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 23-10-2020 "Sovereign Ratings" "Rating Criteria and Definitions"

Rating action

Neuss, 23 October 2020

Creditreform Rating has revised its outlook on the Slovak Republic from "stable" to "negative" and affirmed the unsolicited long-term sovereign rating of "A+". Creditreform Rating has also affirmed Slovakia's unsolicited ratings for foreign and local currency senior unsecured long-term debt of "A+".

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Key Rating Drivers

1. After years of strong and stable growth, Slovak economy will contract sharply in 2020; next year's rebound likely to be buttressed by consumption and foreign demand, whilst investment will take longer to recover; however, unusually high uncertainty related to the further development of Covid-19 here to stay for the foreseeable future
2. Income convergence towards EU levels appears to have eased; challenges to sustaining productivity growth compounded by structural changes associated with the rise of electric vehicles and the need for greening and digitalizing the economy; persistent credit growth has led to increasing household debt, weighing on risk-bearing capacities, while risks to cost competitiveness stemming from non-aligned wage and productivity growth should wane in the near term
3. Generally strong institutional set-up which benefits from EU/EMU membership, but considerable gaps towards rating and EMU peers remain in place, in particular in terms of rule of law and control of corruption; we expect new, pro-EU governing coalition to engage in improving institutional conditions – despite lack of track record of formulating and implementing policies, we observe a swift and adequate Covid-19 response
4. Indispensable but costly measures, together with plunging economic growth and operating automatic stabilizers, will translate into deteriorating public finances and a material change in the sovereign's debt trajectory; while public debt ratio is likely to grow further afield in absence of policy adjustments, fiscal risks are somewhat balanced by increasingly affordable debt as well as by ECB and EU support
5. Small open economy very susceptible to external risks, also due to the vital role of the automotive sector; still, the decomposition of the NIIP hints at limited credit risks from the external front, also mirrored by metrics such as NENDI

Reasons for the Rating Decision and Latest Developments

Creditreform Rating has revised its outlook on the Slovak Republic from stable to negative, reflecting

(i) the fiscal damage inflicted by the Covid-19 pandemic via collapsing economic growth, operating automatic stabilizers and costly, though essential, health and economic support measures will see Slovakia's headline deficits increase sharply and cause public debt to rocket to historically high levels;

(ii) the prospective government debt trajectory, as public debt will likely continue to rise over the medium term unless authorities formulate a fiscal strategy geared towards reining in public debt;

(iii) concerns over structural damage to international supply chains and the automotive industry, dealt by Covid-19, and uncertain prospects regarding timely reforms targeted towards greening and digitalizing its economy given the pivotal role of the automotive industry.

Macroeconomic Performance

The Slovak Republic's credit ratings continue to mirror its macroeconomic performance profile, which we deem as robust, thanks to a track record of strong and broadly stable growth, as well as relatively high and rising per GDP per capita levels. At the same time, we note that income convergence towards EU levels has eased and wage developments have decoupled from productivity trends over recent years, thereby threatening the economy's cost competitiveness, and household debt remains on a credit-driven upward trajectory. While the Covid-19 pandemic is likely to mute wage pressures, medium-term challenges related to structural change – inter alia regarding the automotive sector – remain in place.

While the Covid-19 pandemic has hit Slovakia with tremendous force, we saw remarkably strong economic growth prior to the outbreak. The Slovak economy has been growing vividly over the last five years, outpacing the euro area by far (2015-19: 3.2% p.a., EA-19: 1.9%), although real GDP growth eased from 3.8% in 2018 to 2.3% in 2019. Slower growth in 2019 came mainly on the back of feeble export growth, which pulled back to 0.8% (2016-18 average 4.6%) given receding external demand and transitory factors related to the automotive industry. Private consumption was the main driver of last year's output expansion, underpinned by brisk employment and wage growth, rising by 2.3% and contributing 1.3 p.p. to GDP growth. Owing to strong investment in machinery and equipment, posting growth of 15.6%, gross fixed capital formation expanded by 5.8% in 2019.

