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 07-10-2022 "Sovereign Ratings" "Rating Criteria and Definitions"

Rating Action

Neuss, 07 October 2022

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.

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Key Rating Drivers

1. Slovakia's economy showed moderate growth from a European angle in 2021, and we expect the Russian invasion of Ukraine to hamper economic activity this year and next; geopolitical developments aggravate pre-existing inflationary pressures and supply-side shortages, and will pose a significant drag on domestic demand and external trade alongside pronounced energy dependence on Russia; the weaker macro backdrop is set to further slow the Slovak convergence process

2. National Recovery and Resilience Plan (RRP) will be key with regard to the economy's main structural obstacles, namely reinvigorating income convergence, making its automotive industry future-proof, and preserving the economy's competitiveness; some uncertainties in view of the country's track record related to the utilization of EU financing and the public administration capacities

3. Generally strong institutional set-up, aided by substantial advantages stemming from membership in the EU and EMU; still ample room to improve on issues regarding its judicial system and the combat against corruption, but significant headway on milestones expected under the RRP; political stability risks have increased as the government lost its majority following the SaS party's withdrawal from the governing four-party coalition

4. Fiscal sustainability risks remain manageable in the near to medium term, mainly due to still moderate debt levels, prospectively rising but ultimately low debt servicing costs of new debt, low maturity risks, and the implementation of multi-annual expenditure ceilings; we expect a gradually declining debt ratio over the medium term, although consolidation efforts are obstructed by new challenges coming on the back of the Russian war against Ukraine; despite sound banking sector metrics, we monitor risks pertaining to dynamically rising residential property prices in a context of increasing household debt and vivid mortgage lending

5. Limited external sustainability risks, although net international investment position (NIIP) remains relatively high and negative; foreign direct investments dominate the NIIP composition, whilst a gradually normalizing geopolitical situation should facilitate GDP and export growth over the medium term, bolstering Slovakia's external position

Reasons for the Rating Decision and Latest Developments[1]

Macroeconomic Performance

The Slovak Republic's favorable macroeconomic performance profile continues to support the sovereign's credit ratings. That said, macro-related risks have continued to build since our last review, as the speed of recovery in the wake of the pandemic is tempered by disrupted supply-chains and rising prices. Prospects for significantly improving growth dynamics seem remote, as the Russian invasion of Ukraine amidst high Slovakian dependence on Russian energy imports and the energy-intensive industry-heavy economic structure will further weigh on economic activity. Slovakia's generally favorable growth trend thus appears set to experience a marked dent, further slowing the comparatively lackluster income convergence process observed over recent years. Implementation of investment and structural reforms along the lines of the Slovakian RRP will be vital for tackling long-standing challenges. Despite significant implementation risks, entailed by a track record of laggard EU Fund absorption and the sizable amount to be utilized in the near term, we believe that authorities will be able to deliver on RRP milestones, which will be instrumental for economic activity to strengthen further afield, and fostering underlying growth more generally. We will continue to monitor mounting private debt against the backdrop of brisk credit growth.

After the pandemic had resulted in a relatively mild contraction in 2020 (-4.4%), Slovak real GDP bounced back in 2021, expanding by 3.0%. The recovery of its economy was thus relatively moderate from a European perspective, being significantly outgrown by the euro area (EA) as a whole (5.2%). While slower growth is partly due to the less severe slump a year before, headwinds to economic activity starting from the second half of 2021 hit the Slovak economy more heavily than the euro area.

A renewed infection wave and surging energy prices dampened the economic recovery in the second half, resulting in relatively modest growth in household spending, which picked up by only 1.2% vis-à-vis 2020, contributing 0.7 p.p. to last year's growth outturn. Moreover, disrupted supply chains in particular concerning raw materials and semiconductors affected key industries, with negative ramifications for the Slovak economy, which is heavily reliant on the industry sector (~25% of total gross value added) and deeply integrated into global supply chains.

Hence, net external trade was a drag on Slovakia's growth performance in 2021 (-0.6 p.p.), as imports (+11.2%) rebounded more strongly than exports (+10.2%), mainly due to contracting exports in the second half of last year. Investment activity was relatively weak, having grown by only 0.6% in 2021 (2020: -11.6%), driven by a moderate recovery in equipment investment (+9.7%, 2020: -26.9%) and a decline in construction investment (-5.7%).

[1] This rating update takes into account information available until 30 September 2022.

The comparatively weaker recovery translated into another setback regarding Slovakia's already sluggish convergence towards advanced European economies' income levels. GDP per capita is estimated to have expanded by 7.3% in 2020-21, to USD 35,463 in 2021 (IMF data, PPP terms, current prices). Still, the income gap widened by approx. 1 p.p. as measured against the EU27, leaving Slovakia's per capita GDP at 73% of the EU27 average (2016: 73%). Among the Visegrád countries (V4), Slovakia has thus fallen further behind, with Czechia, Hungary, and Poland displaying per capita incomes, which post at 90%, 76%, and 78%, respectively.

