Rabobank

Country report **SLOVENIA**

Summary

After having lost 8% of its GDP in 2009, Slovenia has embarked on a sluggish export-driven recovery, as domestic demand suffers from ongoing corporate deleveraging and weak credit growth on the back of substantial problems in the country's banking sector. Given relatively low bank capitalization levels and strongly deteriorating loan quality, Slovenian domestic banks, some of which barely passed the most recent European bank stress tests, still need additional recapitalizations, which could also involve EFSF funds. Slovenia's government finances have deteriorated markedly since the onset of the global economic crisis, owing to government attempts to stabilize output by means of fiscal stimulus amid falling tax revenues, as well as a series of bank recapitalizations and bail-outs of state owned enterprises. Adding to these problems, the government collapsed in September, leading to elections in December, after an urgently needed pension reform intended to slow public spending was rejected in a referendum. Even though Slovenia's public debt level of 45% of GDP in 2011 remains moderate, its doubling since the onset of the global economic crisis revealed worrying debt dynamics that have to be addressed soon. The recent increase of the country's 10-year government bond yield to more than 7% bears witness to the urgency of this matter.

Things to watch:

- December parliamentary elections
- Fiscal consolidation
- Contagion from the sovereign debt crisis in the euro area, particularly Italy

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Slovenia

National facts	
Type of government	Parliamentary republic
Capital	Ljubljana
Surface area (thousand sq km)	20
Population (millions)	2.0
Main languages	Slovenian (91%)
	Serbo-Croatian (5%)
Main religions	Catholic (58%)
	Muslim (2%)
	Orthodox (2%)
Head of State (president)	Danilo Türk
Head of Government (prime-minister)	Borut Pahor
Monetary unit	euros (EUR)

Economy		2010
Economic size	*bn USD*	*% world total*
Nominal GDP	48	0.08
Nominal GDP at PPP	57	0.08
Export value of goods and services	31	0.16
IMF quotum (in mln SDR)	232	0.11
Economic structure	*2010*	*5-year av.*
Real GDP growth	1.2	2.5
Agriculture (% of GDP)	2	3
Industry (% of GDP)	31	34
Services (% of GDP)	66	64
Standards of living	*USD*	*% world av.*
Nominal GDP per head	23295	236
Nominal GDP per head at PPP	27643	234
Real GDP per head	19023	238

Social and governance indicators	rank / total
Human Development Index (rank)	21 / 187
Ease of doing business (rank)	37 / 183
Economic freedom index (rank)	66 / 179
Corruption perceptions index (rank)	27 / 178
Press freedom index (rank)	46 / 178
Gini index (income distribution)	31%
Population below $1.25 per day (PPP)	1.00%

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
Germany	23	Germany	18
Italy	15	Italy	18
Croatia	9	Austria	12
France	8	France	5

Main export products (%)	
Machinery & transport equipment	39
Manufactures, classified	22
Miscellaneous articles	11
Chemicals	16
Main import products (%)	
Machinery & transport equipment	29
Manufactures, classified	19
Chemicals	14
Manufactures, miscellaneous	10
Openness of the economy	
Export value of G&S (% of GDP)	64
Import value of G&S (% of GDP)	64
Inward FDI (% of GDP)	0.8

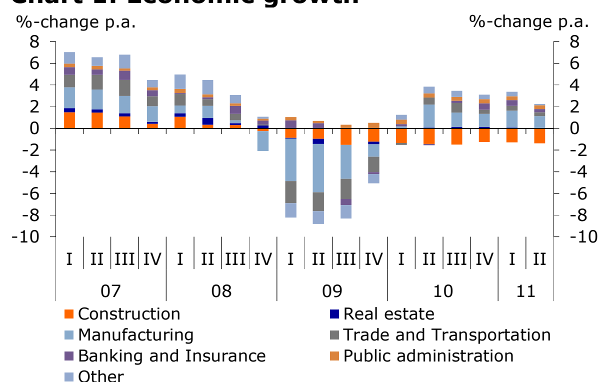
Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

