



KBC Focus

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Slovenia: Welcome to the Euro Bond universe

Summary

Slovenia adopted the euro on January 2007, as it fulfilled all the Maastricht criteria. In this focus, we briefly look into the significance of the step for the Slovenian economy. However, our attention focuses especially on the overhaul of the Slovenian Bond market, as the government used the euro adoption to modernise its bond market. So, from now on, Slovenian government bonds will be treated in the same framework as other euro government bonds. We think that it creates opportunities for various investors.

Slovenia, first of the newcomers to make it into EMU

Slovenian strong and unconditional commitment to convergence since joining the EU on May 1 2004 has been very successful, as it led to a rapid fulfilment of all Maastricht EMU entry criteria and the adoption of the euro on January 1 2007. The EUR/SIT conversion rate has been irrevocably fixed at 239.64 after the Tolar stayed in the ERM rate mechanism for 2 years in which its currency barely deviated from the central rate.

The inflation criterion is clearly one of the obvious hurdles for the EU newcomers to make it into the euro club. Especially the Baltic States are struggling with inflation and Lithuania was even refused entry to EMU on this basis when its readiness was assessed alongside the Slovenia one in spring 2006. However, Slovenia did take the hurdle rather easily.

Compared to Lithuania, Slovenia, of course, benefited from the higher per capita income than countries like Lithuania. Slovenian per capita income

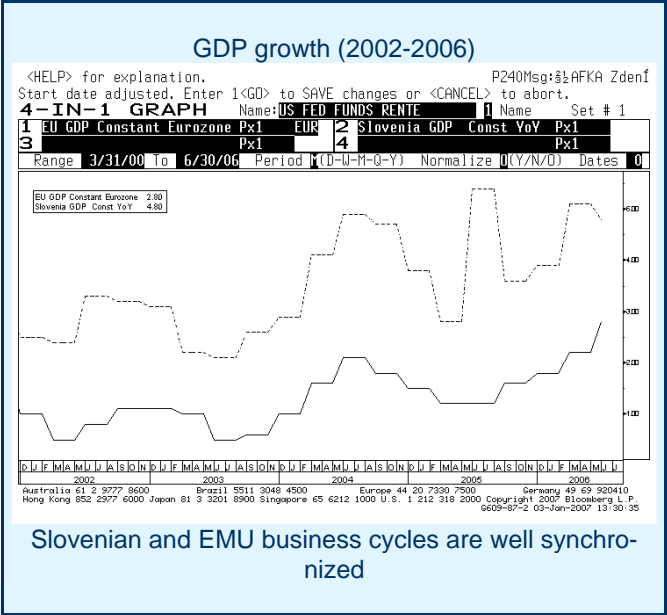
already approaches levels of existing euro countries like Portugal and Greece. This meant that the Balassa Samuelson effect of the catching up process that pushes inflation up under a fixed or quasi-fixed exchange rate was far less powerful in Slovenia than in the Baltics. However, it would be unjust not to recognize the impact of government policy on the reduction of inflation. Monetary policy has been kept tight with positive real interest rates and no fiscal loosening has been allowed. On top of that, the government and the social partners agreed to keep wage growth 1%-point below productivity growth. