State debt management strategy for the years 2011 to 2014

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Introduction

The 2011-2014 State Debt Management Strategy has been prepared against the backdrop of turbulent developments on the financial markets and in the real economy. The global economy has not yet overcome one of its gravest crises in decades and Slovakia, being a small and open economy, could not avoid its ramifications. On a more positive note, the Slovak economy has the fastest growth rates in the EU.

This unfavourable macroeconomic development has had an adverse impact on the deficit of the state budget which, in turn, posed new challenges for the state debt management. In the past two years, the general government debt in Slovakia increased by more than 15% of GDP. At the same time, the government resorted less transparent ways of borrowing (PPP projects, railways, hospitals, and the like). Apart from the increased demand for refinancing, the state debt management was also influenced by changes in the sentiment of investors who, in crisis times, prefer safe investments to risk margins. The Slovak bond spread above the reference rate increased and the investors began to prefer short-term maturities. Although the steep decline in short-term interest rates reduced the overall interest cost, this development also impaired the parameters and increased the risk potential of the state debt portfolio for the future. This is why the new government set itself the ambitious goal to reduce general government deficit as from the first year of its term of office and bring it below 3% of GDP in 2013. Hence, the general government debt should culminate in 2012 at 47% of GDP and decline thereafter. After having announced its consolidation plan at the end of 2010, Slovakia managed to secure financing with a maturity of up to 15 years, which was quite an exception in the region. Against the rise of the sovereign risk margins in a number of Eurozone members, including Spain, Italy and Belgium, the Slovak sovereign risk margin followed a slightly downward trend, which indicates that the investors perceive Slovakia at least as one of the "semicore" Eurozone members.

The state debt management remains 'business as usual'. There is no need to resort to the less traditional forms of refinancing or change the orientation of debt management any significantly. Practically the whole of Slovakia's debt is denominated in EUR, the Slovak banking sector has more deposits than loans, and the private debt is below the benchmark level for comparable EU economies.

The proposed 2011–2014 Debt Management Strategy builds on the previous Strategy, since the developments in the past years showed that the 2007-2010 state debt management targets were appropriate in the Slovak economic framework and, in terms of risk, the debt management system in place had been able to flag well in advance any changes in the debt portfolio structure. The targets set out in the present Strategy are thus in line with the previous targets. The new Strategy slightly modifies and defines more specifically the quantitative targets for risk management and for the optimisation of the structure of non-marketable debt, introduces a limit for the foreign currency risk, and introduces targets for the diversification of the investor base and for improvements in the state debt management infrastructure. Under the Strategy, non-transparent debt increases need to be avoided.

The Strategy has been discussed within the Advisory Committee for Debt Management and Liquidity at the Ministry of Finance of the Slovak Republic (MoF).

1. State debt management and development in 2007-2010

1.1. Evaluation of the 2007-2010 State Debt Management Strategy

The 2007–2010 State Debt Management Strategy built up on the previous strategy and preserved the main targets, namely to provide liquidity and access to the market for the state debt financing in a transparent, prudent and cost-efficient manner, as long as the risks remain within acceptable limits. The ability to achieve this target was 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 increases 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.*

Meeting of the partial targets:

1 – Reducing the number of issues of new government securities and introducing a standard volume per issue

From the beginning of 2007 until the end of 2010, nine new issues were placed on the domestic market and two syndicated issues were sold internationally. During the same period, twelve issues (including one international) were redeemed. As of 31.12.2010, the MoF had a total of 26 "live" issues (including four registered abroad). The securities were issued at standard nominal value of SKK 40 billion per issue. On Slovakia's accession to the Eurozone, the nominal value of new issues was set to EUR 1–2 billion, while the new benchmark issues available as of 2010 have a nominal value of EUR 3 billion.

All securities issued (Government Bonds and, from 2009, also Treasury Bills) meet the criterion of acceptability of assets by the European Central Bank (EC) and, as such, may be used in direct ECB/NBS operations as a security in the monetary policy operations.

2 – Enhancing the transparency in the issuer's objectives (MoF) and improving its communication with investors and financial markets

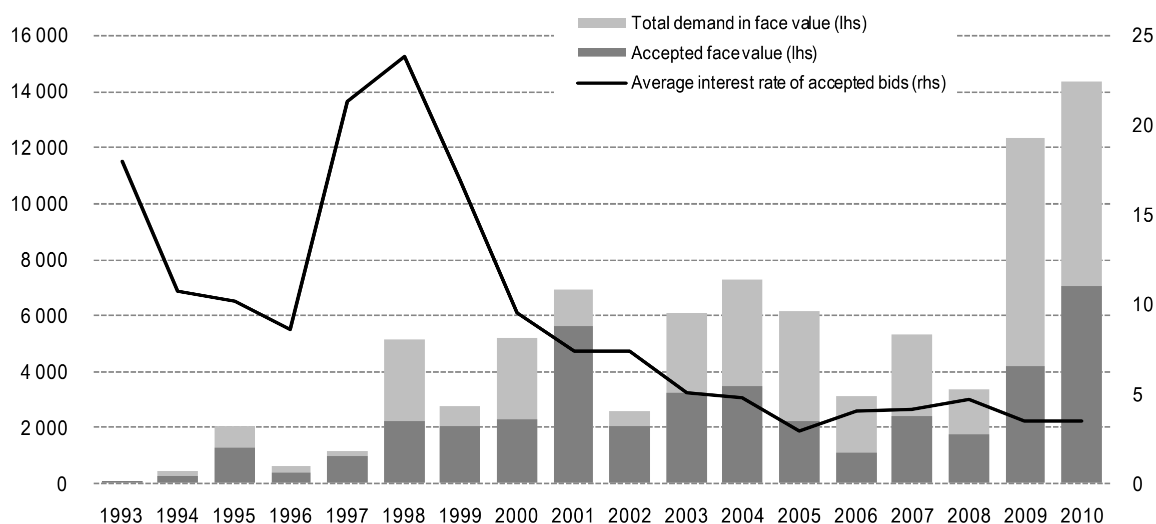
At regular interactive meetings with auction participants and investors, the Debt and Liquidity Management Agency ("ARDAL" or "Agency"), representing the issuer, provides information on the issuer's objectives for both the primary and secondary security markets. The evaluation of the sale of government securities in the previous period is one of the points on the meetings' agenda.

