Slovak Republic
Rating Report

SCOPE 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:

The revision of the Outlooks on Slovakia's ratings to Stable reflects Scope's projection that general government debt-to-GDP levels will stabilise and gradually decline in the medium term. This is due to slowly declining fiscal deficits and continuing, though slightly weakened, economic growth momentum, underpinned by the authorities' reaffirmed commitment to credible national fiscal rules and reforms to the fiscal framework.

The affirmation of Slovakia's A+ long-term ratings considers Slovakia's institutional strengths, supported by its membership in the EU and euro area. The A+ rating recognises Slovakia's still-moderate levels of public debt and competitive export-oriented industrial base.

However, Slovakia's credit ratings remain constrained by outstanding short- and longer-term credit challenges relating to: i) a degree of uncertainty over a sustained economic recovery from the pandemic, reflecting the economy's high exposure to international value chains; ii) pre-existing debt sustainability challenges, compounded by adverse demographic trends; and iii) the Slovak economy's relatively high reliance on the car industry, exposing it to 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	
Public Finance Risk		25%	a-		+1/3	
External Economic Risk		10%	b-		-1/3	
Financial Stability Risk		10%	aaa		0	A+
ESG Risk	Environmental Risk	5%	aaa		0	
	Social Risk	5%	a+		0	
	Governance Risk	10%	bbb-		0	
Overall outcome		**a**		**+1**	**0**	

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
- Sustained stronger-than-anticipated economic growth
- Implementation of reforms improving longer run growth potential, including by means of structural adjustments to ongoing changes in car industry

Negative rating-change drivers

- Materially higher debt ratios in the medium term than currently projected
- Material widening in net external debtor position
- Structural shock to automotive industry, undermining growth fiscal outlooks

Ratings and Outlook

Local and foreign currency

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

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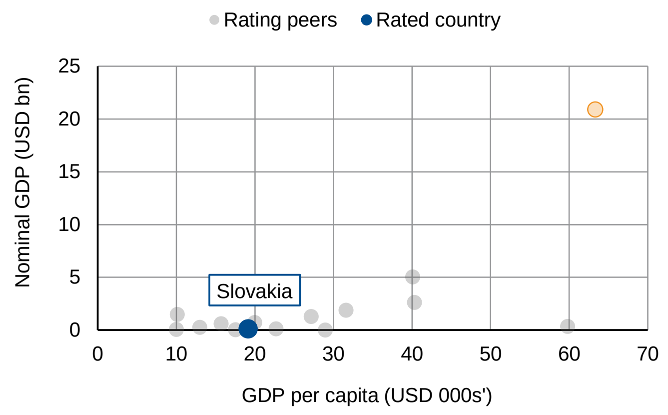
Domestic Economic Risks

- **Growth outlook**: Slovakia's A+ rating is anchored by its historically strong macroeconomic fundamentals and a competitive export-oriented industrial base. Scope expects a medium-term economic recovery to be supported by resumed flows of foreign direct investment into Slovakia's automotive industry post-pandemic. Scope expects Slovakia's economy to recover to pre-pandemic levels by H1 2022 and projects real GDP growth of 3.7% this year, 5.3% in 2022 and 4.5% in 2023, accounting for ongoing component shortages in the car industry. However, Scope notes that Slovakia's medium-term growth outlook is exposed to structural changes taking place in the car industry, including potential reorganisations of supply chains due to rising demand for electric automobiles and changing regulatory frameworks. The industry accounts for 13% of GDP and half of industrial production of Slovakia.
- **Inflation and monetary policy:** Higher energy prices and rising production costs due to shortage of intermediary goods are expected to raise inflation to around 2.9% in 2021 and 3.6% in 2022. These factors are expected to slowly fade in the second half of 2022 and cause inflation to fall towards the 2% target in 2023. While some central banks have started tapering their asset purchase programmes or indicated interest rate rises in the near term, the ECB has signaled that it will maintain its accommodative monetary policy in the near term.
- **Labour market:** Labour market situation has been improving with a continuing economic recovery**.** Unemployment rate declined to 6.3% as of September, below the EU average of 6.7%, but above the pre-crisis rate of 5.7%.