Going into 2022, the economic environment has deteriorated drastically in light of the Russian war against Ukraine, and with it the economic outlook for the Slovak economy, which has not yet fully recovered from the corona crisis. To be sure, a lukewarm recovery continued in the first half of the year, with real GDP rising by 0.4% and 0.5% in Q1 and Q2, below the respective euro area averages (0.7%, 0.8%). Surging consumer and commodity prices, supply-side shortages and the military conflict affected exports and fixed investment. Private consumption also decelerated significantly in the second quarter (0.7%, EA: 1.3%). By mid-22, Slovakia was among the few EU27 members still falling short of their pre-pandemic real GDP levels (-0.3% vs. Q4-19).

Russia's military aggression against Ukraine is affecting Slovakia's economy via multiple channels, making it very susceptible to the war's negative repercussions. First and foremost, the Slovak Republic is highly dependent on Russian energy sources. In 2020, natural gas and oil and petroleum products accounted for 46.7% of Slovakia's energy mix, with more than 85% of natural gas and 78% of oil and petroleum products imported from Russia alone, thus comprising a significant share of Slovakia's energy mix. As a point of reference, the respective shares in the euro area amount to 35% and 21% respectively (EU: 39%, 23%).

All else being equal, Russia's decision to cease gas supplies to Slovakia would imply serious adverse effects for its energy-intensive industries. Most Russian gas supplies, in particular via Nordstream 1 have been discontinued as of Q3, while a few (e.g. Turkstream) are still active. However, Slovak authorities have gone a long way to forego a scenario in which hard rationing would be necessary, putting great effort into reconfiguring its energy sources over recent months. This September, a nuclear reactor starts operation in Slovakia, raising the share of nuclear energy in electricity production. The fallout in Russian gas appears to be partly offset by greater LNG imports. We note that Slovakia's gas storage capacities are well-filled at 85.3% (20-Sep-22, AGSI+ data; EU: 86.5%).

Furthermore, Slovakia's key trading partners had hitherto covered a high proportion of their energy needs through Russia and feature a rather industry-heavy economic structure, including Germany, Czechia, Poland, Hungary, and Austria. Indirect effects via main trading partners may turn out to be of greater importance in light of a combined export share of 52%, while the share of exports to Russia amounted to roughly 2% (2021, SORS data).

The Slovak economy is more vulnerable to supply chain disruptions than many European peers, partly due to the key role of the automotive industry. Judging by OECD TiVA data, the foreign content of Slovak exports posts at 48% (2018), well above the OECD average (28%). Automotive manufacturing accounts for almost 31% of value added in exports. Raw materials that were previously sourced from Russia and Ukraine and have been deployed in the car manufacturing process are now becoming increasingly scarce, magnifying pressure to an already struggling sector, given far-reaching semiconductor shortages in 2021, which have continued into 2022, and the transition to electric cars (see below).

Lastly, 798,232 border crossings from Ukraine have been recorded as of 20-Sep-22, of which 94,334 refugees have registered for temporary protection (UNHCR data). Whilst Ukrainian refugees could help in alleviating shortages on the Slovak labor market, primarily with a view to low-skilled jobs, this will add to already existing structural challenges associated with its health care and social care systems.

Economic prospects increasingly deteriorate as the Russian war against Ukraine wears on, but we still expect the Slovakian economy to expand this year and next. At this stage, we project real GDP growth to ease to 1.7% in 2022, and fall further to 0.5% in 2023. We assume that inflationary pressures, which are significantly accelerated by the military conflict, will weigh on household spending. Likewise, the weakening external environment and very high uncertainty should dampen exports and fixed investment.

Negative reverberations from the geopolitical backdrop are likely to extend well into next year and fade only gradually. On the other hand, EU financing as well as public support to cushion the economic and social fallout (see below) will contribute to growth in 2023. We have to highlight that the forecast is subject to unusually high uncertainty, being largely dependent on the further development of the geopolitical situation.

Net exports will likely continue to contribute negatively to Slovakia's total output growth in 2022 and, to a somewhat lesser degree, in 2023. We expect export growth to be significantly hampered by declining external demand as economic growth in Slovak main European trading partners decelerates. In addition, export performance of Slovakia's manufacturing-heavy economy will be stifled by disrupted supply chains and soaring commodity prices which boost input prices. Substituting Russia, Ukraine, and Belarus as trading partners will obviously take some time, leading to transitory trade frictions for Slovak exporting businesses.

Although we think domestic demand will be the main driver of growth, surging consumer and commodity prices will be a major constraint to its near-term expansion, being heavily influenced by current geopolitical events. We expect households to cut back on spending, due to downbeat consumer confidence and price pressures, which will curb real disposable income significantly, and as energy and food stand for a relatively large share of consumption.