The first Strategy (2003 to 2006) put in place a standard procedure for the regular publication of a timetable of the issues and auctions in the respective budgetary year. The Agency continued to apply the standard also after 2007 and, every year in December, published the securities issue plan and a binding timetable for the issuance of government securities for the next year. In its capacity as representative of the issuer, the Agency acquired profound knowledge of the type and scope of information required by investors and banks. In connection with the introduction of the standard system for the provision of information to investors, as well as in the interest of making Slovakia more attractive to potential investors, the Agency revamped the design of its Internet site. In addition to the information concerning the state debt, the website also contains information on the sovereign debt rating and selected macroeconomic information. The Agency sends to the investors and puts on its website monthly reports on the activities relating to the management of the state debt and liquidity.

3 – Optimising the cost (expenditures) incurred by the state budget in connection with debt service

The overall average interest rate on the newly issued Government Bonds on the domestic market reached 4.16% p.a. in 2007, 4.65% p.a. in 2008, 3.47% p.a. in 2009, and 3.46 % p.a. in 2010. The overall average interest rate in the portfolio of outstanding Government Bonds, including those issued internationally, decreased from 4.84% p.a. in 2006 to 4.038% p.a. in 2009 and stood at 3.76 % p.a. as of 31.12.2010.

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



Source: ARDAL

In the period of 2007–2009, the Agency strived actively to reduce the share of non-marketable debt, taking into account the relevant financial conditions. In situations where the commercial and financial conditions of a non-liquid or hardly-liquid debt (government loans, debentures or other liabilities) provided for debt prepayment or amendment of the underlying financial terms and conditions, the Agency proceeded with the prepayment or amendment of the respective loan agreements.

In the course of 2007–2009, four government loans from domestic banks were prepaid and, in the case of two government loans, the terms and conditions were amended, which resulted in the total saving of approximately EUR 2.73 million (SKK 82.3m). In calculating the savings attributable to loan prepayment, the interest expense of the loans was compared with the interest rate applicable to the primary issues of government bonds in individual years. In the second instance, i.e. amendment of the terms and conditions, the interest expense was compared with the cost recalculated using the applicable reference interest rate without margin and using the rates quoted in the projections of the Financial Policy Institute at the MoF.

4 – Maintaining the average maturity and duration of the portfolio of government securities

The 2007-2010 Strategy introduced certain changes in the indicators of duration and average maturity of the portfolio of government securities. Based on these indicators, the portfolio's refinancing and refixing risks were monitored and assessed. In the new Strategy, the indicators have been replaced by a new system of risk monitoring and evaluation, similar to that used by other debt management agencies in the Eurozone.

The second Strategy (for 2007 to 2010) set the limit of cumulative maturity and the debt refixing limit with interest for one year, as well as the limit of cumulative maturity and the debt refixing limit with interest for five years. All these limits were set as percentages of the aggregate state debt. The average maturity and duration were monitored and evaluated as secondary values only.

The refinancing limits were set as follows:

- The cumulative maturity limit in the first year at 22.5% of the aggregate debt.

- The cumulative maturity limit for the next five years at 60% of the aggregate debt.

The refixing limits were set as follows:

- The refixing limit in the first year at 25% of the aggregate debt

- The refixing limit on a cumulative basis for five years at 65% of the aggregate debt.

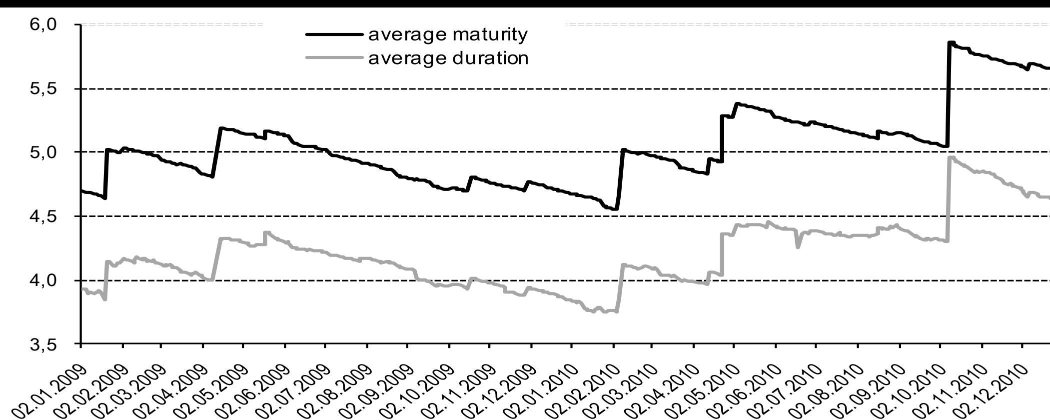
Indicators of the refinancing risk and refixing risk						
	Duration*	Average maturity*	Refinancing in the 1st year * (%, max. 22.5%)	Refinancing in 5 years* (%, max. 60%)	Interest change in the 1st year* (%, max. 25%)	Interest change in 5 years* (%, max. 65%)
4.Q 2006	3,1	4,1	23,3	60,8	45,9	63,6
1.Q 2007	3,4	4,3	31,1	63,0	46,1	64,5
2.Q 2007	3,9	4,8	22,0	62,3	36,2	63,7
3.Q 2007	3,8	4,7	21,3	60,6	35,8	62,8
4.Q 2007	3,4	4,3	19,1	59,5	33,9	61,7
1.Q 2008	3,5	4,2	18,6	59,4	27,2	61,7
2.Q 2008	3,2	3,9	22,4	59,5	29,1	61,9
3.Q 2008	3,4	4,2	22,8	58,9	30,7	61,0
4.Q 2008	3,4	4	21,4	57,9	29,5	59,9
1.Q 2009	3,5	4,1	30,3	65,8	39,5	69,4
2.Q 2009	3,9	4,6	21,4	62,1	30,7	65,3
3.Q 2009	3,8	4,5	23,7	63,6	33,6	67,8
4.Q 2009	3,5	4,2	24,6	62,9	34,7	67,7
1.Q 2010	4.3	3.5	29.7	74.5	37.8	75.1
2.Q 2010	4.8	4.1	25.4	67.2	33.1	67.8
3.Q 2010	4,5	3,9	25,9	66,6	32,8	66,7
4.Q 2010	5,4	4,5	18,0	58,2	25,4	58,3

