of details around the coalition agreement in terms of measures and timing – as underlined by the Fiscal Council – supports a conservative fiscal trajectory compared to the previous government. Population ageing also remains a major credit challenge as pension indexation adds to long term challenges, with pension and healthcare spending projected to reach 16% of GDP by 2050.

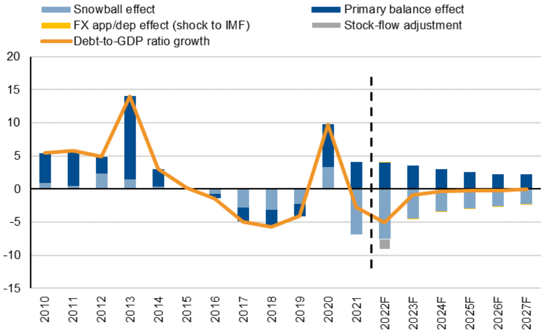
- **Debt trajectory:** Public debt is set to gradually decline from 74.7% GDP in 2021 to around 68% of GDP in 2027. Slovenia has committed to adopt a pension reform by 2024, which is likely based on the pro-EU ruling coalition agreement, which plans to strengthen the first pension pillar and additional pension savings. This could lower fiscal pressures going forward as disbursements from the EU Recovery and Resilience Facility could also incentivise reforms addressing ageing-related spending pressures. Still, energy disruptions make unlikely that the government will pass a comprehensive pension reform in the short term. In addition, adjustment of the domestic fiscal rule (waived in 2022 given exceptional circumstances) to exclude investments would require alignment with the planned revision of the EU governance framework.

- **Market access:** Slovenia's 10-year government bond yields have remained anchored since the onset of the Russia-Ukraine crisis – on average at 1.5% in March-April 2022 – but rose above the 2% mark in May-June 2022. Sound debt management policy in the form of elevated cash reserves (around EUR 8bn, or 15% of GDP), long average maturity (10 years on average), no FX exposure, fixed interest rates (99.3% of debt), and declining share of debt held by non-resident investors (57% in 2021) constitute adequate buffers against market volatility and higher interest rate burden. In addition, Bank of Slovenia's holdings of public debt (almost one third of total) and ECB's Transmission Protection Instrument significantly mitigate funding risks.

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

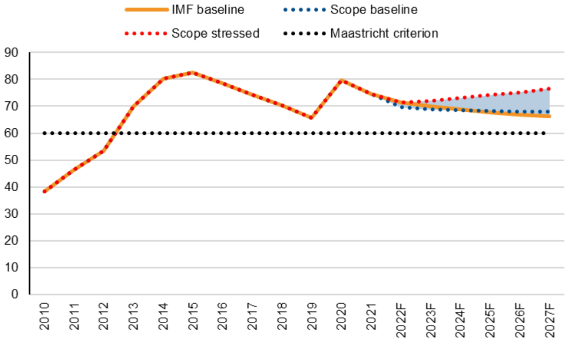
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa-	Fiscal policy framework	Neutral	0	Credible fiscal policy framework; some fiscal space for policy stimulus
	Debt sustainability	Neutral	0	Higher debt burden; positive debt dynamics in a baseline scenario
	Debt profile 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

