MINISTRY OF FINANCE
OF THE SLOVAK REPUBLIC

ARDAL

Government Debt Management Strategy for the years 2015 to 2018

Contents

Introduction

The Government Debt Management Strategy for the years 2015-2018 was prepared at the time when the crisis had already overcome its culmination phase not only on the financial markets but also in the real economy. At the time of global economic stabilisation when some countries, which failed to refinance its needs on the capital markets during the debt crisis, are gradually returning to the market with successful issues.

The Slovak economy performs well in almost all aspects, the economy has been growing continuously since the second quarter of 2009 and achieving one of the biggest EU GDP growths, the inflation is under control at stable low levels and the balance of payments has been positive for the second year. The persistent long-term problem of Slovakia lies in a still relatively high unemployment rate.

The management and refinancing of the Slovak state debt got through the financial and debt crisis in the years 2009 to 2012 without any problems. This was achieved by a strict observance of the government debt management strategy, a good credit rating, a positive investors' perception of the country, consolidation efforts of the government and the stable banking sector. Stability of government financing has been strongly supported by extensive investor base diversification through the issuance of bonds outside the Eurozone in foreign currencies which began in 2012. Currently the investors from the outside of Eurozone in others currencies are covering about 10% of the Slovak government debt. This diversification has brought the possibility of alternative funding sources for the state, an increased demand from the traditional bond investors as well as positive marketing in markets where Slovakia in terms of its size and significance is not known as a government bonds issuer. Successful issues in the US, Swiss and Czech markets have been creating since 2012 an indirect downward pressure on spreads of the Slovak Government Bonds issued on the domestic European capital market.

The financial needs of the state (due liabilities and ongoing financing of the budget deficit) in 2011 were partially covered by liquidity reserves and resources of the State Treasury. The reason was in recurring turbulences in the financial markets at the end of 2011. Subsequently in 2012, there were issued more bonds than required by the ongoing financing of the state which was sufficient both to replace the sources of the State Treasury and to increase a liquidity buffer. The situation changed in 2013 and especially in 2014, when the cash reserve had gradually been tapering. In this case the reason was not the shaky situation in the financial markets but necessity of adapting the issuance of the new debt to the law on fiscal responsibility. The liquidity buffer reduction was also the result of early redemption of government bonds before maturity which brought a more convenient government bonds repayment and a slight reduction in the costs associated with holding the cash reserves. Capital markets consolidation has gradually brought favourable conditions for the "safe" countries in respect of interest rates at the historic lows and for Slovakia an additional demand of those investors who were forced to restrict the bond purchases of the "peripheral" countries due to the debt crisis. The consolidation in the financial markets and historic interest rates lows enabled Slovakia to substantially improve the risk profile of the government debt portfolio towards the higher average maturity and the lower risk of possible negative portfolio revaluation. This principle of portfolio management is the standard for countries with developed capital markets and sophisticated management of the government debt. This necessary stabilization of the government debt portfolio forced by the debt crisis was carried out in the years 2011 - 2014 without a significant increase in the government debt management average costs.

The proposed Government debt management strategy for the years 2015 - 2018 follows the principles of the previous one. The development of public finances and government debt costs in recent years and especially the assessment of Slovakia by investors, banks and rating companies showed that the aims in the state debt management for the years 2011 to 2014 had been set appropriately for the conditions of the Slovak economy, public finance and governance of the Slovak debt. Due to the limited capacity of the regional bond market, the still tightening general financial regulation and the cumulative increase in the state debt´s absolute value it is necessary to shift the risk parameters of the managed portfolio into a smaller risk area. The new setting of the risk parameters in the government debt management will allow Slovakia to join Eurozone core countries with a modern and rigorous approach to financial risk management. The objectives of the proposed strategy are in line with the aims defined in the previous government debt management strategies. The new strategy slightly modifies the primary quantitative risk management parameters.

1. State debt management and development in 2011-2014

1.1. Evaluation of the 2011 – 2014 State debt management strategy

The 2011 – 2014 state debt management targets were built up on the previous strategy and have upheld the main goals, which are to provide liquidity and market access for the state debt financing in a transparent, prudent and cost-efficient manner while maintaining the risks contained in a debt at an acceptable level.

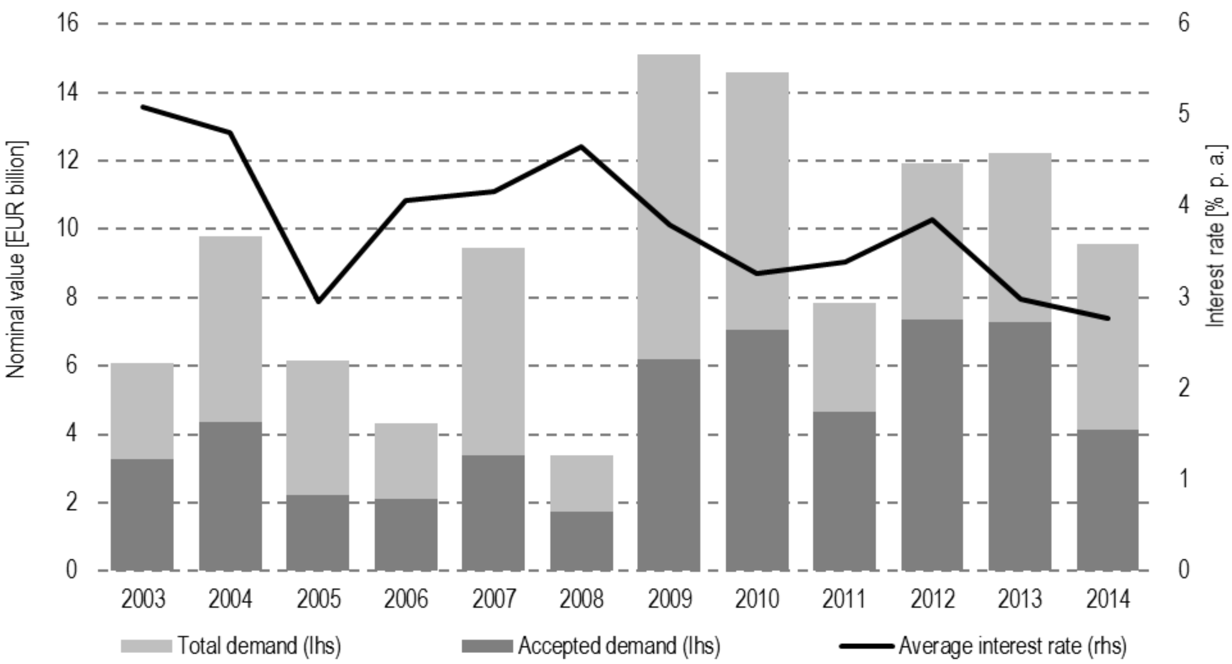
Meeting of the partial targets:

<u>1 – Standardising the attributes of the new government issues</u>

Between the years 2011 and 2014 eleven new bond issues were placed on the domestic market, thereof eight executed by bank`s syndication. During the same period seventeen issues (including one international) were redeemed. As of 30.06.2014, Ministry of Finance (the "MoF") had a total of 31 "live" issues (thereof 14 registered abroad). The newly opened domestic benchmark issues have the maximum nominal value limited to the standard EUR 3.0 billion. New other issues (not benchmark) have usually a maximum nominal value of EUR 1.5 billion. During the years 2013 and 2014 there were issued bonds with a maturity of 20 years (one issue in a form of private placement). Since 2012, Debt and Liquidity Management Agency (the "ARDAL") has implemented on a larger scale buy back operations of government securities, particularly in periods at the end of the year when it is necessary to adjust the size of the debt due to the Fiscal Responsibility Act, which only takes into account the gross debt. Buy backs of the bonds contribute to smooth repayment of the large issues and slightly reduce the cost of liquidity buffer management.

