

Central & Eastern Europe - Slovenia, Slovakia and Hungary

The euro introduction and creditworthiness

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Kazuki Hara Senior Analyst, International Department
Kenji Sekiguchi Senior Analyst, International Department

Slovakia's introduction of the euro from January 2009 was formally approved in July 2008. This makes Slovakia the fourth of the ten Central and Eastern Europe countries that joined the EU in May 2004 to introduce the euro, following Slovenia in January 2007 and Malta and Cyprus in January 2008. Hungary, on the other hand, which led the Eastern and Central European countries in taking market-oriented economic reforms, abandoned its fixed exchange rate regime against the euro in February 2008, and thereby prospects for Hungary's participation in the European Exchange Rate Mechanism (ERM II) have also dimmed.

R&I upgraded Slovenia's Foreign Currency Issuer Rating to AA- in November 2006 when that the EC approved its adoption of the euro. Following that, upward pressure on prices has intensified in Slovenia, which currently has the highest inflation rate in the euro zone. R&I does not believe accelerating inflation has damaged Slovenia's creditworthiness, however, and in August 2008 affirmed the rating at AA-. In July 2008 R&I upgraded Slovakia's Foreign Currency Issuer Rating as well to A from A-, following Slovakia's formal decision to adopt the euro. For Hungary, however, elimination of the fixed exchange rate trading band has been pushed the date for introduction of the euro into the future. Given heightened uncertainty in the outlook for Hungary to achieve sound fiscal administration, R&I downgraded Hungary's Foreign Currency Issuer Rating in August 2008 from A- to BBB+.

While R&I evaluates the benefits after introduction of the euro conservatively, it judges the ratings with placing greater emphasis on the economic realities of each country, based on the thinking that a country's creditworthiness could decline significantly as a result of the economic and fiscal measures implemented after introduction of the euro. For the EU member states in Central and Eastern Europe, which are less robust economically than countries that have already adopted the euro, R&I has accordingly incorporated into each country's rating the progress toward greater fiscal soundness in advance of introduction of the euro, and the progress in improving fundamental economic capabilities. As there are countries like Hungary that will require more time than originally anticipated until introduction of the euro is realized, R&I reflects in the rating of each country the differences in creditworthiness produced by economic and fiscal management efforts aimed at adoption of the euro.

	Foreign Currency	
	Rating	Outlook
The Republic of Slovenia	AA-	Stable
The Slovak Republic	A	Stable
The Republic of Hungary	BBB+	Stable

Differences in the race to introduce the euro and the convergence criteria

In May 2004, ten countries in Central and Eastern Europe including Slovenia, Slovakia and Hungary newly joined the European Union (EU). When viewed from the extent to which they have achieved the Maastricht convergence criteria for introduction of the euro, the differences among three countries are plainly evident - namely, Slovenia, which achieved introduction of the euro in January 2007, Slovakia, which is approved for introduction of the euro from

January 2009 and Hungary, where prospects for participation in the European Exchange Rate Mechanism (ERM) II, that is a presupposition for introduction of the euro, have faded.

When introducing the euro, EU signatories must clear the five conditions specified by the convergence criteria: (1) the ratio of the annual government deficit to gross domestic product (GDP) must be 3% or less, (2) the ratio of gross government debt to GDP must be 60% or less, (3) the inflation rate must not exceed by more than 1.5% points the rate of the three best-performing Member States in terms of price stability, (4) the nominal long-term interest rate must not exceed by more than 2% points that of the three best-performing Member States in terms of price stability and (5) participation in ERM II without break for a minimum of two years.

Slovenia had already cleared the criteria for fiscal balance and gross government debt outstanding when it joined the EU in 2004, and began participation in ERM II from June 2004. Slovakia also cleared the two fiscal administration criteria, but postponed its participation in ERM II until November 2005.

Hungary, on the other hand, has seen its debt burden expand and its long-term interest rate exceed the euro zone average as a result of its fiscal deficit, which has fluctuated above 6% of GDP since 2005. Without participating in ERM II, Hungary independently set a fixed exchange rate and maintained a trading band permitting fluctuations 15% above or below the fixed rate. Hungary abandoned this mechanism in February 2008, however and moved to a floating exchange rate regime. While the National Bank of Hungary expressed to have taken this decision to adjust the exchange rate to the optimal rate for introducing the euro, the bank has strengthened its stance of emphasizing price controls. This suggests that Hungary's participation in ERM II, which is a presupposition for introduction of the euro, has in fact been pushed further into the future.