Fueled by scarce energy resources and an above-average rise in food and transport prices, HICP inflation has increased rapidly since the turn of the year and significantly stronger than in the euro area as a whole, hitting 13.4% in Aug-22 (EA: 9.1%). Households will likely draw down their savings, and wages should continue to rise dynamically, mitigating the adverse effects of surging prices to some degree. Nevertheless, we expect inflation to outgrow wages. In Q1-22 and Q2-22, real wages thus plummeted by 3.8% and 11.7%, respectively.

Government measures to deflect the fallout from tremendously rising consumer prices should aid households' purchasing power. Authorities will permanently ramp up transfers for families from 2023, with the family stimulus package foreseeing an increased tax bonus for children, higher child benefits, and additional services for children. Moreover, policy-makers recently legislated amendments to laws regarding energy regulation, enabling the government to intervene in the market and allowing it to cap prices for electricity and gas.

While employment should expand in the current year, also supported by the inflow of foreign workers, not least from Ukraine, we assume it to broadly stagnate, or even decrease in 2023, in view of the expected further slowing of economic activity over the coming months. Although

somewhat underperforming against the euro area, Slovakia's labor market has displayed positive employment growth since Q3-21 and has recovered to pre-pandemic levels on this count, following solid growth in the first half of this year (NA data, domestic concept).

We note that labor participation and unemployment rate have continued to show signs of improvement. Labor participation continued its upward trend throughout 2021 and the first two quarters of 2022, climbing to 76.4% in Q2-22, which is broadly aligned with V4 peers. Monthly unemployment fell to 6.2% in July 2022, its lowest reading since the beginning of the pandemic, albeit still clearly exceeding the levels of Czechia (2.3%), Hungary (3.5%), and Poland (2.6%). We expect unemployment to decrease this year and next.

Private investment activity has remained subdued over recent quarters and should be hampered by uncertainty about geopolitics, inflation, and supply chains going forward. Soft data on industry order books and capacity utilization appear constructive, but rapidly rising prices of energy and other raw materials, coupled with supply-side shortages in material, equipment, and labor, drag down industrial production, boding ill for investment growth. Firms could see their profits eroding going forward, alongside gradually tightening refinancing conditions (see below).

At the same time, public investment should provide a uplift to Slovak total output, largely driven by substantial EU financing support. More than EUR 9.3bn (as of 27-Sep-22) remains to be spent from the Multiannual Financing Framework (MFF) 2014-20 by the end of 2023. In addition, massive financial support will be provided via grants from the Recovery and Resilience Facility (RRF). The Ministry of Finance (MoF, as per Stability Program 2022, SP22) announced the allocation of EUR 1.39bn and EUR 1.56bn in 2022 and 2023 (1.4% and 1.6% of 2021 GDP), respectively.

We would, however, take a more cautious view as regards the timely implementation of the authorities' ambitious investment plans and utilization of EU funds. Our reservations are underscored by the sovereign's track record on fund absorption. Drawing on latest cohesion data, the Slovak republic spent only 55% of the funds available under MFF 2014-20, corresponding to one of the lowest readings in the EU, and the lowest take-up among Central and Eastern European (CEE) countries.

Looking further ahead, also with a view to Slovakia's income convergence process, challenges also arise from its relatively sluggish productivity and the related impact on cost competitiveness. Real compensation per employee growth stood at a high 13.3% over the last five years (2017-21), running well ahead of real productivity growth, resulting in an 8.6% rise in real unit labor costs (AMECO data). The euro area as a whole and V4 economies experienced a weaker increase, or even saw a decline in real ULC over the same time horizon, suggesting a slight relative deterioration in Slovakia's competitiveness. At the same time, the global export market share of goods and services does not give reason for concern, in our view. Although edging down from 0.41% to 0.39% in 2020-21, the global share has been relatively stable, hovering at around 0.40% over the last decade.

Slovakia's productivity performance is partly related to structural bottlenecks in terms of labor and education, its business environment, as well as in its digitalization and innovation capacities. Horizontal and vertical skills mismatches remain pervasive. At the same time, skills shortages could complicate putting Slovakia's economy on a sustainable growth path, which is partly explained by shortcomings in the education system, as indicated by e.g. relatively low shares of adult participation in learning and tertiary education attainment among 30-34y old population.

The shortage of skilled labor could be exacerbated by a shrinking working-age population further out, if demographic change is left unaddressed. Concurrently, long-term unemployment remains persistently high at 56.6% in 2021, far above the euro area overall (40.9%), and levels observed in V4 peers (CZ: 27.5%, HU: 31.2%, PL: 26.6%).

We will continue to follow developments around Slovakia's business environment closely. Whilst the Slovak Republic improved slightly in the latest vintage of the IMD Competitiveness Ranking, the sovereign is ranked at 49 out of 63 economies worldwide. By the same token, the EC highlights in its SME performance review that the Slovak business environment is subject to onerous administrative barriers.

