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Country update **SLOVENIA**

Summary

Slovenia is currently experiencing a double-dip recession as a result of fiscal consolidation and banking sector problems. The banks have a high percentage of non-performing loans (especially to the corporate sector) that is causing a credit crunch. The government proposed to set up a bad bank, which is a welcome step. Implementation of the plan is still at risk, as pressure from the public and trade unions remains high. We expect that Slovenia will eventually apply for external assistance and that ESM-funding will be made available given the country’s small size (0.4% of eurozone GDP), its reform/austerity drive and the commitment of the European leaders to avoid further contagion stemming from a Slovenian financial crisis.

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Slovenia

National facts	
Type of government	parliamentary republic
Capital	Ljubljana
Surface area (thousand sq km)	20
Population (millions)	2.1
Main languages	Slovenian (91.1%)
	Serbo-Croation (4.5%)
Main religions	Catholic (57.8%)
	Muslim (2.4%)
	Orthodox (2.3%)
Head of State (president)	Danilo Türk
Head of Government (prime-minister)	Janez Jansa
Monetary unit	euros (EUR)

Economy		2011
Economic size	*bn USD*	*% world total*
Nominal GDP	50	0.07
Nominal GDP at PPP	58	0.07
Export value of goods and services	36	0.16
IMF quotum (in mln SDR)	275	0.13
Economic structure	*2011*	*5-year av.*
Real GDP growth	0.6	1.9
Agriculture (% of GDP)	3	2
Industry (% of GDP)	27	31
Services (% of GDP)	71	66
Standards of living	*USD*	*% world av.*
Nominal GDP per head	24545	226
Nominal GDP per head at PPP	28399	228
Real GDP per head	19161	235

Social and governance indicators	rank / total
Human Development Index (rank)	21 / 187
Ease of doing business (rank)	35 / 185
Economic freedom index (rank)	69 / 179
Corruption perceptions index (rank)	35 / 183
Press freedom index (rank)	36 / 178
Gini index (income distribution)	31.15
Population below $1.25 per day (PPP)	0.06

Foreign trade			2011
Main export partners (%)		*Main import partners (%)*	
Germany	24	Germany	19
Italy	14	Italy	18
Austria	9	Austria	12
Croatia	8	Croatia	5
Main export products (%)			
Machinery & transport equipment			38
Manufactures, classified			22
Chemicals			16
Miscellaneous articles			11
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)			72
Import value of G&S (% of GDP)			71
Inward FDI (% of GDP)			2.2

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

Current economic stance: double-dip recession

Slovenia's economic conditions have deteriorated significantly compared to last year. The economy is expected to contract by 2% this year and 0.4% next year, after a worse than expected growth outcome (+0.6%) in 2011. This is mainly the result of strong fiscal consolidation (necessary for meeting the 3% deficit target in 2013) and deleveraging in the private sector.
Besides the banking sector problems, a main risk factor is the development in the euro area. Slovenia is heavily reliant on exports given that they account for nearly three-quarters of total output. Since 70% of its exports is destined for the Eurozone, which is still grappling with a debt crisis, external demand will remain weak for some time to come.
Positive notes for the Slovenian economy are that the country does not have significant external imbalances and its government debt-to-GDP ratio is moderate compared to the other OECD countries. The latter is, however, dependent on the government's ability to reduce its budget deficit.

Slovenian banking sector

The banking sector suffers from a high percentage of non-performing loans (NPLs) as a result of the credit boom before the global financial crisis. NPLs increased to 12.8% as of mid-2012, compared to 11.2% in Dec-2011. The corporate sector poses the major risk; approximately 18% of

commercial loans are non-performing and more than half of loans to construction companies are overdue. Standard & Poor's reports that the banks have made provisions for 55% of the NPLs, which might not be enough if asset quality deteriorates further.
The government will set up a new bad bank, to which bad loans will be transferred in exchange for state-guaranteed bonds. These bonds can be used by banks to use as collateral for ECB funding. This limits the financial sector's liquidity problems and avoids a full-fledged credit crunch in Slovenia. According to the Slovenian Finance Minister, even after the transfer, the banks need about EUR 1bn (around 3% of GDP) of new capital in order to meet European requirements. Fitch estimates that about 8% of GDP is needed for bank recapitalization. If no private capital can be attracted, new capital support from the government cannot be excluded. Raising capital through higher retained earnings is probably too optimistic given the weak growth environment.

Sovereign risk
Currently, the government is increasingly dependent on short-term funding, which raises, rollover risk and worsens the public sector's debt profile. In our view, it is very uncertain if the state can attract any new private capital from the capital markets for a number of reasons.