It is incontrovertible that efforts to meet the convergence criteria place a considerable burden on the economy when a country takes a step toward introduction of the euro. Nevertheless, it is also true that introduction of the euro brings substantial

Economic Performances and Convergence Criteria

	2004	2005	2006	2007	2008
Slovenia	A	A+	AA-	AA-	AA-
1) Real GDP growth rate	4.4	4.1	5.7	6.1	4.2
2) Fiscal deficit & GDP	-2.3	-1.5	-1.2	-0.1	-0.6
3) Government debt & GDP	27.6	27.5	27.2	24.1	23.4
4) Inflation rate	3.7	2.5	2.5	3.8	5.4
5) Long-term interest rate	4.7	3.8	3.9	4.5	-
6) ERM II entry & Euro adoption	Yes, ERM II	ERM II	ERM II	Yes, Euro	Euro
Slovakia	BBB+	BBB+	A-	A-	A
1) Real GDP growth rate	5.2	6.6	8.5	10.4	7.0
2) Fiscal deficit & GDP	-2.4	-2.8	-3.6	-2.2	-2.0
3) Government debt & GDP	41.4	34.2	30.4	29.4	29.2
4) Inflation rate	7.5	2.8	4.3	1.9	3.8
5) Long-term interest rate	5.0	3.5	4.4	4.5	-
6) ERM II entry & Euro adoption	No	Yes, ERM II	ERM II	ERM II	ERM II
Hungary	A-	A-	A-	A-	BBB+
1) Real GDP growth rate	4.8	4.1	3.9	1.3	1.9
2) Fiscal deficit & GDP	-6.5	-7.8	-9.2	-5.5	-4.0
3) Government debt & GDP	59.4	61.6	65.6	66.0	66.5
4) Inflation rate	6.8	3.5	4.0	7.9	6.3
5) Long-term interest rate	8.2	6.6	7.1	6.7	6.5
6) ERM II entry & Euro adoption	No	No	No	No	No

Note 1: Figures in 2008 are projections as of April 2008.

Note 2: The marked items are those which cleared the convergence criteria.

Source: European Commission *Spring Economic Forecast 2008*, each country's Convergence Program, and Eurostat

advantages to the country in question. Within the euro zone, exchange risk disappears. The euro continues to appreciate vis-à-vis the U.S. dollar, reflecting the euro area's economic potential. For a country that introduces the euro, exchange rate fluctuation risk decreases by virtue of holding a currency with a strong probability of becoming a key currency alongside the dollar. For a country like Slovakia that receives extensive direct investment in sectors such as the automobile industry or the electrical equipment and machinery industry and achieves its economic growth driven by exports of assembled and processed products in particular, it enables the country to provide investing companies with a stable business environment. Even in the case of a country faced with chronic current account deficits, there is no need to worry about trying to control depreciation pressure on the domestic currency. And if the current account deficit is being financed through foreign borrowing from financial institutions, debt payment risk from ballooning external debt resulting from exchange rate depreciation vanishes as well as long as the funds are procured within the euro zone.

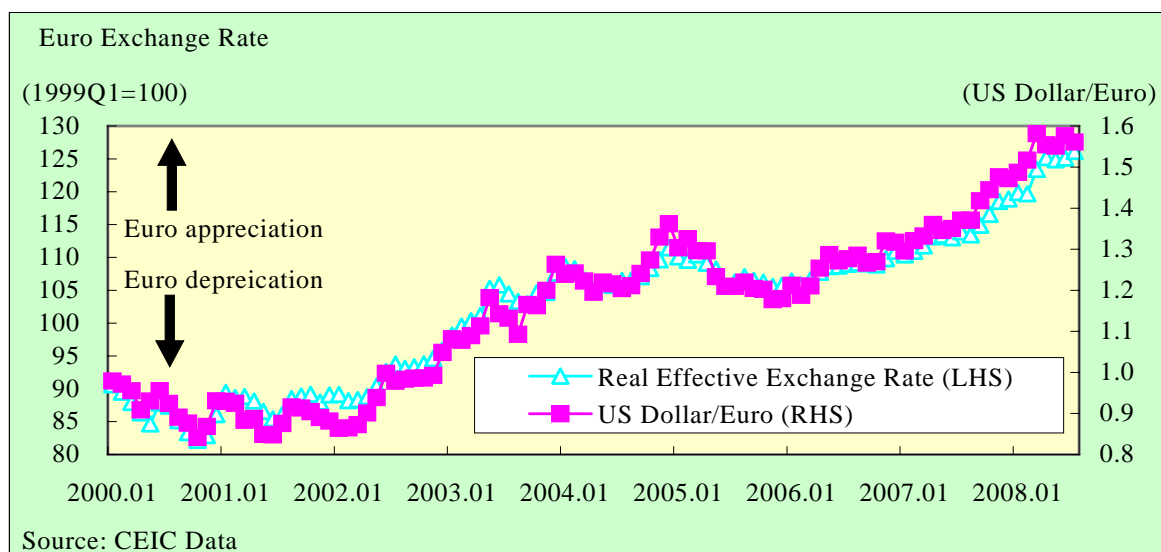
Meanwhile, a country loses its monetary policy independence by introducing the euro. Because the European Central Bank (ECB) determines its policy rate by reviewing the economic averages in the euro area, the policy rate becomes fetters on a country whose economic conditions deviate significantly from the averages within the region. Moreover, because the government is bound by fiscal discipline, the leeway to make flexible expenditures during a recession is

