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 15-10-2021 "Sovereign Ratings" "Rating Criteria and Definitions"

Rating action

Neuss, 15 October 2021

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 is negative.

Contents

Key Rating Drivers

1. The Slovak economy experienced a relatively mild GDP contraction from a European perspective in 2020; signs mounting that incipient recovery will be curbed by supply shortages and rising input prices, stalling consumer confidence, and slow progress in vaccination this year before likely growth acceleration in 2022, also due to EU financing from the Recovery and Resilience Facility (RRF) and gradually waning supply-chain disruptions
2. Formidable structural challenges remain in place which may hamper Slovakia's already stagnating income convergence process, namely misaligned productivity and wage metrics possibly leading to lower cost competitiveness, gaps in education, innovation, and health, as well as the adaption of the pivotal auto industry to new technology and production; we note that the Recovery and Resilience Plan adequately addresses these impediments
3. Against the backdrop of generally robust institutional conditions, further buttressed by the sovereign's EMU/EU membership, we see intensifying efforts to tackle still-prevalent deficiencies in terms of rule of law and control of corruption; political volatility has increased more recently, as reflected by the change in government and a reshuffling of posts this spring
4. Amid collapsing economic activity and extensive Covid-19 measures, public debt surged to new record highs; while we expect debt-to-GDP to climb further this year and next, it should gradually fall over the medium term; at this stage, we believe that fiscal risks are largely mitigated by the still relatively low debt level and strong and increasing debt affordability, the latter being aided by the ECB's monetary policy and the EU financing; planned fiscal and pension reforms should support medium- to-long-term fiscal sustainability
5. Despite the high external exposure of Slovakia's small and open economy, in particular of its car industry, we view external risks as limited, mainly due to the key role of net FDI in

explaining its negative NIIP as well as to our expectation of robust export growth and inflows of EU financing amid moderate, though widening, current account deficits going forward

Reasons for the Rating Decision and Latest Developments[1]

Macroeconomic Performance

Our assessment of the Slovak Republic's credit rating continues to be backed by its solid macroeconomic performance profile. Following a rather tame GDP contraction last year, we expect robust medium-term growth, in particular due to a strong growth impetus from investment, which should be significantly supported by EU financing on the back of NextGenerationEU (NGEU) as well as the previous and the new Multiannual Financing Frameworks (MFF). Investment and structural reforms in the context of NGEU and the national Recovery and Resilience Plan (RRP) are likely to play a vital role in tackling structural impediments, thereby reviving the recently stagnating income convergence. Challenges abound, e.g. improving the health system, enhancing education and innovation, supporting the transformation towards a green and digital economy, and aligning its auto industry to a changing environment. We will follow household debt dynamics closely amid a credit-driven housing boom.

In light of the devastating Covid-19 pandemic, the Slovak Republic experienced a relatively moderate recession last year by European comparison, with real GDP contracting by 4.4% as compared to -6.3% in the euro area (EA) and -5.9% in the EU-27. The relatively mild recession may be explained by Slovakia's economic structure, which exhibits comparatively low exposure to tourism and other consumer-facing industries, whereas the industrial sector plays a more prominent role (Q2-21: 22.7% of GVA, EA: 19.8%). Moreover, confinement measures were less strict than in most European countries throughout 2020, judging by the Blavatnik School of Government's stringency index.

Drawing on latest national accounts data, last year's economic performance was mainly dragged down by gross fixed capital formation, which slumped by 11.6%, thereby shaving 2.5 p.p. off growth in 2020. While the fall in gross fixed capital formation was somewhat buffered by construction investment, which rose by 4.5% on the year, investment in machinery and equipment was hit hard by extreme uncertainty and supply chain disruptions, collapsing by 26.9%. Household spending was adversely affected by two lockdown periods in 2020, but turned out to be rather resilient as its contraction was one of the mildest across EU-27 peers, coming in at only -1.3% (EA: -7.9%). Net external trade contributed positively to last year's outturn (+0.7 p.p.), mainly due to strong import compression, with imports decreasing by 8.2% vis-à-vis a decline by 7.3% in total exports.

Looking at the current year, the Slovak Republic's quarterly GDP profile has broadly reflected epidemiological developments so far. In light of strong restrictions to public life in order to contain the spread of the coronavirus, with the cumulative 14-day infection rate standing well above 1,000 during the first ten weeks of 2021, real GDP fell by 1.4% q-o-q in the first quarter (EA:

[1] This rating update takes into account information available until 12 October 2021.

-0.3%), mainly driven by domestic demand. In tandem with the improving health situation, restrictive measures were gradually eased, and the state of emergency ended on 14 May 2021, laying the ground for a robust rebound in Q2-21, with total output increasing by 2.0% q-o-q.