** Entire portfolio (government bonds, treasury bills, loans, money market and the State Treasury)* *Source: ARDAL*

The table shows that the interest rate indicator represents the biggest challenge (a change in the interest rate that could trigger additional expenses on debt service). Although the indicator "Change of Interest Rate in the 1st Year" improved significantly after 2006 and neared the prescribed level just before the crisis, it has not been attained throughout the entire monitored period. The main reason is that Slovakia, through the refinancing system, uses the temporarily available funds in the State Treasury System.[1] In the course of the monitored (and evaluated) period, these funds accounted for up to 15% of the total state debt. Since these are short-term funds in accounting terms, their use for government financing had influenced, in particular, the indicators of maturity and interest change in the first year. The impact of these indicators can be quantified at about 7% in the case of the one-year indicators and at about 4% in the case of the five-years indicators (i.e. percentage by which the indicators would have been better had these funds been replaced by a bond issue with a maturity over five years).

On the other hand, it should be emphasised that even though these are short-term funds in accounting terms, their outlay from the State Treasury System can be gradual, as opposed to spasmodic. Moreover, this short-term financing in the times of crisis had a positive impact on the government budget expenditure because it carried historically the lowest interest rates.

Average maturity (years) and duration (years) of the state debt in years 2009 and 2010



Source: ARDAL

[1] State Treasury funds are not taken into account when calculating the state and general government debt, however, for the sake of prudency, they are considered in the calculation of risk indicators.

The development of the indicators of duration and average maturity confirms that the decision to introduce the refinancing and refixing risk limits was correct. The table shows continuous improvement of the strategic indicators in the pre-crisis period. The financial crisis and the investor's appetite for shorter maturities impaired the performance of these indicators (from 4Q 2008 onwards). In the first half of 2009, the debt duration increased and the cumulative maturity and the debt refixing risk indicators deteriorated. **However, improvements were largely attributable to the decline in interest rates rather than to the issue of bonds with longer maturities.**

It is fair to conclude that the new indicators are capable of flagging the potential risks much earlier than the indicators of debt duration and average maturity and, therefore, are more appropriate for strategic monitoring and decision-making.

5 – Gradual increase in the share of state debt in foreign currencies to the debt in Slovak currency

The Slovak Republic issued its benchmark bonds denominated in EUR in 2007 and 2009. No Slovak Eurobond was issued in 2008 due to the financial market crisis, impaired market conditions (mainly interest rates) and the collapse of one of the biggest investment banks – Lehman Brothers.

These partial targets were modified on Slovakia's accession to the European Monetary Union. Nevertheless, Slovakia remains determined to further diversify its investor base and become a reliable and stable issuer on the pan-European capital market so that it is perceived as one of the "safest" EU members by investors in Government Bonds.

1.2. Structure and development of the Slovak state debt

While the state debt in nominal terms increased only slightly in 2007 and 2008 (EUR 17.8 billion at the end of 2008), it rose quite considerably in 2009 to EUR 21 billion and surged to almost EUR 24 billion at the end of Q3 2010. The main factors behind the considerable debt increase include the economic crisis with its negative impact on the government deficit, outages in the tax and social security revenues, implementation of the countercyclical expensive fiscal policy, and depletion of the resources used to cover the debt within the refinancing system. The state debt to GDP ratio reached 36.6% as of 30.09.2010. Almost the entire debt is covered by government securities, which account for 96.2% of the total, while loans represent 3.5%.

State debt structure						
	mil. €, as of 31.12.2007	mil. €, as of 31.12.2008	mil. €, as of 31.12.2009	mil. €, as of 30.9.2010	% of GDP 30.9.2010	% of Total 30.9.2010
Government securities	16 104	16 614	20 366	22 942	35 ,2	96 ,2
Loans	1 198	1 037	913	839	1 ,3	3 ,5
Others	117	108	83	57	0 ,1	0 ,2
State debt in face value	**17 420**	**17 758**	**21 362**	**23 838**	**36 ,6**	**100 ,0**

Source: MF SR

In terms of currency, the pre-2008 state debt was denominated mainly in SKK and EUR. Since the adoption of the euro, the share of the EUR-denominated debt represents 99.7% of the total. The share of other currencies was negligible, representing barely 0.3% of the total.

Currency structure of the state debt						
	mil. €, as of 31.12.2007	mil. €, as of 31.12.2008	mil. €, as of 31.12.2009	mil. €, as of 30.9.2010	% of GDP 30.9.2010	% of Total 30.9.2010
SKK	12 662	13 483	0	0	0 ,0	0 ,0
EUR	4 683	4 189	21 287	23 759	36 ,5	99 ,7
USD	0	0	0	0	0 ,0	0 ,0
JPY	70	82	70	74	0 ,1	0 ,3
CZK	0	0	0	0	0 ,0	0 ,0
CHF	4	4	5	5	0 ,0	0 ,0
State debt in face value	**17 420**	**17 758**	**21 362**	**23 838**	**36 ,6**	**100 ,0**

Source: MF SR

From the territorial point of view, the domestic state debt (the lenders are residents) represented 64.6% of the total debt as of 30.09.2010, while foreign debt (the lenders are non-residents) accounted for 35.4%. For the most part, the state debt was financed by domestic entities (residents), mainly commercial banks and mutual funds.