All government securities tradable in a public market (the Government Bonds and Treasury Bills) denominated in EUR meet the criterion of eligibility assets by the European Central Bank (the "ECB") and may be used in direct ECB/NBS operations or as collateral in the monetary policy operations.

Demand and accepted bids in domestic bond auctions (EUR billion) and accepted interest rate (% p. a.)



In 2014 available date as of 30.06 *Source: ARDAL*

2 – Optimising the structure of non-marketable debt

The intensive phase of optimising the structure of non-tradable debt was completed in the years 2011-2012. All loans with the possible positive or neutral early termination effect were terminated and the non-marketable debt was replaced by the tradable debt (bonds). New loans (excluding realised guarantees) had been only approved in case of their economic benefit and "value added" in the form the approved project-related expenditure eligibility audit.

3 – Meeting the refinancing, interest rate and foreign currency risk parameters of the state debt

For the period 2011 to 2014 there were set the optimal values for refinancing and interest rate risk, close to which it is necessary to maintain the portfolio parameters. The cumulative maturity and re-fixing limits in the first year should be maintained close to 25 % of total state´s financial liabilities and the cumulative and re-fixing limits for the next five years should be kept close to the level of 65 % of total state´s financial liabilities.

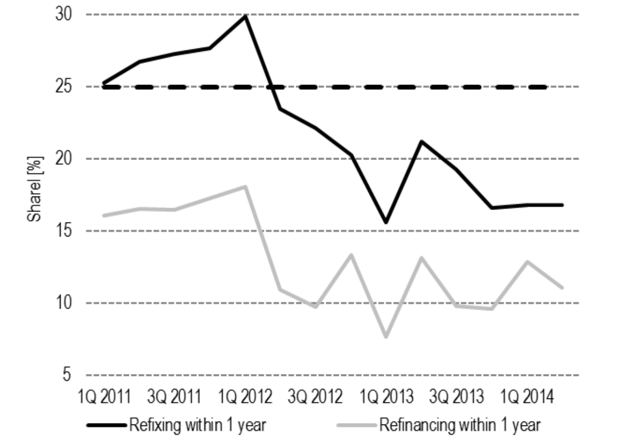
Indicators of the refinancing and re-fixing risk

	Average maturity* [year]	Duration* [year]	Refinancing in the 1st year** (optimal 25%) [%]	Refinancing in 5 years** (optimal 60%) [%]	Interest change in the 1st year** (optimal 25%) [%]	Interest change in 5 years** (optimal 65%) [%]
Q1 2010	4.86	3.99	29.7	74.5	37.8	75.1
Q2 2010	5.23	4.38	25.4	67.2	33.1	67.8
Q3 2010	5.06	4.32	25.9	66.6	32.8	66.7
Q4 2010	5.63	4.62	18.0	58.2	25.4	58.3
Q1 2011	5.67	4.65	16.1	61.4	25.3	61.5
Q2 2011	5.75	4.77	16.5	59.3	26.8	59.3
Q3 2011	5.39	4.51	16.5	59.5	27.3	59.6
Q4 2011	5.15	4.33	17.3	59.6	27.7	59.6
Q1 2012	4.95	4.19	18.1	61.1	29.9	61.1
Q2 2012	5.20	4.47	10.9	62.4	23.5	62.5
Q3 2012	5.39	4.67	9.7	60.2	22.2	60.2
Q4 2012	5.60	4.87	13.3	59.3	20.3	59.3
Q1 2013	6.42	5.54	7.7	50.6	15.6	50.7
Q2 2013	6.37	5.45	13.1	47.6	21.2	47.6
Q3 2013	6.31	5.36	9.8	45.6	19.3	46.8
Q4 2013	6.45	5.44	9.6	47.7	16.6	47.7
Q1 2014	6.93	5.94	11.8	42.2	17.2	42.2
Q2 2014	7.10	6.19	11.1	45.1	16.8	45.1

** Portfolio (Government Bonds, Treasury Bills, Loans)*
*** Entire portfolio (Government Bonds, Treasury Bills, Loans, Money Market and the State Treasury)* *Source: ARDAL*

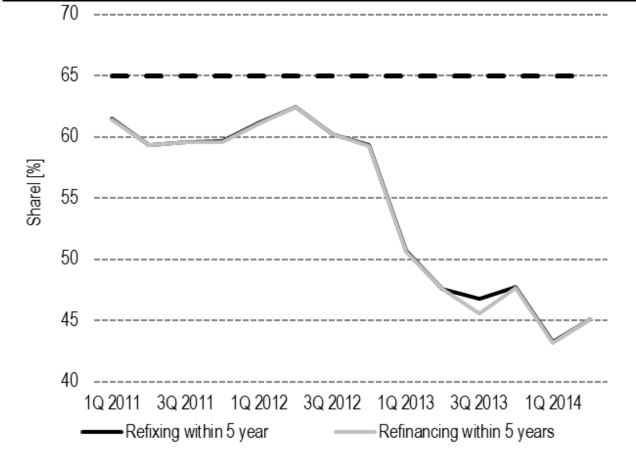
Development of the Slovak debt risk indicators

Refinancing risk (%)



