

RATING PERSPECTIVE

The Slovak Republic

Low government debt provides enough room to absorb large fiscal deficit

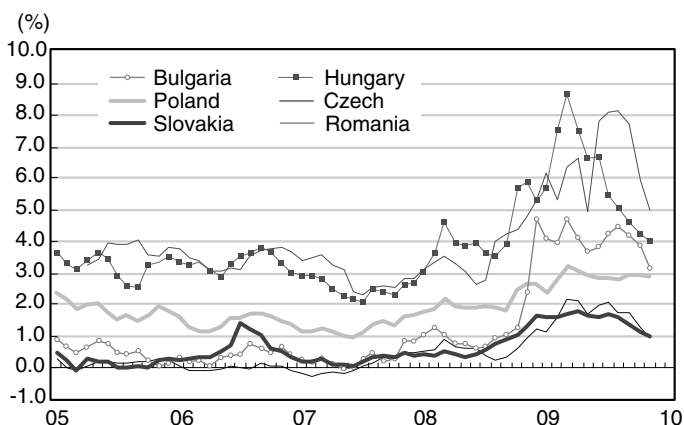
JCR has affirmed its A+ rating on the foreign currency long-term senior debts and the local currency long-term senior debts of the Slovak Republic. The outlook of ratings is stable (Exhibit 1). The ratings are primarily supported by the significant reduction of the country's external financial risks following its euro adoption and the improved productivity rendered by its expanding production capacity resulting from investments on the back of massive foreign direct investment (FDI) and EU subsidies. On the other hand, the ratings are constrained mainly by a sharp rise in the unemployment rate on top of country's high structural unemployment and by the large fiscal deficit which is expected to continue in the coming years on increased spending as stimulus measures and reduced tax revenues induced by the economic slump. This report will review those factors related to the ratings and their future outlook.

Exhibit 1: JCR's ratings to the Central and Eastern European Countries

	Foreign Currency	Local Currency
AA	Slovenia/s	Slovenia/s
AA-		
A+	Slovakia/s	Czech Rep/s, Slovakia/s
A	Czech Rep/s	Poland/s
A-	Poland/s	Hungary/n
BBB+	Hungary/n	Bulgaria/n
BBB	Bulgaria/n	Romania/n
BBB-	Romania/n	

p: positive, s: stable and n: negative

Exhibit 2: Long term interest rate spread with benchmark German bonds



Source: Bloomberg

1. Euro adoption contribute to substantial reduction of external financial risks

Slovakia achieved the adoption of the euro in January 2009. It had not experienced a sharp depreciation of its currency during the latest financial crisis as seen in some neighboring countries. In addition, both long-term government bond yield spread over the German bond and sovereign credit default swap have been less volatile compared with those of the neighboring countries (Exhibit 2).

JCR holds that the euro adoption will bring a country far more merits than demerits for its creditworthiness and contribute to significant reduction of its external financial risks. One of demerits involved is that initiative in the monetary policy is inevitably transferred to the ECB and that the country loses a policy option to adjust international competitiveness through exchanges rates. On the other hand, there are a number of merits. In the first place, euro adoption makes it possible for the country to reduce various risks and costs related to its currency sovereignty. Secondly, the ECB with the stronger credit standing as compared to the country's central bank becomes the last resort of financial liquidity. Thus, euro adoption will contribute to substantially reducing the country's external financial risks as exemplified by the past currency crisis, spurring fresh FDI inflows and expanding international trade.

2. Economic recovery will be moderate

Slovakia's economic growth rates averaged 7.4% during 2004-2008, driven primarily by an expansion of domestic demand led by consumer spending and capital investments which were induced by accelerated inflows of FDI. The productivity has been constantly improved due mainly to the expansion of the production capacity bolstered by investments on massive FDI and EU subsidies. Per capita GDP in PPP terms increased from 50% of the EU-27's average in 2000 to around 72% in 2008, with the gap narrowing considerably.

The Slovak economy deteriorated significantly in the first half of 2009 on a sharp fall in the exports of cars and electric appliances amid the economic downturn in its major trading partners in the EU, which normally account for more than 80% of the total exports. However, there have been signs of recovery lately. The industrial production has been improving since the second half of 2009 (Exhibit 3). The economy grew 1.6% and 2.2% quarter-on-quarter in the second and the third quarters of 2009 thanks to recovery of the external demands (Exhibit 4).