Domestic and foreign state debt						
	mil. €, as of 31.12.2007	mil. €, as of 31.12.2008	mil. €, as of 31.12.2009	mil. €, as of 30.9.2010	% of GDP 30.9.2010	% of Total 30.9.2010
Domestic	10 382	10 551	13 594	15 389	23 ,6	64 ,6
Foreign	7 038	7 207	7 768	8 449	13 ,0	35 ,4
State debt in face value	**17 420**	**17 758**	**21 362**	**23 838**	**36 ,6**	**100 ,0**

Source: MF SR

In terms of tenor, the long-term debt (maturity over one year) stood just above 93% of the total. While there was no need to activate short-term debt financing in the course of 2007, the crisis caused the government to issue (first at the end of 2008 and then in 2009 and 2010) Treasury Bills, i.e. financial instruments with maturity up to one year.

Short-term and long-term state debt						
	mil. €, as of 31.12.2007	mil. €, as of 31.12.2008	mil. €, as of 31.12.2009	mil. €, as of 30.9.2010	% of GDP 30.9.2010	% of Total 30.9.2010
Short-term	118	848	1 024	1 647	2 ,5	6 ,9
Long-term	17 302	16 910	20 338	22 191	34 ,0	93 ,1
State debt in face value	**17 420**	**17 758**	**21 362**	**23 838**	**36 ,6**	**100 ,0**

Source: MF SR

1.3. Risks in the current debt portfolio

The recent developments on the global financial markets have made the state debt management in almost all European countries more challenging than ever before. As risk aversion grows, investors prefer short-term maturities and governments get in a more and more difficult position to issue bonds with maturities over five years under acceptable terms and conditions and in necessary volumes. In a situation like this, the debt coverage structure deteriorates and the refinancing and refixing risk limits tend to get exceeded. A growing share of the short-term debt may increase the refixing risk, particularly in times when interest rates mount in reaction to the anticipated recovery of the global economy.

The investor's aversion to the credit risk is accompanied by greater market volatility and the widening of spreads across all segments of the financial market (see chart in Chapter 2.1). Even if the financial market crisis is widely expected to subside, return to the pre-crisis levels of risk margins may take years. However, developments in certain countries are capable of escalating the risk of spread-widening. Moreover, in the effort to finance giant deficits caused by the crisis and the fiscal stimuli pumped into the economy, a number of countries will (at least) have to maintain the level of their bond issue programmes, which may, in turn, push the yields on the bond market further up.

Despite the unfavourable conditions on the financial markets, the level of the Slovak state debt remains relatively good. In line with projections, the gross state debt to GDP ratio reached 41.6% in 2010 (the general government debt estimate for 2010 is 43.4% GDP)[2] which, unlike in the case of other more heavily indebted countries, is not generating additional pressure on the debt service. A number of CEE countries had to either cancel or at least postpone their foreign bond issues, or issue their bonds at higher interest rates in an effort to procure financing to cover their current needs and discharge their current obligations. After having failed to market their bonds issues, Hungary and Latvia were forced to ask the International Monetary Fund and the World Bank for rescue. In contrast, Slovakia issued syndicated bonds worth EUR 2 billion and 1.5 billion in October and April, respectively, effectively replicating its successful international bond issue of EUR 2 billion in May 2009.

The current state debt structure in currency terms (see table in Chapter 1.2) suggest that there is a room for further diversification of the debt portfolio. Yet, any issue of government securities in foreign currencies depends on the extent to which such debt makes sense in terms lowering the cost of its service or reducing the risk of the entire portfolio (e.g. wider investor base, reduced refinancing risk, advantageous maturity, etc.). Yet, it always carries an exchange-rate risk.

Unlike its neighbours, Slovakia may benefit from the advantages afforded by its accession to the Eurozone. Also as a consequence of the financial and economic crisis, the rating agencies have thus far refrained from upgrading

[2] According to the draft General Government Budget for 2011-2013 (November 2010)

the country's rating which, had it taken place, would have most likely squeezed the risk margins payable on the government securities. Nonetheless, all renowned rating agencies – even amidst the crisis – confirmed a stable outlook for Slovakia (unlike in the case of other European countries). However, many investors trade in CEE securities based on a regional principle, without taking the pain of differentiating the credit risk of individual countries.

The relatively good position of Slovakia in its state debt refinancing is also attributable to the fact that Slovakia – in comparison with other countries – uses its State Treasury refinancing system to activate momentarily available funds to a much larger degree, which reduces budgetary expenditure on the debt service. These refinancing resources are relatively stable and well predictable. These factors need to be taken into account when interpreting the monitored benchmark criteria and their limits. The debt management system will soon become even more efficient upon completion of its infrastructure (which is underway), particularly through improvements in the payment system's conditions. Likewise, the day-to-day management of the debt portfolio by ARDAL will be further improved upon introduction of the system of primary dealers, use of brokers, and the so-called ISDA contracts which will provide legal framework for deals in financial derivatives.

2. Macroeconomic assumptions and fiscal outlook

The global economy has recently gone through one of the most turbulent periods in several decades. The current economic crisis is often referred to as one of the worst crises since the Great Depression of the 1930s. Its root causes originate in the U.S. mortgage market and – as intertwined as the financial markets and major global economies are – the crisis spilled over to other financial markets around the globe and, subsequently, contaminated the real economy. This development has had its ramifications for the macroeconomic and fiscal situation in Slovakia and influenced the state debt management under the *2007-2010 State Debt Management Strategy*. Since the overall economic recovery is expected to be feeble in the years to come, the consequences of the crisis are likely to influence the economy of Slovakia and its debt management also in the 2011-2014 period.