Strong growth has boosted per capita income over the last decade. According to latest IMF data, GDP per capita is estimated to total USD 34,202 (in PPP terms, current prices) in 2019, up by 4.1% from USD 32,859 in 2018. That being said, Slovakia displays a gap, not only as compared to rating peers but also as compared with other Central and Eastern European (CEE) economies such as the Czech Republic and Slovenia, at USD 42,670 and USD 40,717 respectively. Even more importantly from our point of view, Slovakia's income convergence towards EU levels appears to have softened. To be sure, figures in PPP terms may be somewhat biased by the 2019 benchmark revision of national accounts which led to significant changes in the relative weights of different sectors and corresponding deflators in 2016-18. Nevertheless, standing at 73% of the weighted EU average in 2019, its economy has fallen behind CEE peers Estonia (83%), Lithuania

(83%), and Poland (74%). As regards the current year, we expect a transitory setback in per capita incomes due to the Covid-19 crisis.

The Covid-19 crisis has thus resulted in a devastating economic contraction, prompting a large decline in total output over the first half of the year. Quarterly real GDP plummeted to a level last seen at the beginning of 2015, having declined by 5.2% and 8.3% q-o-q in the first and second quarters respectively. Despite the fact that all components contributed to that drastic fall in economic activity, it is worth pointing out that private consumption was comparatively less severely affected from a European perspective, decreasing by 5.0% compared to the previous quarter (EA19: -12.4% q-o-q).

The government's swiftly-implemented health and support measures have likely prevented the worst effects in terms of economic fallout. Still, we expect the Slovak real GDP to decline by 7.4% in 2020, followed by a marked rebound to the tune of 6.0% in 2021. Despite its resilience in the first half and, as reflected by recovering retails sales, the already visible release of pent-up demand, household spending will likely decline in 2020 as a whole, in tandem with disposable income. Labor markets will also be heavily impacted this year, implying compressed employment and wage growth. We note that headline labor market metrics have deteriorated but may be somewhat biased due to substantial government support, inter alia via 'Kurzarbeit' schemes. Thus, we expect to see unemployment rates rise going forward, currently posting at a monthly average of 6.8% (Aug-20, LFS adjusted, s.a.), up from 6.0% in March, while employment (total employment domestic concept) should edge down further, after having dropped by 0.8% and 1.1% q-o-q in the first and second quarters of 2020 respectively (EA-19: -0.3% and -2.9%). To our mind, hours worked appears to be a somewhat more robust indicator on current labor market conditions. As compared to Q4-19, total hours worked in the Slovak economy declined by 19.0% by this year's second quarter, well above the -15.5% observed in the EU27 as a whole. Precautionary saving should remain elevated in the near term, mainly due to the extreme Covid-19-related uncertainty, as illustrated by still depressed consumer confidence among Slovak households.

Significantly disrupted supply chains and easing external demand will drag on export growth, which saw a collapse in the first half of the year with exports of goods and services falling by 3.2% and 25.6% q-o-q in the first two quarters of 2020. While the recovery of Slovakia's exports is already underway, led by the automotive industry, the further development is heavily dependent on the pace of the euro area's recovery, which has tended to soften more recently. Nevertheless, soft survey-based data such as new industry orders and industry export expectations give us some confidence for the months ahead. As we expect import growth to be less affected, net external trade should weigh to some degree on this year's growth performance before buttressing the rebound in real GDP growth in 2021.

Investment activity will take longer to recover, as uncertainty and progressively weakening balance sheets should result in significantly postponed or even cancelled investment decisions. We also think that a growing number of inevitable corporate insolvencies are likely to drag on investment growth. Despite the fact that large automobile plants have resumed production, the industrial sector is still running below capacities, as capacity utilization came in at 78.3% in Q3-20, well below the long-term average of 81.6% (2000-19). Meanwhile, industry confidence returned to its former level prior to the outbreak of Covid-19 (Aug-20: -0.4; Feb-20: -0.8), essentially boding well for business investment. As the end of the Multiannual Financing Framework 2014-20 draws near, we expect that output expansion will be aided by public investment.

