RATING PERSPECTIVE

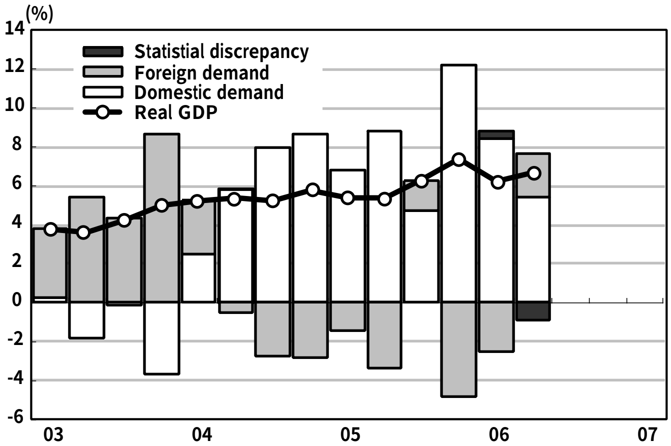
Slovakia: Steady progress on preparations for the planned euro adoption in January 2009

In its annual review of the Republic of Slovakia on September 28, 2006, JCR upgraded its ratings on foreign-currency and local-currency long-term senior debts (A/stable for foreign-currency debts, A+/stable for local-currency debts). The revision was primarily prompted by the steady progress the country has been making on preparations for the planned euro adoption in January 2009, led by improved economic and fiscal performances as well as the introduction of ERM2. The ratings also reflect the country's strong economic growth and reduced budget deficit brought under the former coalition government's ambitious economic and fiscal reform initiatives and further expansion of exports centering on automobiles that stemmed from growing production capacity rendered by massive foreign direct investment (FDI) inflows. On the other hand, the ratings are mainly constrained by the high unemployment, the second highest among EU-25 after Poland. This report reviews some of the main factors JCR had taken into consideration in upgrading its ratings.

Exhibit 1. Ratings for the Central and East European Countries

	Foreign Currency	Local Currency
AA		Slovenia
AA-	Slovenia	
A+		Czech Rep. and Slovakia
A	Czech Rep. and Slovakia	Hungary and Poland
A-	Hungary and Poland	
BBB+		Bulgaria
BBB	Bulgaria	Romania
BBB-	Romania	
BB+		

Exhibit 2. Real GDP (YOY)