With regard to innovation capacities, there is room for improvement, as illustrated by the recently published European Innovation Scoreboard 2022, which attest Slovakia to be an "emerging innovator" (64.3% of the EU average). Notable weaknesses are insufficient business R&D expenditure and government support thereof, PCT patent applications, and lifelong learning (see above). What is more, Slovakia's digital transformation has made slow progress. In the Digital Economy and Society Index 2022, Slovakia lags behind most of the EU member states, being ranked 23rd and displaying below-average performance in the fields of digital public services and human capital.

That being said, authorities have recognized the need for action, and we believe that investment plans and reform initiatives along the lines of the RRP are a key response to the longer-standing challenges elaborated above. The satisfactory fulfilment of milestones related to RRF disbursements gives us some confidence that RRP implementation should resolve at least some of the structural issues the country is confronted with, thus reinvigorating convergence towards western European levels.

We remain wary of brisk loan growth in conjunction with mounting private indebtedness amid increasing credit risks related to the current economic environment and characterized by easing economic activity, rising financing costs, and surging prices. After having entered double-digit territory in June 2021, mortgage loan growth accelerated to 12.3% in Jul-22. On a side note, NFC credit growth has increased sharply since our last review, with its outstanding volume posting yearly growth of 11.7%. Although mortgage loan growth appears to have plateaued more recently, we continue to monitor developments as household debt measured by disposable income persistently rises and remains high from a CEE perspective (latest available data Q4-20: 73.2%).

Institutional Structure

Our credit assessment continues to reflect the sovereign's generally strong institutional conditions, despite continuing to display significant gaps as compared to euro area and rating peers, most notably with regard to its judicial system and corruption. The institutional set-up is buttressed by the sizable advantages the Slovak Republic draws from its membership in the EU and EMU, inter alia entailed by its common currency, deeper and broader financial markets, and ample EU financing support. We assess as positive that the government has embarked on several important reforms, related to education, the justice system, public administration capacities, and the fiscal realm. Political volatility has intensified over the last twelve months, and a snap election cannot be ruled out after the liberal Freedom and Solidarity (SaS) party has left the four-party governing coalition.

Above all, the Slovak Republic's generally strong institutional set-up is reflected in the recently updated set of the World Bank's Worldwide Governance Indicators (WGI), our preferred metrics for assessing institutional quality. Based on the recent vintage referring to 2021 as base year, we reiterate our view that the sovereign has ample room to improve as compared to other A-rated peers, and even more so compared to the EU average. We observe a sizable gap towards the EU average (median) when it comes to government effectiveness, i.e. the quality of policy formulation and implementation (relative rank 65/209 economies, EU: 39). Slovakia has slipped one place from a year before, and arguably more importantly, its relative ranking has persistently deteriorated since 2016 (rank 52).

On the other hand, the sovereign has significantly improved on the WGIs voice and accountability, from relative rank 53 to 49, as well as rule of law, from rank 57 to 54. We have to highlight that the latter outcome marks Slovakia's best result since the inception of the WGIs in 1996, and that the perceived quality of contract enforcement, property rights, and courts (i.e. rule of law) has followed a longer-term improving trend since 2013 (rank 77). Still, and despite these improvements, the sovereign stands below the respective EU averages (34 and 35). As regards the perception of control of corruption, Slovakia exhibits a large gap to the EU average (rank 80 vs. 49).

Tying in with perceived shortcomings related to preventing corruption, we took note of GRECOs recent compliance report (Jan-22) regarding the fifth evaluation round. GRECO concludes that only two of its 21 recommendations have been satisfactorily dealt with, while 16 have not been implemented at all. Having said this, policy efforts geared towards combating corruption are progressing, albeit somewhat slowly. Authorities are thus developing a new Anti-Corruption Strategy 2024-29. Also, a police reform came into force earlier this year, and amendments are being made to the criminal code.

We note that political risks have increased since our last review, as Slovakia's four-party government finally broke apart in early September, with the withdrawal of the liberal SaS party from the governing coalition and the resignation of the ministers from the SaS party. Political tensions between the SaS and OLaNO had been intensifying, escalating earlier this summer over the inflation aid package for families. Following the departure of the liberal coalition partner, the governing coalition no longer has a majority in parliament. Whilst PM Heger wants to continue with a minority government, a snap election ahead of the next regular election in 2024 cannot be ruled out. The opposition is reportedly pushing for new elections.

While further decreasing political stability might be detrimental with regard to the implementation of important structural reforms of the RRP and delivering on milestones for disbursements of RRF grants, the government has, in our view, demonstrated its ability to take action in the present extraordinary circumstances. Not only was the Slovak Republic among the first EU member states to submit a national RRP and receive a positive assessment by the EC in 2021, the government made major strides in fulfilling the necessary milestones to receive RRF payments this year.