At this stage, we expect the Slovak economy to continue its recovery. Largely driven by household spending and net external trade, real GDP growth should expand by 3.9% in 2021, meaning that pre-crisis GDP level should be reached in Q4-21, according to our current projections. A normalization of household spending patterns, together with the release of forced savings accumulated during various lockdown phases since the start of the pandemic, should aid the recovery of private consumption going forward. We deem nominal wage growth supportive to household spending growth, being prospectively facilitated by base effects, the gradual economic normalization and concurrent employment growth, as well as likely increasing shortages of qualified labor over the medium term. From March 2021, annual growth of nominal average wages has surpassed 8%, albeit having slowed somewhat in July (8.6%).

That said, real wages, and ultimately private consumption, are likely to be dented by rising HICP inflation in 2021/22, with energy price pressure prospectively carrying over into next year. Furthermore, we think that an apparently renewed deterioration in the epidemiological situation is likely to limit household spending growth in Q4-21 and Q1-22 to some degree, although not as severe as in the wake of the first and second waves. The number of Covid-19 infections has climbed steadily since July 2021, and the 14-day infection rate recently jumped to 307.4 (week 39, ECDC) amidst a rather lackluster vaccination campaign. The Slovak Republic thus ranks among the EU member states with the lowest share of the adult population fully vaccinated, posting at a mere 51.9% as of 7 October (EU-27: 74.1%).

The Covid-19 pandemic halted the favorable labor market developments observed over the recent years, with the unemployment rate rising from 5.8% in 2019 to 6.7% in 2020 (2014: 14.2%). Although standing below euro area levels (7.9%), we note that the Visegrad peers' (V3) jobless rate was significantly lower last year (CZ 2.6%, HU 4.3%, PL 3.2%). To be sure, there are wide regional discrepancies, as mirrored by an unemployment rate of 3.4% in Bratislava as opposed to 10.6% in eastern Slovakia (2020, Eurostat).

Whilst the participation rate amounted to 72.4% in 2020, close to historically high levels (2019: 72.7%) and the rate observed in the euro area as a whole (73.1%), the Slovak labor market still faces structural challenges such as comparatively high vertical and horizontal skills mismatches, but also pervasive long-term unemployment. Despite trending downwards, the share of long-term unemployment remains among the highest in the EU-27 (2020: 47.8%, EA: 35.4%).

Meanwhile, higher frequency data points to easing labor market conditions, as monthly unemployment (LFS-adj. SA) dwindled to 6.5% in August 2021, its lowest level since the onset of the corona crisis (Mar-20: 6.0%), and down from its transitory peak at 7.2% in March2021. Fiscal support measures such as the short-time work scheme should continue to provide for broadly stable labor market developments, even in the face of a pick-up in infection rates over the winter months, and we expect employment growth to gather steam next year.

Whilst a vivid expansion of both private and public investment is one of the key assumptions underlying our medium-term forecast, near-term dynamics are significantly curtailed by supply shortages of materials, essentially semiconductors, and surging input prices. In this vein, the share of corporate respondents citing equipment as a limiting factor to industrial production quadrupled to 31.2% between Q1 and Q3 this year. Likewise, a rising number of construction enterprises is plagued by a shortage of materials and rising prices.

Mirroring these developments, industry sentiment dipped considerably in August and September. In addition, in what can be interpreted as a harbinger for softer investment growth in the near-term, the Association of the German Automotive Industry (VDA) drastically reduced its forecast for 2021, projecting German car production to plummet by 18% this year to just 2.9mn vehicles (2016: 5.75mn cars).

Still, Slovakia's industrial production had risen by 2.1% and 0.6% m-o-m in June and July respectively, and well-filled order books as well as elevated capacity utilization (Q3-21: 82.7%, 2000-20 average 81.5%) in the industrial sector hint at continued growth. As bottlenecks regarding delivery of microchips can be traced back to a confluence of negative circumstances (i.e. corona crisis, storms in the Gulf of Mexico, US-China trade disruptions) we would tend to view these as temporary, although they may last well into next year.

Even so, we believe that persistently low financing costs and deferred investment plans should give continued rise to investment – not least in view of the necessity for carmakers to adapt to technological changes (see below). Of equal importance is the EU's financing support, which should – if implemented quickly and efficiently – be a boon for investment recovery and underlying growth. The Slovak Republic is one of the main beneficiaries of NGEU, as it will receive around EUR 6.32bn or 6.9% of 2020 GDP in terms of RRF grants. We would caution that the proposed reform, i.e. investment, timeline may be hampered, or at least challenged by the ability of the sovereign to absorb such large funds.

As a case in point, Slovakia trails all EU peers in terms of the share of MFF 2014-20 funds spent (46% as of Jun-21, EU: 57%). On the other hand, roughly EUR 8bn of EU funds from the previous MFF 2014-20 are still available, which the sovereign will presumably draw by 2023 at the latest, further facilitating gross fixed capital formation. Although investment projects under MFFs tend to be somewhat back-loaded, mention should be made of the additional financial resources totaling almost EUR 13bn, standing ready to be deployed under the new EU cycle 2021-27.

