EEMEA: SLOVENIA

# Light at the end of the tunnel

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**Slovenia has suffered from problems in the banking sector, which has substantial recapitalization needs. The situation is aggravated by the ongoing recession. However, successful external issuance and a clear reform programme have calmed investor concerns somewhat over the potential need for a EU/IMF financial assistance programme. We believe Slovenia can avoid a bailout, provided fiscal consolidation and reforms remain on track.**

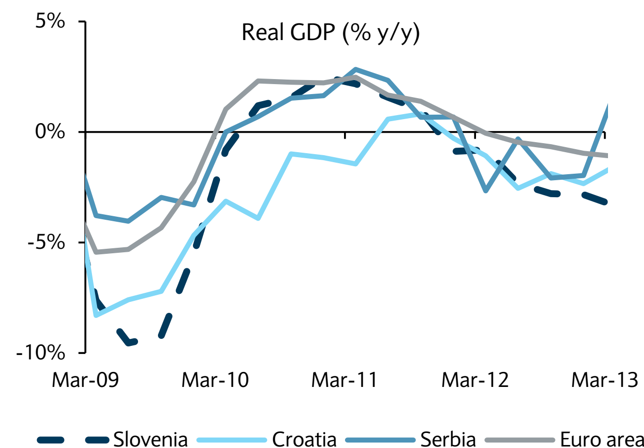
*Key recommendations*

- **Credit: Long Slovenia '18s, '22s, '23s.** We had taken a positive view on Slovenia credit (see *Slovenia: Manageable threats,* 18 April 2013) and recent developments support our view that the country's challenges can be overcome. Spreads have widened in line with the broader sell-off in EM (and EU periphery) fixed income recently; however, we still think that with high probability spreads will eventually tighten for Slovenia. We recommend seeing through potential volatility (often exacerbated by Slovenia being an off-benchmark country for EM investors, ie, Slovenia USD bonds can lack a natural holder base) and suggest remaining long Slovenia USD bonds across the curve.

*Recession will continue this year and next*

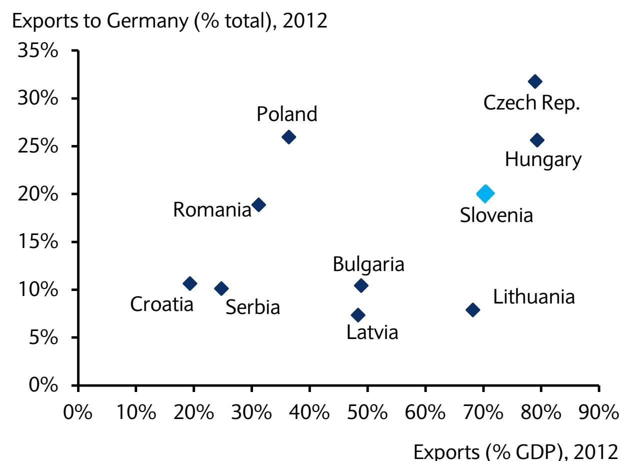
The economy remains in recession, stemming from very weak domestic demand due to fiscal consolidation, rising unemployment and banking sector problems. However, while growth worsened to -3.4% y/y in Q1, it actually improved on a SA q/q basis to -0.7% from -1.0% in Q4 12. Final consumption led the contraction, while gross fixed capital formation turned positive (+1.1% q/q) due to investment in a major energy facility. Unemployment continues to rise, hitting 10.2% in April and we expect it to deteriorate further. On a positive note, exports have risen by 2.4% SA q/q in Q1. We expect the economy to contract by 2% in 2013 as a whole. While positive growth is possible in 2014, this would require a resolution of banking sector problems and a restructuring of the highly indebted corporate sector. Another important factor for growth will be the pace of recovery in Slovenia's main trading partners: Germany, Italy and central and south-eastern Europe. The country's economy is one of the most open in the region, with goods' exports representing 70% of GDP. According to our forecasts, growth in the euro area as a whole would resume in Q2, led by a rebound in Germany while Italy would exit recession in Q3.