In this context, authorities have made significant progress in the implementation of reforms in the areas of judicial system, higher education and research, the fiscal framework, the energy system, sustainable mobility, anti-corruption, digitalization of the public sector, and the audit system for RRF implementation. In light of a recent assessment in which the EC pointed out some shortcomings in public administration, viewing administrative capacities at all layers as a

challenge regarding EU fund utilization, we think the entry into force of the Recovery and Resilience Facility Act and the functionality of the repository system for monitoring the implementation of the RRP are worth mentioning. Furthermore, justice reforms such as the reorganization of Slovakia's judicial map and legislation enhancing judicial independence underscore the authorities' continued efforts to improve the judicial system.

Further meaningful steps pertain to implemented reforms and completed investment projects that facilitate Slovakia's green transformation. Policy-makers have thus set up an investment plan for rail infrastructure and published a methodology for selecting, preparing and implementing projects for cycling infrastructure. Noteworthy legislative amendments coming into force are the energy act, the regulation in network industries act, the promotion of renewable energy sources act, and the thermal energy act.

Indeed, Slovakia remains a country which is still catching up with eco-innovation, as indicated by the EC's Eco-Innovation Index, according to which it is placed at rank 21 among the EU member states (score 82 vs. EU average 121). Similarly, the overall share of energy from renewable sources is still sub-par as compared to the EU average (22.1%, 2020), although having increased markedly over the last decade (2020: 17.3%, 2011: 10.3%). On the other hand, greenhouse gas emissions remained below the EU average, falling from 7.3 tons to 6.8 tons per capita in 2019-20 (EU: 7.5 tons p.c.).

Fiscal Sustainability

The pandemic had severe repercussions on the sovereign's fiscal metrics. After experiencing one of the sharpest increases in the EU27, its public debt ratio stood at comparatively high levels from a CEE perspective. While fiscal consolidation will likely be hampered by slower economic growth in 2022/23 and authorities' efforts to limit the economic and social fallout from the Russian war against Ukraine, Slovakia's headline deficit should narrow going forward. Coupled with high inflation in the near term and gradually accelerating economic growth, we expect debt-to-GDP to decline gradually over the medium term. We think fiscal risks remain manageable, being mitigated by prudent debt management which has lengthened maturities over the last decade and should be able to lock in still relatively low interest rates. Whilst fiscal structural reforms related to the newly implemented multi-annual expenditure ceiling should help reining in rising debt, healthy financial soundness indicators hint at the banking sector's ability to withstand a shock emanating from the residential property market and/or deteriorating private sector balance sheets.

The Covd-19 pandemic continued to have a harsh impact on public finances last year. While the final outturn was markedly below the initial target for the general government balance (-7.4% of GDP), the Slovak Republic was nevertheless one of the few EU members posting a higher headline deficit in 2021 than in 2020 – largely driven by significantly higher outlays to soften the pandemic's economic and social impact. The general government deficit thus widened from 5.5% of GDP in 2020 to 6.2% of GDP in 2021. Government measures with a direct impact on the budget balance rose from 1.9% of GDP to 3.1% of GDP in 2020-21, with last year's pandemic-related expenditure coming in EUR 1.96bn or 2.0% of GDP higher than originally budgeted (MoF data).

The outperformance of the 2021 budget target was largely due to higher tax receipts. Revenue from income and wealth taxes increased by 7.3%, with CIT receipts surprising on the upside in particular, and VAT intake jumped by 10.5%. Strengthening economic activity also resulted in

higher net social contributions (+7.7%). However, total expenditure rose by 9.0% compared to the previous year (2020: +9.1%). Fixed investment fell by 4.0% on the year, but the public wage bill continued to increase briskly, by 7.1% following +9.2% in 2020. Subsidies rose by 10.4%.

Looking forward, we expect the headline deficit to narrow to 4.0% of GDP in 2022 and 3.8% of GDP next year. The deficit decline should largely be driven by decreasing public aid measures aimed to soften the impact of the pandemic and dynamic nominal output growth heavily influenced by surging inflation. Fiscal consolidation will be hindered by the government's efforts to deflect the adverse effect of rising commodity and energy prices on businesses and vulnerable groups of the population. We have to point out the high degree of uncertainty underlying this forecast, in particular against the backdrop of the continuously evolving geopolitical situation and its effects on inflation-related expenditure and energy prices, as well as any adverse effects from potentially resurging Covid-19 infections from this fall.

On the revenue side, we assume that strong growth in tax receipts boosted by high and rising inflation rates will have a deficit-reducing impact. Our expectations are corroborated by recent MoF data on the state budget, according to which its revenues leapt by 15.4% y-o-y in the first eight months of 2022. The marked increase came on the back of a vividly rising tax intake, which stood 17.4% above the previous year's level up to August, mainly supported by higher CIT, VAT, and excise duty revenue.