With all that said, risks to the forecast are heavily skewed to the downside, as Slovakia has experienced substantially rising infection rates over recent weeks. Judging by ECDC data, the cumulative 14-day infection rate peaked at a mere 12.4 in spring, remaining below the 50-mark until 25 September at a time when other European partners had already witnessed skyrocketing infection rates. Since then, however, Covid-19 infections have been increasing at an alarming rate, as is the case in other CEE economies, hitting 292.6 on 18 October, while the positivity rate climbed to 11.5 in week 41 (week 37: 3.3). Hence, containment measures and a state of emergency were reintroduced as of 1 October. To be sure, we believe that the impact on the economy will be less severe compared to the most acute phase in spring, as the government is better prepared and can resort to more targeted, effective, and tested measures than during the first wave. Nevertheless, uncertainty surrounding our projections will remain unusually high unless tested medical treatments are broadly available, which will presumably be the case from mid-2021 at the earliest in the base case scenario underlying our expectations.

We recall risks to underlying growth entailed by the key role played by the automotive industry, which have increased since our last review. Diversification appears to have further diminished, with automotive accounting for roughly a third of total exports in 2019 (32.9%), climbing from 30.7% a year before, whilst the sectors share in total GVA made up for 4.9% in 2018 (SOSR data). Furthermore, the industry stands for a sizable share of total industrial production and employment.

Demand for electric vehicles has gained significant momentum in 2020. Electric vehicles (EV) achieved marked growth rates during H1-20, as total units sold were up 75% amidst a drastic decline in petrol and diesel cars. Overall, for Europe, the share of electric vehicles almost doubled to some 10% during the first half of 2020. The continued fall in diesel car sales reflects a shift in perception across the markets. European policy-makers seem determined to curb carbon emissions to protect the environment, hence the strict regulations suggest that they have already turned against diesel cars. Several governments have also drawn their plans to gradually phase out diesel cars. EV demand is slated to rise going forward, aided by government subsidies, incentives offered by car dealers, and the greater awareness among consumers to opt for environmentally-friendly passenger cars.

We understand that up to 15 electric and semi-electric models may be produced in Slovakia going forward, according to SARIO. Volkswagen has announced plans to launch the production of a new hybrid plug-in model in late September. It is also noteworthy that German carmaker Porsche has communicated plans to build a new plant in 2024-26. Also, policy-makers are reportedly aware of the need to act.

We see, however, rising medium- to long-term risks stemming from digital transformation and the EU's declared plan to green the European economy. From a European perspective, a comparatively larger share of jobs may be at risk of being automated, and as of now education and training systems do not seem to be well-equipped to cope with technological changes. In addition, digital readiness is relatively low, as suggested by the European Commission's Digital Economy and Society Index. In the latest vintage of the DESI, Slovakia achieved the 22nd rank in the EU and has made comparatively less progress since 2015 than other EU member states, with significant room to improve as regards the factors human capital and digital public services. Apart from that, investment in R&D appears insufficient to prepare its economy for a technological transition. According to latest Eurostat data, R&D expenditure totaled 0.84% of GDP (2018), markedly below the EU27 average of 2.14% of GDP.

In our view, sustaining real labor productivity will be key to safeguarding the economy's cost competitiveness over the medium term. Real unit labor costs continued to grow briskly in 2019, edging up by 2.4% (AMECO data), as real labor productivity was not able to keep pace with real compensation per employee. As compared to its key trading partners, Slovakian real ULC increased at a significantly faster pace in 2016-19, rising by 7.3% versus 0.5% in the euro area as a whole. Still, Slovakia's share in global exports of goods and services was broadly stable over 2016-19 (2019: 0.4%).