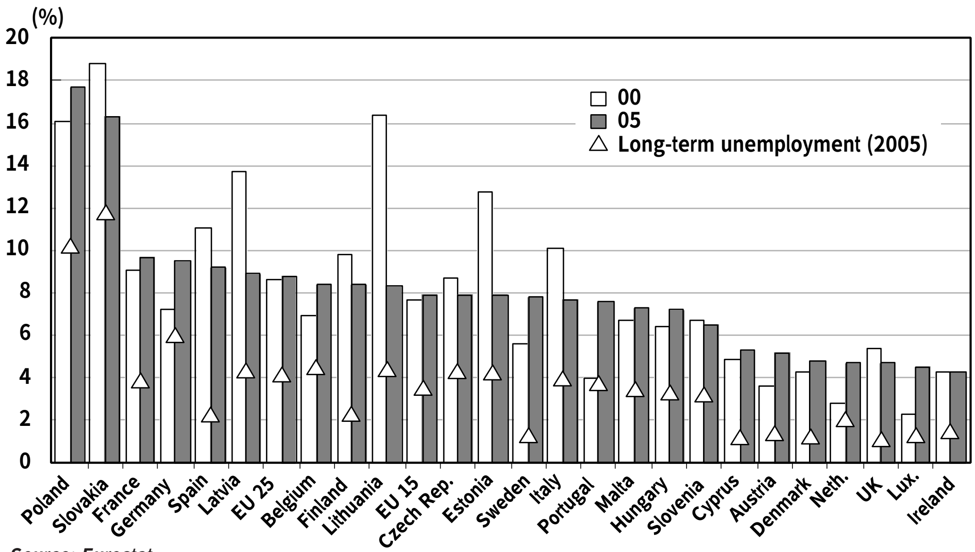


Source: Statistical Office of the Slovak Republic

1. Continued economic expansion led by domestic demand amid moderate inflation

The Slovak economy grew a strong 5.2% annually between 2003 and 2005 despite the slow economic growth in the EU-15 and the appreciation of the koruna. The momentum of the economic expansion shifted from external demand in 2003 to domestic demand after 2004 (Exhibit 2). The ongoing expansion is underpinned by consumer spending buoyed by an improved employment, wage increases and growing consumer credit as well as the expansion of gross fixed capital formation related to the massive FDI inflows. The economic growth rate in the first half of 2006 accelerated to 6.5% year-on-year. The core consumer price inflation rate stayed relatively lower at 2.8% year-on-year in August 2006, but overall inflation rose to 4.6% year-on-year on higher oil prices and a hike of the tobacco tax rate. Taking these developments into consideration, the National Bank of Slovakia in April revised upward its inflation target at the end of 2006 from 2.5% to 3.9% and has raised its policy rate by 175 basis points to 4.75% since the turn of the year.

Exhibit 3. Unemployment rate among EU countries

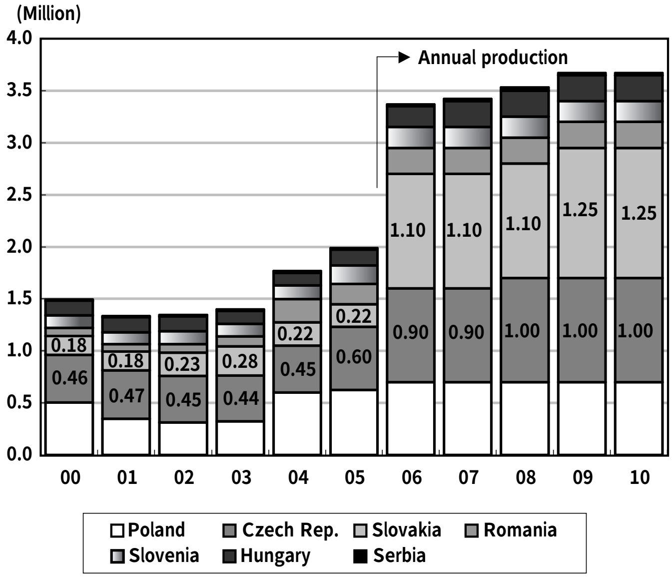


Source: Eurostat

The strong expansion of domestic demand deteriorated the external balance as the current account deficit in 2005 substantially widened to reach 8.6% of GDP. Financing of the current account deficit was rather weak as it was covered not only by FDI inflows but also by short-term deposit from overseas. Nonetheless, there is little concern about short-term external finance as the current account deficit in the first half of 2006 was fully covered by FDI inflows and sufficient foreign exchange reserves, which were four times as much as the value of monthly imports. The financial system continued to improve as bank lending kept growing amid progress on disposal of nonperforming loans and recovery of sound management at banks following privatization of large state-own banks.

On the other hand, the high unemployment rate, though improving thanks to the labor market reforms implemented by the former government, still remained high at 14.0% in July 2006, the second highest among the EU-25 countries (Exhibit 3). The labor market in Slovakia is extremely inflexible. According to the Eurostat, Slovakia's long-term unemployment rate is the highest among EU-25 at 11.7% in 2005 and accounts for more than 70% of the country's total unemployment. The proportion of part-time employment to total employment is as low as 1.4%. Furthermore, there are wide regional gaps in unemployment rates. Unemployment rate in the western part of the country closer to Austria is lower rate than that in the eastern part. The government has taken incentives to encourage FDI in the regions with higher jobless rates. So far, however, it has failed to narrow the regional gaps. Given the country's negative demographic trends, an efficient use of its limited manpower as well as FDI inflows is imperative to ensure sustainable economic growth.

