Creditreform Sovereign Rating

Creditreform Rating

Rating Object	Rating Information	
SLOVAK REPUBLIC	Assigned Ratings/Outlook: **A+ /negative**	Type: Monitoring, Unsolicited with participation
Long-term sovereign rating Foreign currency senior unsecured long-term debt Local currency senior unsecured long-term debt	Initial Rating Publication Date: Rating Renewal: Rating Methodologies:	28-10-2016 22-09-2023 “Sovereign Ratings” “Rating Criteria and Definitions”

Contents

Rating Action

Neuss, 22 September 2023

Creditreform Rating has affirmed the unsolicited long-term sovereign rating of “A+” for the Slovak Republic. Creditreform Rating has also affirmed Slovakia’s unsolicited ratings for foreign and local currency senior unsecured long-term debt of “A+”. The outlook remains negative.

Key Rating Drivers

1. Robust post-pandemic economic recovery with a track record of resilient quarterly growth; despite headwinds from high price pressures and tight monetary policy, we expect solid economic growth in the near term, which should be increasingly underpinned by fixed investment and recovering exports, in line with gradually abating inflation and easing supply-side constraints; while EU financing plays a key role in supporting investment activity, strong labor markets and sustained wage growth aid household spending

2. We expect income convergence to resume, supported by the further roll-out of measures and investments related to the Recovery and Resilience Program (RRP), notwithstanding a track record of EU fund under-execution; medium-term growth perspectives are broadly constructive, but risks remain in place, in particular associated with skills mismatches, shortages of skilled labor, cost competitiveness, and structural challenges in the pivotal automotive industry

3. Generally high institutional quality, buttressed by benefits related to Slovakia’s EU/EMU and NATO membership; we note reform progress pertaining to the justice system and the RRP, but ample room for improvement in the combat against corruption; the highly fragmented political landscape entails high uncertainty about the outcome of the upcoming parliamentary elections, which in turn hampers policy predictability; potentially challenging government formation may lead to a postponement of the implementation of structural reforms

4. Limited risks to fiscal sustainability in the near to medium term; although we expect high headline deficits this year and next, fiscal risks are balanced by moderate debt-to-GDP levels, high debt affordability and a favorable debt profile; we anticipate the public debt ratio to increase moderately over the medium term, as public finances should improve only gradually; while the upcoming snap election creates uncertainty as regards future fiscal policies, financial stability risks related to residential real estate have ebbed somewhat since our last review

5. External vulnerabilities engendered by Slovakia's small, open economy, which also features a still high dependence on energy from Russia and a substantial degree of integration in global value chains; foreign direct investments balance external risks reflected by Slovakia's high and negative net international investment position (NIIP); we expect the pronounced current account deficit to narrow over the medium term in light of the assumed moderation of energy prices and rebounding export growth

Reasons for the Rating Decision and Latest Developments[1]

Macroeconomic Performance

The sovereign's credit profile reflects its favorable macroeconomic performance, which is facing growing pressure amid the ECB's aggressive monetary policy tightening, a protracted period of high inflation and still considerable, though subsiding reliance on Russian fossil fuels and natural gas. Despite solid and resilient economic growth, Slovakia's comparatively slow progress towards income convergence has experienced another setback. Against this background, the absorption of EU funds will become increasingly crucial in executing the twin transition and fostering Slovakia's underlying growth. Recent progress regarding the utilization of EU financing and the achievement of milestones and targets related to the national RRP, lends confidence in the administrative capacities to establish further foundations for growth. Structural challenges related to education, labor market mismatches and skills shortages persist, posing medium-term risks to economic growth and international competitiveness. Similarly, Slovakia's automotive industry remains confronted with structural challenges that pose risks to the economy's growth model. Having lagged behind its main trading partners in terms of productivity growth for many years, and facing high inflation for a presumably longer period than the euro area as a whole, we will monitor Slovakia's cost competitiveness vigilantly. Credit growth has decelerated substantially, but warrants further monitoring due to high interest rates and household debt which has risen considerably over the last decade.

Coming to 1.7% in 2022, Slovakia's real GDP growth slowed down significantly compared to the previous year (2021: 4.9%). Its growth performance was thus far less robust than that of the euro area (EA) as a whole, which expanded by 3.4% and 5.5% in 2022 and 2021 respectively. Still, these figures should be viewed in light of the multiple headwinds stemming from the geopolitical conflict, including energy supply and inflation, as well as high interest rates.

Private consumption (+3.1 p.p.) and gross fixed capital formation (+1.2 p.p.) were the main contributors to real economic growth last year. Household spending was essentially supported by the drawdown on savings accumulated throughout the pandemic, while investment activity was aided by EU funds. At the same time, public consumption (-0.8 p.p.) and especially net exports (-1.5 p.p.) prevented faster real GDP growth, partly due to persistent supply chain bottlenecks and decelerating foreign demand.