FIGURE 1
**Recession has been mainly caused by banking sector crisis**




Source: Haver Analytics, Eurostat, Barclays Research

FIGURE 2
**Slovenia is a very open economy exposed to Germany**




Source: Haver Analytics, Eurostat, Barclays Research

*Banking sector experiencing serious problems*

The banking system represents the weakest part in the economy. The loan-to-deposit ratio is still high, at 145%, and banks continue to de-leverage. Credit quality is poor with rising system-wide NPLs already exceeding 15% of total loans, and capital adequacy is weak. The main reasons for this include bankruptcies in the corporate sector (where the NPL ratio is 24%), with the construction sector being the worst affected, and weak governance in the state-owned banks. The government has substantial stakes in the three biggest banks (the Nova Ljubljanska, Nova Kreditna Banka Maribor and Abanka Vipa), which account for 40% of total loans. The central bank estimates initial recapitalization needs for the banking system at EUR0.9bn (2.5% of GDP). In addition, the government established Bank Asset Management Company (BAMC) which will take over about EUR3.3bn of impaired assets from banks by the end of Q3 to recover what is left of them. The takeover will be financed by the issuance of government-guaranteed bonds, likely directly to banks rather than on the external market. Importantly, further recapitalisation needs may arise due to the ongoing recession as well as be found out from more thorough analysis. On a positive note, the banking sector itself is relatively small, with an asset-to-GDP ratio of 140%, less than half of the euro area average.

*Recapitalization will be done through BAMC*

*EC assessed relatively positively the government's reform programme*

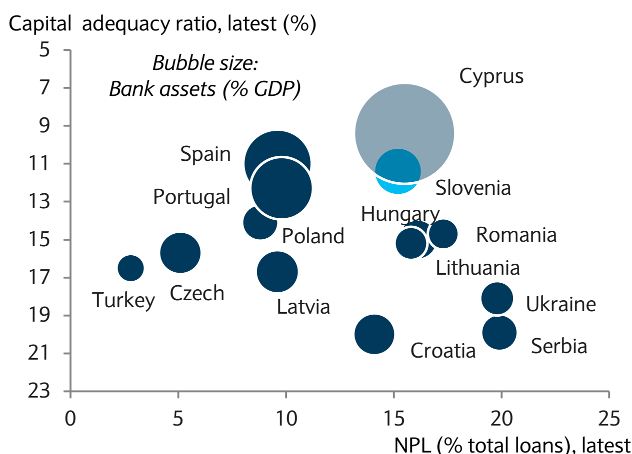
At end-May, the EC provided a relatively positive assessment of the government's reform programme, although it emphasized the need for more ambitious structural reforms to deal with imbalances and urged for swift actions regarding the banking sector. In particular, the EC recommended that the government appoints an independent external adviser by end-June to conduct a review of asset quality within the banking system. Other recommendations include strengthening banking sector regulation and preparing the timetable for sale of state shareholdings in banks.

*Fiscal deficit will likely reach 7.9% of GDP in 2013*

After a remarkable fiscal consolidation, the general government deficit declined to 4% of GDP in 2012. Given the ongoing recession and fiscal slippage in early 2013 due to political volatility, the new government is targeting a 7.9% deficit this year, including 2.5% of GDP of bank recap costs. In May the government adopted a set of consolidation measures, including across-the-board spending cuts and another reduction in public wages. On the revenue side, it increased VAT by 2pp, suspended a planned reduction in corporate income tax and introduced a property tax starting from January 2014. Furthermore, the government plans to introduce another set of spending cuts by year-end, which may be complemented by an additional "crisis" tax. The EC set the deficit target for 2013 at 5.5% of GDP (excluding bank recap costs) and also obliged Slovenia to exit the Excessive Deficit Procedure by 2015 which would mean bringing the deficit below 3% of GDP threshold.

FIGURE 3

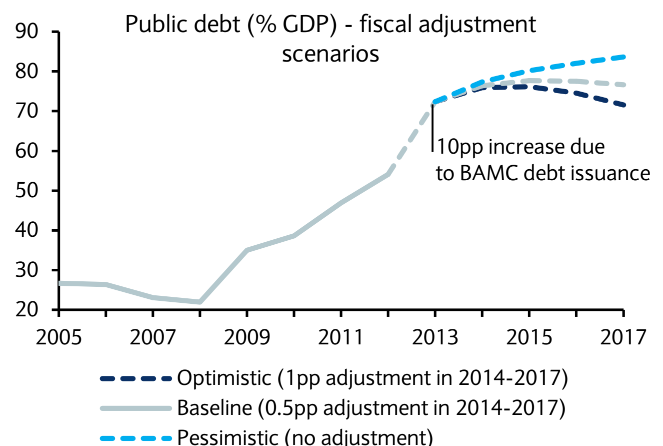
**Banking system scale is relatively small**




Source: IMF, Haver Analytics, Barclays Research

FIGURE 4

**Debt sustainability is conditional on fiscal consolidation**




Source: Eurostat, Barclays Research

*Public debt sustainability depends on fiscal consolidation*

High budget deficits in recent years have brought public debt sustainability into question. Taking into account bank recap costs (2.5% of GDP) and debt issuance by BAMC (c.9.5% of GDP), public debt will likely exceed 70% of GDP in 2013. However, even at this level, it would still remain relatively low compared to the euro area average. In our baseline scenario of steady 0.5pp fiscal consolidation to start from 2014, public debt would peak at 78% of GDP in 2015. Importantly, this scenario assumes Slovenia would recover from the recession by 2015 and gradually reach 2.0-2.5% growth thereafter. A delayed recovery, or further capital injections into the banking sector, represent the main downside risks; thus pursuing fiscal consolidation is crucial for the public debt to be sustainable.