Increasing private debt amidst unabated housing loan growth and persistently strong house price growth remains a concern. At this point in the Covid-19 pandemic, loans for house purchases have only slightly moderated. As of July 2020, the outstanding volume of housing loans stood 9.3% above the previous year's level as compared to 9.9% y-o-y at the onset of the crisis in March (ECB data). With that, growth of outstanding housing loans is among the highest in the EU27. New lending also appears to be largely unaffected so far. At the same time, household indebtedness continued on its firm upward trajectory, posting at 44.0% of GDP in 2019 (2014: 32.4% of GDP, consolidated financial balance sheet data) and at 72.5% of disposable income in Q4-19 (Q4-14: 55.4%, ECB data). On both counts, household debt is well above the levels seen in other CEE peers. Higher household debt and rising mortgage volumes have been matched by vivid house price growth over a prolonged period of time, which also carried over into 2020. In the second quarter, house prices grew at a still high annual rate of 9.7% (Q2-19: 8.3%).

We will monitor developments vigilantly in this respect, in particular against the backdrop of the Covid-19-related financial risks which households may have to bear going forward. Thus, credit risks related to households could increase, as these are likely to be affected by rising corporate insolvencies and layoffs for business reasons - especially as government support measures subside. We note that the current situation seems to be somewhat blurred by the possibility that households can opt to defer loan repayments. We see that Slovak households' perception of the financial situation, as well as the general economic situation over the next 12 months, has brightened up as compared to the trough in April, but is still relatively pessimistic from a European perspective.

Institutional Structure

Our credit assessment continues to be underpinned by Slovakia's generally strong institutional framework, which is further buttressed by significant benefits associated with EU and EMU membership. Despite visible efforts, which we expect to be stepped up after this year's general election that resulted in a materially altered political constellation, considerable shortcomings regarding judicial independence and the combating of corruption remain in place. Despite the heterogeneous composition of the new government, we expect political stability and consensus on important policy goals such as fostering income convergence and fiscal sustainability as given.

As underscored by the recently-published newest vintage of our preferred measure of good governance, the World Bank's Worldwide Governance Indicators (WGI), the sovereign continues to underperform – not only as compared to its A-rated peers, but also to the respective euro area and EU27 averages. In fact, the Slovak Republic even slipped several places relative to other sovereigns when it comes to the perception of the extent to which public power is exercised for private gain, now standing at rank 75 out of 209 economies on the WGI control of corruption. The euro area median is rank 42, while for Slovakia the lag is somewhat smaller relative to the A median (rank 61). With a view to freedom of speech and media, as well as to the quality of

contract enforcement, property rights, and courts, the sovereign also exhibits sizable gaps in a peer comparison, coming in at rank 51 and 61 respectively (EA19: rank 26 and 33). With regard to the latter, arguably one of the most visible results of the improving judiciary system has been the significant reduction in the number of pending cases, which dropped from 5.0 to 3.7 cases per 100 inhabitants in 2017-18 (EU Justice Scoreboard 2020). However, the latest Justice Scoreboard also highlights that the Slovak Republic shows one of the weakest performances in terms of perceived independence of courts and judges.

As regards the quality of public administration, we also observe a y-o-y slippage, as Slovakia dropped from rank 52 to rank 55 (EA19: rank 35). Against this background, the absorption of European Structural and Investment Funds (ESIF) must also be seen as a recurrent issue. As highlighted by latest EU Cohesion data, expenditure reported by selected projects was up from EUR 6.3bn in 2019 to EUR 7.1bn as of October 2020, accounting for a mere 37% of the total ESIF 2014-20 budget, corresponding to one of the lowest take-up rates in the former EU28 (EU average: 46%). Hence, underutilization of ESIF appears to be a pertinent obstacle which may be traced to weaknesses concerning planning and coordination processes. This is also evidenced by the IMF's public investment management assessment, which found that there is scope for improvement in the appraisal process and strategic planning framework, and identified gaps in the allocation phase as there appears to be no central coordination unit and no integrated pipeline for infrastructure projects.