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

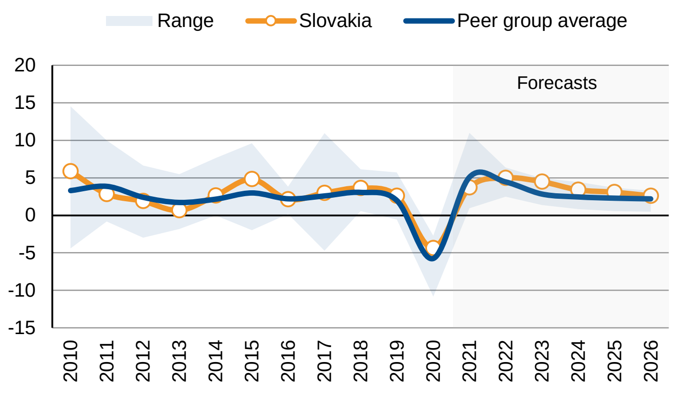
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a+	Growth potential of the economy	Neutral	0	Medium-run growth potential in line with peer average, but moderate productivity growth
	Monetary policy framework	Neutral	0	ECB is a highly credible and effective central bank; appropriate central bank response to the pandemic crisis
	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, USD bn **and GDP per capita,** USD thousands



Source: IMF, Scope Ratings GmbH

Real GDP growth, %



Source: IMF, Scope Ratings GmbH

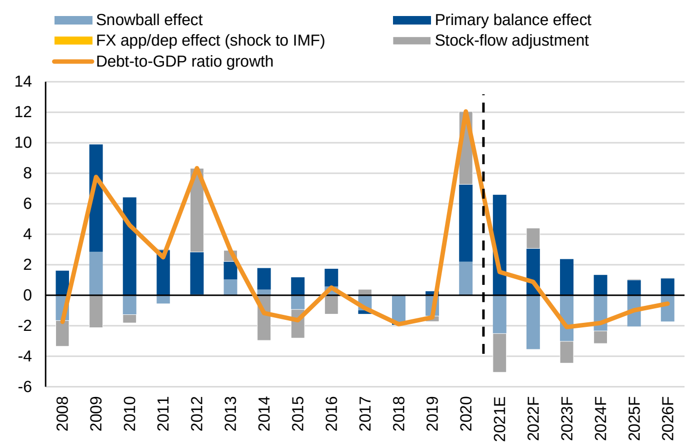
Public Finance Risks

- **Fiscal outlook**: In Scope's view, the authorities' credible medium-term fiscal consolidation agenda and reform implementation will help stabilize Slovakia's public finances over the next two years. The improved projection for public finances is helped by recovery in tax revenues and gradual unwinding of fiscal support measures. As a result, Scope projects that general government deficit will narrow to 4.4% of GDP in 2022 and 3.2% of GDP in 2023, from an estimated 7.5% in 2021.
- **Debt trajectory**: Scope projects general government gross debt will peak at around 62% of GDP in 2021. Going forward, the gross debt ratio will stabilise and gradually fall to 60% over Scope's forecast horizon through 2023, which is in line with the EU's current debt target. Scope, however, notes that significant challenges to public finance outlook remain. As a result of periods of pre-crisis, pro-cyclical fiscal policies and projected fast increase in ageing costs, Slovakia's medium-to-long-term fiscal sustainability challenges are among the most substantial in the EU. Slovakia has the sixth largest fiscal gap of 3.2 percentage points of GDP over the medium term and second largest fiscal gap of 7.7 percentage points of GDP over the long term in the EU. This shows that further fiscal adjustments will be required to sustain a debt ceiling of 60% of GDP in the medium term and stabilise the ratio over the long term.
- **Market access**: Slovakia benefits from favourable financing conditions and a supportive debt profile. The ECB holds nearly half of outstanding Slovak government securities, which has resulted in an all-time-low weighted average yield of 0.14% per annum for new issuances as of September. The average maturity of the Slovak debt portfolio is relatively high at 8.5 years. Almost all debt carries a fixed coupon and is denominated in euros.

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

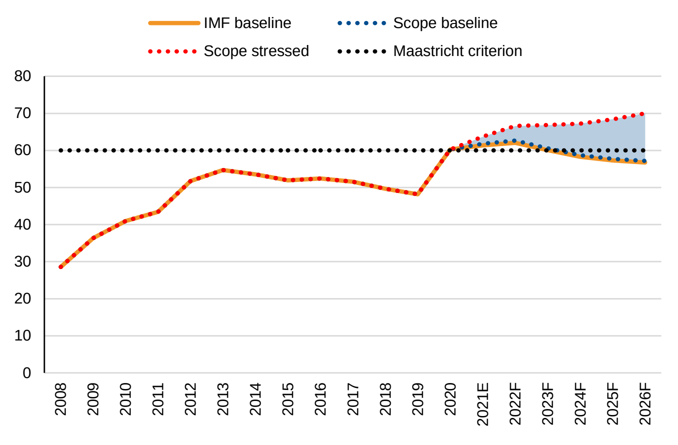
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a-	Fiscal policy framework	Neutral	0	Credible constitutional budgetary framework, but pre-existing worsening in fiscal dynamics
	Debt sustainability	Neutral	0	Still-moderate public debt levels
	Debt profile and market access	Strong	+1/3	Favourable debt structure, significant holdings by the ECB

Contributions to changes in debt levels, pps of GDP



Source: Scope Ratings GmbH

Debt-to-GDP forecasts, % of GDP



Source: Scope Ratings GmbH

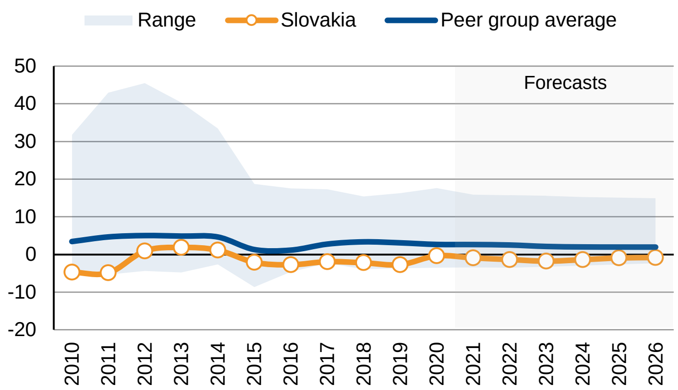
External Economic Risks

- **Current account**: Scope expects the current account deficit to remain moderate over the coming years, factoring in a projected recovery in exports but also growth in imports related to resumed foreign direct investment inflows. The increasing inflow of EU funds should help overfund current account deficits and reduce net external indebtedness in the coming years.
- **External position**: Slovakia's net international investment position remains in a significant deficit of 61% of GDP as of Q2 2021. However, 40% of Slovakia's gross external liabilities relate to inward foreign direct investment, which curbs the risk that external balance sheets deteriorate markedly in times of global stress and enhances the long-term sustainability of the external position.
- **Resilience to shocks:** As a small, open economy that is specialised in the automotive industry, Slovakia is reliant on external demand and vulnerable to external shocks. Slovakia's exposure to international value chains is one of the highest in the EU, with foreign inputs and domestically produced inputs used in third countries' exports amounting to around 64% of Slovakia's total exports.

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

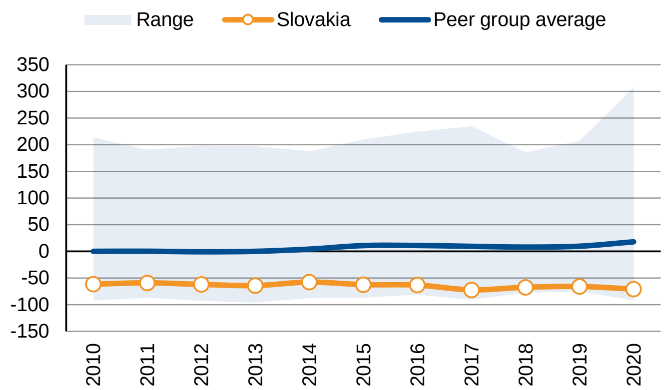
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
b-	Current account resilience	Weak	-1/3	Limited export diversification
	External debt structure	Neutral	0	Substantial share of direct investment in external liabilities
	Resilience to short-term shocks	Neutral	0	Small-open economy; but benefits from euro area membership

Current account balance, % of GDP



Source: IMF, Scope Ratings GmbH

NIIP, % of GDP



Source: IMF, Scope Ratings GmbH

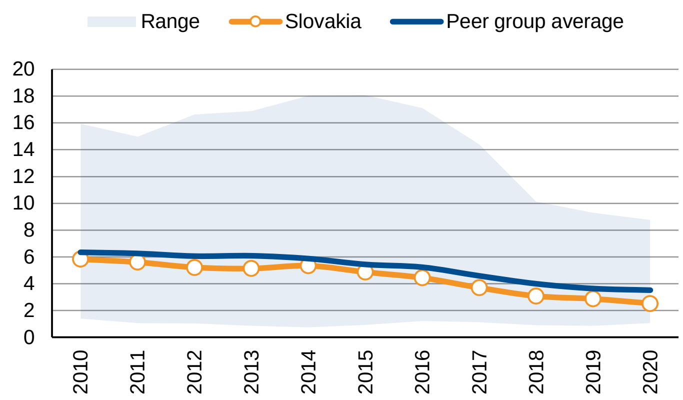
Financial Stability Risks

- **Banking sector**: In Scope's view, the banking sector in Slovakia presents a limited contingent liability risk for the sovereign balance sheet. Slovakia's mostly foreign-owned banking sector is well capitalised and profitable, with a system-wide tier 1 capital ratio of 18.9% and a return on equity of 9.5% as of Q2 2021, above the EU weighted averages of 17.1% and 7.4% respectively. Non-performing loans were close to 2% of total loans as of the same quarter. These buffers should help absorb potential short-term increase in non-performing loans as loan moratoriums provided to households and firms hit hard by the crisis expire.
- **Private debt**: Household debt increased to 82% of net disposable income in 2020, up on 76% in 2019, with household debt ratios among the highest among central and eastern European countries, driven by strong growth in house prices, and associated robust mortgage lending.
- **Financial imbalances**: Scope notes risks associated with rising indebtedness and declines in disposable income of households due to the pandemic, which made Slovak households and banks more vulnerable to an abrupt tightening of financing conditions. Scope expects that the central bank's effective macroprudential measures and improving labour market conditions will help mitigate risks from rising household indebtedness.

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

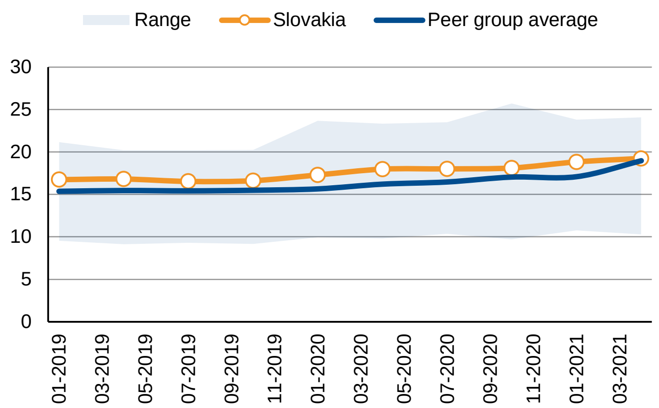
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	Well-capitalized banking sector with a low NPL ratio; but profitability and asset quality to be materially affected by the crisis
	Banking sector oversight	Neutral	0	Oversight under the National Bank of Slovakia and the ECB as part of Banking Union
	Financial imbalances	Neutral	0	Gradual build-up of private sector indebtedness, mitigated by a decline in interest rates and the central bank's macroprudential actions

