Creditreform Sovereign Rating

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Rating Object	Rating Information	
REPUBLIC OF SLOVENIA	Assigned Ratings/Outlook: **A- /stable**	Type: Initial Rating, unsolicited with participation
Long-term sovereign rating Foreign currency senior unsecured long-term debt Local currency senior unsecured long-term debt	Publication Date: 03-03-2017 Rating Date: - Rating Renewal: - Rating Methodologies: "Sovereign Ratings"	

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Rating Action

Neuss, 03 March 2017

Creditreform Rating has published the unsolicited long-term sovereign rating of "A-" for the Republic of Slovenia. Creditreform Rating has also published Slovenia's unsolicited ratings of "A-" for foreign and local currency senior unsecured long-term debt. The outlook is stable.

Key Rating Drivers

1. Although the recent crises led to a transitory setback in income convergence, Slovenia exhibits relatively high per-capita income levels; as we expect solid economic growth, convergence with EU levels is set to continue in the medium term
2. Despite the generally high quality of institutions and reform efforts, Slovenia still faces considerable challenges with regard to government effectiveness and business environment
3. Underpinned by solid macroeconomic performance and improving labor market conditions, Slovenia is making further progress in fiscal consolidation as the headline deficit should continue on its downward trajectory
4. Debt levels still elevated and moderate progress on structural deficit adjustment; contingent liability risks and demographics may endanger medium- to long-term fiscal sustainability
5. Net international investment position is very likely to improve further as high current account surpluses should strengthen Slovenia's external position

Reasons for the Rating Decision

Our assessment of the Republic of Slovenia's high level of creditworthiness balances the country's economic recovery and positive growth prospects, improving external position as well as generally favorable institutions against elevated government debt levels and fiscal sustainability concerns in general.

The Republic of Slovenia is characterized by a well-diversified economy and a comparatively high per-capita income. As compared to other economies from Central and Eastern Europe (CEE), Slovenia's economic convergence with the European Union is well ad-

vanced – in 2015 the country's GDP p.c. was 83% of the average GDP p.c. of the EU-28. That said, the Slovenian economy is gradually recovering from a transitory setback, as the economic convergence process was interrupted in 2008-13, with income levels decreasing from 89 to 80.0% of the EU-28 average, mirroring the economic downturn in the wake of the global financial crisis and the Slovenian banking crisis in 2012-13. According to IMF data, the Slovenian per-capita income stood at USD 32,028 in PPP terms in 2016, somewhat higher than in CEE peers such as Poland (USD 27,715) or the Slovak Republic (USD 31,182). Meanwhile, Slovenia displays a strong export-oriented industry base which stands for a gross value added of 32.7% of GDP (2015, EA-19 median: 23.1%).

In recent years, the economic convergence process has been facilitated by economic growth gathering pace. Slovenian GDP rebounded strongly in 2014-15, with GDP expanding at rates of 3.1 and 2.3% after two years of contraction. According to the first estimate of the Statistical Office of Slovenia, GDP has grown by 2.5% in 2016. Growth became more broad-based, as domestic demand assumed a more prominent role and took over from net exports as the main driver of growth. Thus, 2016 saw a strong increase in private consumption spending of 2.8% y-o-y (2015: 0.4%), thanks to increasing employment and faster wage growth – contributing 1.5 p.p. to annual GDP growth. The growth contribution of net exports was still positive but decreasing (0.3 p.p.), due to robust import growth which came on the back of strengthening domestic demand. Quarterly growth of investment in machinery and equipment averaged at +10.7% y-o-y. Despite this notable pick-up in private investment, gross fixed capital formation dragged on growth, as public investment suffered from the transition to the 2014-20 EU programming period.