Exhibit 4. Annual production and its capacity in the Central and East European countries

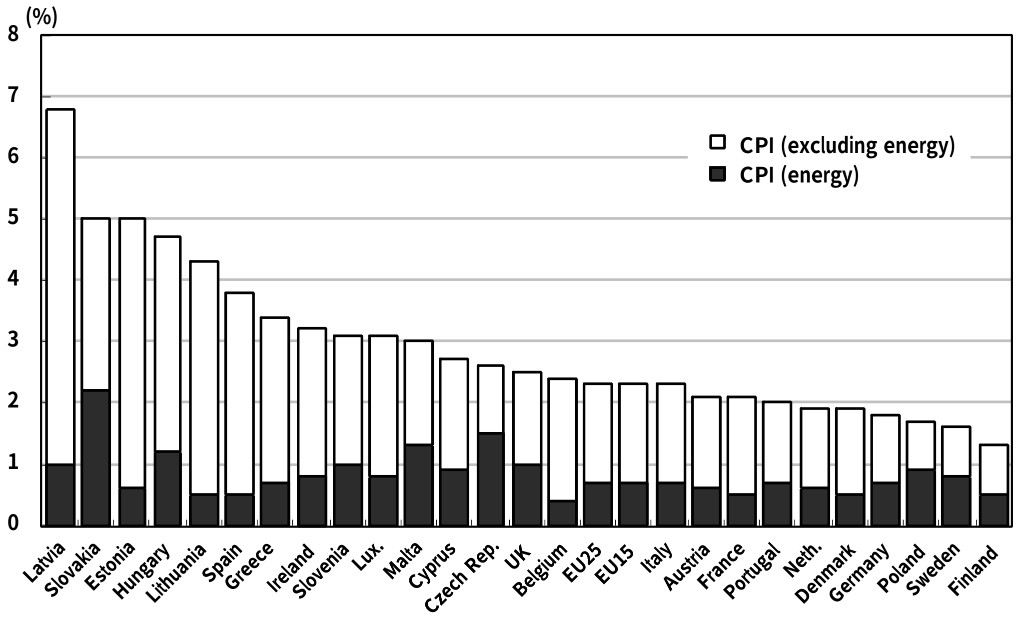


Source: International Organization of Motor Vehicle Manufacturers (OICA)

2. External imbalance will improve amid export-led economic expansion

The country's economic growth rate will remain higher than 5% in 2006 and 2007 on strong exports despite a slight slowdown of domestic demand due to higher interest rates and lower wage increases. In particular, exports will increase robustly following the start-up of two automobile plants with a combined annual production capacity of 60,000 vehicles (Exhibit 4: the total annual production capacity will rise to over 1 million vehicles in 2006). The export expansion may lead to reduction of the current account deficit. Barring further rises in energy prices, inflation is likely to slow to around 3% in 2007. JCR will keep watching how energy prices will affect the inflation. Inflation in Slovakia is highly vulnerable to energy prices due to its inefficient use of energy and high dependence on imported energy (Exhibit 5).

Exhibit 5. Consumer price inflation among EU countries



Source: Eurostat

3. Fiscal deficit narrowing thanks to reforms pushed by former government

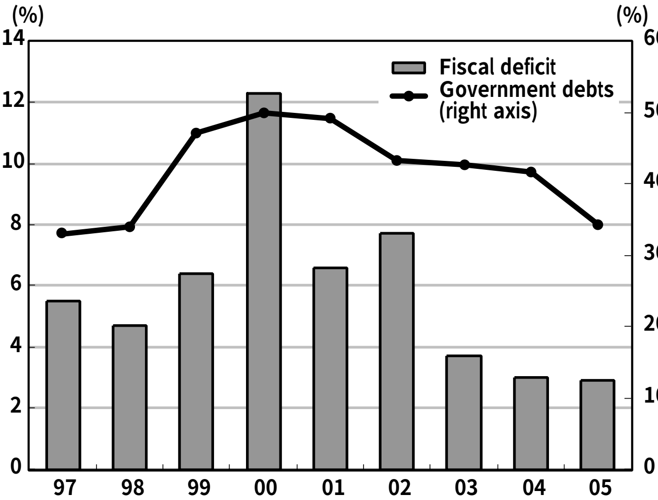
Fiscal deficit continued to improve on the back of the ambitious fiscal reform program implemented by the former government (Exhibit 6). On the expenditure side, the administration has not only slashed current expenses but also carried out wide-ranging social security reforms involving the pension and healthcare systems, which were needed to cut fiscal deficits in the medium term. On the revenue side, it has simplified the tax system by lowering the VAT, income and corporate tax rates to a uniform 19%. All these reforms have proved effective in reducing the fiscal deficit. In fact, the general government fiscal deficit (ESA95) stayed well below the government-envisaged levels since 2003 and narrowed to a level equivalent to 2.9% of GDP in 2005. The government debt was slashed to 34.5% of GDP at the end of 2005. The 2006 budget complied by the former government projected the general government fiscal deficit at 2.2% of GDP (excluding the pension reform costs), which JCR sees as a relatively conservative estimate. The projection was based on the Convergence Program unveiled at the end of 2005 to provide a roadmap to euro adoption. This target is highly likely to be achieved. In fact, the central government fiscal deficit in the first half of 2006 was trimmed to 0.3% of GDP or 9% of the annual deficit as envisaged for the year in the budget plan.