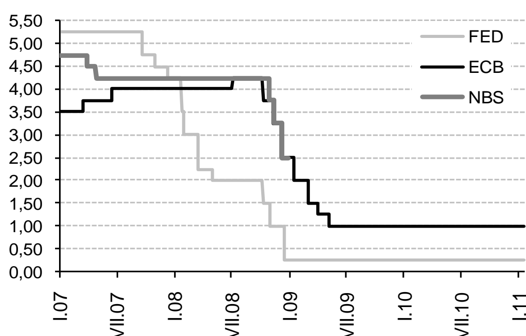
1.4. Financial market development and macroeconomic assumptions

The current economic crisis has its roots in the financial markets (particularly in the U.S.), due to gravely irresponsible borrowing, artificially curbed revaluation of the Chinese currency, unsustainable borrowing in the environment of low interest rates, invention of non-transparent financial vehicles, and insufficient regulation. The plummeting property prices, vast losses of financial institutions, aversion to risk, and liquidity crunch were amongst the first manifestations of the unfolding crisis. The central banks of individual countries reacted by quantitative easing, which went beyond the mere interest-rate cuts aimed at infusing liquidity and attenuating the anticipated recession.

The most radical central bank in the community of the developed countries was the U.S. FED which cut its interest rates in a single year by 5% p.a. to the all-time-low of 0.25% p.a. (January 2010). The monetary policy of the Central European Bank (ECB) followed suit when, several months later, ECB reduced its benchmark interest rate to 1% p.a. The basic interest rate of the National Bank of Slovakia (NBS) remained largely stable throughout the period of the previous Strategy and, in the last months of 2008, copied the ECB reductions in view of the monetary policy alignment prior to entry into the Eurozone. Upon Slovakia's entry into the Eurozone, the NBS ceased to pursue sovereign monetary policy (which now falls under the ECB remit). In the years to come (covered by the present Strategy), the central banks' rates are expected to pick up slightly in line with economic recovery.

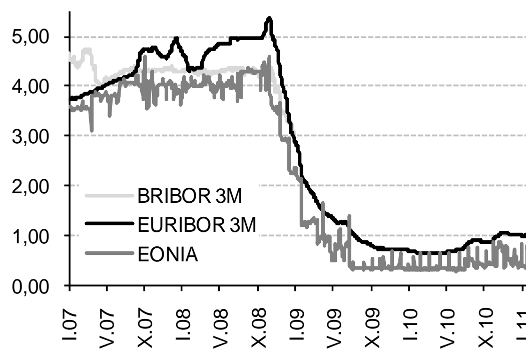
The interbank rates largely copied the central banks' benchmark rates. The interbank rates in the Eurozone had continued to rise approximately until the end of 2007. Subsequently, towards the end of 2007 and in the course of 2008, the unfolding crisis swayed the interest rates and shrivelled liquidity. However, their values, particularly in the second half of 2008, are more-or-less theoretical since the interbank market did not function in a standard mode and the banks took a restrictive stance on credit limits (reduced their credit limits quite substantially). The Interbank rates plummeted in 2009, bringing the 3-month Euribor rate close to 0.5% p.a., and picked up slightly in 2010. Similarly as in the case of central bank rates, we expect the interbank rates to continue to rise in the years to come.

Central bank key rates (% p.a.)



Source: Reuters

Interbank rates (% p.a.)

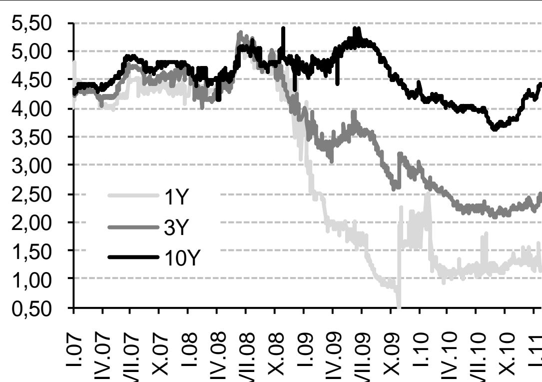


Source:Reuters

The current crisis has also affected the Slovak bond market. Until the end of 2008, the yield curve on Slovak government bonds remained relatively stable and even slightly declined. Influenced by the ECB monetary easing, the ensuing plunge in the short-term interest rates made the bonds' yield curve considerably steeper. While the yield on a one-year Slovak government bond contracted below 1% p.a., the yield on a ten-year bond remained above 3.5% p.a. In addition to the shrinking short-term rates, the demand side of the market showed clear preference for short-term maturities. This translated into the lower-than-expected cost of debt service, but increased the risk of the debt portfolio. **We expect the yield curve to flatten out gradually in the years to come, as the yields on shorter maturities increase more considerably than the yields on longer maturities.**

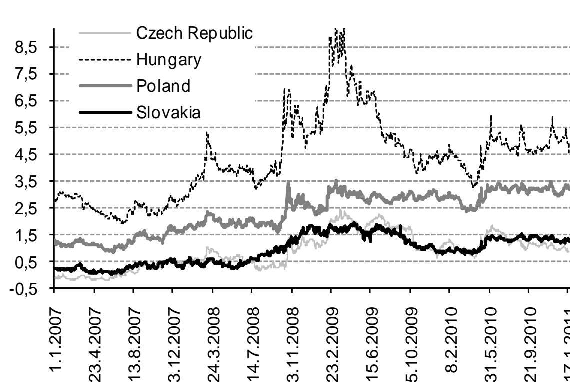
Although the absolute yields on a ten-year Slovak benchmark bond did not rise during the crisis, the growing risk aversion is obvious from the growing spreads of the German bund which, under normal circumstances, is considered the echelon of a risk-free investment. The spreads of the Slovak bonds in 2008 hiked to 2% from the 0.5% before the crisis and currently oscillate at around 1.25%. It is gratifying that, **instead of following the trend in the PIGGS countries (Portugal, Ireland, Italy, Greece and Spain) from the autumn of 2010, the Slovak risk spreads continued to shrink, albeit moderately. It is an indication of trust on financial markets in Slovakia's consolidation plan and the Eurozone membership.** In comparison to the neighbouring V4 countries, only the Czech bonds earn lower yields, while the Polish and Hungarian bonds stand well above the Slovakian spread. Although the risk spread may contract as the crisis fades away, **there is a higher risk of the German bund rates moving in the opposite direction. Their increase began to materialise in early 2011.**

Slovak government bond yields (% p.a.)