Debt to GDP forecasts, % of GDP



Source: IMF, Scope Ratings

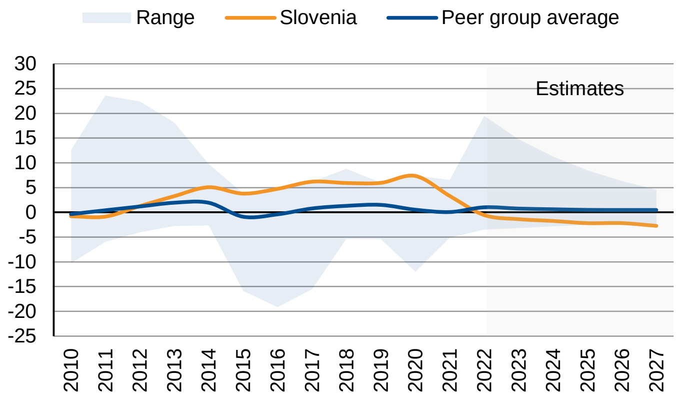
External Economic Risks

- **Current account:** We expect Slovenia to maintain a slightly positive current account balance in the near term (after 3.8% of GDP in 2021), although below pre-Covid levels (4.6% on average between 2012 and 2019) because of higher import prices, supply-chains disruptions, uncertainties among EU trading partners, and stepped-up investment required for the green and digital transformations. Renewed pressures on energy prices would also make a wage-price spiral more likely, with potential implications for the competitiveness of export-oriented sectors where labour costs are already higher than peers such as Slovakia and Croatia. Longer term, Slovenia's external sector could be undermined by shortages of skilled labour force hindering productivity growth and higher value-added exports.
- **External position:** The Net International Investment Position (NIIP) is balanced in comparison to peers, at around -6.6% of GDP as of end-2021. We expect this trend to persist based on moderate but sustained current account surpluses. Contained net external liabilities constitute a strength in case of a downside scenario. Still, gross external debt continues to follow a rising trend, with liabilities amounting to EUR 51bn (or 86.5% of GDP) in May 2022 (against EUR 44bn in May 2019), mainly because of higher liabilities from the central bank and the private sector.
- **Resilience to shocks:** Slovenia's small open economy is highly reliant on external demand and well-integrated in the European supply chains. Despite sustained FDI inflows (2.8% of GDP on average over the past three years) and low exposure to Russia-Ukraine contributing to external resilience, the economy is vulnerable to a pronounced slowdown of economic activity in the European Union. The EU accounts for more than three quarters of good exports, among which main trading partners are Germany (18% of total exports), Italy (11%), Croatia (8%), Austria (7%) and France (5%).

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

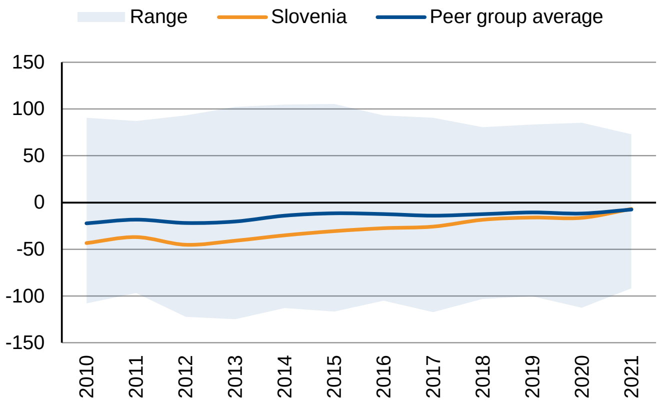
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb	Current account resilience	Neutral	0	Competitive industrial base; strong manufacturing industry
	External debt structure	Neutral	0	Rising external debt stock; significant external assets
	Resilience to short-term shocks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