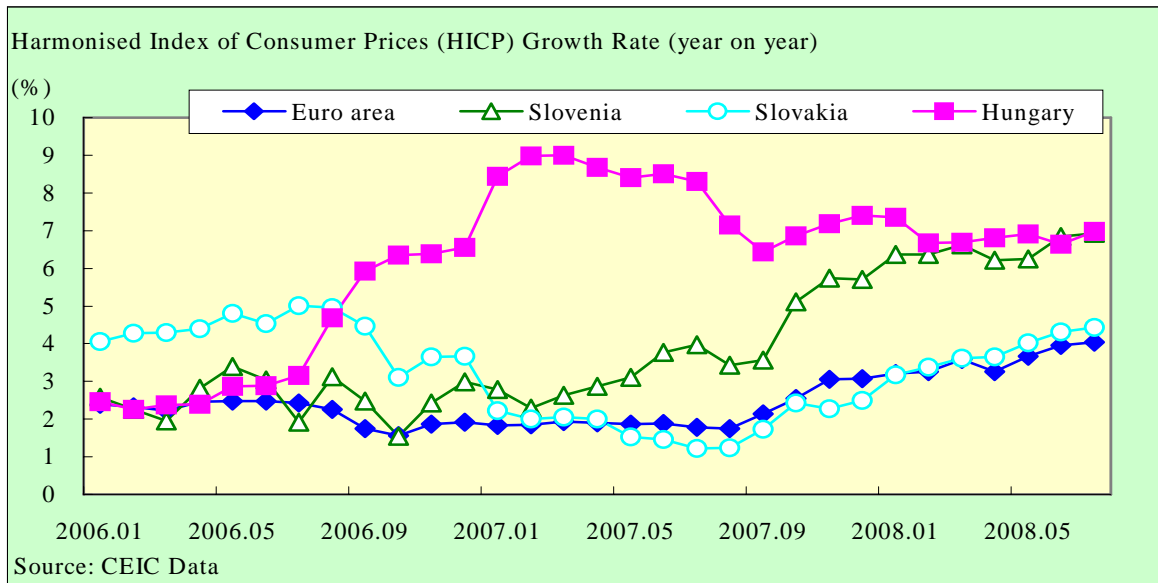
limited. There are also cases such as Portugal which, despite introducing the euro at the end of a difficult preparation period, experienced a prolonged economic slump as the result of a shift to expansionary fiscal measures in reaction to joining the euro zone. In addition, a country's competitiveness within the region can be weakened if its inflation rate remains high relative to other members of the euro zone. Introduction of the euro also makes it impossible for a country to maintain global competitiveness by devaluing its currency. To control inflation and enhance global competitiveness, the country is required to rationalization of firms and the labor market, through measures such as continually improving the productivity of domestic industries, restraining growth of nominal wages and suppressing the rate of increase in unit labor costs.

The euro zone economy has been slowing down

The distortion effects from introduction of the euro can be limited if the economy is enjoying an expansionary period. If introduction of the euro overlaps an economic downturn, however, the downside risks might be amplified.

Boosted by the strength of the global economic expansion, the euro zone recovered to annual growth of about 2% from 2004, and the real GDP growth rate reached nearly 3% in 2006 and 2007. With price increases held to about 2%, the economy maintained