Comparatively slow economic growth translated into a further setback of the Slovak Republic's convergence towards the income levels of the European Union (EU-27). While Slovakia's GDP per capita increased by 9.3% to an estimated USD 39,490 in 2022 (IMF data, PPP terms, current prices), the income gap with the EU-27 widened by around 1 p.p. (2021: -1.9 p.p.). GDP p.c. thus

[1] This rating update takes into account information available until 15 September 2023.

stood at 72.4% of the weighted EU level, down from 73.4% in 2021. In addition, the income gap with Slovakia's Visegrád (V4) peers has become larger as they have narrowed their respective gaps towards the EU-27 GDP per capita level in 2022 (CZ: 90.7%, HU: 77.1%, PL: 79.8%).

Looking at national account data for the first half of 2023, the Slovakian economy was quite resilient and outpaced the euro area overall. Real GDP grew by 0.3% and 0.4% q-o-q in the first and second quarter, respectively (EA: 0.1% and 0.1%). That said, real economic activity saw a strong contribution from net exports in light of collapsing imports (-15.2% q-o-q) and a run-down in inventories in Q1. In the second quarter, net exports continued to buttress growth, while fixed investment rose by 0.2% (Q1-23: -3.4%). At the same time, private consumption weakened markedly, decreasing by 1.8% and 0.7% q-o-q in Q1 and Q2 respectively.

We anticipate private consumption to have a negative impact on real GDP growth in 2023 as a whole, reflecting high inflation, dwindling savings, and rising debt-servicing costs, before picking up from next year. To be sure, government intervention has hitherto helped to contain energy prices, and a memorandum of cooperation between the Slovak government and Slovenské elektrárne, an electricity supplier, has been extended.

Persistently high inflation is likely to mute real wage growth in 2023. Although headline inflation has fallen from its peak of 15.4% this February to 10.3% in July, it is set to post a double digit average rate this year, well above euro area levels (Jul-23: 5.3%). Core inflation (excluding energy, food, alcohol and tobacco) remains sticky, amounting to 9.2% (EA: 5.5%). While we expect high wage growth, coming on the back of wage indexation and Slovakia's tight labor market, to increasingly bolster private consumption in lockstep with receding inflation, energy inflation should remain high in 2024, since gas prices are set to rise due to the phasing out of aid measures.

Whilst consumer confidence has been gradually improving since the turn of the year, household sentiment has remained downbeat as of late. Household savings have been largely drawn down, providing less support for households' purchasing power. Furthermore, households will have to allocate a larger share of their disposable income towards servicing their debt going forward given rising financing costs.

Gross fixed capital formation will likely make a positive contribution to real GDP growth this year and next, largely driven by public investment in the context of NGEU. Although its EU fund absorption rate has been among the lowest in the EU, Slovakia has made some progress over the last year. Total cohesion policy payments of the 2014-2020 financing cycle came in at a low 72% (EU Cohesion data), and we expect the government to continue drawing down on the MFF 2014-2020 funds in 2023, the final year Slovakia can utilize them. According to National Bank of Slovakia intelligence, EU funds will sum to 4.0% of GDP in 2023.

Following the fulfillment of 14 milestones and two targets, the European Commission (EC) approved the second installment of Slovakia's RRP to the tune of EUR 709mn in grants this March. The disbursement was inter alia contingent on structural reforms in education, research and innovation, skills shortages, digitalization and the fight against money laundering. Also, the EC greenlighted Slovakia's modified RRP, which now incorporates a REPowerEU chapter, raising the total allocation to EUR 6.4bn in grants. The updated RRP has a stronger focus on the green transition and encompasses several new reforms and investments as well as scaled-up investments. Overall, the modified RRP should help in diversifying energy sources and decrease the dependence on Russian fossil fuels.

Private investment activity, in particular residential investment, will be dampened by the sharp rise in funding costs related to tightening monetary policy. The entry into force of the Construction Act and the Act on Land-Use Planning from April 2024, which aim to cut red tape and facilitate digitalization of land-use planning and construction, will prospectively shorten the time taken to issue a building permit. However, until then, lengthy building permit procedures will tend to hamper construction activity. Housing investment has been declining in the first half of the year (-0.8% and -1.2% q-o-q in Q1 and Q2), and should act as a drag on fixed investment growth going forward, while equipment investment is likely to benefit from easing supply chain frictions and gradually accelerating external demand.

Likewise, we believe that the positive effects of easing supply chain disruptions, together with slow import growth, will outweigh the weaker external demand from Slovakia’s main trading partners on net external trade. Against the backdrop of abating inflation in the euro area as a whole, foreign demand should recover gradually. As a result, we expect net exports to contribute positively to output growth in 2023 and 2024. In addition to the positive export impulses from the automotive industry, Slovakia's net external trade benefits from moderate import growth prompted by slower domestic demand and following the relatively high imports towards the end of 2022.

On the whole, we expect real economic growth to come in at 1.3% in 2023, followed by an acceleration to 2.1% in 2024. We highlight significant uncertainty surrounding these projections, particularly against the backdrop of the upcoming elections (see below), the unpredictable development regarding the war in Ukraine and bouts of significant energy price increases.