Unemployment rate (Eurostat) dropped to the 7% level in 2007 as the government, in an attempt to make the country

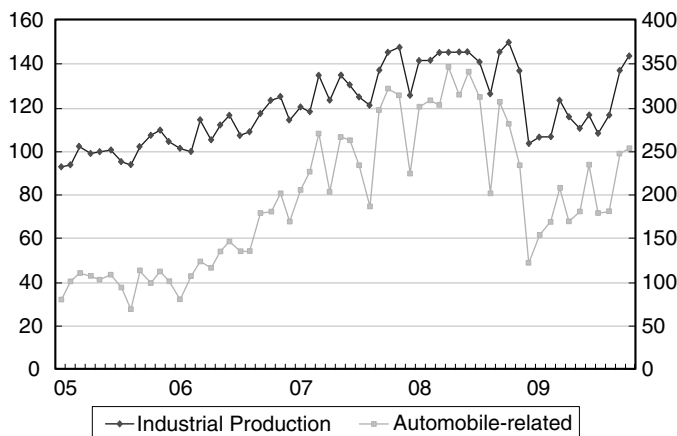
a production base for manufacturing, succeeded to invite many foreign companies which provided employment. However, the rate surged to 12.4% in October 2009 due to the slumped corporate activity amid a steep fall in the external demands. The country continues to hold large amount of structural unemployment, which accounts for more than 80% of the total unemployment, one of the highest among the EU countries (Exhibit 5). In addition, the comparison among major regions across the country shows that a regional gap exists, with the jobless rates being higher in the eastern regions than in the western regions bordering Austria. The government has been providing incentives to attract FDI to the regions with high unemployment rates, but no correction has been made so far.

Consumer price has converged with the EU average level since 2007 as the central bank's inflation targeting framework, implemented in 2005 in pursuit of fulfillment of the

Maastricht criteria, has operated effectively. It has been hovering at a low level since the latter half of 2008 due to fall in food and energy prices as well as the low demand.

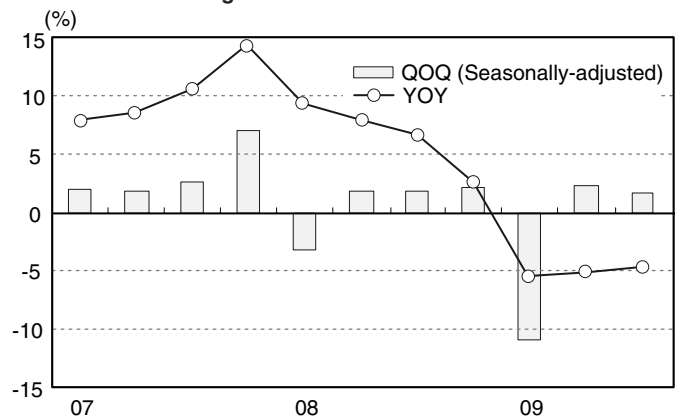
The current account balance has been in constant deficit as the increased dividend payments amid accumulated FDI have led to a wider income deficit although the trade balance, which had been in deficit due to increase in the imports of capital goods used for the construction of new car assembly plants, has begun improving as the start-up of those plants in 2006 has led to full-fledged car shipments. The current account deficit widened to 6.5% of GDP in 2008 from 5.3% the previous year. In the January-September period of 2009, however, it narrowed to 2.7% from 6.4% in the same period of the previous year, as the lower dividend payments on declined corporate profits and the lower imports amid subdued domestic demand led to a contraction of the income and trade deficits (Exhibit 6).