Slovenia is a small, open economy in Central Europe with a total nominal GDP of USD 48bn (2010). With a population of 2 million, its nominal GDP per capita amounts to USD 23,295, or USD 27,643 in PPP terms, which compares very favourably with its regional emerging peers. Slovenia managed to quickly secede from former Yugoslavia in 1991 and avoided being dragged into the ensuing civil war, sparing the country the major devastations that hit its southern neighbors. Benefitting from its comparatively advanced state of development and its proximity to major European economies, like Germany and Italy, Slovenia's economy is relatively well-diversified, relying mainly on its varied industrial sector and tourism. While machinery and transport equipment account for about 40% of Slovenia's exports, largely reflecting production for the French carmaker Renault, it also produces various other manufactured products and chemicals. Reflecting the high degree of intra-industry trade, Slovenia's main trading partners are Germany and Italy, accounting for 23% and 15% of its exports in 2010, respectively. Likewise, Slovenia's imports also largely come from these two countries. Its accession to the euro area in 2007 further strengthened its economic ties with Europe's major economies. However, since the renewed worsening of the sovereign debt crisis in the euro area in 2011, Slovenia's close ties with Italy prove to be disadvantageous. Weaker economic growth in that country depresses export demand for Slovenian products, while increased market scrutiny seems to spread to Slovenia, which could possibly lead to rising interest rates on its considerable foreign debt stock and hurt its already weak domestic demand.

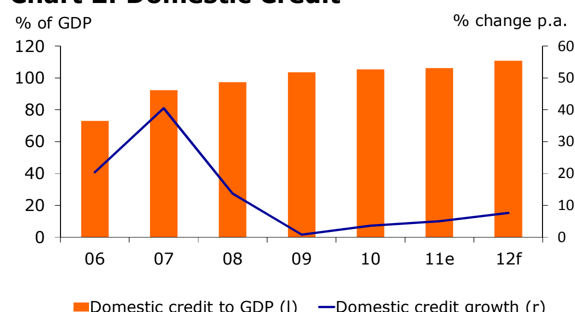
The current shape of the banking sector is quite worrisome and confronts the small country with considerable challenges, even though financial support by the ECB and the availability of EFSF-funds for bank recapitalizations should relieve some of the pressure. Owing to the very deep recession of 2009 that brought about an 8% decline in GDP and the ensuing very sluggish recovery, Slovenia's banking sector struggles with a wave of corporate bankruptcies. End June 2011, non-performing loans equalled 14.8% of gross customer loans, while loan loss reserves remained low. The sector-wide Tier 1-ratio stood at about 10%, which is rather low given the poor asset quality of the sector and the likely further deterioration on the back of the global economic slowdown. Faced with the dire situation of the banking sector, the government has engaged in several recapitalizations of state-owned banks amounting to about 0.8% of GDP. Still, despite a EUR 250mln recapitalization, Slovenia's biggest bank, Nova Lubljanska Banka (NLB), barely passed this year's EU's bank stress tests. Therefore, additional recapitalizations will be needed, also following the October 26, 2011, EU summit, asking for banks' Tier 1 ratios to be increased to 9%. Estimates for NLB's need for additional capital amount to about EUR 400mln (about 1% of GDP). Possibly, EFSF financing will be used to recapitalize the banking sector. Given the recent deterioration of the sovereign debt crisis in the euro area, we expect that private investor demand for equity stakes in euro area banks will be very weak, leaving official sources at the national or European level as the most reliable source of equity funding. The same will likely also hold for the Slovenian banking sector's substantial external funding needs, given a loan-to-deposit ratio of 150% (end June 2011). As available interbank and mutual fund lending to the ailing banking sector will probably be either limited or expensive, increased reliance on ECB liquidity provision is highly likely.

Chart 1: Economic growth



Source: SORS

Chart 2: Domestic Credit



Source: EIU

The problems in Slovenia's banking sector weigh heavily on domestic demand, as loan growth is limited and deleveraging of the highly indebted corporate sector continues. Given the recent increase in Slovenia's sovereign debt yields, risk premia for Slovenia's substantial external debt position (see last section of this report) could possibly also rise and put additional pressure on investments and consumption. Despite being an important source of growth in the pre-crisis years, the ongoing decline of the construction sector continues to burden economic growth. Given these considerable headwinds for domestic demand, export demand from the euro area will determine Slovenia's economic fate in the near future. However, the deteriorating outlook for the euro area economy, and Italy in particular, does not bode well for Slovenia. Provided the euro area economy does not relapse into recession and Slovenian domestic demand does not suffer from rising debt servicing costs on the back of increased risk aversion towards its substantial foreign debt position,

economic growth is expected to reach a meagre 1.5% this year, followed by about 2% growth next year. We caution that a renewed recession could be in the cards for 2012.