Current account balance, % of GDP



Source: IMF, Scope Ratings

NIIP, % of GDP



Source: IMF, Scope Ratings

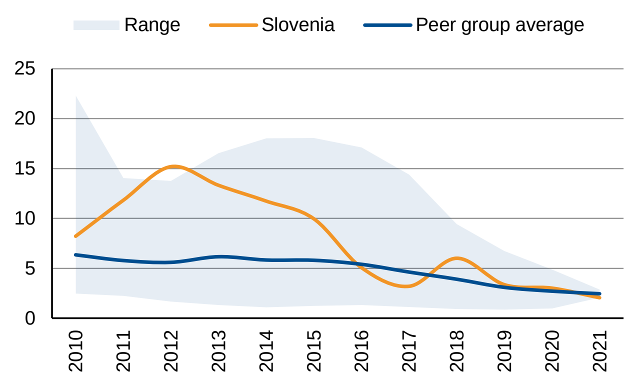
Financial Stability Risks

- **Banking sector:** Banks benefit from a strong capitalisation (CET-1 ratio of 15.7% as of end-April 2022), a declining but still high liquidity supported by TLTRO-III (coverage ratio of 290%), and an adequate profitability (pre-tax return on equity of 8.22%). Non-performing exposures (NPEs) have remained stable (1.2% since December 2021), although aggregated figures hide disparities across sectors with elevated NPEs in the tourism industry (14%). Exposure to Russia, Ukraine and Belarus is marginal (0.2% of the portfolio), but current pressures on the residential real estate market could undermine the credit quality and profitability through higher impairments and provisions. The implementation of the law requiring banks to redefine repayment terms and cap exchange rate losses for borrowers having taken loans in Swiss Franc is pending on the decision of the Constitutional Court. Still, the legacy from 2000's should remain manageable for local banks with loans estimated at EUR 250m.
- **Private debt:** Consolidated households and corporates' indebtedness is low (around 28% and 42% of GDP, respectively, as of 2020) and below the euro area average (56% and 73% of GDP). Even so, highly indebted corporates experiencing higher refinancing costs and producer prices (energy, raw materials) could face temporary financial difficulties with manageable implications for local banks.
- **Financial imbalances:** Overvaluation of the real estate market prices is the main risk lingering on domestic financial stability. Prices of existing dwellings have followed a sustained rise (+69% in Q1 2022 since Q1 2016 and +18.3% since Q1 2021) compared to economic fundamentals. Still, risks are mitigated by the banks' declining total stock of loans to NFCs in the sector of construction and real estate (down to EUR 1bn at the end of 2021), low private debt compared to peers, and further adjustments of mortgage lending standards by the central bank, including the strengthening of capital requirements.

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

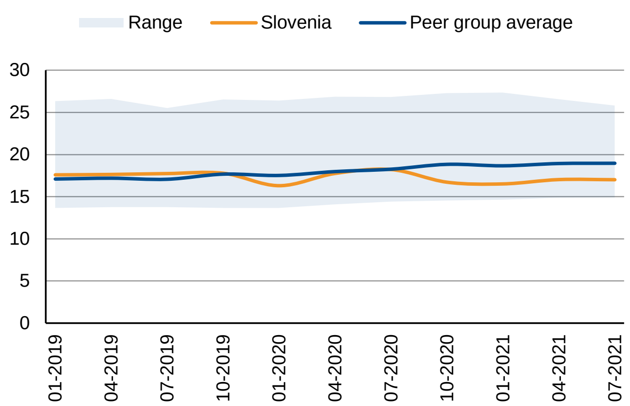
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	High capitalisation levels; emerging contingent risks
	Banking sector oversight	Neutral	0	Rigorous oversight under the ECB as part of the Single Supervision Mechanism
	Financial imbalances	Weak	-1/3	Imbalances in the real estate sector due to rising house prices and real estate market overvaluation; large maturity gap on banks' balance sheets