Looking ahead, we will closely monitor whether there is palpable progress in improving judicial independence, the control of corruption, as well as enhancing public administration and the regulatory environment. This is all the more relevant as Slovakia's political landscape has undergone a significant change. In a landslide victory, the opposition won the majority of the public vote in general elections held in February.

The conservative protest party OLaNO received 25% of the vote, more than twice as many as in 2016 (11%), emerging as the by far strongest political force. OLaNO leader Matovic became the Slovak Republic's new PM, heading a four-party coalition further complemented by right-wing populist Sme Rodina, the neoliberal SaS, and the new 'For the People' party of former president Kiska. Smer-SD, the party which has dominated Slovak politics for much of the past 15 years, suffered heavy losses and ended up with 18.3% (2016: 28.3%).

Prima facie, the new governing coalition's missing track record in formulating and implementing policies, may represent a stumbling block on the sovereign's way out of the Covid-19 crisis and with regard to decisively addressing the economy's institutional obstacles. This ties in with the impression that the rather heterogeneous composition of the coalition may hamper cohesive policy-making; however, we see political stability and consensus on important policy goals such as fostering income convergence and fiscal sustainability as given. As a case in point, we have witnessed a swift, timely and adequate policy response to the Covid-19 pandemic. We also took note of promising first signs in terms of tackling reform needs, as the government forged ahead with a comprehensive policy package containing a plethora of measures to improve the business environment. Against the background of Next Generation EU (NGEU, see below), the Ministry of Finance recently presented a reform plan.

Fiscal Sustainability

We would still consider Slovakia's public finances as a credit strength. However, collapsing economic activity and the extensive policy response to the Covid-19 pandemic will push up the headline deficit,

boosting government debt to historical highs. Equally important, the debt trajectory will be reversed, as the public debt ratio is likely to remain on a rising path over the medium term without corrective action. Due to the favorable starting position, debt service should remain feasible thanks to low interest costs as well as ECB and EU support.

Drawing on latest information contained in the draft budgetary plan 2021, fiscal consolidation had already slowed prior to the outbreak of the Covid-19 pandemic, as the Slovak headline deficit widened from 1.0% of GDP in 2018 to 1.4% of GDP last year, roughly twice as high as projected in the draft budgetary plan 2020. The deterioration was largely driven by the public wage bill, which rose significantly from 9.3% to 10.2% of GDP in 2018-19. Also, public investment came in notably higher at 3.6% of GDP (2018: 3.7%) as opposed to the 2.9% of GDP envisaged in the DBP20. In addition, tax revenue evolved less dynamically than expected with taxes on income and wealth ticking down from 7.3% to 7.2% of GDP.

In response to the corona crisis, the Slovak government has implemented a substantial policy package to safeguard public health and prevent broad macroeconomic destabilization. Authorities have taken imperative measures to deflect the impact of Covid-19 and related confinement measures on households and businesses, protecting its labor market and avoiding widespread corporate insolvencies. In absence of further amendments in response to a potential escalation of the health situation, discretionary expenditure measures should reach roughly 2.5% of GDP. Drawing on Ministry of Finance data, the short-time work scheme (approx. EUR 737mn in cash terms), nursing and sickness benefits (PN, OCR, EUR 324mn), the allowance for self-employed workers and micro enterprises (EUR185mn), and rent subsidies for companies (EUR 200mn) are among the biggest items in the package. Further key measures with no immediate budgetary impact include tax and social contribution deferrals, as well as extensive bank guarantees provided for up to EUR 1.5bn of loans.