Source: ARDAL

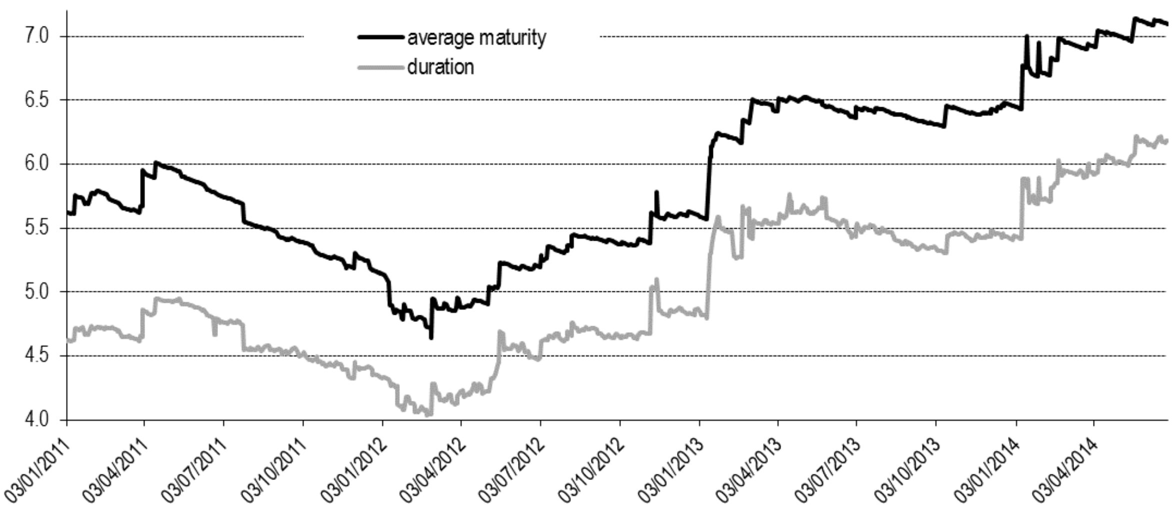
Re-fixing (interest rate) risk (%)



Source: ARDAL

Development in financial markets was influenced by central bank`s struggle with the crisis in Europe, moreover, the debt crisis of some Eurozone countries (Greece, Ireland, Portugal, Spain, Italy and Slovenia). After a critical end of 2011, the financial markets in 2012 were stabilised by central banks and in Europe also by the stabilisation mechanisms. Interest rates of "core" countries had gradually reached new record lows. This, together with reduced investors' confidence in the "peripheral" countries, meant for Slovakia the inflow of new investors, especially in longer maturities in the subsequent years. Record-low interest rates were also reflected in the Slovak bonds, and therefore the favourable conditions have been used to issue Government Bonds with the longer maturities (15-20 years). It shifted portfolio risk parameters to a smaller risk area but due to the low and gradually declining interest rates it was not reflected in a costs increase.

Average maturity (years) and duration (years) of the Slovak debt during 2011 - 2014



Source: ARDAL

For the foreign currency risk management the strategic objective was set. The limit for open unsecured foreign currency position of the government debt had to remain below 5% of the total government debt. This limit has been conveniently met during the entire period (e. g. at the beginning of 2014, the value of the unsecured debt in foreign currency was 0.06% of the total debt).

4 – Diversification of the investor base

During the meetings with the participants of the auctions and investors the ARDAL presented current plans regarding the primary and secondary government securities market. Each year in December there was published a plan of new Government Bonds and Treasury Bills issues and a timetable of auctions for the next year. The ARDAL regularly sends out to investors and publishes on its website monthly reports on the activities related to state debt and liquidity management.

Unfavourable development of European financial markets in 2011 was the main reason for intensifying communication with investors. The ARDAL`s staff in 2012 and 2013 took part in several business trips (Roadshows) to visit the investors and to present Slovakia and its economy mainly in Europe (France, Germany, Switzerland, Norway) and also in the US, Japan and Asia.

The investor base diversification resulted in the sale of 12 tranches of six bonds issues denominated in CHF, EUR, JPY, USD and NOK. Risks arising from such transactions had been eliminated by executed cross currency interest rate swaps (CCIRS). The hedging swaps were concluded through the competitive tenders with banks with which Slovakia has signed ISDA for the financial derivatives transactions. The majority of ISDA agreements also include CSA (defining the rules for collateralisation of a credit risk) which creates additional demand for administration and operation.

The investor base diversification is necessary considering the size of domestic and regional financial market with the limited capacity to absorb the annual state budget deficits each year. This diversification also changes the ratio of the government debt owned by domestic investors in favour of foreign investors (higher risk).

5 - Improving the infrastructure of the state debt (primary dealers, ISDA contracts, brokers, improving the conditions of the settlement)

The primary dealers system was introduced in early 2013. Considering nonstandard settlement of transactions on the capital market (members of the Stock Exchange are obliged to register all trades on the Stock Exchange, the absence of real DVP settlement for OTC transactions), it was decided to establish a system of primary dealers so far only for the primary market. The electronic secondary market with the quoting obligation for benchmark issues by primary dealers will be introduced after more favourable conditions for its implementation are created.

Since the beginning of 2012 the ISDA Master Agreements have been concluded with ten banks. The banks, which have a valid ISDA contract with Slovakia, may be invited to a tender for the hedging transactions. Slovakia also uses services of broker`s companies (foreign) in certain money market transactions and for buy backs operations in the secondary capital market.

1.2. Structure and development of the Slovak state debt

The state debt[1] (all figures in nominal value) in the years 2011 to 2014 increased due to several factors. The budget deficits contribution was EUR 12.1 billion (of which 9.1 billion was in the years 2011 - 2013). Part of the debt is in the form of government guarantees provided to the EFSF in the amount of EUR 1.9 billion, which increases the reported debt, but not real funding needs. In the period 2007 - 2010, when the crisis influenced more financial markets than a real economy, the debt of Slovakia increased by EUR 10.2 billion. The period from 2011 to 2014 can be characterized as a culmination of the financial market crisis which subsequently hit the real economy in Europe. Due to the debt crisis of European governments and the situation in the money market, the role of liquidity buffer in debt management began to be more significant. Managing of the cash reserve size (also monitored by rating agencies) created in 2012 and 2013 was adversely affected by the constraints arising from the Law on Fiscal Responsibility. The government debt to GDP ratio reached 52.8 % at the end of 2013. Almost the entire state debt consists of the issued securities whose share in total debt is 90.2 %, while the share of loans is 4.9 % (share of the issued government guarantees to the EFSF is 5 %).

[1] The state debt, for purposes of the Government debt strategy, considers only issuing activities of the ARDAL. It does not contain information about obligations of hospitals, EOSA claim and deposits of the State Treasury clients that do not belong to the public sector.

State debt structure in nominal value (in EUR million)						
	As of 31.12.2011	As of 31.12.2012	As of 31.12.2013	As of 30.6.2014	% of GDP 31.12.2013	% of total 31.12.2013
Government securities	27 029.4	32 776.2	34 326.0	35 582.8	47.6	90.2
Loans	1 360.6	1 577.9	1 851.6	1 678.1	2.6	4.9
EFSF	172.6	1 494.0	1 894.8	1 895.1	2.6	5.0
Others	8.0	0.0	0.0	0.0	0.0	0.0
State debt in nominal value	**28 570.6**	**35 848.1**	**38 072.4**	**39 155.97**	**52.8**	**100.0**

Source: MoF SR

In terms of currency, the state debt in 2014 was mainly denominated in EUR. The share of other currencies against the previous period had increased from negligible 0.3% of the total debt to almost 8% of the total debt as of the end of 2013. This change was caused by the decision taken at the end of 2011 to extend the investor base and to entry to foreign currency capital markets (registration and listing at the foreign institutions). Despite the increase in the share of foreign currency debt, unsecured share of foreign currency liabilities throughout the period was much less than the maximum 5.0% of total liabilities (only 0.6%).