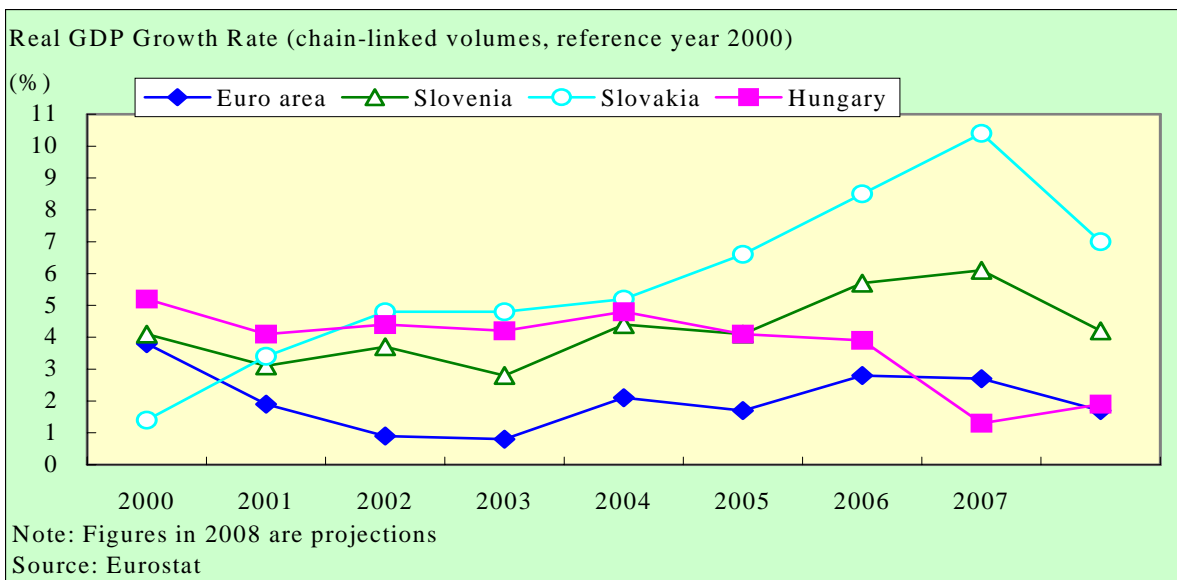


stable growth supported by domestic demand. During 2008, however, the slowdown in the euro area has become clear. The real GDP growth rate in the euro area in the second quarter of 2008 fell to minus 0.2% compared with the prior quarter. In July 2008, the rate of increase in the European Harmonized Index of Consumer Prices (HICP) reached 4.1%, and as of September 4, 2008 the ECB has maintained the policy interest rate at the high level of 4.25%.

In addition to the growing uncertainty in the economic outlook in the EU region, a combination of factors is at work against the backdrop of the economic slowdown. This includes the flagging U.S. economy, which is being affected by the still unraveling subprime

problem, and the steep rise in the international commodity prices of products such as oil and grains. In Spain, which had enjoyed a real estate boom, housing starts have fallen sharply. The weakened rate of increase in property prices has showed no sign to stop, and domestic demand, which previously supported the robust economy, has cooled rapidly. Germany and France, which support the heart of the euro zone economy, also plunged into negative growth in the second quarter.

Slovenia and Slovakia, which safely accomplished introduction of the euro amid the wave of the euro area economic boom, could see their benefits from introduction of the euro eroded as the tide of the euro



economy has shifted. Maintaining or further improving creditworthiness will require both countries to continue steady economic and fiscal measures in the future. For Hungary, on the other hand, the most critical issues are likely to be steadily restoring fiscal discipline with the goal of achieving introduction of the euro and stabilizing the economy with reining in the inflation.

Republic of Slovenia – Maintaining creditworthiness following introduction of the euro in 2007 despite growing inflationary pressures

Slovenia participated in ERM II one month after joining the EU in May 2004. By steadily climbing the rungs toward introduction of the euro through stable economic and fiscal management over the minimum two-year period required under the ERM II participation criteria, on January 1, 2007 Slovenia became the first Central and Eastern European EU signatory to introduce the euro. Boosted by adoption of the euro, Slovenia continued to grow in excess of 4% annually every year after 2004, and in 2007 achieved 6.1% growth, the highest rate of expansion since becoming independent in 1991. Per capita GDP rose from US14,000 dollars in 2004 to US23,000 dollars in 2007, overtaking Portugal.

