Government Debt Management Strategy for the Years 2007 to 2010

Contents

1. Evaluation of the Government Debt Management Strategy Until the Year 2006

The approved Government Debt Management Strategy until the year 2006 determined the following priorities and targets:

- Reduced number of issues of new government securities and standardized volume of individual issues

- Improved transparency of the intentions of the issuer (Ministry of Finance of the Slovak Republic) and its communication with investors and financial markets

- Optimization of costs (expenses) of the government budget for government debt service in medium-term and long-term horizon

- Extending the average maturity and duration of the government securities portfolio

- Gradual increase of the government debt in foreign currencies to Slovak Crowns ratio

Reduced Number of Issues of New Government Securities and Standardized Volume of Individual Issues

In 2004, new „open“ issues of Treasury Bonds were introduced into the primary market in accordance with the strategy. Five issues were opened with the option of gradual sale of bonds via several auctions. From the beginning of 2004, each issue was in the standard nominal value of SKK 40 billion. By that, the issuer created the basic prerequisite for improved current ratio and achievement of more effective secondary market with Treasury Bonds. The foreign bond issued in May 2004 in the same nominal value of EUR 1 billion (approximately SKK 40 billion) as the first Slovak Eurobond meets the criteria for being accepted for trading in the important European bond market (MTS). In 2005, ARDAL continued in the issue policy in accordance with the strategy and opened one new issue of treasury bond, with maturity of 7 years, with zero coupon in the total nominal value of SKK 40 billion. The maturity of the new treasury bond was determined according to the profile of maturity of the government debt in individual years. In 2005, ARDAL entered the primary market with 5 issues, same as in 2004. The treasury bond with zero interest rate of the coupon with maturity of 3 years was sold to investors in the entire nominal value in 2004. As in 2005, the treasury system included also funds determined for the pension reform, ARDAL suggested for the year 2005 to realise no issue of foreign treasury bond. Also in 2006, ARDAL proceeded in the issue policy as in the years 2004 and 2005. It introduced one new issue of treasury bond to the local capital market, namely the historically first issue with maturity of 20 years, with fixed interest rate of the coupon, in the nominal value of SKK 40 billion.

Improved Transparency of the Intentions of the Issuer (Ministry of Finance of the Slovak Republic) and Its Communications with Investors and Financial Markets

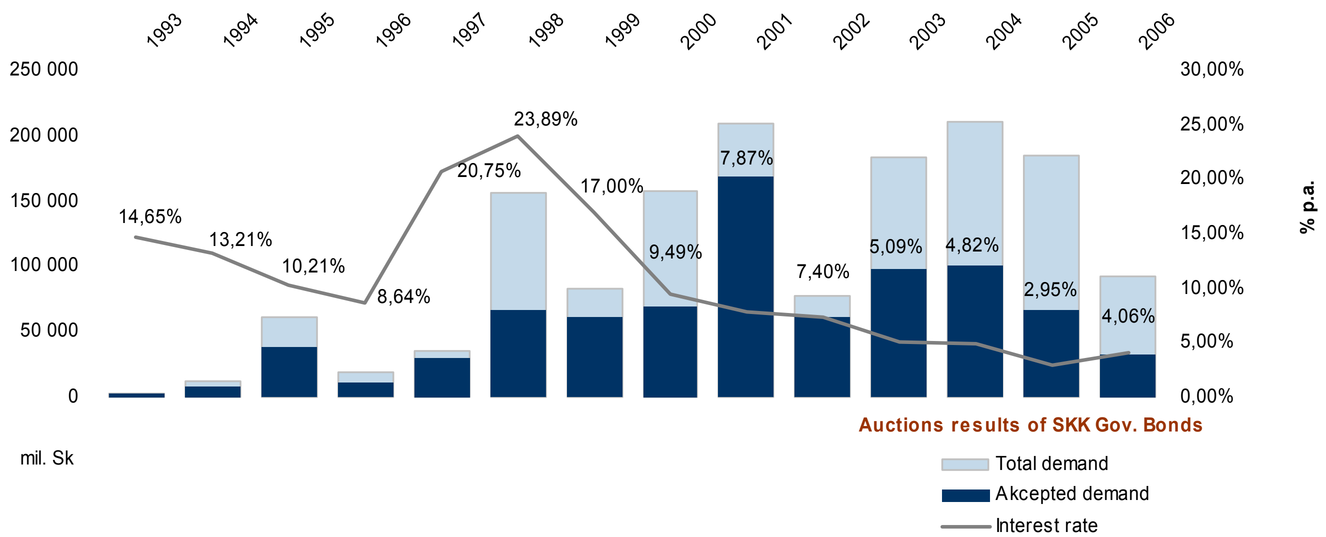
During the years 2004, 2005, and 2006, the Ministry of Finance of the Slovak Republic attempted, via ARDAL, to improve communication with financial markets and investors in the local market and in foreign countries. In December 2003, for the first time in the history of Slovakia, the investors and the financial market received the complete plan – the binding time schedule of issue of government securities for the year 2004. In the end of 2004, 2005, and 2006, a binding time schedule of issue of government securities for the years 2005, 2006, and 2007 was prepared and published. The aim of this step was achieving the standard of the EU member states and improved transparency of the issuer´s objectives. Publishing the binding time schedule for the whole year in advance and the binding character thereof resulted in positive responses from the local and foreign investors and financial markets.

In the regular interactive meetings with investors, ARDAL informs about the current plans of the Ministry of Finance of the Slovak Republic and ARDAL in the area of primary and secondary market of government securities. The objective of the meetings is also evaluation of sale of government securities in the preceding period.

Optimization of Costs (Expenses) of the Government Budget for Government Debt Service

The overall average interest rate of newly issued Treasury Bonds in the local market was 7.403% p.a. in 2002, 5.091% p.a. in 2003, and 4.821% p.a. in 2004. In 2005, the interest rate of newly issued Treasury Bonds in the local market was 2.952% p.a. and in 2006 it was 4.064% p.a. The overall average interest rate of the outstanding portfolio of Treasury Bonds fell from the value of 6.286% p.a. in 2003 and from 5.92% p.a. in 2004 to the value of 4.998% p.a. in 2005. In 2006, the average interest rate of the outstanding portfolio of Treasury Bonds was 4.841% p.a.

Review of Treasury Bonds Auctions Results Denominated in SKK in Individual Years



Source: ARDAL

An additional benefit of the reduced costs of the government budget was favourable development of the government budget deficit as well as the tax incomes paid during 2005 and 2006. Such benefits, application of the funds determined for the pension reform, as well as favourable development of the key interest rates in the interbank market resulted in cost savings of the Government Debt Client.

Review of the Budget and Real Figures for the Years 2004 to 2006 for the Government Debt – Cash Principle			
in million SKK	2004	2005	2006
INCOMES			
Approved budget	512.30	2,596.31	69.38
Adjusted budget	611.40	2,596.31	69.38
Real income	3,179.50	1,711.68	2,617.50
Difference between the real and approved budget	2,667.20	-884.63	2,548.12
EXPENSES			
Approved budget	30,267.90	30,296.00	24,027.90
Adjusted budget	26,646.70	23,822.50	26,597.10
Real expenses	26,561.60	23,715.20	26,370.00
Difference between the real and approved budget	-3,706.30	-6,580.80	2,342.10

Source: MoF SR

In 2004, the incomes of the Government Debt Client were budgeted in the amount of SKK 512.3 million. These incomes were adjusted by a budget measure to SKK 611.4 million, and in reality, they reached the amount of SKK 3,179.5 million. The expenses of the Government Debt Client were budgeted in the aggregate amount of SKK 30,267.90 million and during the year, they were adjusted by a budget measure to SKK 26,646.70 million.

In 2005, the incomes of the chapter General Treasury Administration – Government Debt Client were budgeted in the amount of SKK 2,596.31 million, and in reality they reached the amount of SKK 1,711.68. The expenses were budgeted in the amount of SKK 30,296.0 million and during 2005, they were adjusted by a budget measure to SKK 23,822.50 million, and in reality they reached the amount of SKK 23,715.20 million.