Source: Reuters

Spreads of 10-year government bonds of V4 countries vs. german bunds (% p.a.)



Source:Reuters

Instead of remaining within the confines of the financial market, the financial crisis spilled over to the real economy. Slovakia, being a small and open economy, had no way of protecting itself from its impacts. The record GDP growth in 2007 turned into a considerable decline in 2009. The unfavourable economic development, through shortfall in revenues, inflated the deficit and made the debt management much more challenging. The economy began to recover relatively swiftly in 2010, although the labour market remained feeble. We expect the economy of Slovakia to continue to recover and the economic growth to progressively accelerate nearing 5% in the medium term.

MF SR forecast – main indicators (february 2011)

Indicator (in %)	2009	2010	2011	2012	2013	2014
GDP, real growth	-4.8	4.1	3.4	4.8	4.8	4.8
Employment (LFS), growth	-2.8	-2.1	0.7	0.9	1.2	1.2
Unemployment rate (LFS)	12.0	14.4	13.9	13.3	12.5	11.8
Real wage, growth	1.4	1.3	0.2	2.5	2.2	2.8
Inflation, year average; HICP	0.9	0.7	3.5	3.1	3.7	3.7
Current account, % of GDP	-3,2	-3,8	-2,2	-1,7	-0,6	-0,3

zdroj: MF SR

1.5. Fiscal outlook

The fiscal policy of Slovakia in 2009 was influenced by the economic crisis; in the effort to soften its impacts on the economy, the government allowed the free play of automatic stabilisers and adopted a set of anti-crisis measures. Because of the permanent loss of potential output in the economy and excessive fiscal expansion, the structural balance began to deteriorate. This brought the total general government deficit in 2009 to 7.9% of GDP. In spite of the economic recovery in 2010, the general government deficit is expected to reach 7.8% of GDP. This is because of the structure of economic growth, fuelled mainly by exports, while the labour market development remains unfavourable and contracts household consumption. The low tax intensity of exports is reflected in shortfalls on the income side of the budget due to low collection of taxes and social security contributions. What is crucial from the debt management point of view is that this development increased the gross general government debt from 27.8% of GDP at the end of 2008 to the estimated 43.4% of GDP at the end of 2010[3].

The relatively high levels of the general government deficit and debt make the consolidation effort in the medium-term absolutely essential. Hence, the main medium-term fiscal objective of the government is to bring the general government deficit under 3% of GDP by 2013 in line with the recommendations formulated in the Excessive Deficit Procedure which, in view of the unfavourable starting fiscal position in 2010, requires truly ambitious consolidation targets.

The draft General Government Budget for 2011 to 2013 anticipates deficit reduction to 4.9% of GDP in 2011. The deficit should then reach 3.8% of GDP in 2010 and fall to 2.9% in 2013. This means that the medium-term deficit reduction effort will be concentrated mostly in 2011, when the fiscal consolidation measures worth EUR 1.8 billion, representing 2.5% of GDP[4], will be taken.

General government deficit and debt (ESA 95, % GDP)

	2008	2009	2010E	2011B	2012B	2013B
General government deficit	-2,1	-7,9	-7,8	-4,9	-3,8	-2,9
General government debt	27,8	35,4	43,4	45,6	46,9	45,5
State debt	**26,5**	**33,9**	**41,6**	**43,7**	**45,0**	**43,6**

Note. According to the draft General Government Budget for 2011 – 2013 (November 2010) *Zdroj: Ministerstvo financií*

The success in achieving these consolidation targets will also reduce the gross general government debt which is expected to decline from 2013 onwards from the level of **47% of GDP**.

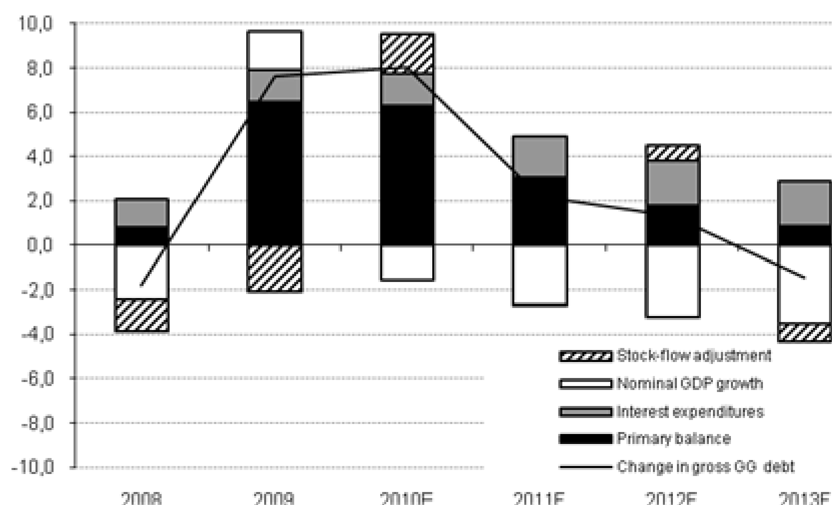
In terms the contribution of individual factors to the increase in the gross general government debt, the planned general government deficits represent the most significant factor. In addition to higher interest payments, this period will also be marked by quite a large primary deficit, although it will progressively decline as the planned fiscal consolidation unfolds. The stock-flow adjustment contribution to the gross debt change will be primarily influenced by the development of deposits in commercial banks, i.e. assets which will not be used for debt coverage. The beginning of 2011 is a good example, when the relatively high volume of maturing government securities requires sufficient liquidity to be available in the pre-redemption period, i.e. at the end of 2010. In order words, the unavailability of these funds for debt service will increase the gross debt at the end of the year despite the existence of a higher quantity of assets. This projection does not include possible EFSF guarantees.

On the other hand, the debt-to-GDP ratio can be expected to decrease as the nominal GDP continues to grow, which will fully offset the other above-mentioned negative factors in the course of 2013. For this reason, the debt-to-GDP ratio is projected to decline moderately in 2013.