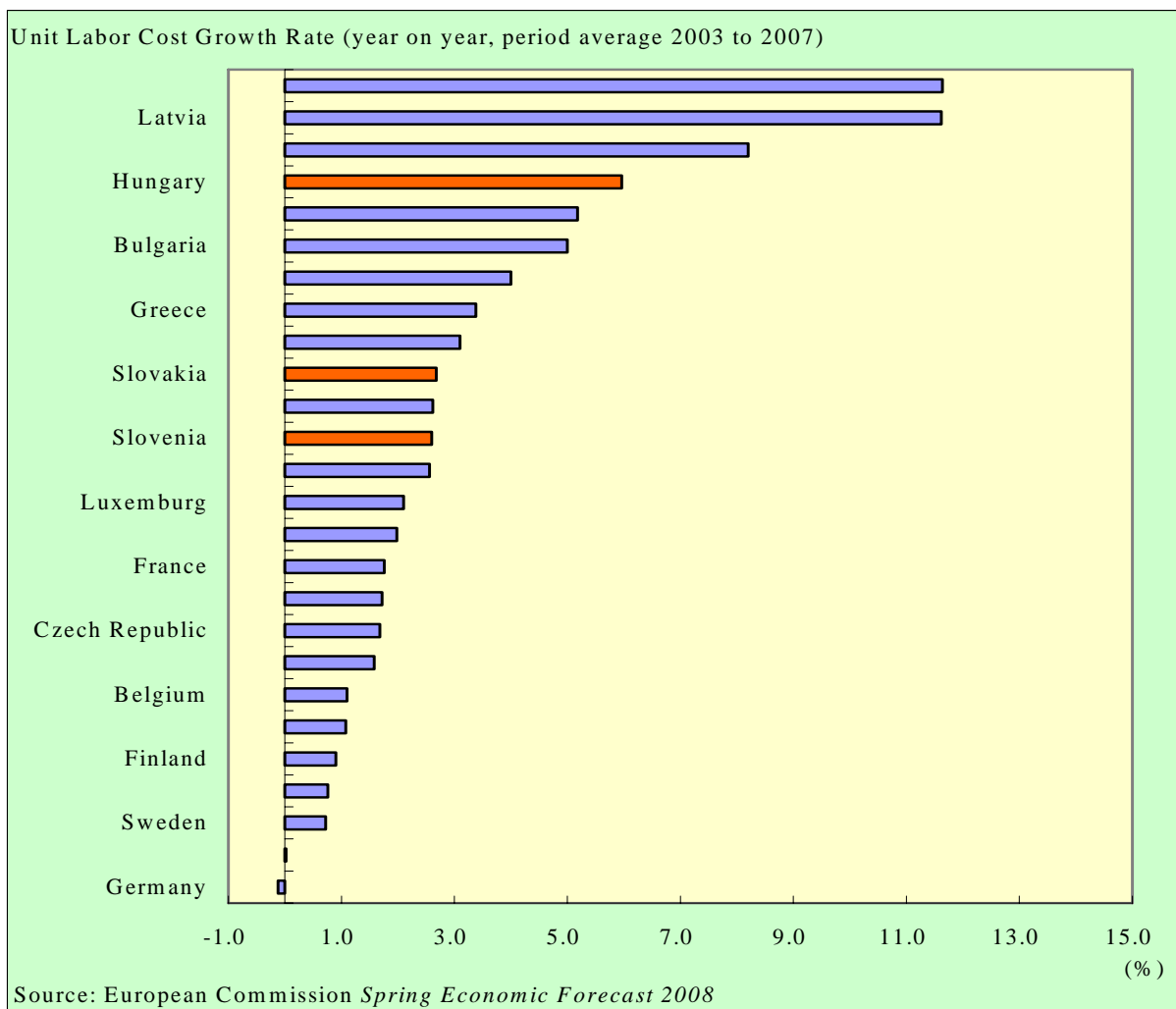
Although Slovenia has advanced steadily, inflationary pressures are building. Before introduction of the euro, the rate of increase in the HICP fluctuated around 3%, never deviating by more than 1% above or below the average rate of increase in the euro area. Since about mid-2007, however, prices has kept increasing, which reached 6.9% in July 2008. This is substantially above the 4.1% average in the euro region, and is the region's highest inflation rate. The jump in prices for foodstuffs and fuel has been especially marked, with prices said to have been affected by the sharp rise in international commodity prices. Although Slovenia's energy-related price has increased at nearly the same level as the euro area average, food prices in Slovenia have risen much more quickly than the euro area average since the first half of 2007. The rapid increase in Slovenia in core prices excluding prices for food and energy has been similarly conspicuous. These facts suggests that factors different from those causing price pressures within the euro area are at work in that

country.

Introduction of the euro itself can easily generate upward pressure on prices. In Central and Eastern Europe countries in particular, where product prices and workers' wages are relatively low compared with countries such as Germany and France, prices and wages will be adjusted upward following introduction of the euro by the effects of convergence with the economic level of the euro economic bloc. Moreover, a reduction in interest rates accompanying the euro's introduction can easily stimulate consumer demand. In Slovenia's case, demand-pull type inflationary pressures appear to have been caused by continuous economic growth in excess of the potential growth rate and overheated demand during the past several years. Therefore prices were expected to return to a stable rate of increase once the financial and labor market supply and demand adjustment phase was passed. Unfortunately, the sudden recent run-up in international prices for oil products and foodstuffs has generated cost push-type inflationary pressure, making it difficult to control inflation through adjustment of supply and demand alone. In addition, Slovenia faces the structural issue of a price adjustment mechanism that does not work well because of oligopoly conditions in the food distribution market.

While increases in labor costs can also produce cost push-type inflationary pressure, Slovenia has established a systematic framework for controlling labor costs. An increase in unit labor cost, which refers to the ratio of nominal wages per worker to productivity, means the increase in nominal wages is greater than the growth in productivity. Under such a condition, there is a strong tendency for firms to impute an increase in personnel expenses in prices, which becomes a factor pushing up prices. Consequently, how well firms can control increases in their unit labor cost becomes a key to restraining price increases. Slovenia's government has reached an agreement with employers and trade unions to set annual worker pay raises at least 1% below the rate of productivity growth. The average annual growth rate in the unit labor cost in Slovenia from 2003 to 2007 was 2.6%, reflecting the extent of labor cost control awareness within Slovenia's government.