While emphasizing that projecting the likely budgetary outcome is extremely challenging and uncertainty is unusually high due to the constantly evolving Covid-19 pandemic, we expect the headline deficit to jump to 9.4% of GDP this year before narrowing significantly in 2021, explained by the phasing out of exceptional support measures and the prospective economic recovery. Whereas so-called 13th pension payments and the newly implemented cap on the retirement age will put additional pressure on this year's budget, policy-makers have adopted changes to the 13th pension, which are set to provide for some budgetary relief next year. The resulting decline in pensions will be offset by an increase in Christmas pay. Other deficit-increasing measures for 2021 are targeted towards stepping up social support for families and disadvantaged groups, and increasing support for education. We view scrapping the bank levy as generally conducive to bank profitably and stability (see below), coming at the expense of further downward pressure on the budget. Furthermore, we take note of funds reserved for possible further waves of Covid-19, budgeted at EUR 1.04bn (approx. 1.2% of GDP). In terms of consolidation, the government envisaged higher excise duties and vehicle taxes, and to keep the public wage bill in check.

Slovakia's debt-to GDP ratio had been displaying a multi-year decline, amounting to 48.5% in 2019, down from 49.4% in 2018 and the lowest level since 2011. Plunging economic growth, together with operating automatic stabilizers and the Covid-19 response, are set to translate into surging general government debt, which we forecast to total approx. 62% of GDP this year. To be sure, we view debt servicing as broadly feasible at these levels, and we think that the government makes prudent use of the available fiscal space. However, the further development

of the public debt ratio will have to be monitored vigilantly, as is the case with efforts to rein in public debt going forward, since we expect government debt to climb further over the medium term unless authorities formulate a fiscal strategy geared towards putting the brakes on rising debt.

Apart from comparatively moderate post-crisis debt levels, debt-to-GDP already posted at 84.1% in the euro area as a whole in 2019, increasing fiscal risks are somewhat balanced by increasingly affordable debt as well as ECB and EU support. As measured by general government revenue, interest outlays have dwindled to their lowest level on Eurostat records, standing at 3.0% in 2019 (2018: 3.3%, 2014: 4.8%). Moreover, we believe that refinancing risks have decreased over time, as mirrored by a declining share of foreign currency-denominated debt (Oct-20: 3.7%, Oct-17: 6.1%) and by an upward trending average maturity of the Slovak debt portfolio. As of 30 September, the average maturity posted at 8.23y, having averaged 8.62y in 2017-19 (Ardal data). Long-term government bond yields continue to stand at historically low levels after having re-entered negative territory in July – 10y bond yields posted at -0.261% at the beginning of October (weekly quote 02-10-20).

In this vein, we believe that the ECB's very accommodative monetary policy will remain a key support in the near term. The Pandemic Emergency Purchase Program (PEPP) was implemented by the ECB in the wake of the Covid-19 crisis. PEPP totals EUR 1,350bn and is to run at least until the end of June 2021. Reinvestments of maturing principal payments from securities purchased under PEPP until at least the end of 2022 will add further to the accommodative stance. An additional envelope of EUR 120bn to the Asset Purchase Program until the end of the year remains in place, as do a number of measures to ensure liquidity to the banking sector, a comprehensive set of collateral measures to mitigate the tightening of financial conditions across the euro area, and measures to temporarily mitigate the effects of rating downgrades on counterparties' collateral availability.

Meanwhile, we think that large-scale financial support on the back of NGEU is a further decisive factor mitigating fiscal sustainability risks over the medium term. We reckon that Slovakia will gain access to grants and loans amounting to an estimated 6.2% and 5.0% of 2019 GDP, making it one of the main beneficiaries among EU member states. The EU Parliament's consent to NGEU is still pending, but we do not expect this to present a major obstacle with regard to the implementation of the Recovery and Resilience Facility. What is more, the Slovak Republic is set to receive EUR 631mn in financial support via SURE which is designed to support national short-time work schemes and comparable initiatives.