Going forward, the economy is set to maintain its growth momentum. This year, we expect Slovenian GDP to rise by 2.9%, significantly faster than the euro area average. We believe that output growth will be mainly driven by private consumption which is likely to accelerate, supported by further improving labor market conditions. While employment growth stepped up a gear and increased by 2.1% y-o-y in Q3-16 (Q2-16: 2.0%, Q1-16: 1.6%), unemployment fell to a monthly average of 7.5% in Dec-2016 after peaking at 10.8% in Apr-2013 and reaching its lowest level since Oct-2010. Concurrently, we believe that public investment will rebound against the backdrop of increasing EU funds absorption and burgeoning private investment should remain robust. According to the Draft Budgetary Plan 2017, EU funds absorption is expected to rise to 2.0% of GDP. Moreover, deleveraging in the corporate sector continued as non-consolidated private debt of non-financial corporations dropped to 102.0% of GDP in Q3-2016, down from 113.0% of GDP a year before (Q3-2011: 138.1%).

Nevertheless, it has to be seen whether the growth momentum can be sustained over the medium- to long term. While potential output could be impeded by the projected demographic development (see below), the decline in investments has taken its toll on potential growth, which is recovering only gradually. Thus, private investment fell to a mere 15.1% of GDP in 2016, averaging at 15.9% of GDP since 2009 as opposed to a pre-crisis average of 22.9% in 2000-08 (AMECO data). What is more, Slovenia is currently placed well below CEE peers such as the Czech Republic or Slovak Republic with 21.2 and 17.4% of GDP respectively, and remains below the euro area average of 17.3% of GDP.

In our view, investment is still curtailed by impediments stemming from the quality of public administration and the business environment in general. To be sure, Slovenia's institutional setting is of generally high quality. According to the World Bank's World Governance Indicators (WGI), the country ranks 48th out of 209 countries (2015) in terms of government effectiveness, 42nd as regards the quality of contract enforcement and 50th when it comes to the extent to which public power is exercised for private gain. It has to be noted, however, that Slovenia's scores place the sovereign somewhat below the respective median ranks of the euro area (31, 34 and 42, respectively). Furthermore, the quality of policy formulation and implementation has deteriorated since the onset of the financial crisis as Slovenia has slipped several places from rank 36 in 2009. What is more, the OECD's Indicators of Product Market Regulation show that competition is hampered by state ownership in multiple companies across a broad range of sectors.

The Slovenian government has begun to address these shortcomings as it implemented measures targeting the business environment and public administration, while other measures were adopted, still awaiting implementation. Thus, Slovenia adopted a new insolvency framework (2013), geared towards the efficiency of the judicial system and the reduction of the length of proceedings. Moreover, the government launched the SME test (Jun-16) and simplified the requirements and costs of public procurement (i.e. law on public procurement, Apr-16). In addition, the strategy (Apr-15) and the action plan (Jun-16) for the development of public administration were adopted, which include numerous reforms to improve the quality of public services – the strategy is planned to be implemented stepwise by 2020. Recently, the government has emphasized that upgrading the transport infrastructure and strengthening the rule of law are among the priority tasks in 2017.

At the same time, the reform process may be described as rather gradual and complex. In this vein, the Act on Civil Servants and the Act on Public Sector Salary System, which aim to enhance efficiency within the public sector by introducing more performance-based compensation for public service sector employees, have been delayed and are expected to be adopted by the end of 2017. According to the 9th progress report on the status of implementation of the Single Document, some 60% of the measures have been implemented.

Although competitiveness indicators suggest that some progress has been made, these signal room for improvement as structural reforms obviously need some time to impact institutional conditions, and tangible benefits have yet to materialize. As measured by the World Economic Forum's global competitiveness indicator, Slovenia has gained 14 places in the last two years and now ranks at 56 out of 138 economies, having suffered a significant drop since 2009 (rank 37) and standing well below the euro area median (32). By the same token, the latest Doing Business report shows that the sovereign has made some progress and ranks Slovenia 30th/190 economies, up from 35 two years before. The World Bank identifies the enforcement of contracts and getting credit as the most pressing issues. As data of the 2016 EU Justice Scoreboard reveals, the number of pending cases per 100 inhabitants in Slovenia stood at 12.0 as compared to 7.3 in the Slovak Republic or 4.0 in Poland. Hence, despite the fact that some progress has been achieved

in accelerating court procedures, Slovenia's judicial system is still struggling with a large backlog of pending cases.