Considering the government's steady economic

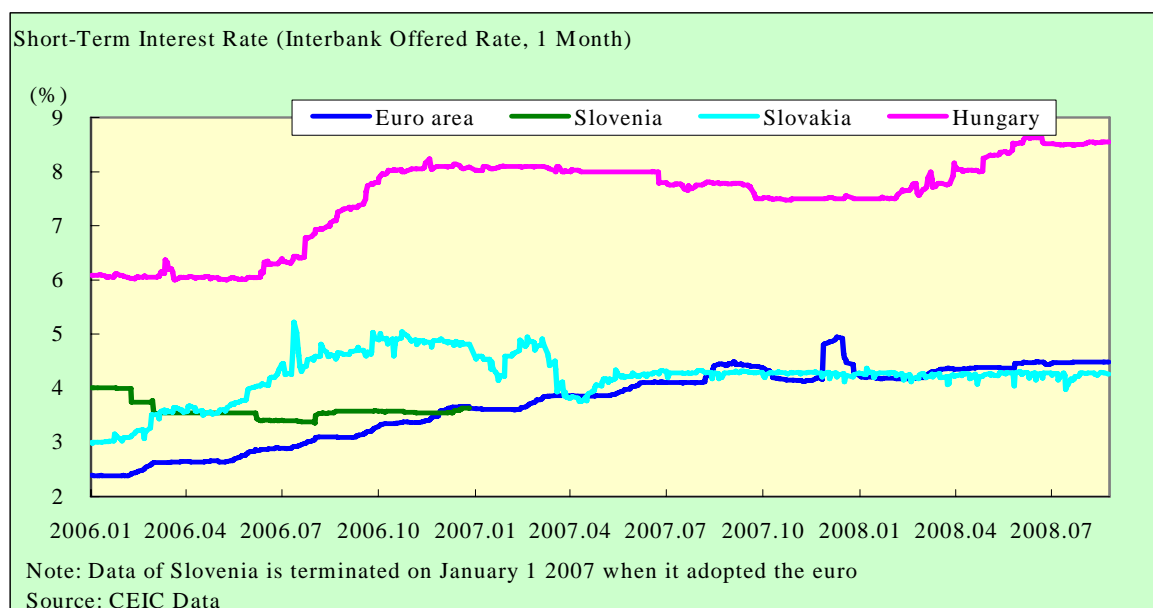


and fiscal management and strong labor cost control awareness, there is little concern that inflation will damage Slovenia's creditworthiness. Based on this consideration, R&I affirmed Slovenia's Foreign Currency Issuer Rating at AA- in August 2008. To achieve a further improvement in creditworthiness, however, the government will have to formulate and implement an industrial policy, which it has not clearly spelled out until now. Although Slovenia possesses a manufacturing-based industrial structure, unlike other Central and Eastern European countries, it has not actively introduced foreign investment so far. Improving the competitiveness of its economy and industries will be absolutely essential, however, for maintaining a certain share of the region's economy. Continuing to aggressively introduce foreign investment, the government will also be required to adopt fiscal policy that places priority on improving the economy's competitiveness. As achieving a fiscal surplus equivalent to 0.3% of GDP in 2007, and maintaining sound fiscal position, Slovenia has the

advantage of the fiscal capacity to pursue flexible fiscal measures even in an economic slowdown phase. The point to watch closely for judging Slovenia's creditworthiness in the future will therefore be whether the government is able to pursue effective fiscal management aimed at boosting competitiveness while maintaining its labor cost control stance.

The Slovak Republic – Will adoption of the euro boost investment inflow?

The European Commission (EC) on July 8, 2008 officially announced the decision of introduction of the euro by the Slovak Republic on January 1, 2009. While the EC had already given the green light in May 2008, after Slovakia achieved the Maastricht convergence criteria, the last official procedure was completed when the Economic and Financial Affairs Council (ECOFIN) decided the euro-Slovak koruna exchange rate on July 8. Based on its consideration of Slovakia's economic fundamentals, which were



improved by ongoing reforms until the introduction criteria were achieved, and the bullish economic outlook, R&I upgraded the Foreign Currency Issuer Rating of the Slovak Republic to A in July 2008.

Becoming the leading party in the general election in June 2006, the center-left party “Smer” (Direction-Social Democracy Party) led by Prime Minister Robert Fico chose as its coalition partners the nationalist SNS (Slovak Nationalist Party), and the HZDS (People’s Party - Movement for a Democratic Slovakia) led by former Prime Minister Vladimir Meciar, which has been the subject of criticism for its nationalistic and authoritarian political style. This political alliance grow concern among the international community regarding the direction of Slovakia’s fiscal management and investment environment. The coalition government, however, continued along the basic policy stance towards introducing the euro and emphasizing ties with the EU. Defusing concerns by political management that was more pragmatic than anticipated, however, the government also avoided ultimately major changes through fiscal management and other policy stances.