Currency structure of the state debt (in EUR million)						
	As of 31.12.2011	As of 31.12.2012	As of 31.12.2013	As of 30.6.2014	% of GDP 31.12.2013	% of total 31.12.2013
EUR	28 490.0	33 705.7	35 246.6	35 920.9	48.9	92.6
USD	0.0	1 160.1	1 160.1	1 160.1	1.6	3.0
JPY	75.5	61.4	272.8	274.0	0.4	0.7
CZK	0.0	500.0	500.0	500.0	0.7	1.3
CHF	5.0	420.9	892.9	892.9	1.2	2.3
NOK	0.0	0.0	0.0	408.0	0.0	0.0
State debt in nominal value	**28 570.6**	**35 848.1**	**38 072.4**	**39 155.97**	**52.8**	**100.0**

Source: MoF SR

From the territorial point of view, the domestic state debt (the lenders are residents) represented 34.9% of the total debt as of 30.06.2014, while foreign debt (the lenders are non-residents) was 65.1%. The government debt was covered mainly by foreign entities, partially commercial banks, insurance companies and pension or investment funds. Change in the ownership ratio compared to earlier periods is caused mainly by the fact that in the domestic economy, despite one of the highest GDP growth in Europe, the capacity of the domestic capital market is not growing so fast as the debt grows. The bigger part of the public budget deficit must therefore be "exported" abroad.

Domestic and foreign state debt (in EUR million)						
	As of 31.12.2011	As of 31.12.2012	As of 31.12.2013	As of 30.6.2014	% of GDP 31.12.2013	% of total 31.12.2013
Domestic	16 662.1	18 296.4	13 682.9	13 656.4	19.0	35.9
Foreign	11 908.4	17 551.8	24 389.5	25 499.6	33.8	64.1
State debt in nominal value	**28 570.6**	**35 848.1**	**38 072.4**	**39 156.0**	**52.8**	**100.0**

Source: MoF SR

The long-term debt (maturity over one year) as of 30.6.2014 was 100% of the total debt. Since 2011, it was not necessary to use short-term funds to cover the state debt. Treasury Bills were only used as a reserve and a tool for "fine tuning" of the state cash flow.

Short-term and long-term state debt (in EUR million)						
	As of 31.12.2011	As of 31.12.2012	As of 31.12.2013	As of 30.6.2014	% of GDP 31.12.2013	% of total 31.12.2013
Short-term	1 136.9	1 316.0	11.5	0.0	0.0	0.0
Long-term	27 433.7	34 532.1	38 060.9	39 156.0	52.8	100.0
State debt in nominal value	**28 570.6**	**35 848.1**	**38 072.4**	**39 156.0**	**52.8**	**100.0**

Source: MoF SR

1.3. Risks in the current debt portfolio

Development in the financial market in the last few years resulted in reduction or even suspension of investments in the debt of particular euro area countries (Greece, Ireland and others) from the side of some investors and seeking other investment opportunities. Slovakia, with the stable banking sector and good fundamentals of the economy, was a very good candidate for investments, as the Slovak interest rates were higher than in all the "core" Eurozone countries. Seeking of the higher interest rates, the investors were willing to invest in maturities until then for Slovakia unavailable due to too high interest costs or the inability to place the adequate nominal value of the new issue. This situation enabled Slovakia to issue bonds with maturities longer than 10 years at relatively good interest rates. Consequently, the debt portfolio´s risk parameters have moved far away into the smaller risk area at the same, stable costs. In the future this portfolio composition will enable to maintain longer approximately the same relative costs (if abstracting from debt increasing) and portfolio risk parameters in case of interest rates hike on the financial market.

Furthermore, through its diversification efforts Slovakia showed its ability to be open towards the other capital markets, for example in 2012 Swiss, American one, and as the first country also the Czech market. In 2013 it applied to the Japanese market and in 2014 the Norwegian market.

Issuance of bonds in international capital markets implies a need for hedging the risks arising from such issues by derivative transactions (mainly CC IRS). Due to the relatively long maturity of the derivative transactions, which corresponds to the maturity of the bonds issued, there is a prerequisite for a robust legal documentation (ISDA contracts), which "treats" such operations in case one of the counterparties fail. Counterparty´s credit risk arising from a change in the derivative´s market value is significantly reduced by collateralization whose rules are defined in the Annex (CSA) to the ISDA agreement. Such comprehensive documentation is currently a market standard.

The derivative portfolio and the related collateral management bring more personal, procedural and system requirements. As collateral there is commonly used cash in EUR - the counterparty´s account balance, for which the current market value of the derivative is negative. The received collateral is a commitment to the counterparty and becomes part of the government debt.

2. Macroeconomic framework and fiscal outlook

The world economy has been undergoing a fragile recovery after the most severe economic crisis since the Great depression in 1930s. The situation on financial markets has stabilised mostly since the end of 2011 after the central banks´ strong verbal and non-verbal actions. Economies of most countries, Slovakia included, have recorded substantial drop in interest rates and overall improvement in debt management conditions. This development has also influenced the macroeconomic and fiscal environment in Slovakia and has affected debt management in the period of the Government debt management strategy for the years 2011 to 2014. The ongoing economic recovery is expected to continue in the following years, as well as the gradual increase in interest rates from their~~s~~ historical lows. This will impact the economy and debt management in the next years, in the horizon of new Government debt management strategy for the years 2015 to 2018.

2.1. Financial markets development and macroeconomic framework

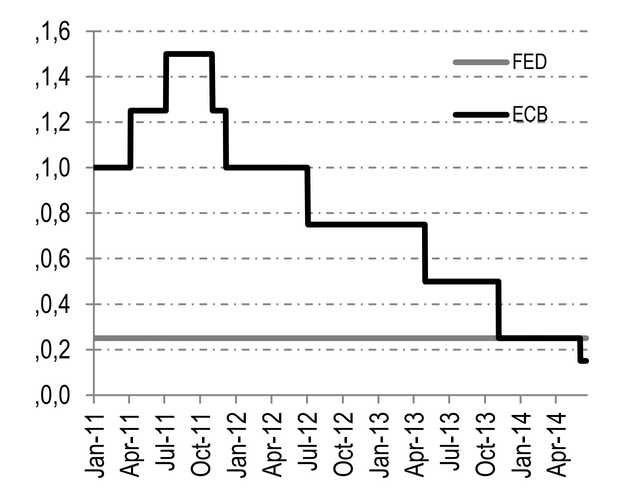
The period of the previous Strategy had been affected by economic recovery after the crisis and by effort of central banks to start economic growth through unprecedently loose monetary policy. The key rates of major central banks remained on record lows and the same applied to the interbank money market rates. The stock markets recovered relatively sharply and most major stock indices breached their historical or long time highs. The situation on the bond market calmed significantly down too, with decline in yields through whole market, from corporate to government bonds, from core euro area to periphery countries in the south of Europe.