Our assessment of Slovenia's creditworthiness is mainly constrained by its fiscal performance. Slovenian general government debt posted at 22.8% of GDP, when entering the euro area in 2007. As a consequence of the Slovenian banking crisis in 2012-13, the sovereign's general government debt climbed to unprecedented levels and peaked at 83.1% of GDP in 2015, while government debt in other CEE economies had been stabilized at more sustainable debt levels after the global financial crisis (CEE avg. 53.1% of GDP in 2015). In particular, the recapitalization of the Slovenian banking sector led to a significant increase in the government's net borrowing. In 2009-13, Slovenia's headline budget deficit soared from 5.9 to 15.0% of GDP.

To keep fiscal sustainability risks at bay, the Slovenian government curbed expenditures across the board. The drivers behind budget consolidation were mainly temporary measures and the resumption of GDP growth rather than structural adjustments. To be sure, the government implemented some structural reform steps such as the increase in VAT rates, the introduction of fiscal cash registers or the pension reform (see below). Thus, the government successfully brought the headline deficit down to below 3% of GDP in 2015 (2.7% of GDP) and last year, the Slovenian government should have again overachieved its deficit target as set out in the Stability Program 2016 (2.2% of GDP). We expect the headline deficit to come down further in 2017-19, mainly due to the favorable macroeconomic performance and the concurrent yields from tax collection which are likely to balance the increasing wage bills in the public sector. Furthermore, the government is likely to increasingly resort to its fiscal buffers built up over recent years and which are among the highest in the euro area, amounting to EUR 7.4bn or 19.9% of GDP (currency and deposits). Accordingly, we believe that general government debt declined to 80.5% of GDP in 2016 and will continue on its downward trajectory, falling to around 75% of GDP in 2017-19.

As regards Slovenia's fiscal framework, we regard the adoption of the Fiscal Rules Act (Jul-15) as an important step towards strengthening fiscal governance. The act introduces a balanced budget rule in structural terms, as well as an independent Fiscal Council which will be tasked with evaluating the compliance with fiscal rules and monitoring the implementation of the state and local budgets. However, the government has failed to appoint the members of the council as of yet.

Notwithstanding the generally benign perspectives, we see two key risks which might endanger Slovenia's medium- to long-term fiscal sustainability. First and foremost, the demographic development is likely to put fiscal sustainability at risk. In this context, the fiscal pension reform of 2013 and the favorable labor market performance are lifting some pressure – at least until the years 2023-25. The decline of the ratio of insured persons to pension recipients came to a halt in 2013 (1.38; 2000: 1.8) and rose to 1.45 in 2016. Nevertheless, the projected increase in Slovenia's age-related spending is the highest in the EU-28, as the share of working age population (age 15-64y) is expected to drop by 12.2 p.p. GDP between 2013 and 2060. As a result, Slovenia's age-related expenditure is projected to increase by 6.7 p.p. to 31.5% of GDP by 2060, with rising pension costs as

the main contributing factor to this increase (+3.5 p.p. GDP). An important step forward was the White Book on Pensions published in April 2016. The key proposals with regard to which a consensus needs to be achieved include a further increase in the actual retirement age (three models under consideration), the introduction of a point system, elimination of early retirement and the indexation of pensions. According to the White Book's projections, a full implementation of the proposals would result in savings of 2.5 to 3 p.p. of GDP. Still, a consensus has not yet been reached and we view consensus-building as difficult, as upcoming elections and the favorable macroeconomic performance may take away some reform pressure. More progress has been achieved with regard to the awaited healthcare reform. Only recently the Ministry of Health presented a draft law on health care and health insurance geared towards sustainable financing of the health care system.