As far as contingent liability risks to fiscal sustainability are concerned, we perceive a somewhat mixed picture at present. Apart from the above-mentioned credit risks related to looming insolvencies and the associated job losses, overall risks with regard to Slovakia's comparatively small banking sector (total assets-to-GDP at 91.8% in Q1-20) seem limited. While compared to other CEE peers capitalization of the sector as measured by its CET1 ratio moves at the lower end of the spectrum, the ratio has hovered around levels recorded for the EU as a whole over the last two years. As of Q2-20, Slovakia's banking sector exceeded the capitalization level recorded for the EU, with CET1 at 15.9% vs. 15.0% for the EU (EBA data), suggesting that banks have some buffers to draw on. Strengthening this impression, we note that the sector's asset quality as measured by the NPL ratio has been improving over recent years and has been broadly stable over the current year, posting at 2.5% in Q2-20, thus comparing favorably with the EU (Q2-20: 2.9%). Contrary to the situation regarding NPLs, the corona crisis seems to have taken a more

visible toll on banks' profitability lately, judging by a deteriorating ROA that has come down from 0.9% in Q4-19 to 0.4% in Q2-20. Nevertheless, by this measure Slovakia still fares better than EU overall (Q2-20: 0.0%). Apart from this, the government cancelled the special levy on financial institutions around the middle of the year, which should result in relief to the tune of about 0.13% of GDP for the banking sector (MOF estimate).

Looking at public guarantees, we would flag a relatively high level when guarantees linked to EFSF and ESM are included (MOF data). The latter accounted for about 11.7% of GDP in 2019 (10.8% in 2018), thereby lifting the total amount of public guarantees to 19.8% (2018: 19.3%). Even excluding capital subscribed to these facilities, the remaining 8.1% appears elevated by European comparison.

Assessing risks to fiscal prospects potentially arising from demographic developments, we would highlight the relatively unfavorable projection pertaining to age-related costs, in particular pension and health costs in the longer term, whereas projections for the more medium term still compare as rather benign in the European context (EU Ageing Report). Recent reforms to the pension system including the introduction of a 13th pension, a cap on the retirement age, and payment amendments to the pay-as-you-go pillar add to sustainability risks in the longer run, as also stressed by the Council for Budget Responsibility. In this vein, the government's intention to address long-term sustainability issues by, among other things, linking pension expenditures to demographic developments as expressed in the DBP21, seems to be a step in the right direction. We also gather that a constitutional law is to define basic elements of the first and second pillars of the pension system.

Foreign Exposure

Despite its small open economy, which renders Slovakia very susceptible to external risks due to e.g. the vital role of the automotive sector, we view credit risks stemming from the external front as limited. This is mainly due to less crisis-prone foreign direct investments, which make up for a very large share of the otherwise highly negative net international investment position (NIIP).

Slovakia has been running a relatively stable current account deficit since 2015, averaging 2.3% of GDP in 2015-19. Over this period, a surplus in goods trade has turned into a deficit, whereas the surplus in services trade has grown persistently. These developments continued last year when, on the back of slower export growth in a more challenging international trade environment and sector-specific issues in the automotive industry, a larger deficit in goods trade translated into a widening current account deficit, increasing by 0.5 p.p. to 2.7% of GDP. A slightly larger deficit in the primary balance (-0.3 p.p. to -2.1% of GDP) also added to this, whereas the increasing surplus in services (+0.3 p.p.) had the opposite effect. At 1.3% of GDP, the surplus in services trade marked the highest level since 2006 – largely driven by manufacturing services, ICT services, and other business services.

Under the impression of the corona crisis, the second quarter of this year saw further widening of the goods trade deficit (-1.8% of GDP), pushing the current account balance deeper into negative territory (-3.2% of GDP). For 2020 as a whole, we would expect the current account to move more or less within the range seen recently, as sharply recovering economic activity over the summer months has recently slowed down again in light of re-introduced constraints to suppress the spread of the virus.