*May Eurobond issuance has covered 2013 financing needs*

The financing needs for the remainder of the year, at c.EUR2.5bn, are covered by the USD3.5bn Eurobond issuance in May. Additional funds will likely be raised through T-bills auctions and privatization. In its national reform programme published in May, the government presented an extensive list of potential privatization targets which include various enterprises as well as Nova Kreditna Banka Maribor. This represents an important step forward as excessive state involvement in the economy has had a negative impact on public finances (through recapitalisations and government guarantees) and stalled private domestic and foreign investment. Earlier this year the government established Slovenia Sovereign Holding to implement privatisations and the EC has recommended making it fully operational in a timely manner. For 2014, the financing needs could amount to EUR5bn, depending on the extent of fiscal consolidation and possible additional bank recap costs.

*Concerns over a possible EU/IMF programme have eased*

Given the challenging banking sector problems, the markets have been concerned that Slovenia may have to request financial assistance from the Eurogroup. However, successful external bond issuance, coupled with a detailed reform programme in May, has calmed these concerns, at least for now. We believe that the government can avoid a bailout due to its relatively low public debt level; moreover, the EC did not mention possible financial assistance in its recent assessment either. The challenge for the government now lies in ensuring the smooth implementation of the announced measures and the EC recommendations. In addition, the political situation needs to be monitored given political volatility in early 2013. The current ruling coalition comprises PM Bratusek's Positive Slovenia, President Borut Pahor's Social Democratic Party, as well as the Civic List and the pensioners' party DeSUS. It has a relatively narrow majority in parliament (49 deputies out of 90) and thus any disagreement over the tough measures the government has to implement could be a threat to its stability. To be fair, thus far there have been no signs of any tensions within the coalition over the difficult measures this government has already adopted.

*Political situation warrants monitoring*

FIGURE 5

**Slovenia macroeconomic forecasts**

| | 2009 | 2010 | 2011 | 2012 | 2013F | 2014F |
|---|---|---|---|---|---|---|
| **Activity** | | | | | | |
| Real GDP (% y/y) | -7.8 | 1.2 | 0.6 | -2.3 | -2.0 | 0.0 |
| GDP (USD bn) | 50 | 47 | 50 | 46 | 47 | 48 |
| **External sector** | | | | | | |
| Current account (USD bn) | -0.3 | -0.3 | 0.0 | 1.1 | 1.5 | 1.8 |
| Current account (% GDP) | -0.7 | -0.6 | 0.0 | 2.4 | 3.1 | 3.8 |
| Net FDI (USD bn) | -0.9 | 0.6 | 0.9 | 0.2 | 0.5 | 1.5 |
| Gross external debt (USD bn) | 58 | 54 | 52 | 54 | 58 | 61 |
| **Public sector** | | | | | | |
| Public sector balance (% GDP), ESA95 definition | -6.0 | -5.7 | -6.4 | -4.0 | -7.9 | -3.9 |
| Primary balance (% GDP) | -2.4 | -2.9 | -3.0 | -1.5 | -2.8 | -1.0 |
| Gross public debt (% GDP) | 35.0 | 38.6 | 46.9 | 54.1 | 72.4 | 76.9 |
| **Prices** | | | | | | |
| CPI (% Dec/Dec) | 0.9 | 1.8 | 1.8 | 2.6 | 2.5 | 2.0 |

Source: Statistical Office of the Republic of Slovenia, Haver Analytics, Barclays Research

**Analyst Certification**

We, Koon Chow, Christian Keller, Andreas Kolbe, Bruno Rovai, Aziz Sunderji, Igor Arsenin, Rahul Bajoria, Wai Ho Leong, Daniel Hewitt, Eldar Vakhitov, Jian Chang, Joey Chew, Nick Verdi, Rohit Arora, Krishna Hegde, CFA, Siddhartha Sanyal, Avanti Save, Prakriti Sofat, Ridle Markus, Piotr Chwiejczak, Alia Moubayed, Dumisani Ngwenya, Mike Keenan, Mamokete Lijane, Vladimir Pantyushin, Apolline Menut, Peter Worthington, Alejandro Grisanti, Donato Guarino, Sebastian Vargas, Guilherme Loureiro, Marcelo Salomon, Alejandro Arreaza, Sebastián Brown, Marco Oviedo and Hamish Pepper, hereby certify (1) that the views expressed in this research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this research report and (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this research report.

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