As the effects of the supply shortages should gradually subside and broader vaccination coverage be realized, we expect real GDP growth to increase to 4.8% in 2022, with domestic demand significantly contributing to accelerated growth, although we have to emphasize that the degree of uncertainty around these assumptions remains unusually high. Tailwinds from brisk investment activity, as well as the expanding automotive sector will likely foster export growth, but we expect net external trade to turn negative beyond 2021, as exports should be outpaced by stronger import growth.

Despite a relatively favorable macroeconomic profile and the expected economic recovery, we have to recall that the Slovak economy faces critical structural challenges in a medium- to-long-term perspective, which may obstruct the economy's income convergence if – contrary to our assumption – they are left unaddressed.

Firstly, the sovereign has displayed very strong wage growth in recent years, which is likely to precipitate a decrease in Slovakia's cost competitiveness without improvements in labor productivity going forward. Over the last five years (2016-20), Slovak real unit labor costs rose by 12.4% (AMECO data), far above the level observed in its key European trading partners and the euro area as a whole (2016-20: 2.8%). At the same time, we note that the ULC-based real effective exchange rate appreciated somewhat in 2019-20 (+2.2%) and compares rather unfavorably with medium-term developments in the euro area overall, but is broadly aligned with its V3-peers. Additionally, Slovakia's global export market share of goods and services has hovered at around 0.4% since 2016, inching up to 0.41% in 2020.

Secondly, and related to comparatively slow labor productivity growth, challenges pertaining to its business environment, innovation, and education remain. Judging by survey-based data, regulatory and administrative burdens present a considerable challenge for SMEs. Catching-up potential in terms of innovation is underscored by relatively scarce spending on R&D, amounting to just 0.83% of GDP in 2019, having stagnated at this level since 2012 and well below euro area levels (2.24% of GDP). Furthermore, we see gaps related to digital transformation and a shortage of qualified workers, as illustrated by the latest vintage of the European Commission's (EC) Digital Economy and Society Index, placing Slovakia at rank 22, whilst its lagging innovation performance is reflected by the European Innovation Scoreboard 2021. In this regard, high productivity growth of foreign-owned corporates and imported technology has not sufficiently translated into the domestic sector so far, as also highlighted by the Slovak central bank (NBS), as well as OECD.

Thirdly, we have to reiterate that the automotive sector will be facing considerable challenges due to the rise of electric vehicles and the adaption to new production standards. The Slovak economy is highly dependent on this key industry. Vehicles, aircrafts, and vessels accounted for 34.9% of exports in 2020 (2019: 33.4%), and 275,000 people are directly or indirectly employed by the automotive industry (SARIO).

The shift to electric cars has particularly taken off in Europe, given strict government rules and regulations concerning vehicle emissions and attempts to achieve carbon-neutrality and bolster the transition towards Electric Vehicles (EVs). Hence, demand for electric vehicles has been growing rapidly more recently. Hybrid electric vehicles (HEV) currently dominate the alternatively powered vehicle market, as their share doubled from 9.5% in H1-20 to 19.0% of new car registrations in H1-21 in the EU-27. On the other hand, petrol and diesel shares declined to 42% and 22% respectively in H1-21. With more than one million units sold in H1-21, the number of HEVs in the EU rose by almost 150% compared to the previous year. Looking ahead, we expect that the demand for electric vehicles to continue to rise sharply, especially thanks to public subventions allocated to the environmental transition.

To be sure, the e-mobility segment appears to be making headway in the Slovak Republic, as e.g. illustrated by four BEV, five PHEV, and eight MHEV models of seven brands being produced in the country (SARIO). Also, we gather that KIA Motors expects to start production of a new EV model at its Žilina plant in 2024 as part of the company's new strategic plan to strengthen the electric car segment. In the same vein, it plans to produce eleven new EV models and to reach a production of 500,000 vehicles p.a. from 2025. Volkswagen envisaged w investment worth of EUR 1bn in Slovakia, especially for the production of a new generation of Skoda Volkswagen models in its Bratislava factory.

Anemic productivity growth may explain Slovakia's broad stagnation in terms of income convergence in recent years. In 2020, GDP per capita stood at USD 32,866 (IMF data, PPP terms, current prices), dropping by 3.7% compared to the previous year's level. Slovakia's GDP per capita currently represents 74% of EU-27 average (2016: 73%, 2011: 75%). Furthermore, the Slovak Republic not only continues to display an income gap towards the EU average, but also as compared to other CEE economies such as Lithuania (2020: 87% of EU average), Slovenia (89%), the Czech Republic (92%), and Poland (77%).

This notwithstanding, we think that the RRP and related deep-seated, quite ambitious reform proposals (see below) adequately address the structural bottlenecks identified above. At the current juncture, we thus believe that NGEU funds and corresponding reforms will boost Slovakia's potential growth and speed up its income convergence. According to EC simulations, the RRP may raise Slovak GDP by 1.3% to 1.8% p.a. between 2021 and 2026. Drawing on latest AMECO data, potential growth is estimated to post at 2.2% and 3.0% in 2021 and 2022 respectively, somewhat below the better-performing CEE economies from this point of view.