The US FED was keeping loose monetary policy in the years 2011 to 2014. Its key rate remained at historic low at 0.25% p.a. The FED also continued using unconventional monetary instruments. The second round of quantitative easing (QE), where government bonds of total value estimated at USD 600 billion had been bought by FED, ended in the first half of 2011. The third round of easing (announced in September 2012) did not have a specified period in which it would be conducted. The total monthly asset purchases (US government bonds and mortgage backed securities) was raised to USD 85 billion from initial USD 40 billion in December 2012. They started to decrease at the beginning of 2014 and it is expected that the FED will fully end its purchases till the end of 2014. The gradual interest rate hikes are expected throughout the 2015.

After short-term increase in key interest rate from 1% p.a. to 1.5% p.a. in 2011, the ECB continued its course of monetary policy easing, following FED. All interest rates were subsequently (last time in June 2014) reduced to a record low. Currently, the key interest rate is at 0.15% p.a. and deposit facility rate at -0.1% p.a. An unprecedented reduction of deposit facility rate into a negative territory should promote bank lending. The ECB continued supporting Eurozone economies by conducting the long-term refinancing operations (LTRO) and by verbal interventions. These low interest rate loans were provided by the ECB for the period of 36 months in 2011 (EUR 489.2 billion) and in 2012 (EUR 529.5 billion). In 2012, President of the ECB (Mario Draghi) promised an immediate purchasing of endangered countries' bonds. Draghi's statements had helped to calm investors' mood and also eliminated the risk of a Eurozone collapse. The new LTRO programme will be launched in the second period of 2014. Its aim is to provide private loan support for non-financial sector. Generally, the ECB is expected to keep flat interest rates.

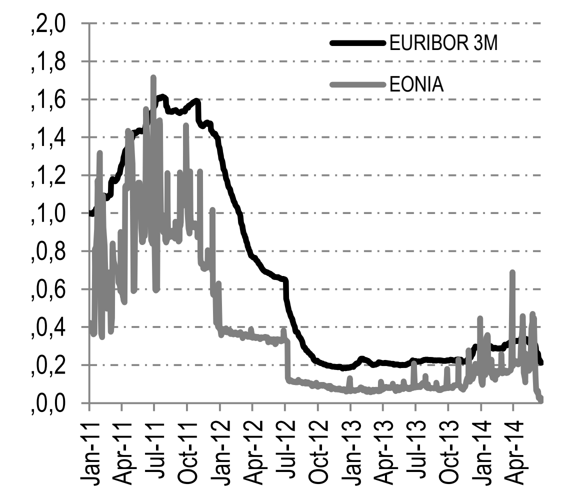
Interbank rates have largely copied the development of ECB's rates until mid-2012, when they sharply plummeted. From the end of 2012 interbank, interbank rates have remained low, but with increased volatility since Q4 2013. The last ECB's rate cut has moved one day interbank rates almost to zero and has contributed to further lowering of three-month Euribor to 0.2% p.a. Moreover, interbank rates are expected to stay at low level and they start to rise in line with the increase of central banks' rates.

Central bank's key rates (% p. a.)



Source: Bloomberg

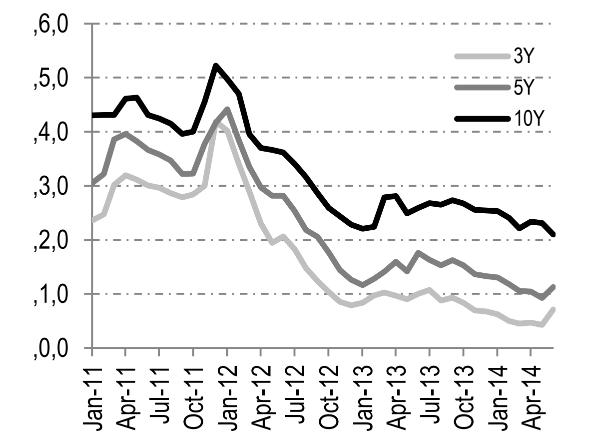
Interbank interest rates (% p. a.)



Source: Bloomberg

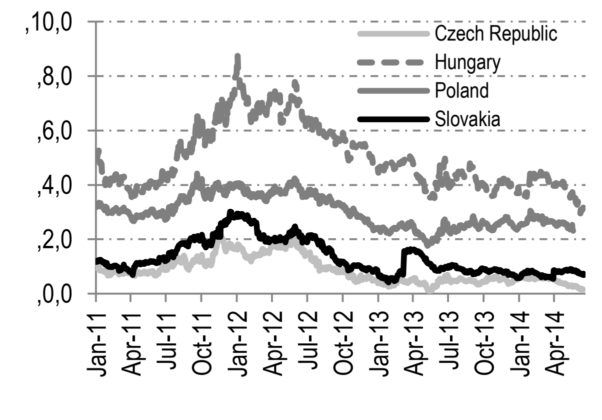
Stabilisation of European markets, low interest rates and liquidity injections from the central banks has reduced yields on Slovak bonds to historical lows. The yields on three-year bonds are currently below 0.5% p.a. and 10-year bonds yields are below 2% p.a. Spreads toward benchmark German Bunds had been decreasing alongside the former strategy horizon and substantially approached the spreads of Czech Republic bonds. In the following years it is possible to expect continual flattening of the yield curve through steeper increase in yields of short-term maturities and only slight yield increase in long-term maturities.

Slovak Government Bond yields (% p.a.)



Source: Bloomberg

Spreads on 10Y Government Bonds of V4 countries against German Bunds (p.p.)



Source: Bloomberg

After the 2009 crisis the Slovak economy experienced a significant recovery. Slovakia has been one of the fastest growing economies in Europe. However, domestic demand remained subdued and the GDP growth was driven mainly by foreign demand. The debt crisis in the Eurozone led to a recession and the growth of the Slovak economy slowed down to 1.8% in 2012 and 0.9% in 2013. However, 2013 also brought some positive news, when the domestic demand started contributing to GDP growth after four years. Unemployment rate peaked in 2013 at 14.2% and is gradually declining. With the continuing recovery abroad, the Slovak GDP growth is accelerating again and brings new jobs as well. Inflation, however, started significantly decelerating and in the first half of 2014 prices even declined.