In 2006, in the chapter General Treasury Administration – Government Debt Client, the incomes were budgeted in the amount of SKK 69.38 million, and in reality, as of the end of the year, they reached the amount of SKK 2,617.50 million. The expense side was budgeted in the amount of SKK 24,027.9 million and adjusted to SKK 26,597.10 million, due to pre-payment of interests from the cancelled interests of term deposits determined for the pension reform, which resulted in transfer of expenses from the years 2007 through 2012 to the year 2006. The real expenses for the year 2006 were in the amount of SKK 26,370.0 million, and the increase thereof was compensated by achieving higher incomes in the year 2006.

Simultaneously, the active management of coverage of the government debt resulted in improved structure thereof, reduced market risks of the Treasury Bonds portfolio and significant restructuring of the government loans portfolio. During the reviewed period, 11 government loans were prepaid, and in respect of 4 government loans, the margin was reduced from 2% and 1% to 0 % p.a. The given restructuring resulted in saving of approximately SKK 329 million. Another important contribution to reduction of the government budget costs for the government debt service is interconnection between the current ratio and the debt, thank to which the market has no space for creating of any pressure on artificial increase of expenses for the debt service, and the related problems in refinancing the government debt.

Restructuring and Current Status

Coverage of the government financial obligations, and thus also financing of the government debt depends on many factors and various conditions. Important conditions are the overall indebtedness and the debtor´s short-term and long-term ability to repay the obligations. As the most important is considered the debtor´s reliability – his ability to repay the obligation within the terms and conditions of the loan (credit risk), which comprises evaluation of the current status – debtor´s creditworthiness and probable future development of his financial condition.

The government debt is defined in Section 2(1) of the Law No. 386/2002 Coll. on government debt and government guarantees as the „aggregate obligations of the Slovak Republic from previous years“. In broader context, the government debt means all government financial obligations assumed by the Slovak Republic Government. The history of the government debt of Slovakia began with delimitation of the obligations of the former Czechoslovakia at foundation of the separate Slovak Republic. After the year 1993, the government obligations grew directly by deficit of the government budget or indirectly by providing government guarantees to those enterprises which were unable to repay their obligations. The risk government guarantees provided in the past increase the debt even in 2007.

During the period from foundation of the Slovak Republic until 2002, the Slovak economy may be described as transitive with relatively unstable economic environment. In this period, the State was able to borrow funds for relatively short period only and with high surcharge to the market interest rates. The reason was the relatively low rating of the country, the administrative manner of debt management, and the traditionally weak liquidity of government securities in the secondary market. The obligations of the State until the end of 2003 were covered mostly by bonds with one or two years maturity with very low value of the entire issue (mostly between SKK 1 to 5 billion) and loans with interest rates higher than the market interest rates.

In accordance with the latest government strategy, during the years 2004 to 2006, the given apparently inappropriate structure of the government obligations was intentionally changed:

- the bonds issued since 2004 had maturity mostly above 5 years and the standard volume of the issue was SKK 40 billion,
- since 2004, the portfolio of loans has been restructured; some loans were prepaid, and in respect of the other, the interest rates were decreased to the market level.

The result of restructuring is the reduced refinancing risk – the necessity of annual refinancing has been reduced by one third since 2006. The prepayment of loans resulted in reducing the non-marketable debt by 50 %.

The improving rating of Slovakia, reflecting the fiscal discipline and lower demand in financial markets by the Government, together with active communication with investors has resulted in reducing the margin demanded by the market. In connection with insufficient volume of debt for issue of „liquid“, i.e. large-volume issues of bonds in the European capital market, it is still necessary to reduce the volume of the non-marketable debt.

Any debtor´s obligations always comprise the market risk. The least risky debtor´s obligation is a direct and unconditional obligation specified by the determined currency in which the debtor´s cashflow is realised (for the state, it is the local currency) and a fixed interest rate. The obligation is clear. Any deviation from the given criteria means introduction of a market risk to the obligation. Certain risk may be expected in both directions, i.e. there exists not only the risk of loss but also the risk of profit. E.g.:

- change of the fixed interest rate to the floating interest rate in case of permanent course of normal form of the interest curve shall ensure lower costs for the debtor,
- change of the fixed interest rate to the floating interest rate in case of permanent course of inverse form of the interest curve will result in higher costs for the debtor,
- an obligation denominated in foreign currency in case of depreciation of the foreign currency will ensure lower costs for the debtor,
- an obligation denominated in foreign currency in case of appreciation of the foreign currency will result in higher costs for the debtor.

Restructuring in Order to Reduce Costs

Any change in the portfolio of government obligations in order to reduce the costs inevitably brings higher risk.

In management and restructuring the obligations, the key point is to determine the size of the risk which the debtor is willing to accept. Any restructuring should account for the probability to reduce the given risk and to manage it actively.

The size of the risk of the government debt of Slovakia is determined in the debt management strategy by maximum share of debt with floating interest rate and maximum share of debt denominated in foreign currency (particularly in EUR). Currently, the government debt of the Slovak Republic has financial parameter comparable with the EU countries (the average maturity, sensitivity to changes in market interest rates, the refinancing risk, and the exchange rate risk) which result from the reformation process during the years 2003 to 2006. Due to this reason, the government debt need not be restructured in the next following years (until 2010), and its parameters need not be modified in any significant way.

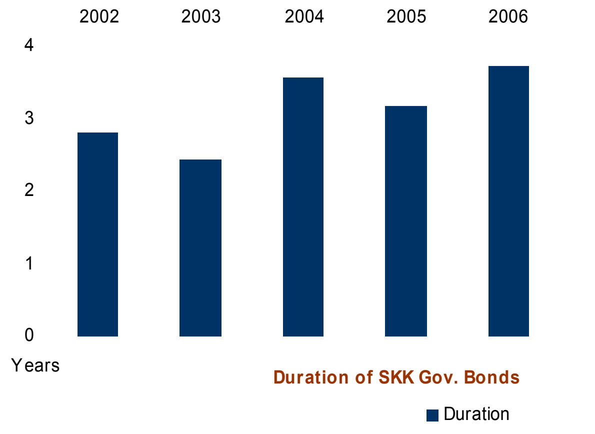
In relative comparison of the volume of the government debt, the total costs for administration of the government debt in 2006 were the lowest in the history of the Slovak Republic.

Extending the Average Maturity and Duration of the Government Securities Portfolio

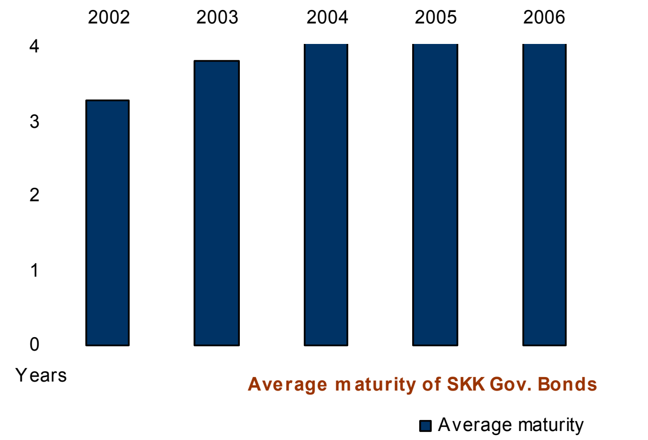
Extending the maturity for longer period and extending the duration results in reduced refinancing risk of the debt of the SR, which allows overall improvement of the conditions of coverage of the government debt and stabilization of the costs (expenses).