We would still flag risks related to increasing private debt amid fast mortgage loan growth. Irrespective of the tremendous economic and social impact of the pandemic, loans for house purchase have continued to grow rapidly since our last review. After showing somewhat weaker, albeit still high, growth in the first quarter amid a severe second infection wave, the outstanding volume of mortgage loans resumed double-digit growth in June and stood 10.4% above its previous year level in Jul-21, fostered by favorable financing costs, competitive pressure in the banking sector, and residential property developments.

Institutional Structure

The Slovak Republic's creditworthiness remains backed by its generally robust institutional set-up, and the extensive benefits the sovereign draws from its membership in the EU, the euro area, and NATO. Despite visible improvements regarding its justice system and the control of corruption, as well as notably intensifying efforts to strengthen institutional outcomes in this respect, Slovakia still has room to improve as compared to rating peers and the euro area as a whole. While the RRP will be a cornerstone of the sovereign's strategy to tackle structural challenges, we will closely follow headway being made. Political volatility flared up this year, but we expect unchanged policy-making going forward. At the same time, a steadfast and effective implementation of measures may be impaired by the increasing fragility of the governing coalition, which was reformed earlier this year.

The recent update of the World Bank's Worldwide Governance Indicators (WGI) reflects the overall picture of generally strong institutional conditions, and broadly resembles last year's outcomes. Thus, the sovereign's WGIs still show considerable gaps towards the respective median outcomes of the euro area, as well of 'A' rating peers. We assess as positive the significant progress when it comes to the rule of law, where the sovereign has shown continuous improvement over the last years, climbing seven places to rank 56 out of 209 economies in the latest vintage – equaling the record low first achieved in 2016, but still significantly behind the EA and 'A' universe median (rank 32 and 45).

We note that decision-makers have made significant strides in enhancing the independence and efficiency of the sovereign's judicial system, inter alia via an encompassing constitutional reform which created a Supreme Administrative Court, amended selection and appointment processes for judges, and have strengthened the Judicial Council. To ameliorate judicial quality and efficiency, a draft reform of the judicial map has been tabled. However, the latest Justice Scoreboard exhibits a further weakening in the time needed to resolve civil, commercial, and administrative cases.

Illustrating the notable efforts concerning the combat of corruption, Slovakia improved from relative rank 81 to rank 71 out of 209 economies, the highest rank since 2008, but surpassing peer median readings by a wide margin (EA: rank 43). Considerable catching-up potential is reflected by e.g. the latest edition of the GRECO report (Feb-21) which attests only slow progress in implementing measures to prevent corruption of prosecutors, judges, and members of parliament, as more than half of the recommendations were not implemented.

Less positive developments could be observed as concerns the perception of the sovereign's quality of policy formulation and implementation, with regard to which the World Bank metric mirrored a further weakening. In fact, the deterioration in the WGI government effectiveness to relative rank 60 represents the weakest result in over 20 years. What is more, this compares rather unfavorably with the euro area as a whole (median rank 35) and Slovakia's rating peers (rank 47). The abovementioned underutilization of ESIF funds continue to reflect difficulties in planning and coordination processes. More importantly, we think that increasing shortcomings in public administration generally bode ill for the upcoming critical reforms under the RRP.

Likewise, the pace and efficiency of implementing ambitious RRP reforms may be impaired by further increasing tensions within the center-right four-party coalition, composed of OLaNO, Sme Rodina, SaS, and Za Ludi. Following controversies within the coalition during the winter of 2020-2021, PM Matovic resigned in March 2021 and the coalition split. A new government was formed on 1 April 2021, with Finance Minister Heger and PM Matovic exchanging posts, whilst the cabinet remained broadly unchanged otherwise. Going forward, we would view a snap election as rather unlikely at this stage, as the ruling parties would have to incur heavy losses, judging by current polls (OLaNO 9% vs. 25% at the parliamentary election).

We will closely monitor any progress in implementing the proposed reforms in the national RRP. On the whole, the envisioned initiatives appear well-suited, to respond to the economy's structural challenges accelerate the green and digital transformation, and address key aspects in trying to safeguard sound public finances and rebuilding fiscal headroom. According to Ministry of Finance (MFSR) information, the judicial map reform and a reform to make the anti-corruption and AML-framework more efficient are among first reforms to be presented during this year's fourth quarter and in the first half of 2022.

One of the key building blocks of the RRP will be the establishment of a modern and accessible healthcare system (EUR 1.163bn). As the Covid-19 pandemic highlighted deficiencies in this respect, hospital network optimization and its reclassification into five categories should increase its efficiency. As an undeterred and effective implementation of the RRP may well prove challenging, reforms geared towards an effective public finance management, the enhancement of public procurement and the digitalization of public services seems pivotal.

