Creditreform Sovereign Rating

Creditreform Rating
www.creditreform-rating.de

Rating Object	Rating Information	
SLOVAK REPUBLIC	Assigned Ratings/Outlook: **A /stable**	Type: Follow-up Rating, unsolicited
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 27-10-2017 “Sovereign Ratings”

Contents

Rating Action 1
Key Rating Drivers 1
Reasons for the Rating Decision .. 1
Rating Outlook and Sensitivity...... 7
Economic Data 7
Appendix 8

Rating Action

Neuss, 27 October 2017

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 stable.

Key Rating Drivers

1. Strong export- and investment-driven growth which is set to gain further momentum; potential growth remains among the highest in the euro area
2. Slovakia’s growth model is subject to elevated volatility due to its high dependence on EU funds and the automotive business cycle; Slovakia continues to be highly susceptible to adverse events, as exports are concentrated in only a few industries
3. Favorable fiscal metrics provide ample room for cushioning domestic or external shocks; government committed to further fiscal consolidation
4. Despite reform efforts to address shortcomings regarding public efficiency and corruption, relative weakness of institutions as compared to euro area peers

Reasons for the Rating Decision

Our assessment of the Slovak Republic’s high creditworthiness continues to be constrained by weaknesses in its institutional set-up. The recently updated World Governance Indicators (WGI) for 2016 indicate that Slovakia still has considerable potential for enhancing its public-sector efficiency and mitigating the extent to which public power is exercised for private gain. Concerning the quality of public administration, the World Bank ranks Slovakia at 50 out of 209 economies as compared to the euro area median rank 35. The sovereign still displays a sizable gap in comparison with the euro area when it comes to perceived corruption (rank 77 vs. 41). It is noteworthy that the Slovakian Republic has climbed several places as regards the WGI rule of law, up from rank 65 to 53, but remains well below the euro area median (53). Also, Slovakia compares unfavorably with its CEE peers, in particular as regards reducing corruption, with only Hungary ranking lower.

Challenges with regard to an effective policy formulation and implementation, the quality of the courts, and corruption persistently weigh on the Slovakian business environment.

This is illustrated by the WEF's latest Global Competitiveness (GC) report which identified corruption and inefficient government bureaucracy as the main hurdles for doing business. The GC index is significantly dragged down by the institutional pillar, albeit improving from rank 65 to 59 in 2016-17. Likewise, businesses face inadequate infrastructure, with a considerable backlog in terms of improving the road, port, and air transport infrastructure. Equally important, there has been minor progress in improving the quality of the judiciary. As mirrored by the 2017 EU Justice Scoreboard, Slovakia remains among the worst performers when it comes to perceived independence of courts and judges. Against this background, the economy slipped from rank 30 to 33 in the World Bank's 2017 Doing Business report. Moreover, public administration inefficiencies appear to hamper the quality of public investment. As flagged by the OECD, Slovakia came in last among OECD members in a benchmarking exercise of public spending efficiency.

That being said, the government has implemented an instrument targeted towards improving its spending efficiency, the so called Value for Money project. Irrespective of whether efficiency gains will eventually be reaped, a first round of expenditure reviews (healthcare, transport, IT) was conducted in 2016 and a second round (labor market, social system, education, environment) is underway. Legislated measures geared towards increasing the efficiency and transparency of public administration include the anti-offshore law (effective Feb-17) under which corporates have to disclose their ownership structure, and the civil service law (effective Jun-17) which focuses on increasing the quality of public sector employees, mitigating political interference in the hiring process, and setting up a central information system for staff. In March 2017 a reform of the bankruptcy and restructuring law entered into force, and at the end of last year an amendment to the Distrainment Code was adopted. Further modernization of public administration is envisaged, e.g. by enhancing analytic capacities and expanding information provision by local governments. To improve the efficiency of the justice system, the authorities plan to overhaul the selection procedure for judiciary positions and to carry out a judicial audit. Additionally, the government intends to reduce the administrative burden by implementing a comprehensive set of measures (e.g. enabling advanced electronic communication with businesses). What is more, the enhancement of the transport infrastructure is ongoing and a strategic development plan for transport was approved by the government in January 2017.