NPLs, % of total loans



Source: IMF, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

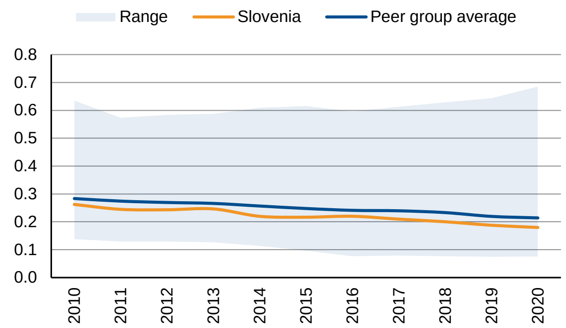
ESG Risks

- **Environment:** Net-zero by 2050 is an ambitious target that would require strengthening public sector regulations (effective use of carbon price) and providing incentives to the private sector, with electricity and manufacturing industries and transport accounting for the largest share of CO_2 emissions. The country's energy mix is relatively diversified, with the highest share represented by oil (31%), followed by nuclear (23%) and fossil fuels (18%), although additional investments in renewables are necessary to diversify energy supply. The government's plan to build large solar power plants of 1 GW in total by 2025 could reinforce this trend. Still, efforts to accelerate the green transition are at risk of slowing down as coal-based electricity generation (which the phasing out is planned by 2033) may appear as the most immediate alternative to supply disruptions. The National Energy and Climate Plan Meeting estimates that reducing GHG emissions by 36%, improving energy efficiency by at least 35% and the share of renewable energy resources by at least 27% would require EUR 28bn of investment by 2030 (or 6% of GDP per year on average).
- **Social:** The median age of the population is forecast to reach about 50 years by 2050 – pushing the old-age-dependency ratio around 65% in 2050 from 35% in 2020 according to the OECD given older ages and less new-borns. Slovenia's public pension expenditures are thus expected to experience the second biggest rise in the EU-27 (after Luxemburg) by 2070. In addition, addressing persistent skills mismatches constitute another long-term challenge, although Slovenia's benefits from a productive and well-educated labour workforce. This also reflects total public education expenditures (4.6% of GDP in 2019) in line with the EU-27 average (4.7%).
- **Governance:** Following April's legislative elections, Robert Golob was elected prime minister by the National Assembly in May and his government was appointed in June. The ruling coalition – composed of the Freedom Movement, Social democrats, and Left party – has an absolute majority (53 seats out of 90 seats) that could support the reform momentum. While the three party-coalition seems to be more stable than the one formed in 2018 (five party-coalition), the implementation of controversial reforms under challenging conditions could test the stability of the ruling coalition. Finally, while the state's ownership in the economy is still higher than peers in various sectors (banking, insurance, agriculture, tourism), the current coalition is likely to accelerate privatisations.

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

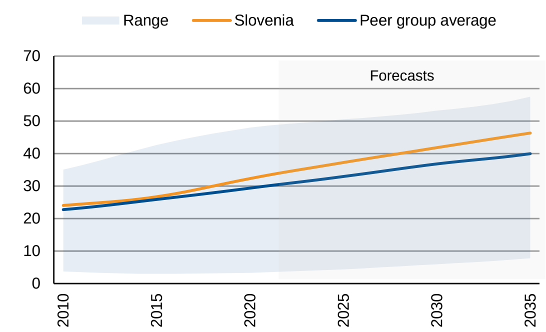
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a	Environmental risks	Weak	-1/3	Energy mix represents transition risks towards gradual decarbonisation
	Social risks	Neutral	0	Well-educated labour force and low levels of income inequality, although rising old-age-dependency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