The RRP contains numerous reforms for tackling the environmental and digital transition. Roughly 21% and 43% of RRF financing shall be devoted to the country's digital transition and climate change objectives respectively, both above the shares required by the EC. We think that greening the economy will be an arduous task in the face of Slovakia's carbon-intensive production, and as authorities have to deploy continuous efforts to achieve a green transformation while reconciling this objective with the goal of moving closer to the EU-27 average income levels. The National Energy and Climate Plan, which was approved by Parliament in December 2019, sets 2050 as the legally-binding year for reaching climate neutrality.

According to the EC's Eco-Innovation Index, Slovakia is ranked 21st among the EU members. Whilst lagging CEE peers such as the Czech Republic, Slovenia, and the Baltic States, it stands above V3 peers Hungary and Poland. The Slovak Republic's greenhouse gas (GHG) emissions came in at only 7.4 tons p.c. in 2019, below the EU-27 as a whole (8.4 tons). A less benign picture is given by renewable energy metrics, according to which Slovakia features a relatively low share of energy from renewable sources. As of 2019, the overall share of renewables posted at 16.9% (EU-27: 19.7%). Moreover, the Slovak Republic displays a particularly low share of renewable sources in gross electricity consumption (21.9%, EU-27: 34.1%).

Fiscal Sustainability

The sovereign's public debt ratio increased sharply amid the devastating corona crisis, and we expect debt-to-GDP to inch up further against the backdrop of persistently high fiscal deficits, in particularly as many support measures have been extended in 2021. Still, we continue to view fiscal sustainability risks as largely contained, due to the still relatively low debt level by euro area standards, the economic recovery which should lead to a gradually falling debt ratio over the medium term, and strong and increasing debt affordability. We believe that the envisaged fiscal and pension reforms should be conducive to fiscal sustainability over the medium to longer term.

In light of collapsing economic growth and the implementation of a myriad of supportive measures to prevent adverse economic consequences and protect public health, public finances deteriorated visibly in 2020. As measured against the revised 2020 GDP, the Slovak Republic concluded the year 2020 with a general government deficit amounting to 6.1% of GDP, up from 1.3% of GDP in 2019.

Indeed, the government implemented a huge fiscal package totaling approx. EUR 4.9bn (5.3% of 2020 GDP). Most costly were the measures targeted towards labor market support, in particular the short-time work scheme, coming in at EUR 921mn (1.0% of GDP), followed by ramped up funds to aid the health system (0.4% of GDP) and social assistance (0.3% of GDP). Discretionary Covid-19 measures with a direct budgetary impact should have summed up to roughly 2.1% of GDP. In order to safeguard corporate and households' liquidity, the government introduced bank guarantees and permitted tax and bank instalment deferrals, which authorities gauge at 2.1% of GDP (Stability Program 2021, SP21). To be sure, the total volume of state-guarantee schemes was substantially larger (approx. 4.2% of GDP), but the take-up of those schemes proved rather moderate.

Accordingly, last year's fiscal outturn was mainly driven by the total general government expenditure, having risen from 42.6% of GDP to 47.5% in 2019-20. In absolute terms, expenditure rose by 9.1% in 2020, fueled by the public wage bill (+8.9%) and subsidies which jumped from EUR 928.1mn in 2019 to EUR 1236.6mn in 2020 (+33.2%). On the revenue side, income and wealth taxes took a heavy hit, dropping by 9.4% on the year.

Looking at the present year, we expect the headline deficit to widen further against the backdrop of the epidemiological situation. A severe second infection wave heavily influenced economic and social conditions, in particular in the first half of the year and prompted the extension of Covid-19 related fiscal support measures. Authorities thus decided to e.g. prolong short-time work measures until 31 December 2021, to launch a third aid package to the tourism sector under the so-called minimal aid scheme, and to offer additional support to the consumer-intensive industries such as food and accommodation.

As per SP21 (2022 budget published after cut-off), the measures with a direct budgetary impact included in the 2021 budget increase to approx. EUR 3.58bn (3.9% of 2020 GDP) as compared to last year. Labor market measures make up for the largest share (1.6% of GDP), whilst the government budgeted the build-up of a reserve in the amount of EUR 588mn. This year's tax revenue intake should increase on the back of beginning economic recovery and also due to discretionary measures such as the increase in excise taxes on tobacco products, but we also see, on balance, additional social spending related to pensions and associated subsidies (e.g. Christmas pension, 13th pension, early retirement for mothers). At this stage, we would expect a headline deficit to the tune of 7.0% of GDP in 2021. Thanks to the lifting of most fiscal aid measures and to accelerating economic growth, we cautiously forecast the general government deficit to narrow to about 4.0% of GDP next year.

We expect the sovereign's public debt ratio to broadly stabilize in 2021/22, driven by a significant deficit which will likely be broadly balanced by the effects of recovering economic growth and increasing inflationary pressure on the one hand, and dwindling interest expenditure on the other. Sizable stock-flow adjustments should keep the debt increase at bay this year. At the current juncture, we would tentatively project debt-to-GDP to edge up to 60.2% of GDP in 2021 and to 60.4% in 2022. The MFSR will reportedly present a budget foreseeing a deficit of approx. 4.9% of GDP in 2022, which we do not take into account at this stage due to limited visibility. All else being equal, this would result in a mechanical increase in the debt ratio to 60.9% of GDP for 2022. We have to point out that the forecasts remain more uncertain than usual, with epidemiological developments and the dynamics of the economic recovery in a context of supply shortages being the primary sources of uncertainty.