Authorities thus have recognized the need and have taken action to tackle the preeminent institutional challenges. However, it is too early to assess the impact of the adopted measures and it has to be seen to what extent the government can progress along its proposed policy path. It has to be emphasized that there may be some downside risks related to maintaining the momentum for structural reforms, as efficient policy management may be impaired by lingering political instability. The events of August 2017, when the Slovak National Party (SNS) called for a new deal giving SNS more say in decision-making, are a case in point. In the end, a snap election could be avoided. Against the backdrop of differing views and tensions within the three-party-coalition of Smer, SNS and Most-Hid, and the upcoming regional elections which might lead to new political alli-

ances, the possibility of an early election still cannot be ruled out. In our view, this may jeopardize the reform process going forward.

In general, we believe that the Slovak Republic benefits from euro area membership which entails broader and deeper capital markets as well as advantages associated with the euro as a reserve currency.

Institutional weaknesses remain balanced by one of the Slovak Republic's key strengths, the very favorable macroeconomic performance. While growth fell somewhat short of the 3.9% reached in 2015, the Slovakian economy maintained its strong growth momentum in 2016. With real GDP expanding by 3.3%, Slovakia displayed the strongest output expansion among the CEE countries (euro area average 1.8%). Last year's growth was largely driven by net foreign trade, due to very solid exports (+6.2%) and dented import growth (2016: 3.7%, 2015: 8.4%). By contrast, investment fell off sharply in 2016, declining by 8.3% as compared to 2015, which was also the main reason behind slower output growth in 2016. Robust private investment in machinery and equipment (+2.0%) and, in particular, vivid growth of private investment in vehicles (+13.2%) could not make up for the decrease in public investment which was due to substantially lower ESI fund absorption. Economic growth was also backed by brisk private consumption which was up by 2.7%. Hence, household spending continued on its upward trajectory, having picked up by 6.4% in real terms as compared to 2013, being buttressed by declining consumer prices and strong labor market performance.

In 2016 the Slovakian unemployment rate dropped by 1.8 p.p. to 9.7% (annual average), its lowest level since 2008. Furthermore, its participation and employment rate have risen to 71.9 and 64.9% respectively, up from 70.9 and 62.7% a year before. At the same time, unemployment remains elevated as labor market performance continues to be plagued by structural shortcomings. Although gradually dissipating, regional disparities remain high – the jobless rate in the Bratislava region stood at 5.1% (2016) as compared to 13.2% in Eastern Slovakia. In addition, long- and very long-term unemployment are still seen as a serious concern as the respective rates are not only the highest among the CEE peers but also in Europe – posting at 60.2 and 43.8% of total unemployment respectively. The tighter labor market and productivity growth have resulted in rapidly rising wages over the recent years, with real compensation per employee increasing by 2.1% in 2016 and 5.5% in 2014-16. Thus, real unit labor costs have begun to pick up (2014-16: +2.7%) after staying virtually flat over the past decade, reflecting real wages growing faster than real labor productivity.

We expect the labor market to strengthen. The unemployment rate has continued to follow its downward path in 2017 – its quarterly average falling from 9.8% in Q2-16 to 8.2% in Q2-17. However, we believe that employment growth will become constrained by labor supply. As indicated by survey data provided by the EU Commission, labor shortage is increasingly perceived as a serious constraint to the expansion of the industrial production capacity. A declining working-age population should further boost wages, which may pose downside risks to the cost competitiveness of the Slovakian economy in the medium to long term. Although Slovakia currently has the most favorable population age profile in Europe, the population in the age of 15-64y is set to experience one of the sharpest de-

clines. The UN projects the share of the 15-64 year old to drop from 70.7 to 65.7% in 2015-25. More importantly, these factors may also curtail income convergence with the EU levels, which continued to stall in 2016. To be sure, Slovakia's per capita GDP increased from USD 29,979 to 31,331 (PPP terms, IMF data) in 2015-16, thus comparing well with its CEE peers – surpassed only by Slovenia and the Czech Republic. However, with Slovakian GDP per capita at 77% of the EU-28 average, Slovakia remained at the level first reached in 2013.