The 2003 strategy envisaged achievement of average maturity of the portfolio of government debt until 2006 in the interval of four to six years and the duration of 4 years. As of 31.12.2004, the portfolio of Treasury Bonds had the average maturity of 4.654 years and duration of 3.553 years. As in 2005 Slovakia had not issued any foreign issue, it clearly shows preference of Slovak investors. The issues with shorter maturity period were sold first, and the issues with 10 and 15 years until maturity were sold in lower volume. Due to these reasons, in the end of 2005, the average duration as well as the average period until maturity showed lower values than in the end of 2004.

Indicators of Refinancing Risk (duration and average maturity)



Source: ARDAL



Source: ARDAL

Year	2002	2003	2004	2005	2006
Duration	2.800	2.433	3.553	3.161*	3.729

Source: ARDAL

Year	2002	2003	2004	2005	2006
Maturity	3.2900	3.824	4.654	4.554 *	5.139

Source: ARDAL

* The duration at the end of the year and the average maturity were also affected by repayment of the restructuring bond in the nominal value of SKK 35.4 billion, whose maturity was in January 2006. Upon payment of the given issue, the values of the average maturity and the average duration were higher than in the end of 2004.

Structure of Government Debt in Nominal Value

Item	in SKK ,000	in SKK ,000	in SKK ,000	in SKK ,000
	as of 31.12.2003	as of 31.12.2004	as of 31.12.2005	as of 31.12.2006
1. Treasury Bonds	341,070,320.90	397,622,965.40	408,941,990.40	436,398,372.72
TB issued in SKK	269,038,570.90	310,331,965.40	352,169,990.40	349,965,872.72
TB issued in foreign currency	72,031,750.00	87,291,000.00	56,772,000.00	86,432,500.00
2. Treasury Bills	54,585,000.00	38,881,000.00	5,820,000.00	0.00
3. Government loans	10,718,629.60	16,252,291.47	14,791,288.74	13,734,252.32
4. Assumed loans	22,677,653.80	33,722,009.84	27,643,602.03	13,875,599.25
5. Obligation to ČSOB, a.s., Prague	0.00	25,177,000.00	0.00	0.00
6. Short-term borrowings from financial instit.	0.00	10,850,000.00	2,802,666.35	0.00
7. Risks from realisation of govern. guarantees	63,089,000.00	40,862,800.00	29,879,410.00	19,921,700.00
8. Swap transaction	0.00	0.00	31,792,320.00	0.00
Government debt in national methodology	492,140,604.31	522,505,266.72	521,671,277.52	483,929,924.29
Exchange rate as of	31.12.2003	31.12.2004	31.12.2005	29.12.2006
EUR	41.161	38.796	37.848	34.573
USD	32.920	28.496	31.948	26.246
JPY	0.30799	0.274550	0.271030	0.220810
CZK	1.265	1.271	1.308	1.256
CHF	26.377	25.121	24.275	21.537

Source: MoF SR

Gradual Increase of the Government Debt in Foreign Currencies to Slovak Crowns Ratio

By realisation of the foreign issue in the amount of EUR 750 million in 2003 and EUR 1 billion in 2004, the Ministry of Finance of the SR, via ARDAL, gradually fulfills the strategy of increasing the government debt denominated in foreign currencies to SKK ratio. From the initial ratio of 82 % (SKK) to 18 % (other currencies) in the portfolio of Treasury Bonds in 2003, the ratio was changed particularly by the given issues, and as of 31.12.2004, it was 78 % (SKK) to 22 % (other currencies). In connection with transfer of funds determined for the pension reform to the Treasury system and in connection with the decision on use of these funds particularly for coverage of debt, no foreign issue of Treasury Bonds was realised in 2005. Upon payment of the foreign issue of treasury bond in May 2005 in the nominal value of EUR 750 million, the ratio was changed and as of 31.12.2005 it was 86 % (SKK) to 14% (EUR). By issuing the Slovak Eurobond in 2006, the ratio was changed again and was 79 % (SKK) to 21% (EUR). As of 31.12.2006, the government debt (bond portfolio) in Slovak Crowns to foreign currency ratio was 80 % to 20%.

2. Macroeconomic and Fiscal Forecast

2.1. Macroeconomic Forecast and Financial Markets

Global Environment

It is generally known that development in the financial market is sensitive to macroeconomic development and vice versa – these are connected vessels. Moreover, all markets – of goods and services, labour force, as well as the financial markets – are gradually more and more opened and reflect the common worldwide trend of globalization, harmonization, standards of trading, clearing and settlement of transactions with various financial assets, and improving the conditions for expedient and relatively simple approach to other markets. Thus, the development in financial markets in individual countries more or less depends not only on development in the surrounding markets, but also the situation and expectations in the largest international markets which principally determine the trends in the global financial market. It means that also the financial markets in the Slovak Republic are influenced by the deepening integration and accelerated economic convergence, and become a clear part of the united European market, including the market with financial assets. From this aspect, the primary factor for development of the Slovak financial market is the development in the Eurozone and in the surrounding countries of the central European region. However, the future thereof is subject to trends in the largest business centers in the U.S.A., the Eurozone, the United Kingdom or Japan[1].

The traditional drive of the world economy and the global financial market is the U.S.A.; for development of the Eurozone, the US economy and its financial markets represent an inseparable external environment. The interconnection between these economies suggests, on one side, development of macroeconomic indicators, particularly in respect of the balance of payments, and on the other side, development and relations in the financial markets, which indicate benchmark indicators of interest rates, exchange rates or prices, or yield rates of various financial assets. From the aspect of direct participation of the government in financial markets, we find the most important the segment of government bonds in capital markets, and thus also all relevant indicators, the so-called fixed income markets. As the forecast for the global financial market depends on the expected development of macroeconomic fundaments in the U.S.A., our first concern is to know the current macroeconomic forecast for the US economy.

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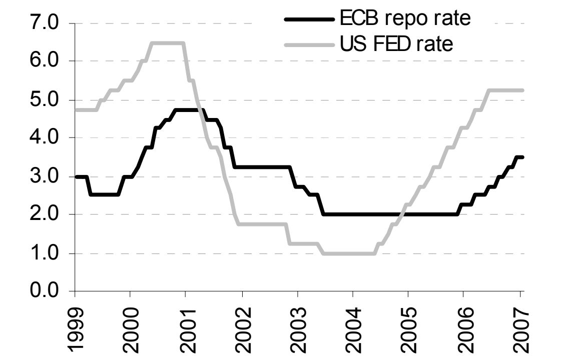
[1] Currently, approximately 80% of all international financial and capital flows are produced in three financial markets, U.S.A., Eurozone, and United Kingdom.

U.S.A.

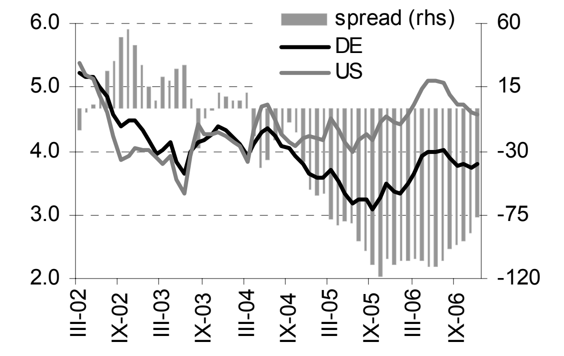
Despite the fact that the economic growth in the U.S.A. in 2006 slowed down (to 3.3 %), it has still preserved a good performance. After the strong 5.6 % annualized [2] growth in the first quarter, it fell to 2.6 % in the 2nd quarter, mainly due to the effect of falling prices and weakened market with real estates, which contributed to fall of investments and production in the building sector. In this year, the ICF expects slow-down of the US economy below its production potential, to 2.9 %, which shall be reflected in slowing-down the inflation. Further decline of the market with real estate is expected, which is indicated also by the so-called soft indicators as e.g. the „builder confidence“ or the number of issued building permits. When compared with the preceding year, even more significant decrease of investments in the building sector is expected. Decline of the market with real estates may be negatively reflected in consumption of households (representing approx. 70 % of the total demand). Similarly, other indicators as the „manufacturing confidence“ or any other so-called leading indicatory indicate slow-down of the economic growth. Recession is expected also in the labour market, although the latest published data from the labour market indicate that the slow-down need not be so serious. However, until now, the expectations are not changing in a significant way. The concerns regarding growing unemployment lead to speculation on soon turn in the Fed´s monetary policy[3]. In the last year, the Fed continued in applying more strict monetary policy by increasing the rates, however, after slow-down of the economic growth and decrease of the inflation rate in the second half of the year, it kept its key rates unchanged on the level of 5.25 %. The overall inflation has slowed down more than the core inflation, because it was suppressed by the falling prices of crude oil in the international markets. Currently, it is difficult to predict when the decrease of the rates in the U.S.A. will occur, particularly when the stimuli for the economy may be a lower USD exchange rate or lower long-term interest rates. Because the latest development in the labour market or the core inflation rate do not clearly indicate further quick slow-down of growth of the GDP, the expectations of decreasing the rates in the U.S.A. are postponed to the end of the first quarter or by the end of the first half of 2007.