Although Slovakia has gone a long way in terms of energy security, we think it remains vulnerable to renewed price hikes on global energy markets and energy security risks appear higher than in other European member states. According to ARDAL intelligence (May-23), energy imports from Russia have been reduced, but still stand at around 43% (Jan-22: 70%). Concurrently, fossil fuels still accounted for a substantial share in its energy mix in 2021, with natural gas and oil and petroleum products amounting to 46.6% (EU-27: 56.3%). While the Poland-Slovakia gas interconnector went into operation in November 2022, Slovakia’s gas consumption only fell by 1% from August 2022 to March 2023. In contrast, the EU-27 average saving amounted to 18% (EC intelligence).

Risks entailed by excessive credit growth have receded somewhat since our last review. Mortgage lending growth came to a halt at the turn of this year and has contracted since Feb-23 (Jul-23: -4.5% y-o-y), inter alia mirroring the impact of rising interest rates. Additionally, NFC credit growth cooled as well in the first half of 2023, but remained pronounced at 6.9% y-o-y this July. Against this backdrop, we consider the risks from private sector debt to be limited: However, we will continue to monitor household debt, which amounted to 74.1% of disposable income in Q4-22, comparing high to peers from the CEE economies.

The labor market situation remains favorable overall. Monthly unemployment figures have continued to trend downward since our last review. At 5.8% in July 2023, it moves well above the levels of Czechia (2.7%), Hungary (4.0%) and Poland (2.8%), but below the euro area as a whole (6.4%). Slovak labor participation increased to 76.3% in Q1-23, continuing to be broadly aligned with V4 peers. Employment growth decelerated notably during the first half of 2023, posting at 0.7% (Q1) and 0.2% (Q2) y-o-y, comparing unfavorably against the euro area (1.6% and 1.4%).

We expect unemployment to remain broadly stable in annual terms, as employers should abstain from layoffs amidst tight labor markets and due to a shrinking workforce. Pockets of vulnerability relate to long-term unemployment, which accounted for 66.5% of total unemployment in 2022, the highest reading in the EU. Structural challenges pertain to the significant degree of skills mismatches, which at 35% is one of the highest among the OECD countries (in the EU-ISCED 3-8). At the same time, Slovakia faces skills shortages, also in areas needed to drive the green transformation.

We closely follow developments related to Slovakia's cost competitiveness, which is equally important for the further path of Slovakia's income convergence. Nominal labor productivity per person and per hour worked amounted to 73.7% and 72.8% of the EU-27 total respectively. Over the last five years (2018-22), real unit labor costs increased by 3.4% as compared to a decline in the euro area as a whole and the other V4 peers. More recently (2021-22), Slovakia's real unit labor costs fell on the back of a reduction in real compensation per employee. However, the other Visegrád economies experienced a stronger decline in their real unit labor costs.

As regards non-cost competitiveness, Slovakia continues to show scope for improvement in terms of its business environment. In the 2023 edition of the IMD World Competitiveness Ranking, the Slovak Republic ranked 53rd out of 64 economies, down four places compared to the previous year. As highlighted by the EC's SME Performance Review 2023, administrative complexity constitutes the main hindrance to SMEs participating in public procurement. On the other hand, we are aware that authorities are progressing in implementing reforms geared towards enhancing Slovakia's business environment, also in light of the RRP.

The Slovak Republic's recent decrease in the global export market share of goods and services (2022: 0.37%, 2021: 0.39%) may indicate a somewhat weaker international competitiveness. We assume that this is closely related to the frictions in global supply chains and repercussions on Slovakia's pivotal automotive industry. The country's dependence on lower value-added activities and a relatively large share of jobs at high risk of automation pose additional risks for Slovak cost competitive. At this stage, we would carefully monitor inflation developments, given that a protracted period of high inflation rates would likely be accompanied by persistent wage growth, which could have negative implications for Slovakia's cost competitiveness.

Drawing on OECD TiVA data, the share of domestic value added embodied in foreign final demand in total value added amounted to 38.7% in 2020, illustrating Slovakia's deep integration in global value chains. The easing of supply-side shortages and a gradual recovery of global trade should thus essentially support Slovakia's automotive industry. Following significant challenges in 2022, the global auto industry is adapting and gradually reconstructing its supply chain to support car production. However, persistent global geopolitical tensions, elevated inflation and ongoing monetary policy tightening present challenges for the industry, at least in the near term. The Russia-Ukraine conflict, coupled with trade tensions between the US and China adds further strain, with China limiting semiconductor material exports from July. While the semiconductor shortage has improved, the underlying problem of inadequate mature node production capacity remains unresolved.

In this regard, we have to reiterate downside risks pertaining to cyclical developments, but also to structural changes that originate from Slovakia's high dependence on the automotive industry. Structural challenges mainly relate to the rising importance of electric vehicles. That said, we note that the Slovak automotive sector has already begun to address these. As a more recent case in point, Volvo Cars started to build a new plant in Slovakia this year, which focuses on the production of up to 250,000 electric cars per year and is scheduled to be launched in 2026.

Supported by EU funds, Slovakia's potential growth is estimated to post at 2.5% and 2.1% in 2023 and 2024 respectively, surpassing the euro area as a whole (1.3% and 1.5%). Medium-to-longer-term underlying growth could be curtailed by a declining working age population and skills shortages, if left unaddressed. In addition, the moderate level of R&D expenditure could hold back potential growth in the medium term. At 0.93% of GDP in 2021, Slovakia's R&D expenditure ranges among the lowest in the EU-27.

In the same vein, innovation and digitalization indices suggest room to improve. Slovakia ranks 46th in the UN's Global Innovation Index 2022, trailing the other V4 peers. While awaiting the 2023 update of the Digital Economy and Society Index, we note that Slovakia ranked 23rd among the 27 EU member states in the 2022 edition. On a more positive note, Slovakia's performance as an emerging innovator improved slightly to 65.6% of the EU average with regard to the European Innovation Scoreboard 2023.

Institutional Structure

The sovereign's credit rating reflects its generally strong institutional framework, further buttressed by significant benefits tied to its EU/EMU and NATO membership – these include access to deep and broad capital markets, EU financing and external security. The Slovak Republic exhibits gaps compared to the euro area regarding the Worldwide Governance Indicators. Moreover, it still faces challenges regarding its justice system and corruption matters, although several reforms have been initiated or completed to address these issues. Political volatility remains high in light of the imminent snap election and the broad spectrum of political parties with significant support, rendering policy predictability difficult.

While awaiting the upcoming release of the World Bank's Worldwide Governance Indicators for 2022, due in September, the latest edition that refers to the base year 2021 affirms Slovakia's generally strong institutional quality. That said, the sovereign has scope to enhance performance across all four dimensions we put the highest emphasis on when assessing the sovereign's institutional setup, in particular considering the euro area as a whole. We have to reiterate that the Slovak Republic had improved in terms of 'voice and accountability' and 'rule of law', while having deteriorated concerning 'control of corruption' and 'government effectiveness'. As regards the latter, i.e. the perceived quality of policy formulation and implementation, the sovereign has remained on its downward trend since 2016.

Political uncertainty is high ahead of the upcoming snap election on 30 September 2023. The rather fragmented Slovak political landscape makes a variety of coalition scenarios conceivable, including the failure of forming a governing coalition. According to current polls, the Slovak Social Democracy (Smer) party is in the lead, ahead of the Progressive Slovakia party and the Voice –Social Democracy (HLAS) party. Six parties would receive between 5% and 10% of the vote, illustrating the complexity of forming a government going forward. Against this backdrop, political predictability appears challenging, rendering our projections for economic growth, public finances and related policies uncertain. Potentially lengthy talks on forming a new government could push back reform initiatives, and may prove obstructive to further RRP progress.

We assess the successful implementation of milestones and targets, which have resulted in the second disbursement of RRP-related funds, as positive. The government's persistent efforts have enabled the sovereign to be among the first EU member states whose modified RRP received the endorsement of the EC and the Council. It should be noted, however, that the spending of the allocated funds have frequently encountered delays in the past.

With a view to Slovakia's justice system, two reforms have entered into force since our last review, albeit delayed by several months, namely the reform of the judicial map, which reorganizes the structure of courts, and the establishment of a separate administrative court system. Both reforms should improve the quality and efficiency of the judiciary.

Tying in with the potential to catch up in the combat of corruption, the EC's Rule of Law Report 2023 highlights that the update for the 2019 National Anti-Corruption Program is still pending, and work on the new 2024-28 program is only in its early stages. Progress has been made with regard to whistleblowing legislation, as the Slovak Whistleblower Act was amended this July.

We are aware that Slovakia remains committed to fight against money laundering and terrorist-financing. The police have been endowed with more power to e.g. verify the origin of assets and freeze them. MONEYVAL's first enhanced follow-up report & technical compliance re-rating shows that Slovakia has addressed some of the identified technical compliance deficiencies.

Turning to greening the economy, the Air Protection Act went into effect on 1 July 2023, strengthening the power of municipalities in controlling air pollution. Earlier this year, the Ministry of the Environment presented a draft of a first climate law, enshrining the goal of becoming climate neutral by 2050, which underscores Slovakia's commitment to meet international agreements. As an intermediate goal, the law aims to reduce greenhouse gas (GHG) emissions by 55% by 2030 compared to 1990 levels.

Looking at per capita GHG data in 2021, Slovakia stood slightly below the EU average in 2021, but has recorded an increase compared to 2020 to above pre-pandemic levels. Slovakia sources a significant share of its energy demand from fossil fuels and nuclear energy. Renewable sources, on the other hand, play a minor role, accounting for 17.4% in 2021, standing below the average of the euro area as a whole (20.7%). Slovakia's relatively poor performance in the Eco-Innovation Index 2022 suggests potential for improvement. The recently approved modified RRP should help the country in achieving its climate objectives, with 46% of financial resources dedicated to implementing the green transition.

Fiscal Sustainability

Our credit assessment reflects relatively limited risks to fiscal sustainability, underpinned by a moderate debt-to-GDP ratio from a euro area perspective, prudent debt management and commitment to fiscal consolidation. That said, after an improvement, Slovakia's general government deficit should widen markedly again this year due to the adoption of discretionary measures related to energy subsidies, family support and defense spending as well as an overall significant increase in the public wage bill. We expect the sovereign's public debt ratio to increase moderately over the medium term. Despite rising refinancing costs, we consider risks to fiscal sustainability to be mitigated by Slovakia's debt affordability and the benign debt profile. Financial stability metrics indicate that the banking sector is in a sound condition, balancing risks of adverse shocks. We assess the adoption of a multi-annual expenditure ceilings as positive, which will become binding from next year. While there may be some uncertainty related to the upcoming snap election and the impact of a newly formed government on future fiscal policies, we assume that the government will remain committed to fiscal sustainability.

After two years of pandemic-induced large general government deficits, Slovakia's budget balance improved markedly in 2022, posting at -2.0% of GDP, only half of what we estimated in our last review. While several measures were adopted to cushion the impact of the energy crisis, the phasing out of most Covid-19 emergency measures led to a 12.6% net reduction in subsidies. Public investment (+17.9%), intermediate consumption (+13.7%) and final consumption expenditure (+6.7%) recorded large increases. Interest payment started to rise, albeit to a rather limited extent (+3.0%). As a result, total general government expenditure climbed by a moderate 1.4%. Due to high nominal GDP growth, however, total general government outlays as a percentage of GDP declined by a significant 3.3 p.p. in 2022.

Taxes boosted total general government revenue, with VAT and taxes on income and wealth rising by 13.2% and 13.0% respectively. In this context, it is worth mentioning that the VAT gap as a percentage of the VTTL dropped to 13.9% in 2020 (2019: 15.0%), albeit it continues to exceed the EU average of 9.1% (EC VAT gap report 2022). We believe that the planned introduction of online cash registers and an online invoicing system will further enhance VAT compliance. At the same time, net social contributions increased by 4.8%. Overall, total general government revenues mounted by 9.6%.

This year's fiscal balance will be heavily influenced by the budgetary impact of the adopted energy support measures. Drawing on estimates by the Ministry of Finance (MoF), the fiscal policy response to soaring energy prices will amount to 3.0% of GDP in 2023, up from 0.4% of GDP in 2022. While some measures, such as the energy price cap for unregulated companies have been extended, new measures have been introduced, e.g. an energy price cap for households and small and medium-sized enterprises. Part of the cost incurred will be offset by a windfall tax on the excess profit of energy suppliers. Moreover, EU funds will be partially used to finance energy measures. Similarly, the winding down of pandemic measures will relieve the burden on public expenditures.

At the same time, public wages will grow significantly this year as a result of the valorization of salaries. Social spending will rise sharply in light of the indexation of pensions, family support and the parental bonus, the latter being introduced as part of the pension reform, which took effect on 1 January 2023. On the other hand, we ultimately assess the indexation of the retirement age to life expectancy as positive, as it should strengthen fiscal sustainability in the medium-to-longer term. Boosted by EU funds, public fixed investment is set to significantly exceed its five year average (2018-2022) of 3.4% of GDP, climbing to 4.9% of GDP in 2023 and to amount to 4.1% of GDP in 2024. A y-o-y increase in defense spending will also contribute to rising government expenditure in 2023.

Against this backdrop and the slower growth momentum, we expect the headline deficit to widen significantly to -6.0% of GDP in 2023 and to narrow to -4.5% of GDP in 2024. Uncertainty surrounding these projections remains high, not least due to the uncertainty regarding the formation of a new government following the elections at the end of September. Our projections are underscored by budget execution data for the first half of the current year (cash basis), which show an increase in total revenues that was overcompensated by a rise in total expenditures, resulting in a markedly higher deficit. Higher current transfers and wages and salaries were the main reasons for the deterioration in the overall balance.

Slovakia's debt-to-GDP ratio declined from 61.0% in 2021 to 57.8% in 2022, reflecting the lower headline deficit and relatively high nominal GDP growth. More recently, Slovakia's public debt ratio came in at 57.9% of GDP as of Q1-23, standing well below the public debt ratio of the euro area as a whole (91.2% of GDP in Q1-23). Based on our assumption of high budget deficits and significant nominal GDP growth, we project Slovakia's debt-to-GDP ratio to remain broadly stable in 2023 (57.9% of GDP), before ticking up to a still moderate 58.3% of GDP in 2024.

Following the approval of the State Budget Act on 22 December 2022, the Council for Budget Responsibility submitted the public expenditure ceilings for 2023-2025 to parliament. The final approval of the expenditure ceilings by parliament took place on 1 February 2023. However, due to the activation of the general escape clause of the Stability and Growth Pact, the government will only have to comply with the rules once the clause is deactivated, which according to the Commission will not happen before 2024. While the multi-annual expenditure ceilings should have a positive effect on medium- to long-term fiscal sustainability, we understand that the incoming government will be exempted from the strictest sanctions of the national debt brake thanks to a two-year escape clause, adding uncertainty to the evolution of fiscal metrics in the near term. We also understand that an amendment to the Constitutional Act on Fiscal Responsibility is still under discussion, which would, among other things, adjust the number of debt brake sanction bands.

Fiscal sustainability risks are mitigated by Slovakia's debt affordability, a low share of foreign-exchange and its overall favorable maturity profile. As regards the latter, the average weighted maturity amounted to 8.67 years in July 2023, up from 8.58 years one year before. The domestic central bank and the foreign official sector together held 42% of Slovak government debt in 2022. Interest expenditure measured against total general government revenue fell to 2.53% in Q1-23 from 2.67% in the previous year.