Slovak economy should accelerate in 2014 to 2.4%. In the following years the growth should accelerate further with a more balanced structure. Increasing foreign demand will lead to higher exports which will continue to gain foreign market shares. Domestic consumption will reflect the labour market recovery, as well as increased purchasing power due to slower price growth. Economic growth will push the unemployment rate below 14%. In the following years the employment growth will further accelerate. Real wages will grow the fastest since 2008 in 2014 due to falling inflation. In the following years their dynamic be will slightly weaker and they will be following the growth of labour productivity.

MoF SR forecast – main economic indicators (June 2014)						
Indicator (%)	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
GDP, real growth	1,8	0,9	2,4	3,0	3,5	3,5
Employment (LFS), growth	0,6	0,0	0,6	0,7	0,9	1,1
Unemployment rate (LFS)	14,0	14,2	13,7	13,1	12,3	11,3
Real wages, growth	-1,2	0,9	2,8	1,7	2,0	2,3
Average annual inflation (HICP)	3,7	1,5	0,3	1,6	2,1	2,3
Current account (% of GDP)	2,2	2,1	2,3	3,1	4,3	5,7

source: MoF SR

2.2. The fiscal outlook

The consolidation of the public finances has been conducted in line with government's plan which resulted in the exit from Excessive Deficit Procedure in June 2014. The general government budget deficit declined from 4.5% GDP in 2012 to 2.8% GDP in 2013. The fiscal target for 2014 is at 2.6% of GDP. The main medium-term objective is to create favourable conditions so as to achieve long-term sustainability of public finances. This requires the further consolidation of public finances after 2013, so that Slovakia remains on a trajectory towards its medium-term budgetary objective[2].

The Draft Budgetary Plan for 2015 – 2017 sets main fiscal targets for the following years at 2.5% of GDP in 2015. In 2016 the deficit is expected to decline to 1.4% of GDP and in 2017 to 0.4% of GDP.

From the perspective of the debt management strategy it is crucial that such development of fiscal policy enables to maintain the ratio of the government gross debt to GDP at 55.4% of GDP. Meeting budgetary targets will ensure the debt to GDP ratio will remain at this level both in 2014 and 2015. Yet, in nominal terms, the gross debt is expected to grow. The gross debt forecast in the draft budgetary plan is draft in ESA 95 methodology and does not contain the new ESA 2010 methodology-related effects.

The general government gross debt and budget balance (ESA 95, % GDP)							
	2012	**2013**	**2014**	**2014F**	**2015 F**	**2016 F**	**2017 F**
General government budget balance	-4.5	-2.8	-2.6	-2.8	-2.5	-1.4	-0.4
General government gross debt	52.7	55.4	56.5	55.4	55.4	53.4	51.4
State debt (net of EFSF and ESM)	48.4	50.6	51.7	49.7	50.0	48.3	46.7

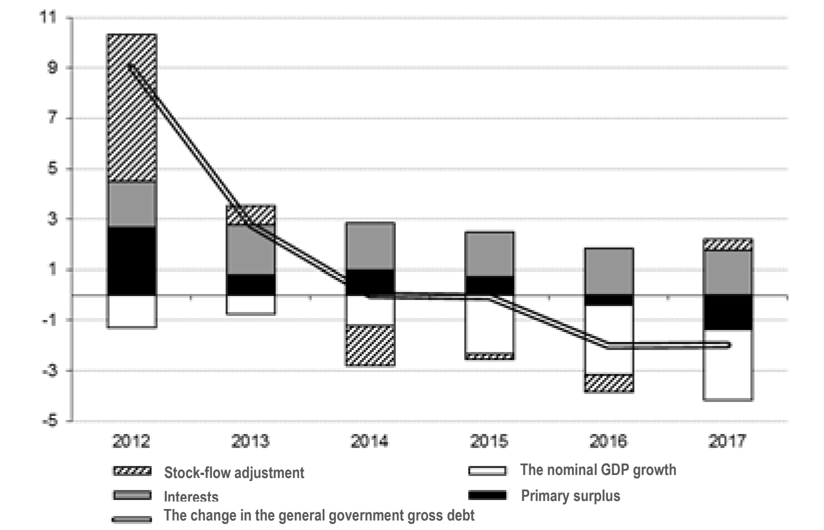
Source: MoF SR

The analytical perspective on the contributions to the debt development indicates that the debt increase is due to the budget deficits and international liabilities within the EFSF and ESM mechanisms. In the light of the ongoing fiscal consolidation, the primary surplus is expected since 2016, which means that the general government budget balance net of interest payments will have a downward effect on the debt level.

The contribution of the stock – flow adjustment to the debt change in the forecast period will be influenced by the developments of State Treasury funds and the difference between cash and accrual recording of the general government budget balance. The planned privatisation in the amount of 1.3% of GDP is expected to have a significant cash impact, hence lowering the debt levels without affecting the budget balance. The stock – flow adjustment is also affected by the Slovakia's contribution to the EFSF's debt – in 2013 the debt level increased by 0.6% of GDP, while in 2014 additional 0.2% of GDP is expected. **The main factor causing the debt to GDP ratio decline is the nominal GDP growth which will more than offset other negative effects.**

[2] The medium budgetary objective of Slovakia is structural deficit of 0.5% of GDP which should be achieved in 2017 according to the Stability Programme 2014 - 2017.

Contributions to the change in the gross government debt (p. p.)



Source: MoF SR

3. Strategic targets for state debt management in the years 2015 to 2018

The main objective of the state debt management is to ensure the government's ability to fulfil its obligations and ensure a reliable refinancing through the capital markets at a reasonable cost and acceptable risks. The targets formulated in the strategy for the years 2015 to 2018 are in line with the objectives of the previous strategies. In the previous period the setup of the state debt and liquidity management objectives was appropriate for the economy conditions and sufficient for the debt management system in the Slovak Republic. The present Strategy only slightly modifies the quantitative aims for risk management and adjusts targets regarding the investor base diversification and improvement of the state debt infrastructure.

The ability to achieve the targets pursued is contingent on compliance with the following three main general principles:

Principle One: *Any debt increase must be transparent and subject to clear rules. Any uncontrolled and uncontrollable debt increase must be avoided.*

Principle Two: *In the process of active debt management, the medium and long-term targets should be preferred over short-term savings. Short-term "savings" may not be at the expense of future cost increase or higher risk of additional expenses.*

Principle Three: *The debt management should be based on the optimum risk principle. It means that the active debt management should quantify and take due account of the differential between the potential cost increase attributable to the uncontrolled risk and the cost of eliminating such risk.*

1. <u>Standardised properties of new issues of governments securities</u>

Since the euro adoption the Slovak Republic has issued bonds with standard attributes. The standard size for the benchmark bond issue is EUR 3 billion (in nominal value). Except for the size of the bond issue, which is more dependent on the country´s size, its debt and cash flows, all other characteristics of the bonds are consistent with the capital markets of the euro area (including the mandatory part of "Collective Action Clauses"). If the situation on the financial markets allows (in the form of a favourable yield), the issuer will effort to issue a bond with a maturity of 30 years (for pricing long-term financial assets and liabilities of the Slovak entities). In addition, the execution buy-back operations of Government Bonds and Treasury Bills will continue with the aim of maintaining cash reserves (with respect to the Fiscal Responsibility Act) for a sufficiently long time and also eliminate fluctuations in cash flows due to particular sizes due benchmark bond issues.