ECB and FED Interest Rates



Source: Reuters

Long-term Rates in the U.S.A. and Eurozone



Remark: Spread in basic points (bp), 1 basic point = 0.01% p.a., otherwise in % p.a., (rhs) means „right hand scale“, i.e. on the right axis

Source: Reuters

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[2] The annualized growth expresses the would-be annual growth, should the current quarterly growth continue also in the next following quarters; formula: $(1+growth)^4$

[3] Central Bank in the U.S.A., the so-called Federal Reserve System, abbreviated Fed.

Eurozone

In the Eurozone, the situation is contrary. It appears that the revived growth of economy, which occurred in the first half-year 2006, should have a more stabile character – the GDP in 2006 was increased by 2.6%. This is why the local demand is supported not only by household consumption, but also by business investments which is a good signal for further growth of the economy. Also the soft indicators as the German business climate index indicated improved trust of entrepreneurs in favourable future of the economic environment. Concerns of the growing risk of wage inflation pressures or from the secondary cost pressures of the prices for crude oil and energies pressed the ECB to increase the rates several times during the year and to determine the repo rate to 3.5 % p.a. The favourable financial situation in the business sector and the perspective of higher demand for labour indicate growth in the labour market. Declined unemployment may lead to expected growth of wages in the next following period, which results in improved trust of consumers and their consumption. All such favourable data on the economy indicate optimistic forecast of growth also in 2007, however, slow-down of the economic growth in the U.S.A. or the world economy, weaker USD (and simultaneously strengthened euro), or more strict ECB´s monetary policy may shatter the firm foundations of the enliven growth. However, if the signal on continuing growth of the local demand and growing labour market are still present, the ECB will continue in making the monetary policy more strict. This is supported also by the data on growth of loans and money reserves. Thus, it is expected that the growth of GDP in the Eurozone shall be slowed-down in 2007 to approximately 2.0 %.

The macroeconomic development in the U.S.A. and Eurozone and at the same time the development of the ECB´s and Fed´s key interest rates are connected with the financial markets, namely via expectations of the markets in respect of the future development of these economies. The forecast for later future then determines long-term inflation expectations and interest rates. In connection with the prevailing expectations on slow-down of the economic growth and inflation in the U.S.A. and the turn in the Fed´s monetary policy, a declining trend of long-term rates was profiled in the second half of the preceding year, which reflected the development of yields of 10-year Treasury Bonds. In spite of the fact that the macroeconomic development in the Eurozone is different, the long-term interest rates in the European market followed the same trend as in the U.S.A. In the environment of globally interconnected financial markets, the investors move from one financial markets to other ones, and therefore not only the expectations on development of the economy in the Eurozone determine the position of long-term and short-term interest rates. However, the expected more favourable development in the Eurozone in the first half-year 2007 and continuation of the ECB´s monetary policy has slowed-down the declining yields of the 10-year Treasury Bonds, and thus, in the end of 2006, the spread between the yields in the U.S.A. and Eurozone was smaller.

In the beginning of this year, upon publishing the data from the labour market in the U.S.A., certain signal appeared on slight slow-down of the economy. Thus, a part of investors had probably moved back to the US markets, and by opening long positions in the assets denominated in the USD [4] supported the currency by higher demand, whereupon the USD exchange rate had partially balanced its losses from the previous year and at the same time had stopped the decline of long-term rates in the U.S.A. and the Eurozone. This is affected to certain degree also by the continuing favourable development in prices for crude oil. Thus, the long-term interest rates in the next following period shall be affected by further development of the individual macroeconomic indicators and the resulting signals on the future performance of the monetary policy in both economies. If only slight slow-down in the U.S.A. is proved, further decrease of the Fed´s rates may be postponed. Similarly, if the concerns of growth of wages are still preserved in the Eurozone, which might speed-up the growth of consumer prices, then the spread in case of short-term interest rates may be narrower.

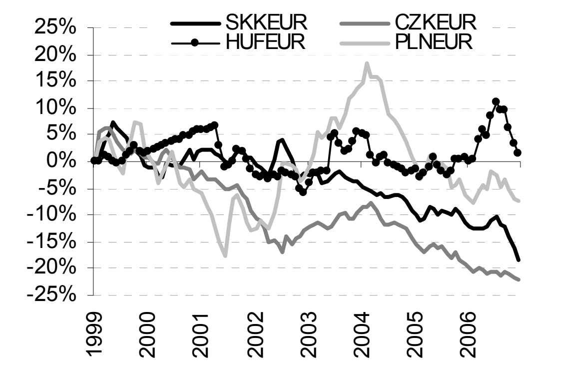
[4] Opening of a long position is a normally applied term for purchase of a financial asset, therefore, opening of long positions in the context expresses increased interest of investors in purchase of assets in USD, e.g. Treasury Bills, Bonds or interbank deposits.

Trends in Financial Markets in Central Europe

From the aspect of diversification of portfolios of various financial assets, the investors seek for the opportunities also in markets with different potential of economic development. In addition to diversification by extending the portfolio of financial assets, there exists also diversification by distributing investments in several markets. Thus, financial flows are moved not only between the most effective and largest markets. Specific example are the so-called emerging markets. The Slovak Republic belongs to such markets. Together with the surrounding countries in the region, it is significant particularly by that it continues in the integrating effort and moves forward in catching up with the more advanced countries in the Eurozone. It is the economic convergence and positive expectations on the coming period of introducing the common European currency which form a firm foundation for the long-term expectations in the Slovak Republic as well as in the other V4 countries. Such expectations are based on the strict conditions for introduction of euro as well as on the inevitable fiscal discipline particularly following the complete entry into the EMU. The accompanying phenomenon of the convergence process is then lower risk of investments in the financial markets in the Slovak Republic and the whole V4. The forecast of the V4 economies is connected also with inflow of direct and portfolio investments. All these factors together with the high dynamics of economic growth are reflected in higher rating of these countries, and subsequent decrease of their risk profile.

Particularly the so-called credit risk of the country is reflected in e.g. the spreads of yields of long-term Treasury Bonds of SR, CZ, PL, and HU, denominated in euro vs. the yields in Germany with approximately the same period until maturity. In the last years (2004 - 2006), the spreads move around 20 basic points (bp) [5]. Although the political instability and the resulting uncertainty in financial markets temporarily deviates the level of long-term rates from the rates in Germany or the whole Eurozone, in the middle-term or long-term horizon, such spreads will probably move near or below the limit of 20 bp

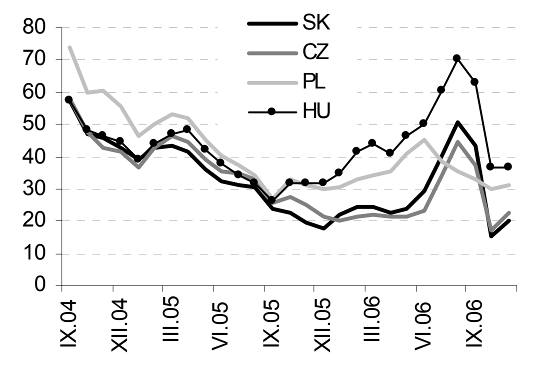
Foreign-exchange Markets in V4 Countries



Remark: Changes from January 1999

Source: Reuters

Spreads of Long-Term Eurobonds V4 vs. DE



Remark: in basic points (bp), 1 basic point = 0.01% p.a.