Having said this, capital market conditions have become less favorable against the backdrop of the ECB's aggressive monetary policy tightening cycle. In its latest monetary policy meeting, the ECB decided to raise key policy rates by another 25bp. The APP portfolio continues to be wound down as scheduled. Furthermore, maturing government bonds under the PEPP will be reinvested until at least the end of 2024. We expect that the ECB's main refinancing rate to remain at 4.50% until the end of 2023. In our view, a first rate cut is unlikely to occur before the second half of 2024.

Bond yields have increased since our last report, but remained relatively stable at a high level over the last couple of months. Whilst Slovakia's 10-year government bond yields drifted upwards to 3.75% as of 1-Sep-23 (weekly data), the Bund spread has not changed significantly since our last review, posting at 120bp. The impact of the deteriorating refinancing conditions for Slovak public finances will be felt only gradually. In addition, Slovakia can draw on a substantial cash buffer.

We will continue to monitor developments in the residential property market. Drawing on latest Eurostat data, house price dynamics appear to have cooled, with y-o-y house price growth at 7.6% in Q1-23, down from 14.2% a year earlier. Concurrently, the 3-year growth rate stood at a high 25.3% and well above the reading of the euro area as a whole. A stress test conducted by the National Bank of Slovakia confirmed the resilience of the Slovak banking sector to external shocks. In a bid to address brisk credit growth and to support the shock-absorbing capacity of the banking sector, the countercyclical capital buffer (CCyB) rate was raised by 50bp to 1.5% from 1 August 2023.

Slovakia's relatively small and highly concentrated banking sector remains in a healthy state. The NPL ratio amounted to 1.4% in Q1-23, below the EU average of 1.8%, mirroring the banking sector's overall sound asset quality (EBA data). Judging by the CET1 ratio, capitalization was well aligned with the EU, posting at 15.6% (EU: 15.8%). Rising interest rates had a positive impact on banks' profitability, as illustrated by an increase in return on assets by 0.4 p.p. to 1.0% (EU: 0.7%).

Foreign Exposure

As a small and open economy with energy links to Russia and a high degree of integration in global supply chains, Slovakia continues to exhibit external vulnerabilities. Soaring commodity prices have pushed the current account balance into deep deficit. While Slovakia remains a net external debtor, external risks are mitigated by the FDI-heavy composition of the NIIP. As we expect energy prices to normalize and exports to recover gradually, the current account deficit should narrow in the medium term.

Concluding 2022 with a deficit of 8.2% of GDP, Slovakia's current account balance recorded its lowest level since 2006 and stood well below the average current account balance over 2012-2021 (-1.0% of GDP). The sharp deterioration from -2.5% of GDP in 2021 was almost entirely due to a widening goods deficit, which was driven by the surge in energy import prices and lower net exports of non-energy goods. At the same time, the decline in the services balance and the primary income balance was somewhat offset by the shrinking deficit in the secondary income balance.

The moderation in energy prices subsequently led to a slight adjustment in the current account balance. Based on the four-quarter average, the current account deficit fell to 6.7% of GDP in Q1-23 on the back of the narrowing goods deficit (+1.7 p.p.). We note that Slovakia's energy dependency on Russia remains significant (see above), which could potentially lead to a more pronounced rise in energy prices compared to CEE economies. In our baseline scenario, we expect the current account balance to improve further, also in view of the projected recovery of exports.

Slovakia continues to be one of the larger net external debtors among the EU-27 countries, with its NIIP amounting to -61.0% of GDP in 2022 (-1.1% of GDP vs. 2021). The external risks stemming from its net external debtor position are mitigated by the large inflows of foreign direct investment, with net FDIs totaling -44.4% of GDP in 2022. As a result, the NENDI stood at -18.2% of GDP in 2022. More recently, Slovakia's NIIP has become less negative, posting at -58.2% of GDP in Q1-23.

Rating Outlook and Sensitivity

Our rating outlook on the Slovak Republic's long-term credit ratings remains negative. The negative outlook reflects the uncertain economic prospects, particularly in the context of the still evolving geopolitical environment and the still significant dependence on Russian energy. In addition, there is limited visibility on the political agenda following this month's general election and the implications for policymaking, in particular in the fiscal realm.

We could consider downgrading Slovakia's credit ratings if the incoming government fails to consolidate its public finances, which would be accompanied by an entrenched upward trend in the debt-to-GDP ratio over the medium term. We could also contemplate a downgrade if Slovakia's economic growth decelerates significantly over a protracted period, possibly related to a further deterioration in its cost competitiveness, leading to a sustained stagnation or even reversal in its income convergence towards EU levels. A failure or significant delay in the implementation of structural reforms by the new government could result in a downgrade as well. Likewise, downward pressure on the credit ratings would arise from the extension of the military conflict in Ukraine to NATO members.

Conversely, we could consider an upgrade of the rating or outlook if Slovakia exhibits significantly stronger-than-expected medium-term growth and/or makes significant progress in achieving energy independence from Russia while diversifying its energy demand. A sustained reversal of the sovereign's debt trend could also prompt a positive rating action, as could the timely implementation of RRP reforms and investments that could reinvigorate Slovakia's income convergence process.