It is difficult to believe, however, that introduction of the euro will bring dramatic changes in the economy. Interest rates have been sufficiently low, and thus moving to the euro will not bring the additional benefit of a drop in interest rates such as Ireland and other countries have enjoyed. Of course the advantages for firms – from elimination of exchange risk and foreign

exchange-related administrative costs – could be substantial. Entering a currency zone with a large-scale economy can be expected to reduce exchange rate fluctuations against the U.S. dollar and other currencies, and stabilization of economic activity can also be anticipated. The greatest advantage for Slovakia’s economy, however, is likely to generate the sense of stability, which could promote trade and direct investment. Such indirect effects might be difficult to discern, but could become an opportunity for Slovakia – which has used investment from other countries as a lever for growth – to boost its appeal further.

Naturally, Slovakia must pay the “cost” of foregoing an independent monetary policy. For a small-scale economy like Slovakia’s, however, which is very open to foreign investment (total value of imports and exports was 155% of GDP in 2007 on a balance of international payments basis), the effectiveness of monetary policy is not believed to be that large. The disadvantages of abandoning monetary policy are at least unlikely to offset the advantages from introduction of the common currency. In its comprehensive analysis report concerning the impacts from introduction of the euro (2006), the National Bank of Slovakia (NBS) stated its conclusion that entry to the euro area represents the “fully credible option” when compared with the option of “independent monetary policy and lower credibility of the central bank.”

Slovakia’s income level is about 60% of the euro

area average (purchasing power parity basis). Given this fact, the price level will also almost certainly rise in tandem with convergence in the economic level. In the report referred to above, the central bank projects upward pressure on the long-term price level to be about 1.5 percentage points annually. The fundamental cause will not be the euro's introduction, however, but the inevitable forces at work through the process of Slovakia catching up to the economic level of the EU region. This means Slovakia probably will have to stay sharp and work to ease the excessive upward pressures on prices in the future, by maintaining labor market flexibility and a competitive market environment.

After overcoming the confusion of the closing stages of the Meciar government at the end of 1990s, Slovakia's economy has sustained a long-run expansion. The real GDP growth rate recorded in 2007 was 10.4%. The growth, which was backed by balanced contribution of internal and external demand at 5.4% and 4.9% growth respectively, is likely to be on stable track. According to the Financial Policy Institute (FPI) at Slovakia's Ministry of Finance, this high growth was achieved not by a mere cyclical boom but by raising the potential growth rate through productivity improvements. It is assumed that structural change has occurred around 2006 in particular, when Kia Motors of Korea and the French automobile manufacturer PSA Peugeot Citroen brought new plants on-line. Thus in the opinion of Slovakia's Ministry of Finance, the latest GDP gap is small and the economy has not overheated even as it recorded double-digit growth rates. While upward pressure on wages also is not negligible the increase in unit labor cost is being controlled because productivity gains have continued under the inflow of vigorous direct investment.

The rate of increase in the HICP in 2007 was held to a low 1.9%, and in the March 2008 convergence examination Slovakia achieved the convergence criterion by a wide margin at 1% point below the HICP reference value. In the future, the focus will be on the medium-term stability of this inflation rate. Slovakia's inflation rate has been rising since August 2007, against the backdrop of the global inflationary trend. Since 2008, price increases have exceeded the euro area inflation rate, and the core HICP has also edged upward to 3.0% because of price hikes for

processed foods and services. Because Slovakia's economy is predicted to continue its strong growth during 2008-2009 as well, it will be necessary to see whether pay raises and various cost increases are imputed in prices of manufactured goods. With Slovenia providing an example, the inflation management of countries that intend to introduce the euro will be viewed with a bias. In fact there is no evidence that Slovakia has not fallen into the same rut, and the ECB has roused attention with its stern wording on this point.

The Republic of Hungary – Delay in adopting the euro rises uncertainty in the outlook for fiscal administration improvements

On February 25, 2008, the National Bank of Hungary (MNB) announced it would abandon the trading band system for maintaining a fixed exchange rate against the euro and move to a fully floating exchange-rate regime. The national bank had adopted the quasi-managed an exchange rate mechanism similar to ERM II to set the band in May 2001 for fluctuation against the euro at 15% on either side of a fixed rate. With the consumer price index continuing to increase faster than the inflation target (3% rate of increase in the Consumer Price Index \pm 1%) since 2007, however, the national bank dropped the fixed rate and adopted a stance emphasizing price stabilization.