Political and social situation

Slovenia's consensus-based political system, which guaranteed considerable political stability since the country's independence, faced major headwinds amid the need to cut spending this year. This eventually led to the demise of the government and snap elections are scheduled for December 4th, 2011. The ousted four-party coalition government, which fell after a lost vote of confidence in September, comprised Prime Minister Borut Pahor's Social Democrats (SD), the Liberal Democracy of Slovenia (LDS) party, the Zares-New Politics (Zares) party, as well as the small single-interest Democratic Union of Slovenia's Pensioners (DeSUS). The government gradually disintegrated over the course of the year, as it attempts at reform of the generous pension system and a liberalization of the labor marked sparked insurmountable tensions within the coalition. The eventual break-up in September thus did not come as a surprise. The clear rejection of the government's pension and labor market reforms in two separate referenda also put substantial pressure on the already weak government.

While the December 4th parliamentary elections should not result in major political shifts, as fiscal consolidation is a commonly shared goal among all parties, the strong public opposition towards major reforms is worrisome. While part of the no-votes in the referenda reflect voters' disapproval of the government, there is a clear indication that a future government will likely face considerable non-parliamentary opposition to urgently needed reforms, even if it receives a strong mandate in the upcoming elections. We expect only weak support for these reforms from the country's relatively strong trade unions, as the population's feeling of entitlement to a generous welfare state and strictly regulated labor markets is strong. Still, Slovenians' current complacency and apparent distaste for reform might change, if the sense of urgency were to increase amid a further worsening of the debt crisis in the euro area.

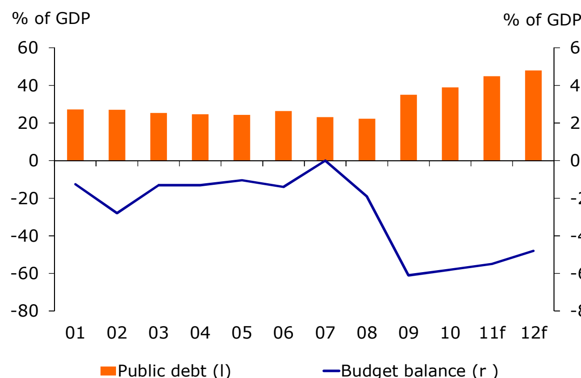
Despite the government's loss of its parliamentary majority, Slovenia's external relations were hardly affected. The country's parliament approved the extension of EFSF without major opposition, which should help the country access funds if the need were to arise. Tensions overshadowing Slovenia's relations with its neighbors Croatia and Italy have abated in recent years and should not lead to major problems going forward.

Public finances

Slovenia's public finances have deteriorated noticeably since the onset of the financial crisis, as tax revenues receded markedly and public spending increased on the back of the functioning of the automatic stabilizers and bail-outs for various state-owned enterprises. While posting a healthy balanced budget in 2007 in line with its track record of prudent fiscal management, Slovenia's public finances tumbled in 2009 when the budget deficit reached a level of 6.1% of GDP. In line with EU requirements to restore a balanced budget by 2013, the government has embarked on a fiscal consolidation strategy, but so far, progress has been limited. Even though tax revenues had been increasing strongly on the back of the economic recovery, recurrent recapitalizations, as well as growing social expenditures, namely pensions, prevented the deficit from falling markedly. Rising interest costs also burdened the budget. Consequently, Slovenia's budget deficit only improved gradually to 5.8% of GDP in 2010. For this year, Slovenia's central bank expects a gradual improvement to 5.5% of GDP. Owing to ongoing fiscal consolidation efforts, next year's deficit is expected to come in at 4.8%, provided that the economy does not relapse into recession and interest rate expenses remain limited. While substantial spending cuts are prone to face substantial non-parliamentary opposition, we note that considerable overcapacities and generous

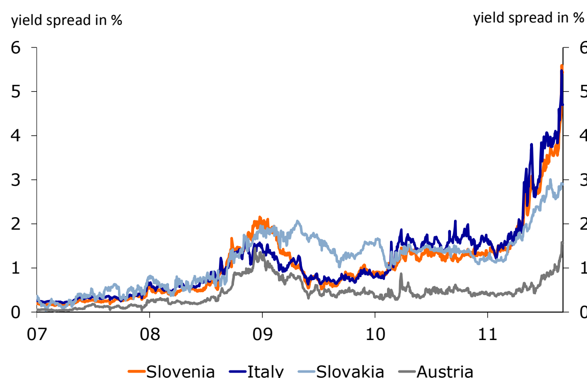
remuneration policies in the public sector should provide ample room to restore Slovenia's primary budget balance.