On the other hand, Slovenia's large state-owned enterprise (SOE) sector bears substantial contingent liability risks. The EU Commission reckons that Slovenia displays one of the highest levels of state involvement in Europe and estimates that over one-third of the rapid increase in sovereign debt in 2007-14 can be linked to SOE-related costs. In 2014, a reform process was launched which aims to improve the transparency and performance of SOEs and to disentangle linkages with the state budget. With the Slovenian Sovereign Holding (SSH), the authorities established an entity to consolidate various state funds holding SOEs. According to SSH data, the direct (RS) and indirect (SSH) shareholdings of the Republic of Slovenia account for 30.1% of GDP (as measured by book value, end of 2015), while total assets of all majority- and minority-SOEs exceed GDP by more than a factor of 1.5 (158.8% of GDP). Meanwhile, the privatization process is underway, though it appears to be advancing only slowly. As of February 2017, nine assets have been sold and the sales process for five assets has been initiated, including the country's largest bank, Nova Ljubljanska Banka (NLB). On 20 February, a potential investor withdrew from the Cimos sale, increasing the number of unsuccessful sales to four. As laid down in the Asset Management Plan 2017 which was approved by the government on 19 January 2017, 20 assets are to be sold in 2017. However, the sale of Abanka is expected for mid-2019.

Although the repercussions of the banking crisis are still being felt, the Slovenian banking sector has shown notable improvements. While banks' CET tier I capital ratio has almost doubled from 9.5 (Q3-13) to 18.7% (Q3-16), non-performing loans have seen a sharp decline over the recent years. NPLs fell to 6.3% of total loans in Q3-16 (IMF data), down from 8.0% in Q2-16 (Q3-13: 18.0%). Still, the Slovenian NPL-ratio remains higher than in most other euro area member states. The decline of the NPL ratio was mainly due to the transfer of NPLs to the state-owned Bank Assets Management Company (BAMC). That said, the wind-down of impaired assets transferred is proceeding rather slowly. At the end of June 2016 assets under management were priced at EUR 1.54bn, down from EUR 1.79bn at the beginning of the year. According to the ambitious Business Strategy 2016-22, the bulk of the portfolio is planned to be worked out by 2019. At the same time, the volume of outstanding loans to the private sector continues to contract, albeit at a lower rate (Dec-16: -2.6% y-o-y) and we expect credit growth to remain anemic in 2017.

As regards Slovenia's external performance, the economy's external position continued to improve. Thus, the current account surplus had significantly widened, posting at 5.2% of GDP in 2015, up from -0.1% of GDP in 2010. This increase was largely driven by a significant improvement of the Slovenian trade balance, in particular the balance of trade in goods. Up from -2.6% of GDP (2010), Slovenia's surplus of trade in goods surged to 3.9% of GDP in 2015, at the same time the country's balance of trade in services further widened from 3.3 to 5.2% of GDP. These developments were supported by declining energy prices and subdued domestic demand – both dampening imports, while improved cost competitiveness has helped export performance. In 2010-16, the decrease of real unit labor costs in Slovenia (-5.2%) was more pronounced than in the euro area as a whole (-1.1%). Although the last year has seen buoyant growth in domestic demand, we expect that the current account surplus has increased sharply to 6.8% of GDP, mainly due to a rapid growth in exports. In the medium term, the current account is likely to narrow somewhat as we project investment to pick up.

The sustained high current account surpluses should result in a further improvement of the negative net international investment position (NIIP), which fell from -51.2% of GDP in 2012 to -38.0% of GDP in 2015. While the NIIP has edged down to around -36.2% of GDP (Q3-16), Slovenia's external liabilities remain at an elevated level. Against this backdrop, it is worth highlighting that sovereign external debt has rapidly increased from 9.3% of GDP in 2007 to 58.7% of GDP in Q3-2016, though stabilizing in the recent years. Concurrently, external debt in the deposit-taking corporate sector was successfully reduced from 49.6 to 10.6% of GDP over the same period.