2. <u>To optimise structure of non-marketable debt</u>

Consolidation of the share of non-marketable debt has already been done. The acceptance of new loans will only be considered in situations where the loans are more advantageous than, or comparable to, the issue of a security (Government Bond) or if it brings additional or other side benefits for the country.

3. <u>Compliance with the parameters of the refinancing, interest rate and foreign currency risk</u>

Also in the future it will be necessary to continue monitoring the refinancing and interest rate risk with slightly modified parameters. In the previous period (2011 – 2014) there were unified types of indicators for monitoring the risk of cumulative maturity and debt revaluation (at slightly higher levels compared to the Strategy for 2007-2010). The experience of the past crisis years, as well as recommendations of investors, banks and rating companies in particular, resulted in a slight modification (tightening) parameters for refinancing and revaluation of the state´s financial obligations. For the refinancing risk the strategic target focuses on maintaining the level of the due state debt in the first year close to 20% of the total state debt. In case of re-fixing risk the aim is to maintain the level of the re-fixed state debt near 25% of the total state debt. The values of due and re-fixed state debt on cumulative basis for next five years should be maintained close to 55% of the total state debt. Compliance with the given targets shifts the state debt portfolio, compared to the previous period, into a smaller risk area, in terms of both refinancing and interest rates, however it is inherently linked to the relative increase in costs. The ability to maintain these ratios is based on the assumption of standard conditions on the financial markets and presupposes standard macroeconomic and fiscal development of the Slovak economy within the Eurozone. Maintaining the values of the portfolio also in case of non-standard conditions can lead to increase in debt service costs.

The different parameters for the refinancing risk and the interest rate risk result from the assumption that the management of the refinancing risk is preferred to the re-fixing risk. Reduction of refinancing risk in case of the normal shape yield curve is associated with a slight and gradual increase in the total debt service interest costs. The aim of the active debt management through the issuing policy and financial instruments will be to regulate and partially offset thus raised interest costs. Different values of the risk parameters open the way for active management of interest rate risk and optimize the government debt cost in the current budgetary year.

The limit value of the state debt´s foreign currency risk has been tightened compared to the previous strategy. The open unsecured foreign currency position of the state debt can temporarily reach maximum 3% of the total state debt.

4. Investor base diversification

In view of fiscal consolidation and the assumed decline in yearly structural budget deficit it will be probably not necessary to increase significantly the share of foreign investors. However, there still remains a need to continue in communication between the issuer and investors, rating agencies and other financial institutions and through ~~a~~ regular meetings and investor conferences with the aim to present the issuer´s results and objectives. Promotion of Slovakia requires having information and presentation meetings with existing and potential investors in state debt along with keeping the positions that Slovakia has gained in foreign markets (mainly USD) by both regular visits of the investors and other new issues of bonds, whenever it is appropriate and necessary.

5. Enhancement of infrastructure for the state debt management (secondary market, improvement of the state securities settlement)

In order to improve the liquidity of government securities on the secondary market, it is necessary to put in place at least one electronic platform accessible to all primary dealers (PDs), where the all PDs will be obliged to quote benchmark issues of the Slovak Government Bonds. For foreign investors, it is necessary to ensure internationally standard conditions of Slovak government securities settlement (in the Slovak Central Depository or ICSD).

4. Conclusion

The Government debt management strategy for the years 2015 - 2018 is a strategic document of the Government of the Slovak Republic which sets the basic rules for the government debt management over the next four years. The purpose of these rules is to maintain optimal management of the government debt at acceptable and controlled market and other financial and non-financial risks, to minimize the costs associated with the management of the government debt in the medium and long term. The Strategy's targets were prepared by using Slovak and European best practices and experience gained during the financial, economic and debt crisis and knowledge of financial markets development in the past years. Objectives and criteria of the Strategy were designed assuming a standard functioning of financial markets and its future modification in case of significant and unforeseen changes in the financial markets cannot be excluded. The strategy was discussed within the Advisory Committee for Debt and Liquidity Management in the Ministry of Finance.

Practical implementation of the Strategy will be necessary in issuing policy considering existing constitutional law on fiscal responsibility, particularly in the management of the state´s cash reserves. The aim will be to optimise the size of the reserve with respect to expected state´s cash flows and outlook for financial markets. The costs of debt management and liquidity management effectiveness will be positively influenced by the projected increase in the State Treasury balance. Reliably functioning State Treasury System was in the past times of crisis one of the key factors that positively influenced the results of the state debt and liquidity management effectiveness.

Annex - Management of the state debt's financial risks

The state debt management is based on a system which sets the target risk values (or limits) and ensures their observance or approximation thereto. This determines the expenditures connected with the debt service. The most important risks of the state debt include:

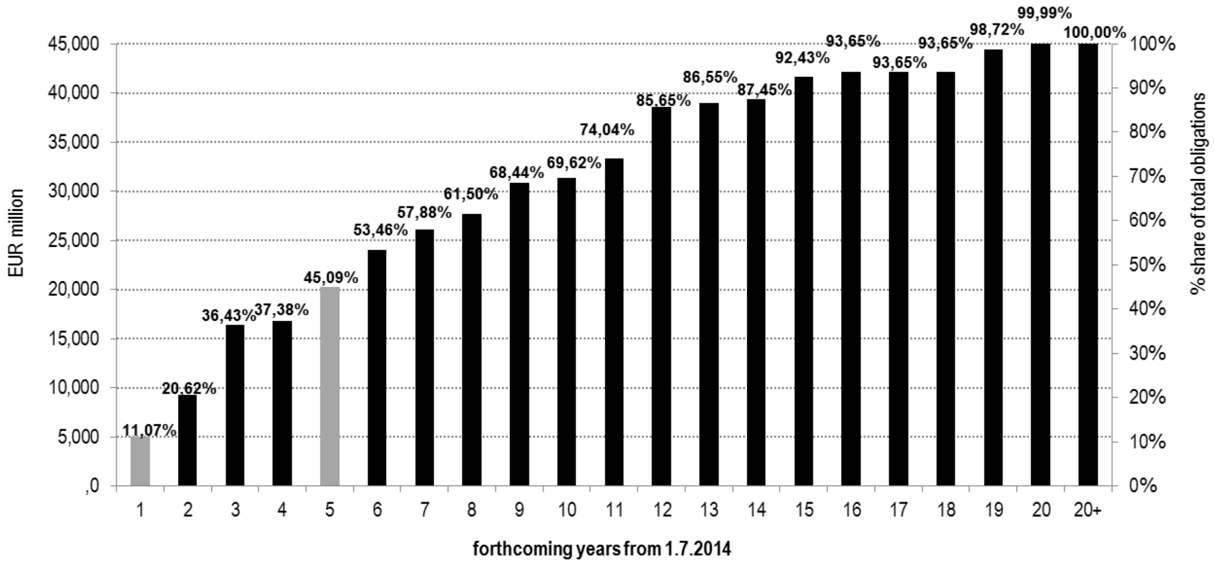
REFINANCING RISK

The refinancing risk represents the possible loss of the government's ability to refinance itself and discharge its maturing obligations, or an ability to discharge such obligations only through emergency operations, most likely at a much higher cost than usual. The risk also arises from the uncertainty as to whether the financial markets are willing to fully carry out the required transactions. This risk is monitored by the indicators of cumulative maturity, i.e. the total of all maturing obligations during the set period of time.

- Indicator of cumulative maturity within one year
- Indicator of cumulative maturity within five years

The strategic objective for 2015 - 2018 is to maintain the ratio of the sum of all maturing debts within one year to the total financial obligations as close as possible to 20%, and the ratio of the sum of all maturing debts within five years to the total financial obligations as close as possible to 55%. The ability to maintain these parameters is based on the assumption of standard conditions on the financial markets and presupposes standard macroeconomic and fiscal development of the Slovak economy in the Eurozone. In case of the non-standard conditions the parameters can only be maintained through substantial increases in the cost of debt service.

Cumulative refinancing risk in the forthcoming years (%, as of 30.6.2014)



Source: ARDAL

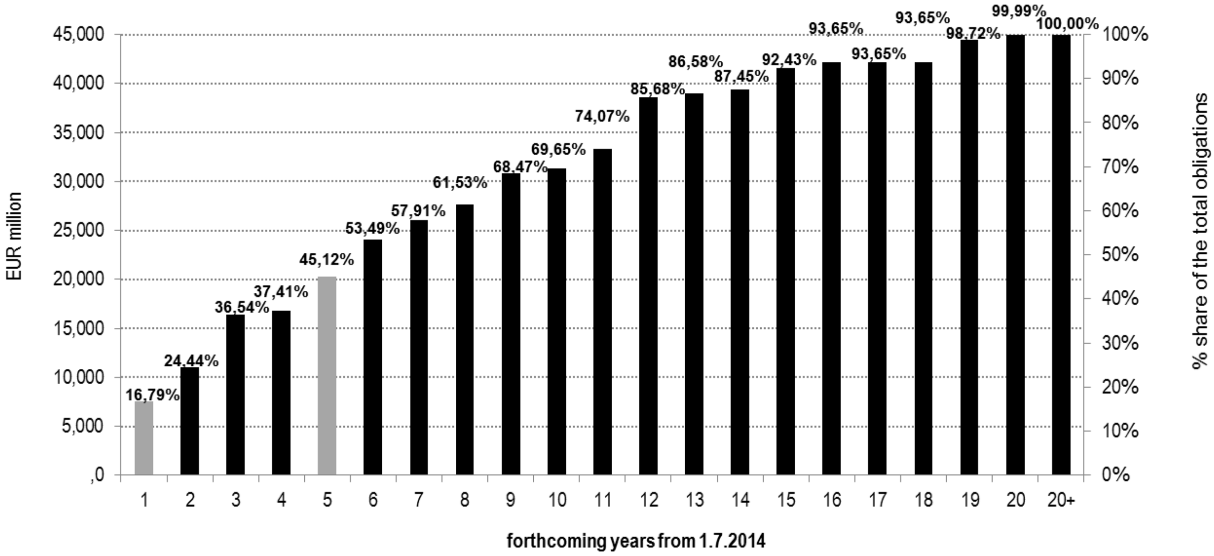
RE-FIXING RISK

The re-fixing risk represents the risk of a change in expenditures connected with the state debt portfolio as a consequence of market rate changes. The debt re-fixing indicators, that are the basis on which the type of risk is managed, indicate the degree to which expenditures may rise (decline) as a consequence of unfavourable (favourable) movement of interest rates. As a secondary indicator, the development of the overall debt portfolio duration is also monitored.

- The debt re-fixing indicator within one year
- The debt re-fixing indicator within five years

Similarly as in the case of the refinancing risk, the strategic objective is to maintain the ratio of the sum of the re-fixed debt within one year to the total financial obligations as close as possible to 25%, and the ratio of the sum of the re-fixed debt within five years to the total financial obligations as close as possible to 55%. Likewise, the ability to meet these parameters assumes the existence of standard conditions on the financial markets, in the economy and in the government's fiscal position.

Cumulative re-fixing risk in the forthcoming years (%, as of 30.6.2014)



Source: ARDAL

EXCHANGE RATE RISK

The exchange rate risk represents the risk of loss caused by a change in the exchange rates of other currencies and impact thereof on government assets and liabilities. With a view to the activities performed by the Agency on behalf of the MoF, this type of risk may only arise in situations where the foreign currency accepted to finance government obligations has been converted into EUR without hedging.

- Indicator of the open unsecured foreign-currency position of the government's financial obligations

The favourable market conditions will endeavour to diversify debt portfolio also in terms of its currency structure. The strategic objective of the government will be to keep a closed – fully hedged foreign currency position in the government's financial obligations. Open unsecured foreign currency position in the government's financial obligations can temporarily reach maximum 3 % of the total financial obligations.

CREDIT RISK

The credit risk represents the risk of loss caused by the default of the borrower or another party in fulfilling their obligations under the agreed terms and conditions. The credit risk also includes the risk of another state (for example, if its authorities or central bank are unable or unwilling to discharge their international obligations and other borrowers cease to be able to discharge their obligations by virtue of being residents of that state), the concentration risk, the counterparty risk, or the settlement risk in situations when a financial transaction is not settled in accordance with the agreed terms and conditions. The credit risk is managed through limits which represent the maximum value of funds deposited at any given point in time with a particular counterparty, be it a state, a banking group or a specific bank. The limits are set and their observance is controlled in line with the internal MoF regulations.

The principle for the setting and the control of compliance with these limits is based on the external ratings by the most renowned independent rating agencies (Moody's, S&P and Fitch). There is a system in place for the continuous control of compliance with credit limits on individual counterparties. In spite of the numerous objections one can have to the reliability of external ratings, their use in the financial world of today represents the only possibility of obtaining information on the financial soundness and credibility of counterparties. In line with the principle of prudency, apart from using the ratings, the Agency continuously monitors the situation on financial markets, evaluates all available market information (e.g. credit default spreads) and/or uses its own rating and scoring systems to evaluate the creditworthiness of individual parties.