Exhibit 3: Industrial Production



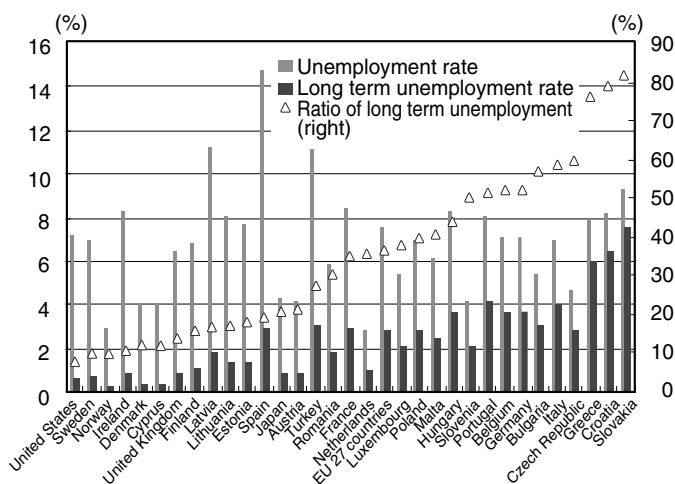
Source: Slovak Stat

Exhibit 4: Real GDP growth rate



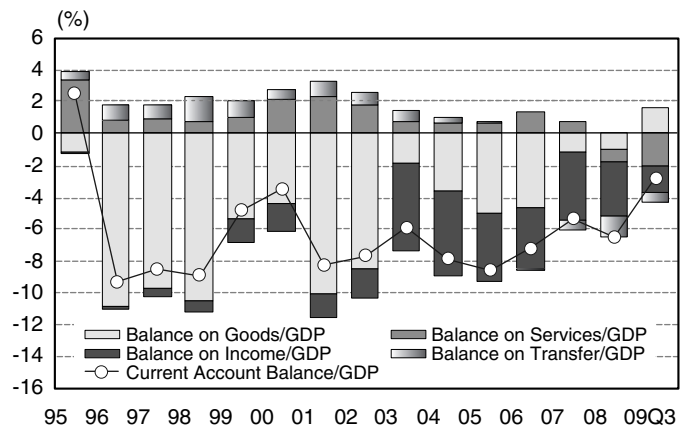
Source: Slovak Stat

Exhibit 5: Long term unemployment rate (2008)



Source: Euro Stat

Exhibit 6: Current Account Balance/GDP



Source: Slovak Stat

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JCR projects that Slovak economy shrank by around 5% in 2009. The GDP growth rate in 2010 and 2011 is expected to be between 1% and 3% assuming the recovery of its major trading partners to be modest and also the high level of unemployment to become a shackle against the rebound in its domestic demand.

3. Relatively sound financial system

Bank lending to the private sector grew by more than 20% between 2005 and 2008 amid the strong economic growth. The central bank promptly responded to the financial crisis started in September 2008 by providing government guarantee to bank bonds, guaranteeing the deposits of individuals and small to medium sized enterprises with no upper limit up until the end of 2010, providing guarantees to the loans of small to medium sized enterprises, and simplification restructuring procedures for personal loans and mortgages. Thanks to these support measures by the central bank and the euro adoption which has helped avert a major deterioration of foreign currency liquidity, no private banks received the injection of government funds availed for the worsening of their financial position. The capital adequacy ratio of the banking sector as a whole has been kept sound, standing at over 12% as of the end of June 2009. The non-performing loan ratio is on the increase amid the economic slump, but still remains at a manageable level. Though more

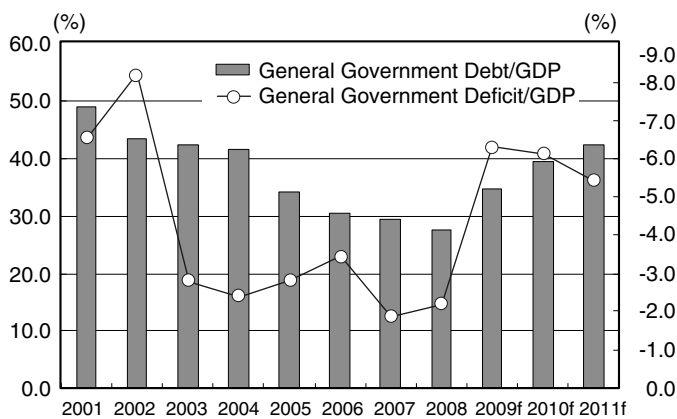
than 90% of the total bank assets are held by foreign banks mainly those in Austria, there have been no movements by the parent banks to withdraw capitals from their subsidiaries in Slovakia.

4. Low government debt provides enough room to absorb large fiscal deficit

As the former and current governments aggressively tackled with fiscal reforms, the budget deficit had been on the decrease until 2008, except for 2006 when it was negatively affected by the general election (Exhibit 7). On the expenditure side, not only cuts in the current primary expenditures were made, but broad based reforms were implemented in the pension and healthcare system, which were crucial to contain expenditures in the medium-term perspective. On the revenue side, the tax system was simplified through the introduction of a flat tax rate of 19% for the corporate and personal income taxes and the value added tax. Thanks to these efforts, the general government budget deficit as a percentage of GDP (ESA95) has always been lower than the original budget targets since 2003, with those of 2007 and 2008 cut to around 2%.

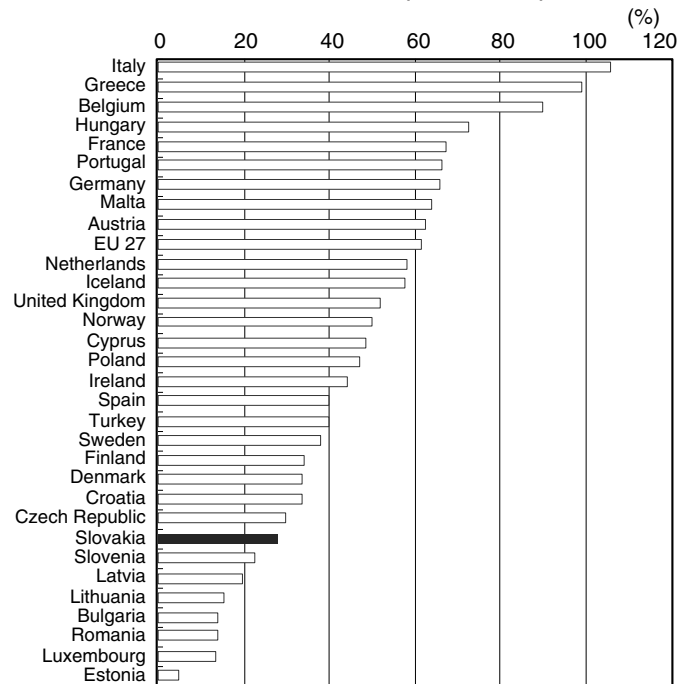
The fiscal deficit is estimated to have widened to around 6% of GDP in 2009 due to a major fall in tax revenues and the implementation of a fiscal stimulus package totaling 1% of GDP in 2009-2010, which includes the car scrapping incen-