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Ratings*

Long-term sovereign rating	A+ /negative
Foreign currency senior unsecured long-term debt	A+ /negative
Local currency senior unsecured long-term debt	A+ /negative

*) Unsolicited

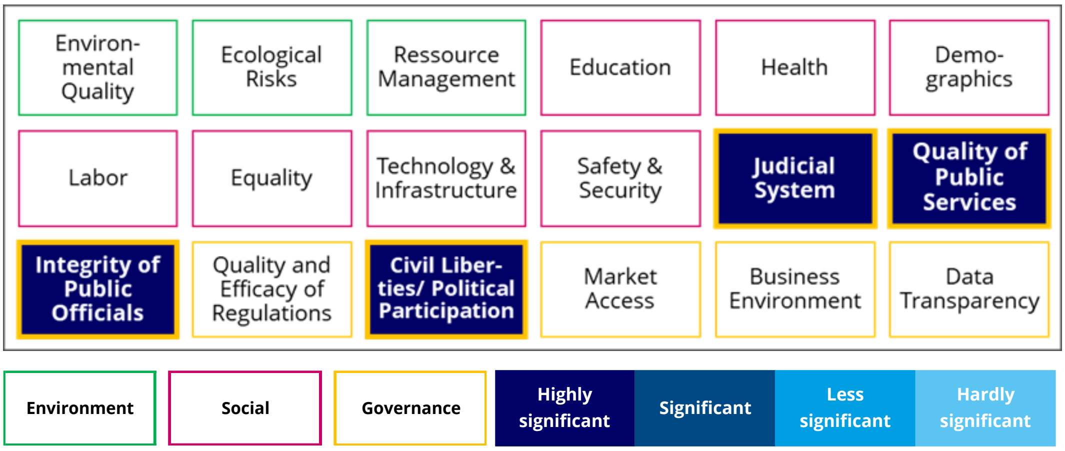
ESG Factors

Creditreform Rating has signed the ESG in credit risk and ratings statement formulated within the framework of the UN Principles for Responsible Investment (UN PRI). The rating agency is thus committed to taking environmental and social factors as well as aspects of corporate governance into account in a targeted manner when assessing creditworthiness.

While there is no universal and commonly agreed typology or definition of environment, social, and governance (ESG) criteria, Creditreform Rating views ESG factors as an essential yardstick for assessing the sustainability of a state. Creditreform Rating thus takes account of ESG factors in its decision-making process before arriving at a sovereign credit rating. In the following, we explain how and to what degree any of the key drivers behind the credit rating or the related outlook is associated with what we understand to be an ESG factor, and outline why these ESG factors were material to the credit rating or rating outlook.

For further information on the conceptual approach pertaining to ESG factors in public finance and the relevance of ESG factors to sovereign credit ratings and to Creditreform Rating credit ratings more generally, we refer to the basic documentation, which lays down key principles of the impact of ESG factors on credit ratings.

ESG Factor Box



The governance dimension plays a pivotal role in forming our opinion on the creditworthiness of the sovereign. As the World Bank's Worldwide Governance Indicators Rule of Law, Government Effectiveness, Voice and Accountability, and Control of corruption have a material impact on Creditreform Rating's assessment of the sovereign's institutional set-up, which we regard as a key rating driver, we consider the ESG factors 'Judicial System and Property Rights', 'Quality of Public Services and Policies', 'Civil Liberties and Political Participation', and 'Integrity of Public Officials' as highly significant to the credit rating.

While Covid-19 may exert adverse effects on several components in our ESG factor framework in the medium to long term, it has not been visible in the relevant metrics we consider in the context of ESG factors – though it has a significant bearing on public finances. To be sure, we will follow ESG dynamics closely in this regard.

Economic Data

[in %, otherwise noted]	2017	2018	2019	2020	2021	2022	2023e
Macroeconomic Performance							
Real GDP growth	2.9	4.0	2.5	-3.3	4.9	1.7	1.3
GDP per capita (PPP, USD)	30,984	32,961	34,351	33,579	36,132	39,490	41,515
Credit to the private sector/GDP	61.4	62.6	63.6	67.2	67.1	67.8	n/a
Unemployment rate	8.1	6.5	5.7	6.7	6.8	6.1	n/a
Real unit labor costs (index 2015=100)	106.4	108.4	111.3	114.6	113.5	112.1	110.6
World Competitiveness Ranking (rank)	51	55	53	57	50	49	53
Life expectancy at birth (years)	77.3	77.4	77.8	77.0	74.6	77.2	n/a
Institutional Structure							
WGI Rule of Law (score)	0.5	0.5	0.5	0.7	0.7	n/a	n/a
WGI Control of Corruption (score)	0.1	0.3	0.2	0.4	0.2	n/a	n/a
WGI Voice and Accountability (score)	0.9	0.8	0.9	0.9	0.9	n/a	n/a
WGI Government Effectiveness (score)	0.7	0.6	0.6	0.5	0.5	n/a	n/a
HICP inflation rate, y-o-y change	1.4	2.5	2.8	2.0	2.8	12.1	10.7
GHG emissions (tons of CO2 equivalent p.c.)	7.8	7.8	7.4	6.8	7.6	n/a	n/a
Default history (years since default)	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Fiscal Sustainability							
Fiscal balance/GDP	-1.0	-1.0	-1.2	-5.4	-5.4	-2.0	-6.0
General government gross debt/GDP	51.5	49.4	48.0	58.9	61.0	57.8	57.9
Interest/revenue	3.7	3.5	3.1	3.0	2.7	2.6	n/a
Debt/revenue	133.6	127.8	122.0	149.4	152.1	143.6	n/a
Total residual maturity of debt securities (years)	7.8	8.5	8.8	8.4	8.5	8.5	8.8
Foreign exposure							
Current account balance/GDP	-1,9	-2,2	-3,3	0,6	-2,5	-8,2	n/a
International reserves/imports	4.4	5.6	8.0	11.1	9.3	9.1	n/a
NIIP/GDP	-68.2	-69.4	-65.7	-64.7	-59.9	-61.0	n/a
External debt/GDP	108.2	114.5	112.3	119.6	132.6	103.1	n/a