Looking forward, we expect Slovakia's convergence process to pick up again, as we assume that GDP growth will accelerate to 3.8% in 2018 and average at around 3.6% in 2019-21, after posting solid growth of 3.3% this year. Expansion will be facilitated by a surge in investment activity, driven by ESI funds coming increasingly on stream in 2017-19. As mirrored by EU Cohesion data, financial resources allocated to selected projects have climbed from around EUR 3bn at the end of 2016, via EUR 4bn in Aug-17 to EUR 5.9bn by Oct-17 (29% of planned investment). Rising private investments in the car manufacturing industry should also buttress growth. According to information provided by the Slovakian automotive industry association (ZAP), 1.04m cars were produced in 2016, after having already exceeded the 1m-mark the 2015. Importantly, it is envisaged that Jaguar Land Rover (JLR) will invest approx. EUR 1.356bn in 2017-20, with investment volume peaking in 2018 (EUR 630m). Based on the car-makers assumptions, it can be expected that the number of manufactured cars in Slovakia will rise to 1.495m by 2020, with positive repercussions on exports and the labor market. Accordingly, we expect export growth to foster economic expansion, also on the grounds of a brightening external environment and solid growth in Slovakia's main trading partners Germany, the Czech Republic, Poland and France. Nevertheless, net export's contribution to growth should be somewhat subdued, mainly due to the investment-driven pick-up in import growth. Meanwhile, we believe that private consumption is set to expand in the medium-term, as the labor market is set to strengthen and real wages to increase strongly. Our forecast is underpinned by quarterly growth data. Thus, GDP expanded by 3.1% y-o-y in the first and second quarter of 2017 respectively, with private consumption remaining on its upward trajectory, growing by 3.3% in Q1-17 as well as Q2-17.

Slovakia's GDP expansion is accompanied by brisk credit growth. As highlighted by ECB data, lending to the private sector was among the strongest in the EU in 2016-17, posting yearly growth rates in the 10-12% range since Nov-15. In particular, lending for house purchase expanded vividly. Credit growth is fueled by both supply and demand-side factors. While pressures on profitability in the banking sector contributed to an easing of credit standards, loan demand was facilitated by an improving labor market situation, and favorable financing conditions. After house prices had accelerated throughout 2016, displaying y-o-y growth of 8.3% in Q4-16, growth lost some steam in the first half of 2017, but remained robust (Q1-17: 3.8%; Q2-17: 6.6%). However, it has to be emphasized that recent house price developments were mainly driven by higher demand for real estate in the capital region and that affordability metrics are not signaling a potential overvaluation of real estate yet. The price-to-rent- and price-to-income ratio have still not deviated significantly from their long-term averages.

Nevertheless, we believe that house price and credit dynamics have to be monitored against the backdrop of rising household indebtedness. Both the debt-to-GDP and debt-to-income ratio of Slovakian households have been trending upwards over recent years and continued to rise in 2016. While household debt amounted to 41.1% of GDP last year (2015: 38.2%), the debt-to-income-ratio reached 64.1%. Thus, the Slovakian debt-to-income ratio stood 19.9 p.p. above the levels seen in 2011 – the largest increase observed in any CEE economy over this period. As a result, weaker borrowers could face difficulties in servicing their debt in the event of an economic slowdown or a pronounced increase of interest rates.

A sharp increase would probably have negative repercussions on bank balance sheets, as the domestic banking sector (asset-to-GDP ratio: 130.0% of GDP) exhibits a high and rising exposure to mortgage lending. In Aug-17, mortgages accounted for almost half (49.5%) of the outstanding loan volume, a 10.0 p.p. increase within five years. Sizeable mortgage operations also impose some liquidity risk, given banks' large reliance on short term deposit funding. As highlighted by NBS data, the Slovakian banking sector is characterized by comparatively large asset-liability-mismatches. While 51.0% (Aug-17) of total assets have maturities of 5y or more, the liability side is dominated by deposits with agreed maturity of up to one year (63.9% of total liabilities). To be sure, at the moment we regard the Slovakian banking sector to be generally sound in terms of asset quality and capitalization. The CET1 ratio was broadly stable over the last year and posted at 15.4% in Q2-17 (EU-28 avg.: 14.3%), while the NPL ratio dropped from an already low 4.8% (Q2-16) to 3.8% in Q2-17. Meanwhile, tighter net interest margins but also regulatory costs had a dampening effect on bank profits (ROA Q2-17: 1.2%, Q2-16: 1.6%).

In order to contain further rising household debt and to safeguard the stability of the domestic banking system, Slovak authorities continue to adopt macro-prudential measures. On 1 January 2017, an NBS decree setting minimum credit standards entered into effect, including tighter requirements on DSTI- and LTV-ratios. As regards new mortgage loans, an LTV cap of 100% was adopted. Furthermore, authorities imposed restrictions regarding the composition of banks' mortgage portfolios and required banks to shore up their capital buffers.