Exhibit 7: General Government Deficit and General Government Debts (as % of GDP)



Source: Euro Stat. Figures for fiscal balance are based on ESA 95, Figures for 2009-2011 are projections made by JCR

Exhibit 8: General Government Debts (as % of GDP)



Source: Euro Stat

tive scheme, the raise in tax credit for low income earners, employment subsidies and encouraging R&D spending. A large fiscal deficit may also continue in 2010 due to reduced tax revenues and increased expenditures on the countercyclical measures.

The general government debt shrank to 27.7% of GDP in 2008 from 49.0% in 2001 thanks to progress in the fiscal reforms. The public debt/GDP ratio is projected to rise to exceed 40% in the coming years due primarily to deterioration of the fiscal balance. However, the ratio is still lower among the EU economies (Exhibit 8).

In December 2009, the European Commission urged the country to slash its fiscal deficit to less than 3% of GDP by 2013. JCR expects that the government will carry out fiscal consolidation measures in accordance with the EU's Stability and Growth Pact once the economy is brought back on a recovery track. The personal income tax rate in Slovakia is one of the lowest among the EU countries. Its rise may be inevitable in the medium term, albeit challenging.

5. Whether the current and next governments will uphold disciplined economic and fiscal policies needs be monitored

The administration of Prime Minister Robert Fico, which came into power in July 2006, chose as its coalition partners the populist People's Party-Movement for a Democratic

Slovakia (LS-HZDS) and the far-right Slovak National Party (SNS). This made other countries and investors concerned as political management could turn reactionary or nationalistic as seen in the 90th when the Meciar administration was in power. But that actually did not happen. The coalition government made some partial changes to the structural reforms implemented by its predecessor such as social security reforms and privatization, but retained its basic policies geared for euro adoption. It achieved euro adoption in January 2009, steadily carrying out its economic and fiscal policies. These efforts won high evaluation from the public, and Fico's Direction-Social Democracy party (Smer-SD) substantially increased the number of its seats in the local elections held in November 2009.


General election is scheduled to be held in mid 2010. The opinion poll conducted by the Slovak Spectator newspaper in December 2009 shows that the total share of the support ratings of the ruling parties stands at 53.3%, well exceeding that of the opposition parties, with Direction-Social Democracy (Smer-SD) seizing 37.9%, SNS 8.4% and LS-HZDS 7.0%. This indicates that the current ruling coalition led by Smer-SD is likely to head the next government. JCR will closely monitor the current and next governments' continued commitment to disciplined economic and fiscal policies. 

Exhibit 9: Major economic indicators

	Unit	2005	2006	2007	2008	2009(f)	2010(f)	2011(f)
Real GDP growth rate	(%)	6.6	8.5	10.4	6.6	-5.0	1.9	2.5
Consumer price inflation (YOY)	(%)	2.8	4.3	1.9	3.9	0.7	2.1	2.4
Unemployment rate	(%)	16.2	13.4	11.1	9.6	12.3	12.7	11.7
General government fiscal balance / GDP	(%)	-2.8	-3.5	-1.9	-2.2	-6.3	-6.1	-5.4
General government fiscal debts / GDP	(%)	34.2	30.4	29.4	27.6	34.6	39.3	42.5
Current account balance / GDP	(%)	-8.6	-7.2	-5.3	-6.5	-3.8	-4.5	-4.0
Trade balance / GDP	(%)	-5.0	-4.7	-1.2	-1.1	1.6	-2.4	-1.5
Net foreign direct investment / GDP	(%)	4.8	7.0	3.5	3.3	1.0	2.0	2.5
External debts / GDP	(%)	57.0	59.3	59.1	55.0	76.5	79.6	80.8
External debts / exports G&S	(%)	74.5	68.7	68.7	67.0	106.0	110.8	111.4

Source: Ministry of Finance, Central Bank, Eurostat. Figures for fiscal balance are based on ESA 95, Figures for 2009-2011 are projections made by JCR