For Hungary, which faced a "monetary policy trilemma" in being unable to simultaneously maintain a fixed exchange rate, achieve complete liberalization of capital transfers and pursue an independent monetary policy, abandoning the fixed rate have been the unavoidable choice. Inflation accelerated from the second half of 2006, and the rate of increase in the HICP reached 7% at the end of 2007. During this period, interest rates on domestic currency-denominated loans rose as a result of the high policy interest rate, which was set at about 8%. This high interest rate environment created increased demands for comparatively low interest euro and Swiss franc-denominated financing among consumers and firms struggling under the loan interest burden. Because of this financing, demand for the forint rose as banks converted foreign currencies to the forint in order to lend. In addition, with interest rates on

forint-denominated bonds stuck at a high level, demand for the forint also increased as investment by non-residents grew more vigorous. The exchange rate appreciated against the euro as a result, and continued to fluctuate near the upper limit of the trading band.

The probability that the Hungarian government's drive to improve fiscal soundness will be lessened has increased by having abandoned the fixed exchange rate at this time. This is because introduction of the euro has been deferred and the government is now able to defer achievement of the convergence criteria. Prime Minister Ferenc Gyurcsany's cabinet, formed in June 2006, has announced austerity measures called New Equilibrium Programme 2006-2008. The programme specifies the goal of reducing the general government deficit, which reached 7.8% of GDP in 2005, to less than 3% by 2010. To achieve this goal the government raised taxes in September 2006, including the corporate tax and social insurance contributions, and also began restructuring efforts including central government organizational reform (reduce the number of ministries from 17 to 12) and staff cutbacks (20,000 people). Initially execution of these measures was in doubt because they would be accompanied by considerable pain among the public, but in 2007 the fiscal deficit improved to 5.5% of GDP. The real GDP growth rate in 2007 slid to 1.3% as a result of the severe tightening policy, however, and private consumption, which had propelled the economy until then, contracted compared with the previous year. Investment stagnated as well.

While the government has maintained its stance to implement sharp cuts in expenditures in the future aimed at achieving the programme, political turmoil could interrupt such efforts towards fiscal reform. On March 9, 2008, a national referendum was held on whether to abolish the higher education tuition fees, outpatient examination fees and hospitalization fees introduced in 2007 as part of fiscal reforms. The result was an overwhelming majority in favor of abolishing the fees, and on March 17, the National Assembly voted to abolish the outpatient examination and hospitalization fees on April 1 and postpone the introduction of tuition fees. Although this change is expected to reduce the amount of government annual revenue in fiscal 2008 by roughly 60 billion forint, this decrease is less than 0.2% of GDP and there is little

concern that fiscal position will deteriorate significantly because of this measure. A precedent has been set for abolishing by national referendum reform programmes that would be painful for citizens, however, and thus uncertainty regarding the outlook for government efforts to return to a sound fiscal position in the future has increased. Moreover, the Alliance of Free Democrats-Hungarian Liberal Party (SZDSZ), a member of the coalition government, canceled the coalition in May 2008, and in June the Hungarian Socialist Party (MSZP) led by Prime Minister Gyurcsany was compelled to run the government as a single-party minority cabinet. As a result, to pass legislation the government will have to garner the necessary votes from the opposition party, and this will demand difficult political maneuvering. Nor can the possibility be dismissed of the dominant opposition party submitting bills to put the brakes on fiscal reform, with an eye on the general election in 2010. The continuity of reforms will have to be watched very carefully.

Based on the heightened uncertainty in the outlook for Hungary's economy and fiscal administration, R&I downgraded Hungary's Foreign Currency Issuer Rating to BBB+ from A- in July 2008. In the meantime, R&I evaluated positively the strengths of Hungary's economy and industrial infrastructure, and maintained the Rating Outlook at Stable. Hungary was first among Central and Eastern European countries when it introduced investment incentives in 1991, and the amount of direct investment inflow viewed on a total stock basis through 2006 greatly exceeds that of Poland or the Czech Republic, which have been similarly aggressive in soliciting direct investment. In transportation equipment manufacturing, a leading industry, Suzuki, Opel and Audi have opened vehicle final assembly plants and engine manufacturing bases. While neighboring Slovakia, which is going to introduce the euro in 2009, also is encouraging firms to make investments in its automotive sector, Hungary has stolen a march on its competitors in areas such as supporting industries. In June 2008, Germany's Daimler AG announced it will build a Mercedes Benz compact car plant in Hungary, scheduled to begin annual production of about 100,000 units around 2011-2012. This suggests that the economic and industrial infrastructure it has put into place is supporting Hungary's creditworthiness. It may have

put adoption of the euro on the back burner for now, but if the government's efforts at realizing early introduction lead results in the form of improved fiscal administration and a stabilized economy, Hungary could be able to improve its creditworthiness. Despite the numerous hurdles, R&I expect the government to not slow the pace of efforts to achieve a sound fiscal footing.