Due to plunging economic growth and a surging deficit, general government debt soared from 48.1% of GDP in 2019 to 59.9% in 2020, just short of the 60%-Maastricht mark, but still the highest level on Eurostat records. We note that the 2020 reading lay slightly above the threshold prior to the national accounts revision (60.6% of GDP). At the same time, we have to highlight that the Slovak debt level stands materially below the euro area average (98.0% of GDP), among others reflecting the significant consolidation effort before the onset of the crisis, and giving us some confidence regarding the sovereign's future consolidation efforts.

In addition, fiscal risks are also mitigated by strong debt affordability as well as by official policy support on behalf of the ECB and EU financing, and we expect further falling debt servicing costs and receding refinancing risks going forward. Measured against total general government revenue, interest expenditure has followed a multi-year downward trend, standing at 2.98% in 2020 (2019: 3.0%; 2016: 4.23%). Refinancing risks have decreased, as mirrored by a declining share of foreign currency-denominated debt (QPSD, Q1-21: 3.1% of general government debt, Q1-18: 5.4%) and in particular by the relatively high average weighted maturity of the Slovakian debt portfolio which has significantly perked up over the last decade and has been exceeding 8 years since 2018 (Aug-21: 8.4y, Aug-20: 8.2y, ECB).

Thus, the sovereign benefits from the ECB's ongoing very accommodative monetary policy conditions and related APPs. Long-term government bond yields have been in negative territory since July 2020, posting at -0.056% as of 01 October 2021, and have recorded a Bund spread of at around 20bp since March 2021, after having transitorily spiked to approx. 130bp at the onset of the corona crisis (2011-20 average: 94bp).

The ECB's PEPP with an overall envelope of EUR 1,850bn runs until at least 31 March 2022. Reinvestments of maturing principal payments from securities purchased under PEPP until at least 31 December 2023 will add further to the accommodative stance. At its September meeting, the ECB decided to reduce its monthly PEPP purchases for the first time, but the monetary policy stance remains unchanged, and while there is some uncertainty regarding the pace over the next quarters, we believe that the ECB will continue to deliver significant stimulus through its exceptional monetary operations, including the APP. As of September 2021, the Eurosystem's cumulative Slovakian asset purchases under the PSPP and the PEPP have totaled EUR 16.6bn and 6.9bn respectively, corresponding to 42.7% of total outstanding general government debt as of the end of 2020.

We continue to hold contingent liability risks to be rather remote at present, thanks to comparatively low public guarantees and the sound Slovakian banking sector. Guarantees totaled 12.2% of GDP in 2020 (SP21). That said, the bulk of guarantees is linked to EFSF/ESM (9.4% of GDP) in 2020, and only 1.1% of GDP are related to the Covid-19 pandemic.

The Slovakian banking sector, which is dominated by foreign-controlled subsidiaries, has remained rather resilient so far, also thanks to the government's measures. Financial institutions thus are in good shape, judging by EBA data as of Q2-21. The banking sector's capitalization has increased throughout the crisis, as the CET1 ratio rose from 15.9% in Q2-20 to 17.2% at the end of the first half 2021 (EU: 15.8%). NPLs fell by 0.7 p.p. to 1.8% in the year up to Q2-21, somewhat below the EU average of 2.3%. While bank profitability had come under pressure in the wake of the corona crisis, return on assets has caught up more recently, rising to 0.8% in Q2-21 (EU: 0.5%), after having temporarily fallen from 0.9% at the end of 2019 to 0.4% in June 2020.

Nevertheless, pockets of vulnerabilities remain in place, primarily pertaining to the abovementioned dynamic mortgage loan growth coupled with vividly growing residential property prices and increasingly indebted households (see also above). Household debt has displayed unabated growth over the last decade, and rose from 43.7% of GDP to 47.5% in 2019-20. Measured against disposable income, household debt rose from 70.4% in Q4-19 to 73.3% in Q4-20, well above the level observed in other CEE peers (ECB data). At the same time, housing prices have retreated from their peak reached in Q1-20 when the annual rate posted at 13.1%, and grew at a more moderate pace this year, at 2.0% and 4.7% in Q1 and Q2. Nevertheless, the three-year growth rate amounted to a still high 24.4% and stood above 20% for 16 consecutive quarters. We will be monitoring developments here, as the price-to-income ratio is also trending upwards (OECD data) and NBS estimates indicate some overvaluation.