4. Progress made on preparations for euro adoption; focus shifts to fiscal reforms by new coalition government

Steady progress has been made on preparations for the projected euro adoption in January 2009 on the back of improved economic and fiscal performances as well as the introduction of ERM2 in November 2005. Slovakia fulfilled the Convergence criteria, one of prerequisites for euro adoption, with the exception of inflation and exchange rate (Exhibit 7). Higher inflation was primary caused by a sharp rise in energy prices. However, continued stabilization of energy prices will help achieve the criteria. Since the country's adoption of ERM2, the koruna has stayed within the upper and lower limits of fluctuation allowances (plus or minus 15%) from the central parity against the euro (38.455) for the past four years. Moreover, per capita GDP in PPP terms, a yardstick often used to examine real convergence, rose to a level equivalent to 55% of the EU average from 48% in 2000 (Exhibit 8). It is expected that the country will be able to fulfill all Convergence criteria in 2007 and introduce the euro in January 2009 if the new government can hold on to the reform path laid by its predecessor and succeed in containing inflation.

JCR considers that the adoption of the euro provides some positive factors for its ratings as it brings a country benefits far bigger than the costs involved. The costs involved include that the country's economic policy is inevitably restricted to fiscal measures, as it is required to transfer its monetary policy to the European Central Bank (ECB).

Exhibit 6. General government fiscal deficit and debts (as % of GDP)



Source: Eurostat

Moreover, the country is required to keep its labor market more flexible since it becomes harder to adjust international competitiveness through exchanges rates. On the other hand, benefits include, in the first place, that euro adoption makes it possible for the country to reduce various costs related to currency exchange. Secondly, it makes currency exchange almost unlimited. Thirdly, the highly credible ECB rather than the country's central bank becomes the last resort of financial liquidity. These will reduce possible currency risks and spur new FDI inflows. Euro adoption, which is conditional on compliance with the Convergence criteria, may have a favorable impact on the economy as it will help stabilize the inflation rate and long-term interest rates.

The new 10 EU members including Slovakia which joined the EU in May 2004 initially planned to introduce the euro between 2007 and 2010. Currently, however, progress on preparations varies from county to country. Slovenia has already decided to introduce the euro in January 2007 as initially planned. By contrast, Lithuania, which had planned its euro adoption in January 2007 together with Slovenia, was forced to put it off as it failed to fulfill the Convergence criteria due to higher inflation rate caused by sharp rises in energy prices and economic expansion. Slovakia, as seen above, is making steady progress on preparations for euro adoption. Estonia, Latvia, Cypress and Malta keep January 2008 as the target date for their adoption of the euro. As these six countries have already introduced the Exchange Rate Mechanism II (ERM2), they are very likely to introduce the euro by 2010 if they can succeed in fulfilling the inflation and fiscal criteria.

The three other countries, Poland, Hungary and the Czech Republic, which have larger economies than the seven, initially planned their euro adoption in 2009 or 2010. However, the three countries have yet to introduce the ERM2.