- The implementation risk of reforms (including the setup of a bad bank) is high amid pressure from the public and trade unions. With the support of 40,000 signatures (2.4% of population allowed to vote), trade unions can call for a binding referendum. Even when legislation is passed by parliament, the outcome of a referendum can veto the new law. In this way, trade unions have much more power in Slovenia than in other countries. Note that the previous government collapsed as result of austerity measures rejected in a binding public referendum.
- Political instability is on the rise. The first early elections in Slovenian history led to a new five-party coalition. It is still to be seen how stable the new government is, as frictions occur between coalition members on much-needed pension and retirement age reforms. A partial reform package is already agreed upon, although implementation risk is non-negligible.
- Repricing of sovereign credit risk by the financial markets in light of the eurozone debt crisis is further weighing on market trust in Slovenian government bonds. The public sector's credit rating got downgraded a few times during the last year; its current rating (Moody's: Baa2) is just two notches above junk.

Increasing probability of external assistance
Due to the combination of economic, banking sector and political problems as described above, it is highly likely that Slovenia will eventually apply for external assistance. If so, we believe that ESM-funding will be made available for Slovenia. This is based on the country's small size (0.4% of eurozone GDP), its reform/austerity drive and the commitment of the European leaders to avoid further contagion stemming from a Slovenian financial crisis. Even if the country's output is a small share of total eurozone GDP, talks of 'slovexit' might once again worsen market sentiment and result in tightening of financial conditions in the entire region. This will put extra pressure on the hard-hit periphery countries that are struggling to regain market confidence.

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Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	7.0	3.4	-7.8	1.2	0.6	-2.0	-0.4
Consumer prices (average % change pa)	3.6	5.7	0.9	1.8	1.8	2.5	1.9
Current account balance (% of GDP)	-4.7	-6.1	-0.7	-0.6	0.0	0.6	2.1
Total foreign exchange reserves (m USD)	980	868	966	927	831	990	940
Economic growth							
GDP (% real change pa)	7.0	3.4	-7.8	1.2	0.6	-2.0	-0.4
Gross fixed investment (% real change pa)	13.3	7.1	-23.2	-13.8	-8.1	-11.0	1.0
Private consumption (real % change pa)	6.3	2.3	0.1	1.3	0.9	-1.7	-0.7
Government consumption (% real change pa)	0.6	5.9	2.5	1.5	-1.2	-3.5	-2.0
Exports of G&S (% real change pa)	13.7	4.0	-16.7	10.1	7.0	0.3	1.8
Imports of G&S (% real change pa)	16.7	3.7	-19.5	7.9	5.2	-2.3	-0.6
Economic policy							
Budget balance (% of GDP)	0.3	-0.3	-5.5	-6.0	-6.3	-3.5	-2.4
Public debt (% of GDP)	23	22	31	33	42	45	46
Money market interest rate (%)	4.1	4.3	0.9	0.6	1.2	0.7	0.7
M2 growth (% change pa)	0	5	2	2	4	5	2
Consumer prices (average % change pa)	3.6	5.7	0.9	1.8	1.8	2.5	1.9
Exchange rate LCU to USD (average)	0.7	0.7	0.7	0.8	0.7	0.8	0.8
Recorded unemployment (%)	7.7	6.7	9.2	10.7	11.8	12.3	12.2
Balance of payments (m USD)							
Current account balance	-2243	-3323	-343	-277	3	300	990
Trade balance	-2331	-3880	-694	-1323	-1452	-1410	-920
Export value of goods	27093	29607	22864	24894	29594	28420	28720
Import value of goods	29424	33487	23558	26217	31046	29830	29640
Services balance	1427	2382	1623	1705	2008	2170	2620
Income balance	-1012	-1529	-1051	-796	-765	-700	-1000
Transfer balance	-328	-296	-222	136	212	240	290
Net direct investment flows	-268	460	-885	439	1046	850	1300
Net portfolio investment flows	-3088	561	6440	2633	1747	2000	1920
Change in international reserves	-6074	-108	123	n.a.	n.a.	n.a.	n.a.
External position (m USD)							
Total foreign exchange reserves	980	868	966	927	831	990	940
International investment position	-10853	-17517	n.a.	n.a.	n.a.	n.a.	n.a.
Total assets	50961	47166	n.a.	n.a.	n.a.	n.a.	n.a.
Total liabilities	61814	64683	n.a.	n.a.	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-4.9	-7.1	-1.4	-2.8	-2.9	-3.0	-2.0
Current account balance (% of GDP)	-4.7	-6.1	-0.7	-0.6	0.0	0.6	2.1
Inward FDI (% of GDP)	3.2	3.5	-1.3	0.8	2.2	2.6	3.8
International investment position (% of GDP)	-22.9	-32.0	n.a.	n.a.	n.a.	n.a.	n.a.
FX-reserves import cover (months)	0.3	0.3	0.4	0.4	0.3	0.3	0.3

Source: EIU