The development of NPLs has to be followed more closely once the loan moratoria expire. Corporate bankruptcies have been on the decline since the onset of the crisis. At the end of the first half of this year, insolvencies posted approx. 38% below the Q4-19 reading (EA: -16%). EBA data points to some below-the-line risks, as stage 2 loans account for 14.9% of total loans and advances as of Q2-21, well above the EU average of 8.8%. Arguably more importantly, 39.0% of loans with expired EBA-compliant moratoria are stage 2 loans, as compared to 24.4% in the EU. Meanwhile, the share of distressed loans in total loans with non-expired moratoria stood at 57.4% as of Q2-21 (EU: 28.2%, EBA). This said, we note that, according to NBS, most of the deferred loans are redeemed fully and on time, with repayment difficulties occurring in 4.7% of deferred loans in the NFC sector and 5.6% of respective loans to private households as of Aug-21. What is more, stress tests conducted by NBS as well as the IMF demonstrate a relatively high resilience of the banking sector under adverse scenarios.

Eminent medium- to long-term fiscal sustainability risks related to Slovakia's aging population amid a relatively generous pension system persist. According to this year's Aging Report update, the Slovak Republic will face one of the most pronounced increases in aging costs among the EU member states. Latest EC projections foresee a material increase in age-related costs to 21.9% of GDP in 2030, up from 18.3% of GDP in 2019, largely driven by public pensions (+1.8 p.p.) and health-care spending (+1.1 p.p.). However, at this level, aging costs will stay below the projected EU average of 25.4% of GDP. Over the long term, aging costs are forecast to soar by 10.8 p.p. – corresponding to the largest increase in the EU (EU average +1.9 p.p.).

We assess positively that the government commits itself to re-establishing a link between life expectancy and the retirement age, as it adopted an amendment to the Slovak Constitution in December 2020 according to which the retirement age cap at a level of 64 years will be abolished from January 2023. Furthermore, decision-makers tabled a draft pension reform aiming at an improvement of the sustainability of the first pension pillar and at increasing the profitability of the second. While transparency is to be enhanced via an annual independent evaluation report, measures such as early retirement after working for a set number of years and the parental credit may create additional fiscal pressure.

Further to structural reforms aiming at improving medium- to long-term fiscal sustainability, the government envisaged a budget responsibility reform by which it seeks to establish multi-year expenditure ceilings and medium-term budgeting. The reform is scheduled for the second quarter of 2022.

Foreign Exposure

As a small open economy, Slovakia displays high foreign exposure. Yet, we believe that external risks continue to be contained, as the sovereign's pronounced negative net international investment position (NIIP) is largely driven by net FDIs. Robust export growth and EU financing is likely to exert upward pressure on its NIIP. Moreover, we expect only moderate, albeit increasing, current account deficits over the next few years.

Although the Slovak Republic has been hit heavily by the Covid-19 crisis, it recorded a modest current account surplus totaling 0.1% of GDP last year, up from -3.4% of GDP in 2019 (2015-19 average -2.5% of GDP). The shift into surplus came mainly on the back of an improved goods balance which posted a surplus of 1.1% of GDP in 2020, following a deficit of -1.2% of GDP a year before, since exports recovered strongly in the second half of last year, as opposed to imports. Also, the primary deficit narrowed markedly from 2.3% of GDP to 1.2% in 2019-20, largely explained by lower non-resident dividend earnings.

According to latest available data, Slovakia's current account surplus widened to 1.1% of GDP in Q2-21 (four quarter rolling sum), given a sharply increasing goods surplus amounting to 2.8% of GDP (Q2-20: -1.8% of GDP). Overall, we expect the current account to post a small deficit this year, and to continue posting a moderate deficit over the next years, due to rising import growth and rising dividend outflows in tandem with economic normalization.

Slovakia remains among the EU member states featuring comparatively large and negative NIIPs, at first view suggesting elevated external risks. In 2020, its NIIP stood at -65.8% of GDP, broadly unchanged from the previous year (-66.3% of GDP). Moreover, Slovakia's NIIP appears to remain relatively stable as compared to other CEE peers, where we observe a visible improvement over the longer term. That being said, we have to recall that the negative NIIP mainly stems from a steady inflow of FDI. Net FDI thus stood at -52.2% of GDP in 2020, accounting for the lion's share of the negative NIIP. In this regard, we would consider Slovakia's NENDI (excluding non-defaultable instruments) as a case in point, as this metric posted at a significantly lower level (2020: -14.9% of GDP).

Rating Outlook and Sensitivity

Our rating outlook on the Slovak Republic's long-term credit ratings is negative, mainly due to the abnormally high degree of uncertainty still weighing on the incipient economic recovery, which may also have negative reverberations on the sovereign's medium-term debt trajectory.