Sources: IMF, World Bank, Eurostat, AMECO, ECB, Statistical Office SR, own estimates

Appendix

Rating History

Event	Publication Date	Rating /Outlook
Initial Rating	28.10.2016	A /stable
Monitoring	27.10.2017	A /stable
Monitoring	26.10.2018	A+ /stable
Monitoring	25.10.2019	A+ /stable
Monitoring	23.10.2020	A+ /negative
Monitoring	15.10.2021	A+ /negative
Monitoring	07.10.2022	A+ /negative
Monitoring	22.09.2023	A+ /negative

Regulatory Requirements

In 2011 Creditreform Rating AG (CRAG) was registered within the European Union according to EU Regulation 1060/2009 (CRA-Regulation). Based on the registration Creditreform Rating AG is allowed to issue credit ratings within the EU and is bound to comply with the provisions of the CRA-Regulation. The rating was not endorsed by Creditreform Rating AG from a third country as defined in Article 4 (3) of the CRA-Regulation.

This sovereign rating is an unsolicited credit rating. The Ministry of Finance participated in the credit rating process as it provided additional information. Creditreform Rating AG had no access to the accounts, representatives or other relevant internal documents for the rated entity or a related third party. Between the disclosure of the credit rating to the rated entity and the public disclosure no amendments were made to the credit rating.

Unsolicited Credit Rating	
With Rated Entity or Related Third Party Participation	YES
With Access to Internal Documents	NO
With Access to Management	NO

The rating was conducted on the basis of CRAG's "Sovereign Ratings" methodology (v1.2, July 2016) in conjunction with its basic document "Rating Criteria and Definitions" (v1.3, January 2018). CRAG ensures that methodologies, models and key rating assumptions for determining sovereign credit ratings are properly maintained, up-to-date, and subject to a comprehensive review on a periodic basis. A complete description of CRAG´s rating methodologies and basic document "Rating Criteria and Definitions" is published on our website.

To prepare this credit rating, CRAG has used the following substantially material sources: International Monetary Fund, World Bank, Organization for Economic Co-operation and Development, Eurostat, European Commission, European Banking Authority, European Central Bank, World Economic Forum, IMD Business School, Council for Budget Responsibility, Národná Banka Slovenska (NBS), Statistical Office of the Slovak Republic, Ministry of Finance of the Slovak Republic, SARIO.

A Rating Committee was called consisting of highly qualified analysts of CRAG. The quality and extent of information available on the rated entity was considered satisfactory. The analysts and committee members declared that the rules of the Code of Conduct were complied with. No conflicts of interest were identified during the rating process that might influence the analyses and judgements of the rating analysts involved or any other natural person whose services are placed at the disposal or under the control of Creditreform Rating AG and who are directly involved in credit rating activities or approving credit ratings and rating outlooks. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant quantitative and qualitative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all risk factors is described in CRAG´s "Sovereign Ratings" methodology. The main arguments that were raised in the discussion are summarized in the "Reasons for the Rating Decision".

As regards the rating outlook, the time horizon is provided during which a change in the credit rating is expected. This information is available within the credit rating report. There are no other attributes and limitations of the credit rating or rating outlook other than displayed on the CRAG website. In the event of providing ancillary services to the rated entity, CRAG will disclose all ancillary services in the credit rating report.

The date at which the credit rating was released for distribution for the first time and when it was last updated including any rating outlooks is indicated clearly and prominently in the rating report; the first release is indicated as "initial rating"; other updates are indicated as an "update", "upgrade or downgrade", "not rated", "affirmed", "selective default" or "default".

In accordance with Article 11 (2) EU-Regulation (EC) No 1060/2009 registered or certified credit rating agency shall make available in a central repository established by ESMA information on its historical performance data, including the ratings transition frequency, and information about credit ratings issued in the past and on their changes. Requested data are available on the ESMA website: https://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

An explanatory statement of the meaning of each rating category and the definition of default are available in the credit rating methodologies disclosed on the website.

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