Furthermore, continued wage growth should also support net social security contribution receipts, and improved tax administration is likely to cater for stronger VAT revenues. As suggested by the EC's latest VAT Gap Report, Slovakia's VAT gap fell to 16.1% of VTTL in 2019 (2020e: 17.1%). We believe that VAT collection will be facilitated by newly introduced measures, such as the launch of a new virtual cash register and a new electronic invoicing information system.

Discretionary expenditure associated with measures in response to the pandemic will drop to EUR 1.0bn (SP22), with labor market support remaining the most important spending item in this respect. The deficit will be further widened by measures enacted to tackle dynamically rising energy prices and their adverse effects. The inflation aid package (~ EUR 1bn) foresees one-off transfers to families with children and permanently higher child benefits from 2023, whilst the ramped-up tax credit for children will reduce PIT revenues. Also, pensioners entitled to a 13th pension will receive two extra payments this year. Further allocated funding to protect the private sector from soaring energy prices (approx. EUR 850mn) pertains to the agreement with a Slovak energy provider to freeze energy prices for selected customer groups.

The public wage bill will presumably continue to rise significantly. Public sector employees will receive a one-off payment of EUR 500 and a 7%-increase in salary from 2023; employees in the education sector will see their wages raised by 10% (MoF intelligence). In addition, public fixed investment is envisaged to be increased after two years of declining public investment activity, to 4.7% and 4.5% of GDP in 2022 and 2023, respectively (2017-21 average: 3.5% of GDP).

We expect the sovereign's public debt ratio to edge down over the medium term. Driven by the pandemic, general government debt continued to increase last year, rising from 59.7% of GDP to 63.1% of GDP in 2020-21. Although the euro area average amounted to 95.6% of GDP in 2021, we note that the current level compares high from a CEE angle. Having risen by 15.0 p.p. since 2019, the Slovak Republic featured one of the strongest increases in its debt-to-GDP ratio in the EU and the strongest among CEE peers. Based on the premise of a gradually narrowing headline

deficit and significant snowball effects, namely continued economic growth and strong inflationary pressures, we project debt to fall to 62.0% of GDP this year and further to 57.7% of GDP in 2023.

Fiscal sustainability will presumably remain underpinned by affordable debt. To be sure, Slovak 10y government bond yields have risen rapidly over the last few months after posting in negative territory at the turn of the year. Exiting from its negative rates policy in July 2022, the ECB delivered a 50 basis point rate hike in its three key benchmark rates. Flanking its decision, it approved a Transmission Protection Instrument (TPI) to deal with any perceived disruption to the transmission mechanism of its monetary policy.

In September 2022, the ECB announced another unprecedented rate hike of 75bps, lifting the main refinancing rate to 1.25%. The ECB puts high emphasis on frontloading its tightening cycle amid the challenging present circumstances, and policymakers have hinted at more interest rate hikes to come over the next several meetings, making an aggregated 75bp increase by the end of the year look likely while leaving the door open for more.

Still, we do not expect the turning tide in monetary policy to threaten medium-term fiscal sustainability at the current juncture, as we assume that the sovereign will still be able to replace maturing higher-yielding debt by lower-yielding new issues. According to ARDAL, the average yield of bond issues stood at a record-low 0.24% in 2021, with the average maturity coming in at a high 14.9y. At the general government level, interest expenditure thus continued to fall as a percentage of total revenues, from 3.0% to 2.7% in 2020-21, and of GDP, from 1.2% to 1.1%.

Prudent debt management has resulted in a well-laddered redemption profile, while the domestic central bank and the foreign official sector hold 38% of Slovak government debt (2021), having increased 10-fold between 2014 and 2019 (IMF data). In addition, the sovereign was able to maintain its average weighted maturity at around 8.5y over the last 12 months (Jul-22: 8.58y, ECB data), standing above 8y since Oct-17.

In any case, we expect that the government will remain committed to prudent fiscal policies and to reducing government debt. Recently adopted and envisaged structural fiscal reforms should strengthen fiscal policy credibility and help in building up fiscal buffers and safeguarding fiscal sustainability going forward.

Most importantly, the Organic Budget Act was passed in Mar-22, introducing multi-annual expenditure ceilings, with the implementation thereof being analyzed and updated by the national fiscal council (Council for Budget Responsibility), depending on a long-term sustainability indicator. An expenditure limit translating into a consolidation of the structural balance by 0.5 p.p. GDP is to be implemented from as soon as 2023. Further to fiscal reforms, a pension reform linking the retirement age to life expectancy is currently pending in parliament. We think implementation of this reform of the first pension pillar could be instrumental for strengthening fiscal sustainability over the medium to long term.