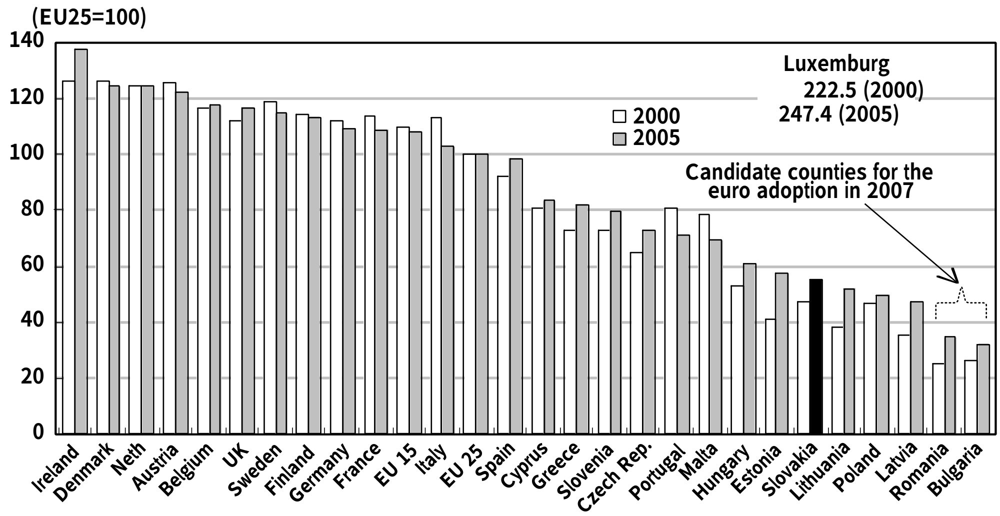
Exhibit 7. Achievement of convergence criteria for the euro adoption

	Fiscal figures		Inflation	Long-term Interest Rate	Exchange Rate	Target date for the euro adoption
	Fiscal balance as % of GDP	Fiscal debts as % of GDP	note 2	note 3	note 4	
(Criteria)	within -3%	below 60%	2.9%	5.4%	2 years	
	(2005)	(2005)	(05/08-06/07)	(05/08-06/07)	adoption date	
Estonia	1.6	4.8	4.4	n.a.	June 2004	2008
Cyprus	-2.4	70.3	2.2	4.2	May 2005	2008
Latvia	0.2	11.9	7.0	3.8	May 2005	2008
Lithuania	-0.5	18.7	3.2	3.8	June 2004	unspecified (initially 2007)
Malta	-3.3	74.7	3.1	4.3	May 2005	2008
Slovenia	-1.8	29.1	2.6	3.7	June 2004	2007
Slovakia	-2.9	34.5	3.9	3.9	Nov 2005	2009
Czech Rep.	-2.6	30.5	2.3	3.6	No	unspecified (initially 2010)
Hungary	-7.5	62.3	3.4	6.7	No	unspecified (initially 2010)
Poland	-2.5	42.5	1.3	5.1	No	unspecified (initially 2009)

Source: The European Commission, Convergence program of each country
Notes 1: Highlighted area indicates fulfillments of criteria.
2: The inflation rate not to exceed the average of three best performing Member States by more than 1.5%.
3: Long-term interest rate not to exceed the average of three best performing Member State by more than 2%.
4: The exchange rate to be kept within the normal margin of fluctuations as stipulated by the Exchange Rate Mechanism II.

They have begun to drop specific dates for euro adoption. It is highly likely that their adoption will be delayed for at least a few years. In Poland, the right-wing coalition government elected after the general election in September 2005, withdrew a specific target date. In Hungary, the Socialist coalition government re-elected in the April 2006 election was forced to postpone its target date beyond 2010 due to substantial deterioration of fiscal deficits. The Czech Republic has also dropped its initial target date in 2010. The country has already fulfilled its Convergence criteria. However, its right-wing caretaker coalition government is rather skeptical about euro adoption. With parliamentary seats equally divided between the ruling and opposition parties, no official government has been formed yet in the country.