Slovakia continued to show a favorable budgetary performance. According to Eurostat, the headline deficit decreased from to 2.7 to 2.2% of GDP in 2015-16. Last year's narrowing of the budget deficit was mainly driven by the expenditure side of the budget. Due to plummeting net receipts from the EU budget (-73.9% y-o-y), largely driven by the transition to the ESIF 2014-20 funding period, government investment almost halved from 2015 levels. According to EU Commission data, public investment was down from 6.3% to 3.2% of GDP in 2015-16. Budgetary relief was also provided by a further decrease in interest expenditure, which fell for the second consecutive year. At the same time, social contributions and CIT receipts came in higher than initially budgeted.

As regards 2017-18, we believe that budget deficits should continue to narrow. The government envisages deficit targets of 1.6 and 0.8% of GDP in 2017-18. With regard to this year, we expect the government to comply with its deficit target as deficit increasing measures, such as the CIT rate cut from 22 to 21%, should be more than compensated

by higher social security contribution rates, excise duties and levies on regulated businesses. In 2018, the government plans to follow an expenditure-based consolidation approach. While Slovak authorities intend to cut intermediate consumption expenditures in nominal terms, the growth in spending on social transfers should lag GDP growth despite the agreement on the so-called 'social package' which is already factored into the government's 2018 budget. On the whole, we expect the deficit to narrow to 0.9% of GDP in 2018.

Notwithstanding the favorable fiscal outlook, Slovakia has room to improve with regard to the predictability of its taxation framework. Concerning the tax system, numerous changes have been recorded in recent years. Furthermore, Slovakia has some way to go regarding the efficiency of public expenditures and tax collection. Although Slovakia made notable progress in terms of VAT collection, with the VAT gap edging down from 37.8 to 29.4% in 2012-15, the gap remains one of the highest in the EU. Against this backdrop, additional measures to combat tax fraud entered into effect in 2017. Meanwhile, last year's spending reviews had identified potential savings in the amount of 8.9% in total spending on healthcare and IT (see above), which were partly incorporated in the 2017 budget. The spending items reviewed in the second round make up for 15% of GDP.

Similar to its CEE peers, Slovakia exhibits moderate levels of government debt. Since 2013 (54.7% of GDP), government debt has been trending downward, reaching 51.8% of GDP last year. Looking ahead, debt consolidation should be supported by sustained GDP growth, a narrowing budget deficit and favorable financing conditions. At the end of Sep-17, Slovakia's 10y bond yield stood at a low 0.85%, with spreads over German Bunds remaining tight. To address infrastructure and healthcare spending needs, the governing coalition intends to change the constitutional debt brake. In the light of sound public finances, we believe that limited modifications to the constitutional debt rule, which are currently being discussed, will not significantly raise medium-term debt sustainability risks. Still, it is uncertain whether legislative changes will finally be approved by parliament, given that some votes by the opposition would be needed to change the constitutional law.

From a risk perspective, Slovakia's external position remained broadly unchanged in 2015-16. The country's external risk profile continues to mirror the economy's deep integration in European value chains and in particular the country's role as an automotive production hub. The Slovak Republic's trade-to-GDP ratio totals 183.9% (2016). At the same time, exports of vehicles and transport equipment account for 28.9% of the total export volume. Last year, its current account deficit narrowed slightly to 1.5% of GDP (2015: 1.8%). Rising surpluses of trade in goods and services more than offset a widening deficit in the economy's primary income balance in 2016. As illustrated by NBS data, Slovakia's persistent primary deficits are mainly due to profit repatriation, which is closely related to the strong presence of foreign-owned automotive corporations. Dividend outflows amounted to EUR 2.9bn in 2016. Sizeable dividend outflows are a result of Slovakia's high and rising stock of FDI liabilities, which amounted to EUR 53.3bn in 2016 (+6.2% y-o-y). In our view, the large share of FDI (mainly equity) in Slovakia's external liabilities is partly mitigating risks related to the country's negative NIIP, which stood at

-62.2% of GDP last year (2015: -64.8% of GDP). In total, equity capital and reinvested earnings explain about 70% of the NIIP. Risks associated with rising interest rates are also limited with regard to the composition of external debt, with long-term debt instruments representing 61.2% of total external debt in Q4-16.

Rating Outlook and Sensitivity

Our Rating outlook on the long-term sovereign rating of A is stable, as we assume that the risk situation underlying the key factors affecting sovereign credit risk – including macroeconomic performance, institutional structure, fiscal sustainability, and foreign exposure – will remain fundamentally unchanged over the next 12 months.

We could consider a downgrade of our ratings if medium-term growth falls significantly short of our current expectations. In our opinion, Slovakia would be disproportionately affected by a longer period of subdued growth in the euro area. Risks related to external demand are further aggravated by a relatively high concentration of exports (in terms of export markets and industries). The build-up of macroeconomic imbalances resulting from strong credit growth could also put medium term growth perspectives at risk.