Source: Reuters

On the other hand, in investing into bonds denominated in local currencies of these countries in the period before introduction of euro, also exchange-rate risk will be present, i.e. the risk arising from conversion of the SKK, CZK, PLN, and HUF exchange rates to euro. However, in connection

[5] 1 basic point (abbreviated bp) = 0.01% p.a.

with development of macroeconomic fundaments, appreciation of these currencies is generally expected in middle-term horizon, and therefore the exchange risk is material mainly in transitional investments for short period. The long-term trends of growing demand for SKK or the other V4 currencies clearly indicate changes in their exchange rates to euro since 1999. Particularly CZK and SKK clearly move, within the long-term horizon, in the appreciation trend (the declining trend in the diagram „Foreign- exchange markets in V4 Countries“). From this aspect, they may represent an interesting opportunity for investors, because they may bring additional capital profits arising from the positive exchange rate.

With continuing real convergence, the attractive character of assets – particularly the issues of Treasury Bonds – will probably fall down in these „emerging markets“. Introduction of euro will finally remove the exchange risk which attracts speculative trades in the FX market with Slovak Crown. The credit risk will significantly fall to the level comparable with the advanced countries of the EMU and the spreads between the yields of treasury bond assets will no more represent an important stimuli for investors in international markets. Smaller differences in the economic cycles as compared with the Eurozone may still be beneficial for the bond issue of the Slovak Republic or the other V4 countries, but only in the nearest middle-term horizon, because the deepening internal trade within the EU, the so-called intra-EU trade, will remove such differences. Upon entry to the EMU (upon cancellation of derogation), the issues of these countries will face the competition in the paneuropean bond market, and therefore, in the later horizon it will be important how quick and successful the Slovak Republic will be in coping with the competition. By its gross government debt, in view of the size of the paneuropean market, the Slovak Republic is a relatively small player, and therefore placement of bond issues in the volume of approx. EUR 2 - 5 billion[6] in the Eurozone market should not represent a serious problem[7].

Local Environment

Analogically as in case of the mentioned US and Eurozone economies, the development of financial market in the Slovak Republic is closely connected with the macroeconomic forecast. The development of the debt service itself reflects the overall condition and direction of the economy, as well as expectations in the financial markets which sensitively respond to the applied and declared fiscal and monetary policy.

Financial Markets and Forecast of Macroeconomic Development in the Slovak Republic

In 2006, the Slovak economy achieved a record growth of the real GDP of 8.3 % (in the 3rd Q. and 4th Q it was even 9.8 % and 9.6% respectively). This growth is due to the accelerated local demand supported not only by the household consumption but also by gross fixed investments which reflect first of all the growing production in the automotive industry. The balanced economic growth signals that the economy might continue also in 2007 in similar dynamic pace – according to the current expectations - above 8%. The accelerated growth of exports, particularly from the automotive industry, and subsequently the lower deficit in foreign trade should be reflected also in lower deficit of the current account of balance of payments (decrease to 4.1% of the estimated 8.2% in 2006). The stabile high growth of economy creates favourable prerequisites for foreign-exchange market. The investors with open Crown positions[8] should be concerned by the information on deficit of the current account of balance of payments and the Crown should continue in the appreciation trend also in 2007. However, the rate of actual strengthening of the Crown will depend on development of the economic fundaments, particularly the labour productivity.

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[6] The estimate approximately corresponds to the annual volume of debt for refinancing between SKK 60 and 150 billion.

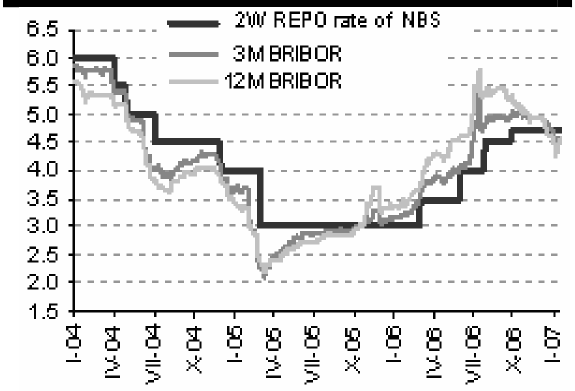
[7] Currently, in the Eurozone markets, issues of Treasury Bonds are trades in the nominal value of approx. EUR 3 trillion.

[8] The investors which have already invested into financial assets in Slovak Crowns.

In the event of excessive appreciation which would be markedly deviated from the current development of determinants of the balance exchange rate, the National Bank of Slovakia will most probably respond adequately. However, the change in cycle of the monetary policy may be prevented by risks, if any, of wage inflation pressures. Therefore, the development in monetary market is currently uncertain to certain degree. However, principally, the expectations prevail in the market that by the end of the year (in the third or even the last quarter), the monetary policy may liberated via interest rates. In the market, decline by 25 to 50 basic points is currently expected. In the next following period – until introduction of the common European currency – the already short-term interest rates should be converged to the levels in the European interbank market.

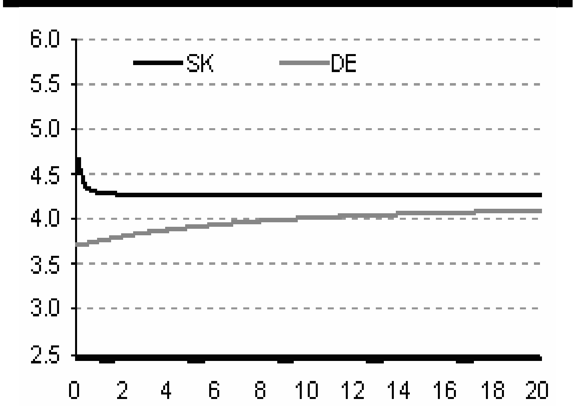
In the long end of the yield curve[9], the spot interest rates fluctuate on the levels which mostly copy the development of long-term interest rates in Germany or in the Eurozone. Thus, also the small bond market existing in the Slovak Republic is affected by expectations on development in the Eurozone or the U.S.A., which reflect the global financial market. Due to the expected turn in the Fed´s monetary policy (expected liberation), the long-term interest rates in the U.S.A. and also in the Eurozone are kept on low levels. Similar situation is also in the Slovak „fixed income“ market[10], which is currently characteristic by the flat yield curve[11] - particularly in the part which depicts the spot interest rates with more than 1-year period until maturity. Comparison of the yield curves in Slovakia and in Germany[12] indicates that the long-term rates in the Slovak Republic should be approximately 20 bp above the rates in Germany.

Short-term Interest Rates in the SR



Source: Reuters

Yield Curve with Zero Coupon



Source: Reuters

2.2. Fiscal Forecast

The strategy of fiscal policy is described in the Convergence Program for the years 2006 to 2010. The direction thereof is determined by two specific objectives of the Government. The first basic fiscal target is to reduce the public finance deficit, including the costs on the pension reform below 3 % GDP in 2007, and thus to meet the criterion for entry into the Eurozone. The second basic target is to reduce, by 2010, the cyclically adjusted public finance deficit, adjusted for single effects, to the level of 0.9 % GDP.

[9] The long end of the yield curve mean long-term interest rates with maturity of more than 5 years, differentiating the spot and term or forward interest rates. The spot interest rates are applicable on the given date. The forward rates mean interest rates applicable at a given moment in the future for a determined period until maturity, and thus are expressed by two time data, e.g. 1-year forward rate in 1 year, 1-year forward rate in 2 years, etc..