Chart 3: Fiscal Policy



Source: Central Bank of Slovenia

Chart 4: 10-year government bonds vs German Bunds



Source: Bloomberg

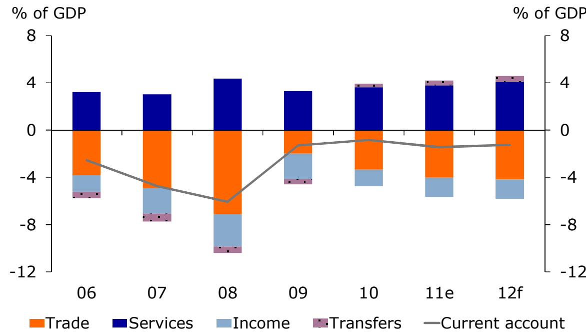
Owing to the deep recession of 2009 and recurring large budget deficits, Slovenia's public debt ratio has doubled since the beginning of the economic crisis, increasing from 23% of GDP in 2007 to an expected 45% of GDP this year. Given a still substantial expected budget deficit of 4.8% of GDP next year, public debt could reach a level of 48% of GDP in 2012. While the overall public debt level is still moderate, the marked increase reveals worrying public debt dynamics that have to be addressed soon, especially given Slovenia's weak growth prospects and increased market scrutiny amid the sovereign debt crisis in the euro area. In line with these concerns, the Slovenian government intends to introduce a debt brake, limiting the public debt ratio to a maximum of 48% of GDP.
In spite of this proposal and the fact that the Slovenian public debt ratio is still moderate, its 10-year government bond yields have risen to levels beyond 7% recently, which can be partly explained by increasing worries about neighboring Italy. Since mid-2009, Slovenian long-term government bond yields closely track their Italian equivalent. Still, in our view, various domestic factors also play a role, like e.g. the rejection of the important pension reform and the ensuing downgrades by major rating agencies, the local economy's exposure to Italy, the state of the banking sector, or the population's current distaste for major reforms. Unless yields decline markedly in the near future, Slovenia's efforts at fiscal consolidation could be seriously undermined by strongly rising interest expenditures, which could put government finances on an unsustainable path. We consequently do not exclude the possibility that Slovenia might opt for EFSF assistance, if demand for its upcoming government debt emissions turns out to be weak, which could exert additional upward pressure on yields. Given the country's small size, its cordial relations with the EU and an overarching commitment to avoid further contagion of the debt crisis in the euro area, timely EFSF-funding for Slovenia should be available in case its government would apply for support.

Balance of Payments and external position

Largely owing to reduced credit growth on the back of difficulties in Slovenia's banking sector, the current account deficit has declined markedly since the onset of the global economic crisis, falling from about 6% of GDP in 2008 to about 1% of GDP from 2009 onwards. Given the bleak outlook for domestic credit growth, we expect no material changes to this level in the coming year, as imports will remain limited. Owing to Slovenia's relatively advanced state of development, foreign

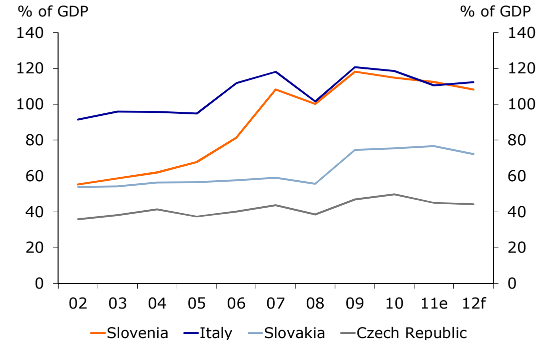
direct investment inflows have been quite limited in recent years, while net portfolio inflows displayed considerable volatility. Consequently, a substantial part of the pre-crisis current account deficits have been financed by debt inflows, leading to a noticeable increase in external debt levels.

Chart 5: Current account balance



Source: EIU

Chart 6 External debt



Source: IHS Global Insight

Since 2002, external debt has almost doubled from 60% of GDP to about 110% of GDP in 2011, which is comparable to neighboring Italy's external obligations in terms of GDP. While part of this development can be explained by Slovenia's accession to the euro area, the increase in foreign debt is considerably larger than for euro area peer Slovakia. Most of Slovenia's debt is denominated in euros, with the notable exception of Swiss franc-denominated mortgages, which should constitute roughly one-fifth of all Slovenian housing loans. Yet, owing to the Swiss Franc's peg to the euro, these non-euro exposures should not pose major problems going forward. About 20% of Slovenia's debt is short-term. While euro area membership certainly facilitates the financing of the large foreign debt burden, increased risk aversion amid a worsening of the sovereign debt crisis in the euro area could bring with it additional risks for Slovenia. In particular, rising doubts about the country's financial prospects, as witnessed by the strong recent increase of its government bond yields, could bring about substantial increases in risk premiums for Slovenia's large external debt. Still, euro area membership and the availability of ECB and EFSF emergency funds should mitigate these risks.