NPLs, % of total loans



Source: IMF, Scope Ratings GmbH

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings GmbH

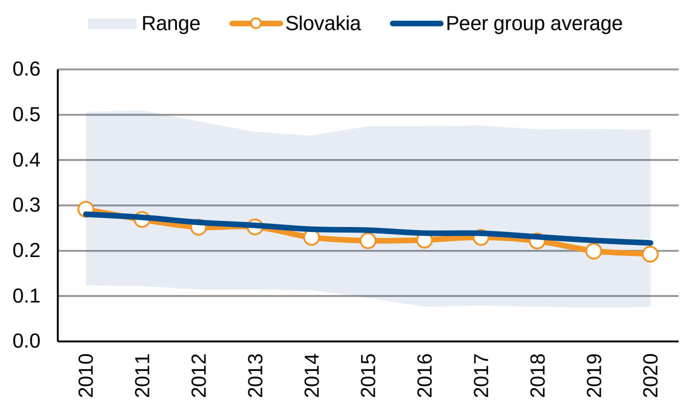
ESG Risks

- **Environment:** Environment-related risks in Slovakia remain material. Energy intensity in Slovakia is higher than the EU average. While increasing, the share of renewables in total electricity production was a moderate 26% in 2020, below the EU's 38%. Enhancing the capacity of the Slovak car industry for a transition towards alternative electric models will be important for the nation's future production and exports. The current long-term EU budget presents a unique opportunity for Slovakia to increase renewable energy production and pave the way for its transition to a low-carbon economic model in the long term.
- **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 (6.3% as of September) around EU averages, and below-EU-average poverty rates and risk of social exclusion.
- **Governance:** Under governance-related factors, 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. Scope views positively the government's plans to undertake judicial and anti-corruption reforms, two areas in which Slovakia has made limited progress thus far.

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

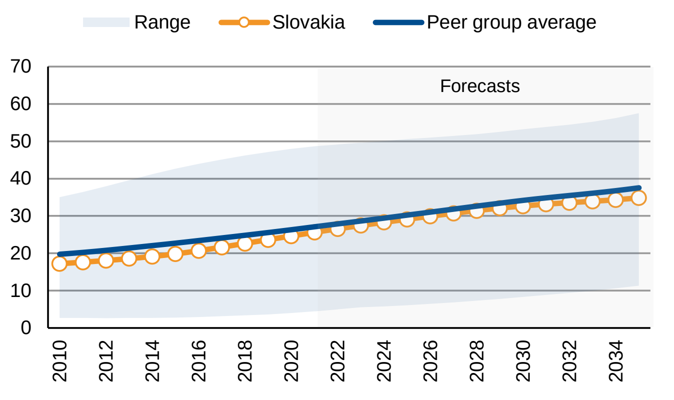
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a	Environmental risks	Neutral	0	Potential pressures from emission standards, below-EU-average but increasing share of renewable energy in total energy consumption, transition risks in line with CEE peers
	Social risks	Neutral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