[10] Collective term for monetary and bond capital markets.

[11] The flat yield curve means that all (or almost all) interest rates fluctuate on almost the same levels.

[12] The German bonds „bunds“ are considered as benchmark issues indicating development of the entire European market.

The basic fiscal indicators which are reflected also in the public finance budget for the years 2007 to 2009, are shown in the following table. The public finance deficit, including the costs for pension reform, should reach in 2007 the level of 2.9 % GDP, and in the next following years, further decline is expected. Although fulfillment of the middle-term budget objective by 2010 falls after the horizon given by the approved budget, on the basis of the mentioned assumed development it may be said that fulfillment thereof will require exercise of additional consolidating effort. The consolidating effort of the Government and the sound economic growth are at the same time reflected in stabilization of the gross public debt and the government debt in middle-term horizon.

Basic Fiscal Indicators (ESA 95, in % GDP)					
	2005	2006E*	2007B**	2008B	2009B
Balance of public finance (excluding the 2nd pillar)	-2.5	-2.5	-1.8	-1.3	-0.7
Balance of public finance (including the 2nd pillar)	-3.1	-3.7	-2.9	-2.4	-1.9
Maastricht Gross Public Debt	34.5	30.8	30.9	31.4	31.1
Maastricht Government Debt	33.3	29.6	29.8	30.1	29.9

** E – expectations*
***B – budgeted value*

Source: MoF SR

From the aspect of the government debt management strategy, it is important to focus on the very prognosis of the amount of the government debt and the factors influencing it. The government budget deficit expressed on the cash basis contributes to growth thereof, whereas some other factors, as for example repayment of governmental guarantees and assumed obligations, reduce the amount thereof. Such factors are summarized in the following table, which also contains figures of the prognosed amount of the government debt as of 31.12. of the given year. The prognosis of debt for the years 2007 to 2009 is based on the preliminary figures of 2006. The amount of the factors affecting the government debt is in accordance with the prerequisites set forth in the public finance budget for the years 2007 to 2009, except for the prerequisite of stabile amount of borrowings from the State Treasury.

Factors Affecting Development of Maastricht Government Debt (cash, in SKK million)					
	2005	2006	2007E	2008E	2009E
Government budget deficit	33,886	31,678	38,386	22,838	12,771
Assumed obligations (Treasury Bonds + other borrowings)	39,954	40,842	20,200	22,500	23,180
Repayment of government guarantees and assumed obligations	-11,489	-6,330	-8,552	-982	-982
Repayment of the debt principal	-123,396	-59,496	-	-	-
Exchange-rate differences	-1,487	-10,726	-	-	-
Other factors	-338	-1,917	-	-	-
Maastricht Government Debt (as of 31.12. of the given year)	**489,879**	**483,930**	**533,964**	**578,320**	**613,289**

Remark.: (+) means increase (-) decrease of the government debt *Source: MoF SR*
E – forecast, expectations

The public finance budget for the years 2007 to 2009 assumed that the amount of funds used from the State Treasury for covering the government debt shall not be changed form 2006 and shall remain on the level of SKK 77.1 billion. According to the preliminary actual figures for the year 2006, ARDAL used additional SKK 74.8 billion for financing the government debt, thus reducing the debt. The aggregate amount of borrowings from the State Treasury reached as of 31.12.2006 the amount of SKK 151.9 billion, and thus ARDAL used the available sources in maximum possible amount.

The current prognosis of the amount of the government debt for the years 2007 to 2010 is based on the assumption that the amount of funds used from the State Treasury for covering the government debt shall be gradually decreased from 2007 by the amount of planned consumption of funds determined for financing the transformation costs for the pension reform, which reduce the available sources for financing the government debt. This means that ARDAL will have to replace such sources by issuing new bonds (the costs for the pension reform in 2009 are partially accounted for in the government budget deficit).

In the next following years, ARDAL will have to issue new bonds to cover the due and payable principal of the debt (the interests are accounted for in the Government budget deficit, in the item government debt interest expenses). It is assumed that ARDAL will issue only such volume of the new debt which shall be required for covering the due and payable old debt, and therefore, this operation shall have a neutral effect on the amount of the aggregate debt. Due to the neutral effect, the item in the table named repayment of the debt principal in the future years is not specified in detail. No other factors, as e.g. changes in foreign-exchange rates, are accounted.

3. Determinants, Targets, and Principles of the Government Debt Management Strategy for the Years 2007 to 2010

3.1. Determinants of the Government Debt Management Strategy for the Years 2007 to 2010

The government debt management strategy for the period of 2007 - 2010 is based on the *Program Declaration of the Government* implemented in binding documents approved by the Slovak Government in 2006, including particularly the *Public Administration Budget for the Years 2007 to 2009* and the *Convergence Program of Slovakia for the Years 2006 to 2010*.

From the aspect of the government debt strategy creation, the most important priority of the Government is the continuing ***consolidation of public finances***, ***more effective use of financial sources, and improved management of financial flows***. The basis is general application of prudent budget and fiscal policy and gradual fixation of long-term stability of public finances. It should be stressed that sufficient level of the consolidating effort[13] - reducing the deficit – is particularly important in the current period of preparation of the Slovak Republic for introduction of the common euro currency. This is why the balanced or even slightly surplus balance of public finances is an inevitable prerequisite for effective functioning of automatic stabilisators in the future and fixation of the stabilizing function of the fiscal policy. The importance of the stabilizing function of the fiscal policy shall be immensely increased by entry of the Slovak Republic to the Eurozone, because the Slovak Republic shall lose the tools of its own monetary policy for elimination of shocks and unbalances in the economy and the application thereof will have to be fully replaced by the fiscal and other sector policies together with flexible and well functioning markets – the labour market and the financial market.

The inevitable condition of consolidation and stability of public finances is compliance with the fiscal ***Maastricht criteria*** (for deficit and debt) and the Slovak Republic´s obligations arising from the reformed Treaty of Stability and Growth. This means particularly sufficiently quick decrease of the main debt factor – the public finances deficit (also from the aspect of future effects of economic cycles and ageing of the population), gradually directed to even balance or slight surplus of public finances and subsequent safe development of the public debt below the level of 60 % GDP, supported by decreasing or stabilization of the relative costs for debt service. One of the important prerequisites for achieving and maintaining these objectives is application of the effective ***active management of the government debt*** (the government debt is the main

[13] The basic consolidating targets and the fiscal forecast are presented in the chapter: Macroeconomic Forecast and Financial Markets, in the part: Local Environment.

component of the public debt, approximately 96.5 % and belongs to full responsibility of the central government) in accordance with the reasonably determined middle-term strategy based on real prerequisites on future development of the main debt factors: 1/ ***government budget deficit, 2/ interest rates in home country and in foreign countries, and 3/ exchange rates of relevant currencies*** (under the assumption of adoption of the common euro currency in the Slovak Republic as of 1.1. 2009). During the entire period to which the current strategy applies, the most important factor of development of the gross government debt will still remain the government budget deficit. However, the negative influence of the primary deficit (excluding the costs for the debt service, i.e. excluding the interests) shall gradually relatively fall under influence of the consolidating effort, and contribution of interest expenses for the debt service will be relatively stabile. Similarly as until now, effective implementation of the strategy will be ensured by special institutions which have been established for this purpose within the reform of public finances – *ARDAL and State Treasury,* with support of adequate legislation and compliance with the system changes in the national accounting methodology (harmonization of the national methodology with the internationally acknowledged and applied methodology of the European Union).