Exhibit 8. Per capita GDP in PPP among EU countries



Source: Eurostat

5. Fiscal policy by new coalition government is crucial

In Slovakia, the election in June 2006 was very important in foreseeing the future course of fiscal reforms and euro adoption. In that election, Smer-SD won 50 seats, the largest number in the 150-member parliament. It formed a tripartite coalition with the nationalist Slovak National Party and the rightist People's Party-Movement for Democratic Slovakia (Exhibit 9). The three parties together command a comfortable parliamentary majority with 85 seats. Robert Fico, the

Exhibit 9. General election results

	Sep. 2002		Jun. 2006	
Political Party	% of votes	Seats	% of votes	Seats
Smer-Social Democracy	13.5	25	29.1	50
Slovak Democratic and Christian Union	15.1	28	18.4	31
Hungarian Coalition Party	11.2	20	11.7	20
Slovak National Party	3.3	0	11.7	20
People's Party-Movement for a Democratic Slovakia	19.5	36	8.8	15
Christian Democratic Movement	8.3	15	8.3	14
Alliance of the New Citizen	8.0	15	1.4	0
Communist Party of Slovak	6.3	11	3.9	0
Other	14.8	0	6.7	0
Total	100.0	150	100.0	150
Ruling parties	45.9	79	49.1	84
Opposition parties	54.1	71	50.9	66

Smer-SD leader, was named new Prime Minister and his Cabinet members were approved in parliament on August 4. Smer-SD took all important portfolios in the Cabinet. The new government has reaffirmed the previous administration's policy to adopt the euro in January 2009. It has pledged to launch a partial review of the social security reforms its predecessor had implemented to revive a social welfare state. It has also said that it will keep the annual fiscal deficit below 3% of GDP through 2009 while increasing spending and changing the tax system to the extent the fiscal deficit may not widen. In view of its closer relations with the business community, Smer-SD is expected to steer its policies with much prudence. All these seem to suggest that any major revision of the current reform commitments is unlikely at least for the time being. However, JCR will closely watch the new government's fiscal and economic policies since Smer-SD's two coalition partners, which had led Slovakia into international isolation in the mid-1990s (e.g., a delay in accession negotiation with the EU), may force some fundamental revision of the ongoing reform programs.

Exhibit. 10 Major economic indicators of the Slovak Republic

	unit	03	04	05	06(f)	07(f)
Real GDP	(%)	4.2	5.4	6.1	6.5	5.5
Consumer price inflation	(%)	8.5	7.6	2.5	4.7	3.0
Long-term government bond yield	(%)	5.0	5.0	3.4	4.8	3.5
Unemployment rate	(%)	15.2	14.3	11.6	11.0	10.5
General government fiscal balance/GDP (ESA95)	(%)	−3.7	−3.0	−2.9	−2.2	−2.0
General government fiscal debt/GDP (ESA95)	(%)	42.7	41.6	34.5	32.0	30.0
Current account balance	(%)	−0.8	−3.6	−8.6	−6.8	−4.9
Current account balance/GDP	(%)	−1.9	−3.7	−5.2	−4.8	−2.4
Trade balance/GDP	(%)	0.7	0.6	0.7	0.9	0.7
Net Foreign direct investment	(%)	−0.4	−1.0	−4.2	−3.8	−4.2
Net Foreign direct investment	(%)	0.7	0.4	0.1	0.9	1.0
Foreign exchange reserve	(%)	2.2	3.3	3.7	3.4	2.5
Net Foreign direct investment	(%)	262.3	93.0	43.3	49.9	51.7
Foreign debt/GDP	(%)	54.0	56.5	57.0	54.7	53.9
Foreign debt/Exports	(%)	72.0	75.8	74.3	67.6	62.0
Public foreign debt/Exports	(%)	39.9	38.1	23.5	19.2	18.7
Public foreign debt/Exports	(%)	20.9	22.0	15.3	12.2	10.5
FOREX/Monthly imports	(months)	5.5	5.3	4.6	4.2	3.8
FOREX/Short-term foreign debt	(%)	1.8	1.7	1.2	1.1	1.3
Debt services	(%)	13.9	11.5	10.4	9.8	8.2

Sources: Central Statistical Office, National Bank of Slovakia, Ministry of Finance and Eurostat. Figures for 2006 and 2007 are based on forecast of JCR