Rating Outlook and Sensitivity

Our Rating outlook on the long-term sovereign rating of "A-" is stable as we assume that the risk situation underlying the key factors affecting sovereign credit risk – including macroeconomic performance, institutional structure, fiscal sustainability, and foreign exposure – will remain fundamentally unchanged in the near term.

We could lower our rating if the Slovenian economy experienced lower-than-expected medium-term growth. In view of Slovenia's high degree of trade openness, growth could be dented by lower export volumes as its economy is highly dependent on external demand from a very small number of trading partners. Taken together, Germany (20.6%), Italy (11.2%), Austria (8.3%) and Croatia (7.8%) make up almost half of Slovenia's exports. Moreover, we see risks to medium-term growth, should public investment fail to pick up due to a slower absorption of EU funds.

Our rating could also be downgraded if marked fiscal sustainability risks materialized. Thus, government debt could be negatively impacted if the clean-up of the BAMC's asset portfolio does not proceed as expected. In the same vein, losses potentially incurred by SOE's may pose contingent liability risks. Also, pressure on Slovenian public finances could emerge, should public wages increase significantly over the coming years.

Further downside risks relate to progress in implementing structural reforms. High state involvement and the relative strength of vested interests may slow down or even halt the

reform process, thus hampering improvement of the business environment. In addition, the governing coalition, consisting of SMC, DeSUS and SD, holds only a narrow majority in the Slovenian parliament (52 of 90 seats). Hence, efficient policy management may be impaired by lingering political instability. Tensions within the coalition and differing views on the way forward may jeopardize efficient policy-making.

On the other hand, we may raise our rating if the Slovenian economy achieves higher-than-expected and sustainable growth, e.g. in the event of a faster absorption of ESI funds, or a marked decline in general government debt, supported by proceeds from asset sales as well as privatization receipts.

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Ratings*

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

*) Unsolicited with participation

Economic Data

[in %, otherwise indicated]	2011	2012	2013	2014	2015	2016e	2017e
Real GDP growth	0.6	-2.7	-1.1	3.1	2.3	2.5	2.9
GDP per capita (PPP, USD)	28,774	28,443	28,542	29,922	30,918	32,028	33,279
Inflation rate, y-o-y change	2.1	2.8	1.9	0.4	-0.8	-0.2	1.4
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	80.0	80.1	80.3	80.5	n.a.	n.a.	n.a.
Fiscal balance/GDP	-6.7	-4.1	-15.0	-5.0	-2.7	-2.0	-1.8
Current account balance/GDP	0.2	2.6	4.8	6.2	5.2	6.8	n.a.
External debt/GDP	105.0	122.2	121.0	113.8	114.4	n.a.	n.a.

Appendix

Regulatory Requirements

This sovereign rating is an unsolicited credit rating. Notwithstanding, Creditreform Rating staff held discussions with the Slovenian Ministry of Finance, the Bank of Slovenia, the Institute of Macroeconomic Analysis and Development (IMAD) and the Bank Assets Management Company (BAMC) during which the authorities provided additional information, updated economic projections and commented on questions which were raised by Creditreform Rating staff. Furthermore, this report represents an updated version which was augmented in response to the factual remarks of the Slovenian authorities during their review of the draft report. However, the rating outcome as well as the related outlook remained unchanged.

The rating was conducted on the basis of Creditreform Rating´s “Sovereign Ratings” methodology. Creditreform Rating AG 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 Creditreform Rating´s rating methodologies is published on the following internet page: www.creditreform-rating.de.

A Rating Committee was called consisting of highly qualified analysts of Creditreform Rating AG. The quality 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 and that the rating action was and is free of any existing or potential conflicts of interest. 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 Creditreform Rating´s “Sovereign Ratings” methodology. The main arguments that were raised in the discussion are summarized in the “Reasons for the Rating Decision”.

Disclaimer

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