Conversely, we could raise our ratings if the Slovak economy were to grow faster than currently anticipated. Implementation of bold reforms in the areas of justice and public administration could yield efficiency gains and improve the business environment, which could be supportive to investment and GDP growth. We could also upgrade our ratings if we observed significant improvements in the economy's external profile.

Primary Analyst
Johannes Kühner
Sovereign Credit Analyst
j.kuehner@creditreform-rating.de
+49 2131 109 1462

Chair Person
Benjamin Mohr
Head of Sovereign Ratings
b.mohr@creditreform-rating.de
+49 2131 109 5172

Ratings*

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

*) Unsolicited

Economic Data

[in %, otherwise indicated]	2012	2013	2014	2015	2016	2017e	2018e
Real GDP growth	1.7	1.5	2.8	3.9	3.3	3.3	3.8
GDP per capita (PPP, USD)	26,610	27,409	28,592	29,979	31,331	32,895	34,743
Inflation rate, y-o-y change	3.7	1.5	-0.1	-0.3	-0.5	1.4	2.0
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	76.1	76.4	76.8	77.2	n.a.	n.a.	n.a.
Fiscal balance/GDP	-4.3	-2.7	-2.7	-2.7	-2.2	-1.6	-0.9
Current account balance/GDP	0.9	1.9	1.1	-1.8	-1.5	n.a.	n.a.
External debt/GDP	73.2	83.6	81.5	83.8	86.8	n.a.	n.a.

Source: International Monetary Fund, World Bank, Eurostat, own estimates

Appendix

Regulatory Requirements

This sovereign rating is an unsolicited credit rating. Neither the rated sovereign nor a related third party participated in the credit rating process. Creditreform Rating AG had no access to the accounts, representatives or other relevant internal documents for the rated entity or a related third party.

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

To prepare this credit rating, CRAG has used 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, Národná banka Slovenska (NBS), Štatistický úrad Slovenskej republiky, Ministry of Finance of the Slovak Republic, Zväz automobilového priemyslu (ZAP).

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 and that the rating action was and is free of any existing or potential conflicts of interest. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant quantitative and qualitative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all risk factors is described in CRAG´s “Sovereign Ratings” methodology. The main arguments that were raised in the discussion are summarized in the “Reasons for the Rating Decision”.

In the case of a 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 regard to the rated entity CRAG regarded available historical data as sufficient.

In case of providing ancillary services to the rated entity, CRAG will disclose all ancillary services in the credit rating report.

In accordance to 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 CRAG`s default rates are available in the credit rating methodologies disclosed on the website.

Disclaimer

Any rating issued by Creditreform Rating AG is subject to the Creditreform Rating AG Code of Conduct which has been published on the web pages of Creditreform Rating AG. In this Code of Conduct, Creditreform Rating AG commits itself – systematically and with due diligence – to establish its independent and objective opinion as to the sustainability, risks and opportunities concerning the entity or the issue under review.

When assessing the creditworthiness of sovereign issuers, Creditreform Rating AG relies on publicly available data and information from international data sources, governments and national statistics. Creditreform Rating AG assumes no responsibility for the true and fair representation of the original information.

Future events are uncertain, and forecasts are necessarily based on assessments and assumptions. Hence, this rating is no statement of fact but an opinion. Neither should these ratings be construed as recommendations for investors, buyers or sellers. They should only be used by market participants (entrepreneurs, bankers, investors etc.) as one factor among others when arriving at investment decisions. Ratings are not meant to be used as substitutes for one's own research, inquiries and assessments. Thus, no express or implied warranty as to the accuracy, timeliness or completeness for any purpose of any such rating, opinion or information is given by Creditreform Rating AG in any form or manner whatsoever. Furthermore, Creditreform Rating AG cannot be held liable for the consequences of decisions made on the basis of any of their ratings.

This report is protected by copyright. Any commercial use is prohibited without prior written permission from Creditreform Rating AG. Only the full report may be published in order to prevent distortion of the report's overall assessment. Excerpts may only be used with the express consent of Creditreform Rating AG. Publication of the report without the consent of Creditreform Rating AG is prohibited. Only ratings published on the Creditreform Rating AG web pages remain valid.

Creditreform Rating AG

Creditreform Rating AG
Hellersbergstrasse 11
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: Prof. Dr. Helmut Rödl
HRB 10522, Amtsgericht Neuss