We continue to follow developments around dynamically rising residential property prices and vivid mortgage loans in a context of rising household debt and increasing credit risks (see above). Housing prices have continued to follow their dynamic upward trajectory throughout the pandemic. The 3-year-growth rate has posted above 30% since Q3-21 and above 20% since the third quarter of 2017 (Eurostat data), whilst Slovakia's price-to-income ratio stood 12% above its long-term average in Q1-22 (OECD). We note that our concerns were echoed by the ESRB last

December, when it issued a warning on medium-term vulnerabilities in the Slovak real estate sector.

However, the banking sector remains healthy and should be able to withstand a shock emanating from the residential property market. CET1 ratio fell from 17.0% in Q1-21 to 16.1% in this year's first quarter, but remained above the EU average of 15.2% (EBA data). Asset quality continued to improve, with the NPL ratio down to 1.6% in Q1 (Q1-21: 2.0%), as compared to 1.9% in the EU overall.

Foreign Exposure

As a small, open economy and as one that is deeply embedded in global supply chains, the Slovak economy is highly susceptible to external shocks, as evidenced by recent geopolitical developments. The Slovakian NIIP is relatively high and negative as compared to other CEE peers and has improved only slightly over recent years. That being said, net foreign direct investment forms a substantial part of that highly negative NIIP, and we expect this to improve over the medium term, reflecting our expectation of a narrowing current account deficit going forward due to strengthening real GDP and export growth in line with gradual adjustment to challenges resulting from the recent succession of crises.

Having exhibited an average current account deficit of -2.5% of GDP over the period 2015-19, Slovakia posted a small surplus in the first year of the pandemic (+0.4% of GDP), mainly on account of the goods balance swinging into a temporary surplus as imports strongly declined. In 2021, amid the economic recovery, the current account balance was back in deficit, amounting to -2.0% of GDP, largely due to the goods balance returning to negative territory (-1.2 p.p. to -0.1% of GDP).

As measured by the four-quarter moving sum, the goods trade deficit became more pronounced in Q1-22, partly driven by rising import prices, causing the current account deficit to swell to -4.5% of GDP. Going forward, while the outlook for exports has clouded with regard to the near term, and with commodity prices likely to remain elevated over the winter season, we expect these latest trends to persist into next year. For 2023, we assume a gradual moderation of energy prices and supply bottlenecks, which should contribute to improving export performance and lower import prices, prospectively narrowing the current account deficit over the medium-term. Uncertainty over the pace of transformation towards electrical mobility and potential fallout for Slovakia as a key supplier to the automotive industry continues to weigh somewhat on medium-term export prospects.

Slovakia's negative NIIP shrank by 3.9 p.p. to -61.9% of GDP in 2021, with the net direct investment position continuing to account for the lion's share of the overall position and mitigating risks associated with its status of net external debtor. Larger movements could be observed in the 'other investment' component last year, the effect of which was more than compensated for by a rising net positive position concerning portfolio investment (+7.7 p.p.) and a decreasing net negative position regarding direct investment.

Rating Outlook and Sensitivity

Our rating outlook on the Slovak Republic's long-term credit ratings is negative, which mainly reflects significant uncertainty over the sovereign's underlying growth and progress in its income convergence towards Western European levels, resulting from structural changes coming on the back of Russia's war against Ukraine and the related geopolitical shifts, e.g. in energy policy. We have to emphasize that the assessment and interpretation of economic developments remains more challenging than under normal circumstances, as is the case for other indicators, in particular fiscal metrics.

We could downgrade Slovakia's credit ratings if the sovereign's medium-term growth falls short of our expectations, which could in particular be the case if the Russian military conflict in the Ukraine drags on, or if it escalates and extends to other neighboring European countries. Such a scenario could feature more severely disrupted supply chains with substantial adverse effects on Slovakia's industry sector and a permanent loss in output.

Resurgent infection waves, possibly in light of new virus strains, could also pose serious macro risks for the Slovak economy amid a relatively low uptake of the primary course (ECDC data). Also, should prices remain higher for an extended period, sharply rising interest rates could entail adverse effects on Slovakia's residential property market.

We could also contemplate a downgrade if authorities fail to reverse the rising debt trend and the public debt ratio increases over a prolonged period of time, essentially resulting from one of the shocks elaborated above. Government effectiveness could deteriorate if we see further escalating political risks, exerting downward pressure on the ratings.

On the other hand, we could consider revising the outlook to stable if we have sufficient confidence in the ability of the Slovak economy to withstand the tremendous macro shock, successfully managing its energy transition, thereby deflecting medium- to long-term economic losses in its pivotal industries. Upward pressure could result from persistently declining debt-to-GDP, or if the income convergence process re-gains traction, e.g. following a successful and swift utilization of EU financing and implementation of structural reforms.

Analysts

Primary Analyst
Fabienne Riefer
Senior Analyst Public Finance
f.riefer@creditreform-rating.de
+49 2131 109 1462

Chairperson
Dr Benjamin Mohr
Head of Public Finance
b.mohr@creditreform-rating.de
+49 2131 109 5172

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

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.