Based on the so far experience it may be further said that from the aspect of concurrence of *realisation of the economic targets of the government and enterprises* - their financial coverage and subsequent pressure on the government deficit and debt – an important role in the strategy of management of the government debt is played particularly by the government plans in privatization of enterprises and the government policy in provision of government guarantees to enterprises [14] (the guarantees represent more than 4 % of debt). As the Slovak Government currently plans no important activities in privatization and final privatization of the government property in strategic enterprises[15], the middle-term strategy cannot account for any positive effect of funds from privatization on development of the gross public debt. However, the other decisions of the Slovak Government – particularly that the Government shall 1/ actively manage the government debt, to rationalize the expenses connected with financing the government debt, and to minimize the risks related to financial assets, liabilities, as well as overall government cash flows, and that 2/ the institute of government guarantees (strong risk factor of debt) shall be used in inevitable extent only and in exceptional cases, are signaling positive effect on future development of the government debt.

In accordance with the several-year budget, in the next following years will continue the ***trend of significant decrease of the volume of government guarantees***, which has been realised since the end of 2002 (the review is shown in the following table).

Development of Volume of Government Guarantees				
in SKK billion	31.12.2002	31.12.2006	02.01.2007	31.12.2010
Volume of government guarantees	102.6	24.7	3.7	2.2
Including: volume of risk guarantees	65.3	19.9	0.0	0.0

Source: MoF SR

The above development is affected by several factors:

- non-provision of any new government guarantees,
- gradual repayment of the obligations with government guarantees by some debtors,

[14] Pursuant to the Law No. 386/2002 Coll. on government debt and government guarantees and on amendment to certain laws, the government guarantee means an obligation of the Slovak Republic to the creditor that it shall fulfill certain obligation on behalf of the debtor, if the debtor fails to fulfill the obligation to the creditor. A government guarantee may be provided for any loans of legal entities and for any bonds issued by legal entities, determined specifically for financing economically returnable projects included in development programs declared by the Slovak Government.

[15] The Government determines which enterprises and institutions are strategic from the aspect of global national interests; shall respect the result of the so-far privatization, and shall guarantee no change in the conditions in the privatized enterprises, provided the privatization process was effected in accordance with the law. In strategic enterprises with capital participation of the state, the Slovak Government shall strictly follow the government interests.

- gradual realisation by the government,
- assumption of a part of the obligations with government guarantees to the government debt.

Since January 2003, no new loans with government guarantees have been provided. Currently, only the existing loans with government guarantees are being gradually repaid.
During 2006, the companies *Slovenské elektrárne, a.s.* and *Slovak Telecom, a.s. Bratislava* prepaid all their obligations from the loans with government guarantees.
The companies *Slovenská záručná a rozvojová banka, a.s. Bratislava, Paroplynový cyklus, a.s.,* and *Pozagas, a.s. Malacky* fulfill their obligations from the loans with government guarantees on regular basis according to the repayment schedules agreed in the loan agreements.
Due to negative financial condition, the obligations of *METRO Bratislava, a.s.* arising from the loan agreements were delimited to the government debt under the Slovak Government Resolution No. 275 dated 29th March, 2006. Subsequently, the Slovak Government by its Resolution No. 1094 dated 20th December, 2006 agreed also with assumption of the obligations of *Slovenský vodohospodársky podnik, š.p. Banská Štiavnica* and *Železnice SR, Bratislava,* arising from the loan agreements to the government debt as of 1st January, 2007.

The provision of government guarantees in the following period shall be significantly reduced by the effect of change in legislation, which shall introduce ***more strict process of approval of government guarantees*** not only by the Slovak Government, but also by the Slovak Parliament in adopting the government budget law for the relevant year. This change was evaluated by the Institute for Economic and Social Reforms within the HESO project – Evaluation of Economic and Social Measures for the 3rd quarter 2005 – as a ***measure with the highest rating***.

The tasks from the Program Declaration of the Slovak Government in respect of government guarantees are realised in full and the current government guarantees no more represent a binding risk for the government debt. As of the 1st January, 2007, the value of the risk government guarantees is zero.

3.2. Targets and Principles of Government Debt Management Strategy for the Years 2007 to 2010

The proposed strategy of management of the government debt is based on the strategy for the years 2003 – 2006. Upon accounting for the existing risks related to the structure and parameters of the government debt and upon accounting of the results of the current system of the debt and liquidity management, the aim of the strategy is to continue in preserving the main targets formulated in the previous strategy, namely to ensure liquidity and access to the market for financing the government needs in a transparent, prudent, and cost-saving way, subject to keeping the risks comprised in the debt on acceptable level. Based on this target, it is also necessary to preserve the following three main general principles.

Principle one: any increase of the debt must be transparent and must have clear rules. Any uncontrolled and uncontrollable increase of debt must be excluded.

Principle two: in active debt management, middle-term and long-term targets should be preferred to short-term savings. Any short-term "savings" must account for larger costs or larger risk of costs in the future.

Principle three: the debt *management should be based on the optimum risk principle. It means that active debt management should be based on quantification of the difference between the potential loss from uncontrolled risk and the costs incurred for elimination thereof.*

From the aspect of the current status of the debt portfolio, the strategy is based on the need to improve and keep the current status of the government debt. Its means particularly the five following targets.

1. Reduced Number of Issues of New Government Securities and Standard Volume of Individual Issues

With the aim to ensure liquidity in the secondary market (which is reflected in the primary market by lower „liquidity" premium required by investors), to further reduce the number of opened issues of government securities to maximum 15 issues (in value of the debt, up to SKK 600 billion). In view of impossibility to repurchase „small issues" issued before 2004, this target may be achieved only by natural maturity of the outstanding bonds and on the other hand by opening and gradual sale of bonds in standard nominal value of SKK 40 billion (or EUR 1 billion) in one issue.

It should be tried to further repurchase the Treasury Bonds and to exchange the bonds from the issues prior to maturity for bonds from the newly opened benchmark issues. The target is to achieve distribution of the due and payable amount for longer period, which will help the investors to remove the need of immediate large investment, and particularly release the Government from the liability to pay a high amount. The secondary effect is stability of the financial market.

2. Improved Transparency of Intentions of the Issuer (MoF SR) and Its Communication with Investors and Financial Markets

Communication of the issuer (MoF SR) with investors, financial markets, and institutions (rating agencies), presentation of results and issuer´s intentions should be further developed and improved by regular meetings with local investors, irregular meetings with foreign investors, and presentations in investors´s conferences.

To implement the system of primary dealers for the primary market with government securities. To create a group of the most active local and foreign banks with the aim to improve liquidity of the government securities in the secondary market.

3. Optimization of Costs (Expenses) of the Government Budget for Government Debt Service

To actively reduce the share of non-tradable debt, accounting for the relevant financial conditions. If possible and appropriate, to terminate by prepayment any non-liquid or low liquid liability (loan, bond, any other obligation). Optimization of costs for the government debt service might also be supported by implementing a measurement of financial efficiency in the treasury system.

4. Maintaining the Average Maturity of Portfolio of Government Securities and Duration of Portfolio of Government Securities

In order to maintain the refinancing and interest risk on acceptable level, it is required to implement a monitoring and evaluating system, similarly as in the other Eurozone countries, by introducing a cumulative maturity limit and refixing limit of debt including interests in one year, and a cumulative maturity limit and refixing limit of debt including interests within 5 years. The suggested monitoring and observing the limit values (refinancing and interest risk) shall have positive effect also on development of the average maturity and duration which shall be monitored only as secondary values.

In respect of the refinancing risk, the strategic target shall be observance of the cumulative maturity limit in one year on the level of 22.5% of the aggregate debt, and the cumulative maturity limit for the next following 5 years on the level of 60% of the aggregate debt.

In case of the refixing risk, the benchmark limit for revaluation of the government debt in the first year will be on the level 25% of the aggregate debt, and on cumulative basis for 5 years, on the level of 65% of the aggregate debt.