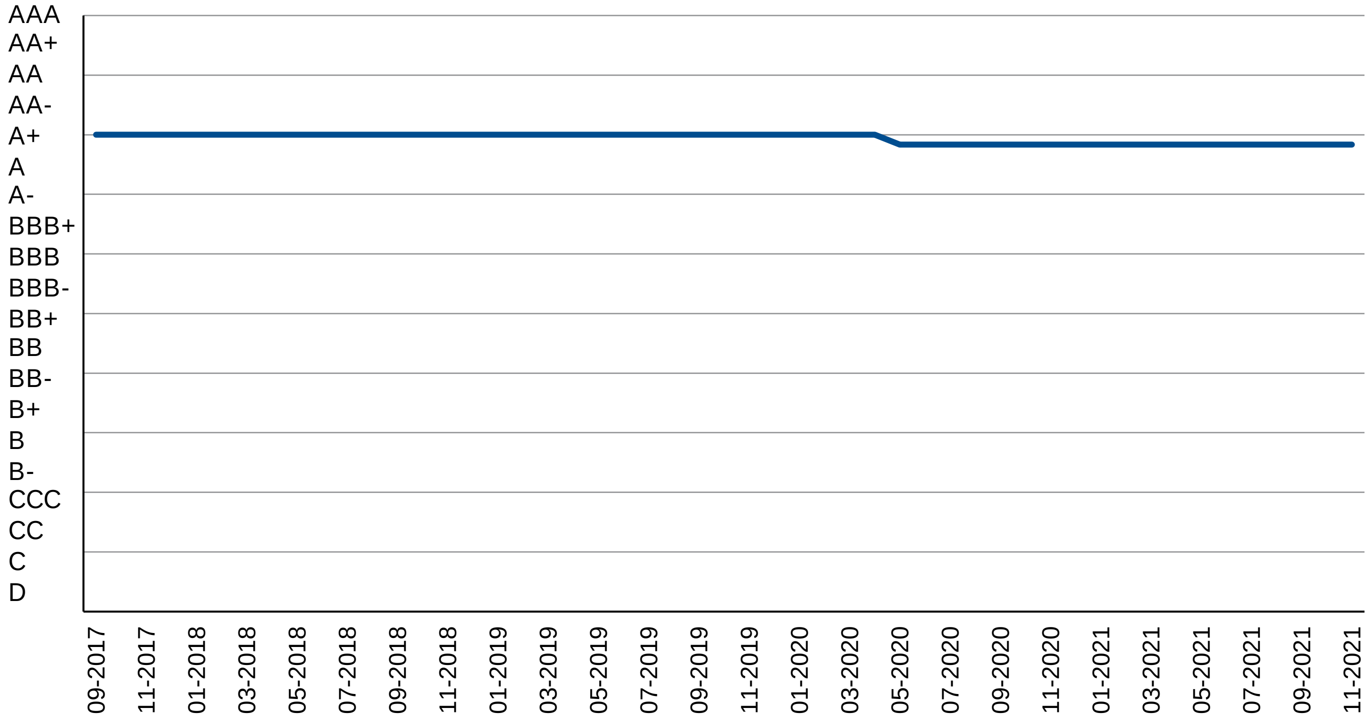
Source: European Commission, Scope Ratings GmbH

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
France
Italy
Japan
Latvia
Malta
Poland
Russia
Slovakia
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	2021F	2022F
Domestic Economic Risk							
GDP per capita, USD 000s'	16.5	17.6	19.4	19.3	19.1	21.4	23.3
Nominal GDP, USD bn	89.7	95.4	105.6	105.1	104.5	116.7	127.5
Real growth, %[1]	1.9	3.0	3.8	2.6	-4.4	3.7	5.3
CPI inflation, %	-0.5	1.4	2.5	2.8	2.0	2.9	3.6
Unemployment rate, %[1]	9.7	8.1	6.5	5.8	6.7	6.7	6.1
Public Finance Risk							
Public debt, % of GDP[1]	52.4	51.6	49.7	48.2	60.3	62.0	61.0
Interest payment, % of government revenue	3.5	3.0	2.9	2.6	2.5	2.2	2.1
Primary balance, % of GDP[1]	-1.2	0.2	0.2	-0.3	-5.1	-6.6	-3.1
External Economic Risk							
Current account balance, % of GDP	-2.7	-1.9	-2.2	-2.7	-0.4	-0.9	-1.3
Total reserves, months of imports	0.4	0.5	0.6	0.8	1.2	-	-
NIIP, % of GDP	-66.8	-68.3	-69.8	-65.9	-65.7	-	-
Financial Stability Risk							
NPL ratio, % of total loans	4.4	3.7	3.1	2.9	2.5	-	-
Tier 1 ratio, % of risk weighted assets	16.2	16.6	16.6	16.6	18.1	19.2	-
Credit to private sector, % of GDP	57.1	60.2	62.1	62.9	67.6	-	-
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	3.9	3.8	-	-	-	-
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
Composite governance indicator[2]	0.7	0.7	0.6	0.6	1.1	-	-

[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 2 December 2021	39

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