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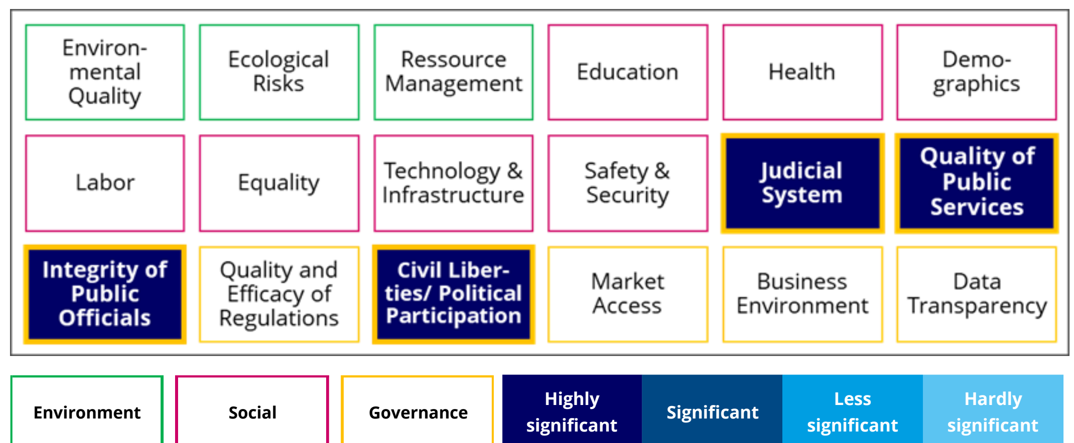
ESG Factor Box



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 have significant 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 concerning economic prospects and public finances. To be sure, we will follow ESG dynamics closely in this regard.

Economic Data

[in %, otherwise noted]	2016	2017	2018	2019	2020	2021	2022e
Macroeconomic Performance							
Real GDP growth	1.9	3.0	3.8	2.6	-4.4	3.0	1.7
GDP per capita (PPP, USD)	29,668	30,901	32,793	34,203	33,061	35,463	38,620
Credit to the private sector/GDP	58.2	61.6	63.0	63.9	68.2	69.4	n/a
Unemployment rate	9.6	8.1	6.5	5.7	6.7	6.8	n/a
Real unit labor costs (index 2015=100)	103.2	106.4	108.6	111.4	115.7	115.5	n/a
World Competitiveness Ranking (rank)	40	51	55	53	57	50	49
Life expectancy at birth (years)	77.3	77.3	77.4	77.8	77.0	74.8	n/a
Institutional Structure							
WGI Rule of Law (score)	0.6	0.5	0.5	0.5	0.7	0.7	n/a
WGI Control of Corruption (score)	0.2	0.1	0.3	0.2	0.4	0.2	n/a
WGI Voice and Accountability (score)	1.0	0.9	0.8	0.9	0.9	0.9	n/a
WGI Government Effectiveness (score)	0.8	0.7	0.6	0.6	0.5	0.5	n/a
HICP inflation rate, y-o-y change	-0.5	1.4	2.5	2.8	2.0	2.8	11.6
GHG emissions (tons of CO2 equivalent p.c.)	7.6	7.8	7.8	7.3	6.8	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	-2.6	-1.0	-1.0	-1.3	-5.5	-6.2	-4.0
General government gross debt/GDP	52.4	51.6	49.6	48.1	59.7	63.1	62.0
Interest/revenue	4.2	3.7	3.5	3.1	3.0	2.7	n/a
Debt/revenue	130.8	133.6	127.9	122.3	149.9	155.0	n/a
Total residual maturity of debt securities (years)	6.8	7.8	8.5	8.8	8.4	8.5	n/a
Foreign exposure							
Current account balance/GDP	-2.7	-1.9	-2.2	-3.4	0.4	-2.0	n/a
International reserves/imports	0.0	0.0	0.1	0.1	0.1	0.1	n/a
NIIP/GDP	-66.8	-68.3	-69.8	-65.9	-65.7	-61.9	n/a
External debt/GDP	92.6	108.4	115.0	112.7	120.5	137.0	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	25.10.2029	A+ /stable
Monitoring	23.10.2020	A+ /negative
Monitoring	15.10.2021	A+ /negative
Monitoring	07.10.2022	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 commented on a draft version. 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, European Center for Disease Prevention and Control (ECDC), UNHCR, UNCTAD, 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 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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Creditreform Rating AG

Creditreform Rating AG
Europadamm 2-6
D - 41460 Neuss

Phone +49 (0) 2131 / 109-626
Fax +49 (0) 2131 / 109-627
E-Mail info@creditreform-rating.de
Internet www.creditreform-rating.de

CEO: Dr. Michael Munsch
Chairman of the Board: Michael Bruns
HRB 10522, Amtsgericht Neuss