5. Gradual Increase of the Government Debt in Foreign Currencies to Slovak Crowns Ratio

Until entry of Slovakia into the Eurozone, benchmark (maturity of 5 years and more, nominal value of the issue EUR 1 billion and more) bonds denominated in EUR will be issued every year according to the EMTN program. The target is to become a reliable and stabile issuer in the paneuropean capital market and to become popular among the investors which purchase Treasury Bonds of the „safest“ EU countries. The secondary aim is to build a yield curve of Slovak eurobonds, usable for revaluation of the other liabilities as well as diversification of the investor base. Issue of Treasury Bonds denominated in EUR and subsequent conversion of the funds raised in this way for local currency shall be realised, accounting for stability of the SKK/EUR exchange rate.

In connection with the low yields until maturity of long-term of government bonds denominated in Japanese Yen ("JPY"), there exists an option to issue Slovak government eurobonds in the Japanese market, which is moreover known by relatively high liquidity. Placement of such issue in the amount of approximately JPY 50 billion (approx. EUR 300 million) would be relatively simple for the Slovak Republic. When compared with the Eurozone, the yields from long-term bonds are lower by approximately 2.0 percentage points. Entry of the Slovak Republic to the Japanese bond market by its eurobond issue may thus represent and attractive challenge particularly from the aspect of low yields or interesting saving of costs for debt service and also higher quality of the debt portfolio by extending the duration or average maturity thereof. However, issue of eurobonds in JPY is connected with the exchange-rate risk which reflects the current and estimated development of the Japanese economy. Although there exist certain doubts on sustainable real growth of GDP in Japan, expectations prevail in the global financial market on favourable development of the Japanese economy, particularly due to the growing local demand and investment sentiment in the business sector. Anyway, the growth of GDP will probably slow-down vs. the year 2006 mainly by influence of the falling foreign demand, particularly by the U.S.A. However, it will depend on the fact how the slow-down of the US economy will be reflected in the global growth of GDP. This is way the trade balance surplus of Japan is created, in addition to the U.S.A., also by significant demand from China; thus, the slow-down of Japanese economy need not be material. Positive forecast for the years 2007 and 2008 is supported also by the labour market, where the lack of labour force already appears, which is proved not only by survey of the investment sentiments, but also by development of unemployment, which is currently on the lowest levels. Such forecast of economy then induces expectations in financial markets that the central bank (Bank of Japan) will probably increase its key interest rate[16]. With gradual more strict monetary policy, it will be more probable that capital flows will be transferred from foreign countries back to the Japanese financial markets. Currently, it cannot be excluded that in the near future, the stage of depreciation of the Japanese Yen would be replaced by the period of appreciation trend. The issuer of eurobonds in JPY, including the Slovak Republic, would face a significant foreign-exchange risk at the time of culminating depreciation of the Japanese currency.

Based on the current development of the Japanese economy and forecast in the middle-term horizon, the bond issue in the Japanese market may be considered as unprofitable, and this unimportant. We assume that during this year, the eurobond in JPY might be issued with a coupon in the rate of 2.2 – 2.8% p.a., and due to the spread which would be required by the issue agent and guarantor (broker through which the issue is realised on the foreign market), the yield until maturity would be even higher. Provided that the JPY/EUR exchange rate would follow similar development as in the long-term horizon in the past, eventually by the effect of change in the exchange rate, the yield until maturity would be increased to the level comparable or even higher

[16] tzv. overnight call rate, ktorá sa momentálne nachádza na úrovni 0,25% p.a.

than in the Eurozone. Thus, the exchange-rate changes could consume the saved interest expenses, for which the issue of eurobonds in JPY could be reasonable or may even bring higher interest expenses than eurobonds in the Eurozone.

There exist options of elimination of the exchange-rate risk by the so-called hedging of exchange rate, in other words, fixing the level of the exchange rate for certain specific period in the future. The fees or commissions for such derivative operations (as e.g. futures or swaps) with the currency are rather high, whereupon the yield until maturity would be increased again and would be closer to the levels in the Eurozone. Because the financial flows in JPY are useless for the Slovak Republic or the Government in the future and would be converted to EUR, via change in the JPY/EUR exchange rate, the volume of coupon payments and eventually also the principal would be changed in such way that probability of the overall exchange-rate loss is rather high. Therefore, it is rather reasonable and safer to avoid issue of any bonds in Japanese Yen.

In order to extend the debt portfolio via eurobond issues, the alternative of the European market is certainly more appropriate. The common European currency shall become in the near future a local currency also in the Slovak Republic, it shall replace the Slovak currency by the conversion exchange rate, which shall result in cessation of the nominal exchange rate and thus also the exchange-rate risk. From this aspect, the issue of eurobonds denominated in euro represents much more secure strategy for refinancing the government debt.

6. To Revaluate and in Case of Suitable Conditions in the Market To Issue Treasury Bonds for the Public.

The idea of issuing bonds for the public is still opened issue, and realisation thereof depends on fulfillment of three main conditions. One is the market environment – the nominal interest rate of the bond should be at least on the level of 3 % to 3.5 % p.a. (and the related demand for such security, subject to prevailing large difference between the market interest rates and the rates offered for the public´s deposits in banks). The second condition of realisation of this plan is to find such method of service of the bonds, which shall bring, at minimum costs, the best conditions for distribution, trading, and repurchase. The third conditions is final solution (harmonization) of different taxation of yields from securities between the individuals and legal persons despite the fact that the issues will be determined for individuals only (retail issue). The bonds issued for the public should be negotiable bonds. Via the bonds, the government may raise funds for financing its needs directly from the citizens – investors without brokers and the margin charged in the commercial sector. With growing standard of life in Slovakia it may be presumed that this method will help to raise several billion SKK annually. With further development of internet and its mass distribution in Slovakia, the use of secured internet seems to be the most probable method of distribution of bonds with minimum costs and will cover the whole Slovakia.

In the EU countries, this supplementary method of financing the government needs is normal, in some countries (e.g. in Portugal) it covers almost 15% of the total need of government financing. The main contribution of such issue is diversification of the investor base (less dependence from the financial and capital market) and lower costs for financing.

3.3. Final Recommendations for the Debt Management Strategy

When compared with the previous strategy, the current proposed government debt management strategy for the years 2007 to 2010 is not significantly different. Development of the debt portfolio in the last years indicates that refinancing of the government debt was realised in the past period between 2003 and 2006 in a way which improves the structure of the government debt, which is proved also by the indicatory of refinancing and interest risk as the duration and average maturity of the outstanding debt portfolio. Thus, it may be said that restructuring of the debt, to which also the previous strategy was aimed, continues in accordance with the basic target of minimizing the costs for the debt service on reasonable level from the aspect risks which are connected with active debt management. Thus it follows from the chapter dealing with evaluation of the previous government debt management strategy for the period of 2003 to 2006, that the strategy for the next following period should be based on the previous targets and should follow-up the commenced process.

Contrary to the previous strategy, this time it is recommended to monitor and evaluate the refinancing and interest risk primarily by benchmark indicators which are applied also in other countries in debt management. These include the indicators of cumulative maturity and refixing which are interpreted more easily. The limits of these indicators, which are determined, will at the same time have positive effect on development of average maturity and duration thereof, which will be monitored only as secondary values. However, a disadvantage of monitoring the indicator of duration and sensitivity thereof to change of the interest rate, it means that if the interest rates rise, the duration shortens. Due to shorter duration, it is required to issue government securities with longer maturity for higher interest rates, which is not most effective (thus, the debt service is more expensive). On the other hand, in case of falling interest rates, the duration is longer and thus enables to cover the debt by instruments which are bound to the floating interest rates, which may result in inadequate increase of the interest risk.

From the aspect of the basic target of the strategy and benchmark indicators for risk control, the most appropriate seems to be only the local financial market and the European financial market. With the approaching date of adoption of the common European currency, any foreign bond issues in the European market, particularly with long period until maturity, are comparably risky, particularly from the aspect of the changing exchange-rate development. Therefore, in diversification of the debt portfolio by issues in foreign currencies, the combination of the government debt in Slovak Crowns and EUR is optimum.

The principles and targets forming the basis of this strategy create an appropriate framework for effective management of the government debt in the next following period between 2007 and 2010.