Slovenia

Selection of economic indicators	2006	2007	2008	2009	2010	2011e	2012f
Key country risk indicators							
GDP (% real change pa)	5.8	6.9	3.6	-8.0	1.4	1.5	2.0
Consumer prices (average % change pa)	2.5	3.6	5.7	0.9	1.8	1.6	1.8
Current account balance (% of GDP)	-2.6	-4.7	-6.1	-1.3	-0.8	-1.4	-1.2
Total foreign exchange reserves (mln USD)	7036	980	868	966	963	1130	1250
Economic growth							
GDP (% real change pa)	5.8	6.9	3.6	-8.0	1.4	1.5	2.0
Gross fixed investment (% real change pa)	10.4	13.3	7.8	-23.3	-8.3	-7.5	6.0
Private consumption (real % change pa)	2.8	6.0	3.9	-0.1	-0.6	0.2	0.5
Government consumption (% real change pa)	4.0	0.6	6.1	2.9	1.5	0.3	-0.5
Exports of G&S (% real change pa)	12.5	13.7	2.9	-17.2	9.5	7.9	6.3
Imports of G&S (% real change pa)	12.2	16.7	3.7	-19.6	7.2	5.2	4.6
Economic policy							
Budget balance (% of GDP)	-1.4	0.0	-1.9	-6.1	-5.8	-5.5	-4.8
Public debt (% of GDP)	26	23	22	35	39	45	48
Money market interest rate (%)	3.4	4.1	4.3	0.9	0.6	1.5	2.0
M2 growth (% change pa)	18	0	5	2	2	4	5
Consumer prices (average % change pa)	2.5	3.6	5.7	0.9	1.8	1.6	1.8
Exchange rate LCU to USD (average)	0.8	0.7	0.7	0.7	0.8	0.7	0.7
Recorded unemployment (%)	9.4	7.7	6.7	9.2	10.7	11.8	11.8
Balance of payments (mln USD)							
Current account balance	-997	-2243	-3323	-635	-394	-760	-660
Trade balance	-1487	-2331	-3880	-979	-1599	-2130	-2210
Export value of goods	21327	27093	29607	22525	24394	28960	30040
Import value of goods	22814	29424	33487	23504	25993	31090	32250
Services balance	1250	1427	2382	1623	1736	2000	2140
Income balance	-548	-1012	-1529	-1068	-672	-850	-850
Transfer balance	-212	-328	-296	-211	141	210	260
Net direct investment flows	-257	-268	460	-885	439	0	-50
Net portfolio investment flows	-1503	-3088	561	6440	2633	420	450
Net debt flows	2588	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Other capital flows (negative is flight)	-852	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
External position (mln USD)							
Total foreign debt	31696	51204	54605	58018	54646	59100	58670
Short-term debt	6900	15799	16138	13971	11362	10740	10610
Total debt service due, incl. short-term debt	6323	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total foreign exchange reserves	7036	980	868	966	963	1130	1250
International investment position	-6987	-10853	-17517	-18563	-17209	n.a.	n.a.
Total assets	33086	50961	47166	50177	47080	n.a.	n.a.
Total liabilities	40074	61814	64683	68740	64290	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-3.8	-4.9	-7.1	-2.0	-3.3	-4.0	-4.2
Current account balance (% of GDP)	-2.6	-4.7	-6.1	-1.3	-0.8	-1.4	-1.2
Inward FDI (% of GDP)	1.7	3.2	3.5	-1.3	0.8	1.7	1.9
Foreign debt (% of GDP)	81	108	100	118	115	112	108
Foreign debt (% of XGSIT)	114	143	136	188	165	151	143
International investment position (% of GDP)	-17.9	-22.9	-32.0	-37.7	-36.0	n.a.	n.a.
Debt service ratio (% of XGSIT)	23	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Interest service ratio incl. arrears (% of XGSIT)	4	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
FX-reserves import cover (months)	3.2	0.3	0.3	0.4	0.4	0.4	0.4
FX-reserves debt service cover (%)	111	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Liquidity ratio	121	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Source: Central Bank of Slovenia, EIU, Eurostat, IHS Global Insight, Rabobank, SORS, UMAR

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