[3] Data from the draft General Government Budget for 2011 – 2013 (November 2010)

[4] The need for the 2011 consolidation effort representing 2.5% of GDP arose from the comparison of the scenario without changes in the existing policies (under which the general government deficit would reach 7.4% of GDP in 2011) and the target deficit of 4.9% of GDP.

Contributions of factors to the change in gross GG debt (p.p.)



Source: MF SR

These projections show that the expected macroeconomic and fiscal development will obviously have a considerable impact on the state debt management. In spite of the expected economic recovery and the ambitious fiscal targets, the macroeconomic situation in Slovakia will be largely determined by the development of global economy, which poses certain risks to the future fiscal consolidation effort and, thereby, to the state debt management.

The ambition of Slovakia's fiscal policy will be to anchor and maintain the country amongst the so-called "core" Eurozone members. To this end, apart from keeping the consolidation momentum, a new law to be enacted during 2011 will establish an independent Fiscal Council and debt rules.

3. Strategic targets for state debt management in the years 2011 to 2014

The main objective of the state debt management is to ensure the government's ability to discharge its obligations and obtain refinancing through capital markets. The targets formulated in the 2011–2014 Strategy are in line with those adopted in the 2007–2010 Strategy. The development in previous years showed that the targets were appropriate for the given economic framework and for the system of debt management in Slovakia. The present Strategy only slightly modifies the quantitative targets for risk management, optimises the structure of non-marketable debt, introduces a limit for the monitoring of foreign-currency risks, and adds new targets concerning the diversification of the investor base and improvement of the state debt structure.

1. Standardised properties of new issues of government securities

Liquidity on the secondary market for securities, which is important from the investors' perspective, can be supported through the issues of standard sizes. The standard size of an issue of Treasury Bills (T-bills) and Government Bonds (nominal value) will be at least EUR 1 billion. **A substantial part of the debt will be financed through benchmark fixed-yield bond issues (5, 10 and 15 years) in the amount** (at nominal value) **of at least EUR 3 billion.** If the financial market situation so permits (also through favourable prices), **the ambition will be to extend the yield-curve into the maturities of 20 or 30 years**, also in the interest of ensuring that the economy has a mechanism in place to appraise long-term financial assets and liabilities**.** Moreover, additional effort will be put into the repurchase of Government Bonds and T-bills and swap the bonds from the issues before maturity for bonds from the new issues in order to eliminate cash flow fluctuations caused, in particular, by large nominal values of the new issues.

2. Optimised structure of non-marketable debt

The target is to further reduce the share of non-marketable debt (mainly government loans), taking due account of the applicable financial terms and conditions. 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 they bring additional or secondary benefits for the government.

3. Compliance with the parameters of the refinancing, refixing and foreign currency risk

The refinancing risk and refixing risk with slightly modified parameters will continue to be monitored. In the previous period, two different types of limits were set for the monitoring of the cumulative maturity and debt refixing risks. In view of the experience with the newly adopted Euro currency and given the better liquidity-raising possibilities afforded by Slovakia's accession to the Eurozone, as well as in the interest of streamlined monitoring of these two types of risks, identical parameters (which are higher in comparison with the previous Strategy) will be monitored for both types of these risks. The data from previous years show that the inclusion of cost-efficient short-term funds from the State Treasury and from the money market tends to increase the monitored value of these parameters, particularly in the first year. That is why the criterion will include net liabilities (in other words, money market deposits will be deducted). This may cause the parameter's volatility to span from 0 to 10%. For the **refinancing risk and refixing risk,** the strategic target is to maintain the level of the **due and refixed state debt in the first year near 25% of the aggregate state debt** and the level **of the due and refixed state debt on a cumulative basis for five years near the level of 65% of the aggregate state debt**. 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 in the Eurozone. If these conditions cease to be standard, the ratios can only be maintained through increased cost of the debt service.

The risk monitoring and evaluation system sets a new limit for the foreign currency risk of the state debt. In managing the foreign currency risk, the strategic objective is to maintain the limit for the open **unsecured foreign currency position of the state debt below 5% of the aggregate state debt**.

4. Diversified investor base

The communication of the issuer (MoF) with investors, rating agencies and other financial institutions will have to be further developed and improved through regular meetings and presentations of the issuer's objectives and conclusions at investor conferences. In order to promote Slovakia and its state debt, it will be necessary to **hold at least one informational-presentational meeting per year with the existing and potential investors in the Slovak state debt.** As regards the new benchmark bond issues, priority will be given to ensuring broader diversification of the investor base and attracting new investors in the Slovak state debt in terms of type and geographical origin. Furthermore, emphasis will be laid on increasing the share of investors from EU member states, as well as from countries outside the Eurozone, where the volume of the sold Slovak bonds has so far been low, as well as to attracting long-term investors from outside the banking sector. This process will be facilitated with the introduction of the system of primary dealers. Likewise, a stronger engagement of (other) domestic entities in the state debt financing, mainly of the pension funds, can provide additional leverage to the state debt financing during critical periods, since savings in the second pension pillar could – as long as that the proposed legislation passes – represent a stable source of financing.

5. Enhanced infrastructure for the state debt management (primary dealers, ISDA contracts. brokers, better conditions for securities settlement)

In order to bolster the liquidity of government securities on the secondary market, it is necessary to put in place a system of primary dealers for the market of government securities by creating a group of the most active domestic and foreign banks. For foreign investors, it is necessary to provide **internationally comparable conditions for the settlement of government securities** in Slovakia. With the objective to improve and expand the scope of the financial instruments that are necessary to keep the risk within the limits, it is also necessary to develop a legal basis (**ISDA contract**) for the conclusion of contracts in financial derivatives. The use of the brokers and their services will improve the awareness of the actual market conditions and may even reduce the cost of the government's financial operations. The above-described infrastructure enhancements should be implemented **by the end of 2011**.