CO_2 emissions per GDP, mtCO2e



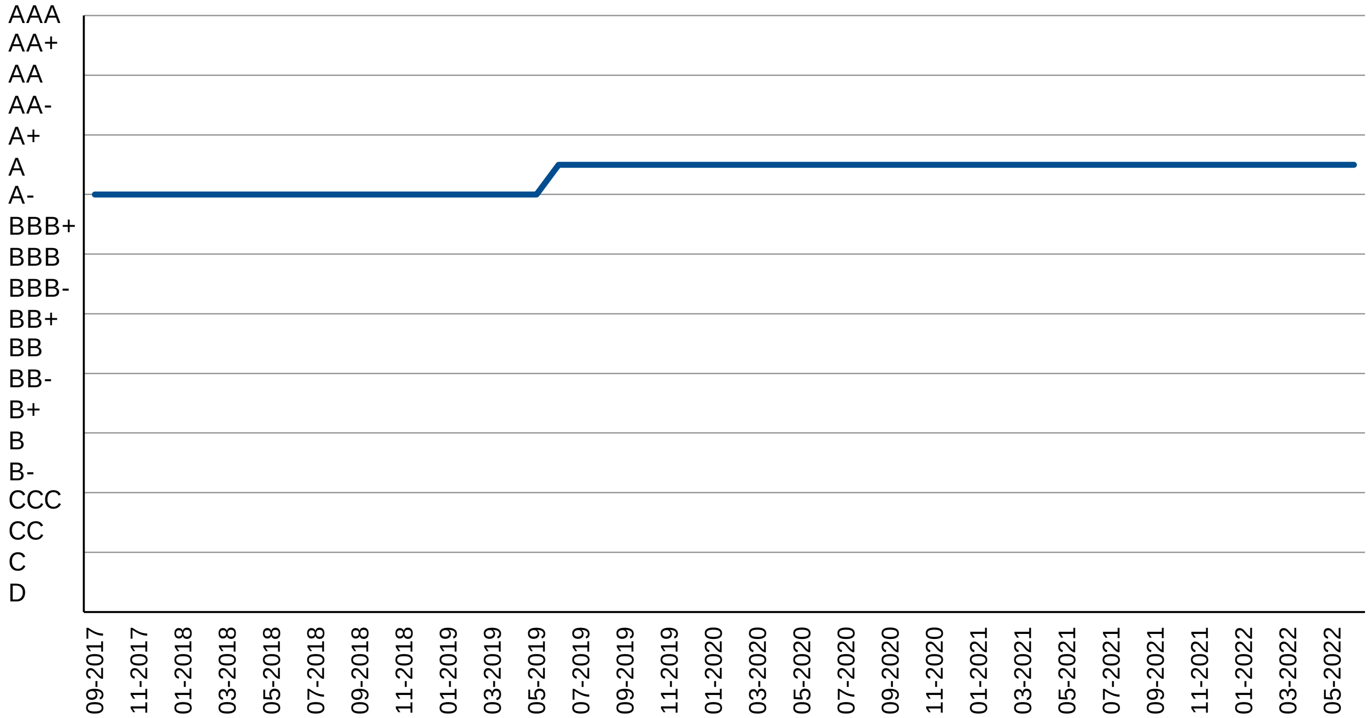
Source: European Commission, Scope Ratings

Old age dependency ratio, %



Source: United Nations, Scope Ratings

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
Estonia
France
Italy
Japan
Latvia
Lithuania
Malta
Poland
Portugal
Slovenia
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 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	29.2	30.2	33.1
Nominal GDP, USD bn	44.8	48.6	54.2	54.2	53.5	61.6	63.6	69.9
Real growth, %[1]	3.2	4.8	4.4	3.3	-4.2	8.1	5.6	2.5
CPI inflation, %	-0.1	1.4	1.7	1.6	-0.1	1.9	6.7	5.1
Unemployment rate, %[1]	8.0	6.6	5.1	4.5	5.0	4.7	4.5	4.3
Public Finance Risk								
Public debt, % of GDP[1]	78.5	74.2	70.3	65.6	79.8	74.7	69.7	68.9
Interest payment, % of government revenue	6.0	4.9	4.1	3.4	3.2	2.4	2.0	1.7
Primary balance, % of GDP[1]	0.7	2.1	2.5	1.9	-6.4	-4.1	-4.0	-3.6
External Economic Risk								
Current account balance, % of GDP	4.8	6.2	6.0	6.0	7.6	3.8	-0.5	-1.4
Total reserves, months of imports	0.3	0.3	0.3	0.3	0.4	0.5	-	-
NIIP, % of GDP	-28.8	-24.2	-18.9	-16.2	-15.6	-6.5	-	-
Financial Stability Risk								
NPL ratio, % of total loans	-	-	6.0	3.4	3.0	2.1	-	-
Tier 1 ratio, % of risk-weighted assets	18.7	17.8	17.6	17.8	16.7	16.8	15.7	-
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	3.4	-	-	-	-
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 August 15, 2022	57.17

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