Slovakia remains among the EU economies with the most negative NIIP, at face value suggesting pronounced exposure to external risks. Last year, its NIIP improved somewhat, going up by 3.2 p.p. to -66.3% of GDP. Moreover, the position has remained more or less flat over recent years, as opposed to the development seen in other CEEs where the investment position was less negative and improved over time. However, we would reiterate that a large part of the highly negative NIIP position is explained by a steady inflow of foreign direct investment (FDI), and thus a less crisis-prone form of investment. Net FDI alone came to -53.3% of GDP in 2019. In this vein, we would refer to a metric which makes a clearer case in this regard: NENDI, which excludes non-defaultable investment. Accordingly, Slovakia's NENDI is significantly lower, posting at -14.1% of GDP in 2019 (2018: -16.5% of GDP), and remaining broadly stable over the first half of this year (Q2-20: -14.7% of GDP).

Rating Outlook and Sensitivity

Our rating outlook for the Slovak Republic's long-term credit ratings is negative, mainly due to rising fiscal sustainability risks stemming from the sharp increase of its public debt ratio, alongside elevated uncertainty regarding the extent to which authorities will be able to reduce government debt to more sustainable levels over the medium term. We would refrain from providing some forward guidance on the time frame underlying our outlook at this stage, owing to the very high uncertainty pertaining to developments around Covid-19 as well as the related economic fallout.

Notwithstanding, we could reinstate the stable outlook if the sovereign is able to achieve a faster and persistent improvement of its headline balance over the medium term and set its debt-to-GDP ratio on a sustained downward trend or, more generally, if authorities formulate a credible fiscal strategy aiming at reining in public debt and safeguarding the sustainability of its pension system. We could also consider a positive rating action if the Slovak economy recovers faster than expected and medium-term growth evolves more favorably than expected at this stage, or if per capita incomes increase robustly, revitalizing income convergence towards EU levels. This could be the case if the government implements structural reforms to sustain productivity growth and meet the structural changes associated with the rise of electric vehicles and the need for greening and digitalizing its economy.

By contrast, we could lower the sovereign's ratings if public finances fail to improve and the expected upward trend of the public debt ratio becomes more entrenched. A deterioration in the epidemiological outlook and renewed, broad-based infection waves necessitating progressively intensified containment measures may be conducive to such a scenario. In this vein, repeated lockdowns may also be followed by a renewed fall in economic activity and more persistent strains on labor markets, weighing strongly on the economy and representing a further rating downside. Moreover, not only medium-term growth, but arguably more importantly potential growth could be adversely impacted if authorities do not seize the opportunity to respond to structural changes in the automotive sector.

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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	2020e	2021e
Real GDP growth	4.8	2.1	3.0	3.8	2.3	-7.4	6.0
GDP per capita (PPP, USD)	29,938	29,676	30,930	32,859	34,202	32,184	35,118
HICP inflation rate, y-o-y change	-0.3	-0.5	1.4	2.5	2.8	1.8	0.9
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	76.7	77.3	77.3	77.4	n.a.	n.a.	n.a.
Fiscal balance/GDP	-2.7	-2.6	-0.9	-1.0	-1.4	-9.4	-6.8
Current account balance/GDP	-2.1	-2.7	-1.9	-2.2	-2.7	n.a.	n.a.
External debt/GDP	84.6	92.5	108.3	114.7	112.4	n.a.	n.a.

Source: International Monetary Fund, Eurostat, 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

Environmental Quality	Ecological Risks	Ressource Management	Education	Health	Demographics
Labor	Equality	Technology & Infrastructure	Safety & Security	**Judicial System**	**Quality of Public Services**
Integrity of Public Officials	Quality and Efficacy of Regulations	**Civil Liberties/ 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	25.10.2019	A+ /stable
Monitoring	23.10.2020	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.

This sovereign rating is an unsolicited credit rating. The Ministry of Finance (MFSR) participated in the credit rating process as MFSR provided additional information during the credit rating process, and commented on a draft version of the report. Thus, this report represents an updated version, which was augmented in response to the factual remarks of MFSR during their review. 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 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, Blavatnik School of Government, ECDC, Národná Banka Slovenska (NBS), Statistical Office of the Slovak Republic, Ministry of Finance of the Slovak Republic.

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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