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 (pursuant to the present 2011-2014 Strategy). This determines the expenditures connected with the debt service. The most important risks of the state debt include:

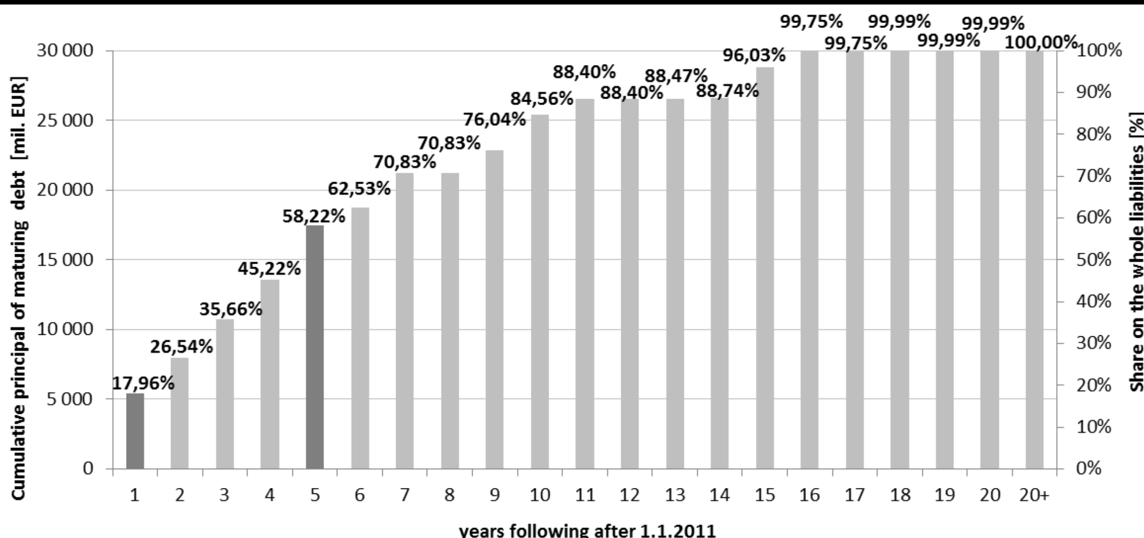
REFINANCING RISK

The refinancing risk represents the loss of the government's ability to refinance itself and discharge its maturing obligations, or discharge such obligations only through emergency measures, most likely at a much higher cost than usual. The risk also stems from the uncertainty as to whether the financial markets are willing to carry out the required transactions. This risk is monitored based on 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 year

The strategic objective for 2011-2014 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 25%, and the ratio of the sum of all maturing debts within five years to the total financial obligations as close as possible to 65%. 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. Should these conditions become non-standard, the parameters can only be maintained through substantial increases in the cost of debt service.

Cumulative refinancing risk in future respective years (%, as of 31.12.2010)



Source: ARDAL

REFIXING RISK

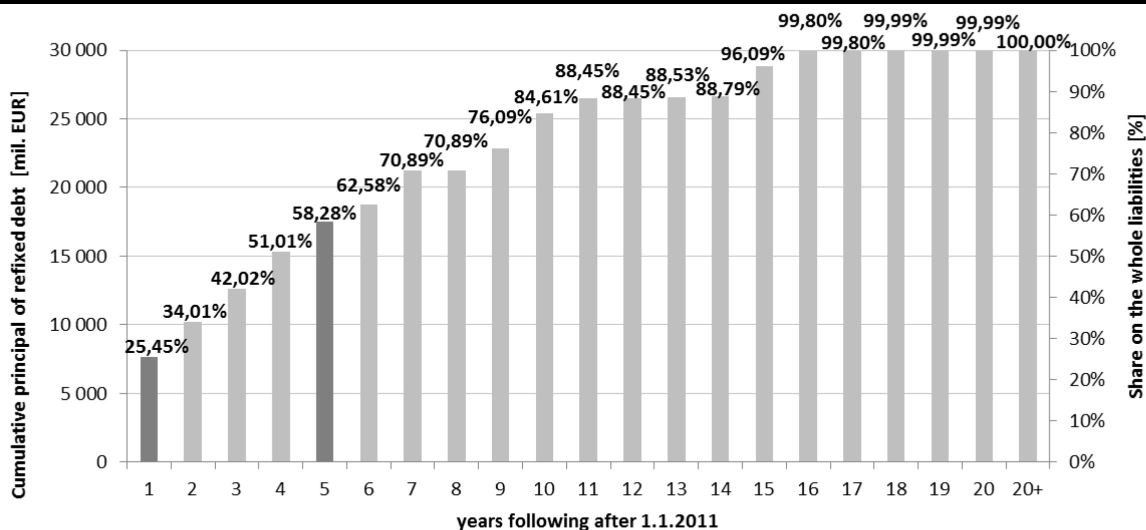
The refixing risk represents the risk of a change in expenditures connected with the state debt portfolio as a consequence of changing market rates. The debt refixing indicators, based on which this type of risk is managed, indicate the degree to which expenditures may rise (fall) as a consequence of unfavourable (favourable) movements of interest rates. As a secondary indicator, the development of the overall debt portfolio duration is also monitored.

- The debt refixing indicator within one year
- The debt refixing indicator within five years
- Duration and average maturity of the portfolio (secondary indicators)

Similarly as in the case of the refinancing risk, the strategic objective for the period of 2011-2014 is to maintain the ratio of the sum of the refixed debt within one year to the total financial obligations as close as possible to 25%, and the ratio of the sum of the refixed debt within five years to the total financial obligations as close as

possible to 65%. 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 refixing risk in future respective years (%, as of 31.12.2010)



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 arise only 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

In case the market conditions are favourable, the MoF will endeavour to diversify its debt portfolio also in terms of its currency structure. This is the reason why the Strategy introduces a limit for the exchange-rate risk management. The strategic objective of the government will be to maintain its open unsecured foreign-currency position in the government's financial obligations below 5% of the total government financial obligations. An active management of the foreign currency position requires that adequate technical conditions be put in place within the State Treasury System.

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 of 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, 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.