We could revise the outlook if we have sufficient clarity on the robustness of the recovery of the Slovakian economy, i.e. that economic activity is not obstructed by a significant resurgence in Covid-19 infection cases, and that the supply shock will turn out rather short-lived, without grave effects on OEMs and the Slovak automotive supplier industry at large. We could also consider a positive rating action if medium-term GDP growth surpasses our expectations, which could be the case if RRF financing is absorbed swiftly and efficiently, alongside the timely implementation of structural reforms aimed at Slovakian structural bottlenecks. A significant boost to productivity and potential growth would feature prominently in such a scenario, leading to a robust increase in per capita incomes, thus reinvigorating the convergence process towards EU levels. Additionally, upward pressure could result if we gain confidence that the sovereign's debt trend has been reversed on a sustainable basis.

By contrast, we could consider a negative rating action if Slovakia's fiscal metrics fail to improve, once the pandemic ebbs, ultimately leading to an entrenched upward trend in its public debt ratio. Another wave of Covid-19 infections with stronger restrictions to public life could trigger such a scenario. A renewed aggravation of the corona crisis, possibly nurtured by the relatively low share of the fully vaccinated adult population in Slovakia, could have significant negative consequences on medium-term growth. If medium-term growth falls short of our expectations this could also engender downward pressure. Persistent supply shortages in the industrial sector with potentially severe repercussions on the automobile sector represents a further risk factor in this respect. More generally, failure to address the economy's structural challenges, not least with regard to the automotive sector, could also be credit negative.

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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

Economic Data

[in %, otherwise noted]	2015	2016	2017	2018	2019	2020	2021e	2022e
Macroeconomic Performance								
Real GDP growth	5.2	1.9	3.0	3.8	2.6	-4.4	3.8	4.9
GDP per capita (PPP, USD)	29,941	29,681	30,918	32,765	34,143	32,866	35,457	38,375
Credit to the private sector/GDP	53.7	58.2	61.6	63.0	63.9	68.2	n/a	n/a
Unemployment rate	11.5	9.7	8.1	6.5	5.8	6.7	n/a	n/a
Real unit labor costs (index 2015=100)	100.0	103.0	106.2	108.5	111.4	115.8	n/a	n/a
Ease of doing business (score)	74.8	75.0	75.2	75.4	75.6	n/a	n/a	n/a
Life expectancy at birth (years)	76.7	77.3	77.3	77.4	77.8	76.9	n/a	n/a
Institutional Structure								
WGI Rule of Law (score)	0.5	0.6	0.5	0.5	0.5	0.7	n/a	n/a
WGI Control of Corruption (score)	0.1	0.2	0.1	0.3	0.2	0.4	n/a	n/a
WGI Voice and Accountability (score)	1.0	1.0	0.9	0.8	0.9	0.9	n/a	n/a
WGI Government Effectiveness (score)	0.8	0.8	0.7	0.6	0.6	0.5	n/a	n/a
HICP inflation rate, y-o-y change	-0.3	-0.5	1.4	2.5	2.8	2.0	2.5	3.5
GHG emissions (tons of CO2 equivalent p.c.)	7.5	7.6	7.8	7.8	7.4	n/a	n/a	n/a
Default history (years since default)	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Fiscal Sustainability								
Fiscal balance/GDP	-2.7	-2.6	-1.0	-1.0	-1.3	-6.2	-7.0	-4.0
General government gross debt/GDP	51.9	52.4	51.5	49.6	48.1	59.9	60.2	60.4
Interest/revenue	4.1	4.2	3.6	3.3	3.0	3.0	n/a	n/a
Debt/revenue	120.5	130.8	127.7	122.0	116.6	144.8	n/a	n/a
Weighted average maturity of debt (years)	6.7	6.8	7.8	8.5	8.8	8.4	n/a	n/a
Foreign exposure								
Current account balance/GDP	-2.1	-2.7	-1.9	-2.2	-3.4	0.1	n/a	n/a
International reserves/imports	0.0	0.0	0.0	0.1	0.1	0.1	n/a	n/a
NIIP/GDP	-63.9	-66.8	-68.3	-69.6	-66.3	-65.8	n/a	n/a
External debt/GDP	84.4	92.6	108.4	115.0	112.7	120.5	n/a	n/a

Source: International Monetary Fund, Eurostat, Statistical Office SR, own estimates

ESG Factors

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.

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.

ESG Factor Box

Environ-mental Quality	Ecological Risks	Ressource Management	Education	Health	Demo-graphics
Labor	Equality	Technology & Infrastructure	Safety & Security	**Judicial System**	**Quality of Public Services**
Integrity of Public Officials	Quality and Efficacy of Regulations	**Civil Liber-ties/ Political Participation**	Market Access	Business Environment	Data Transparency

Environment	Social	Governance	Highly significant	Significant	Less significant	Hardly significant

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	25.10.2029	A+ /stable
Monitoring	23.10.2020	A+ /negative
Monitoring	15.10.2021	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 of the Slovak Republic (MFSR) participated in the credit rating process, as it provided additional information during the credit rating process. 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 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, European Centre for Disease Prevention and Control (ECDC), Blavatnik School of Government, Národná Banka Slovenska (NBS), Statistical Office of the Slovak Republic, Ministry of Finance of the Slovak Republic, SARIO, GLOBSEC.

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" method-ology. 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 case 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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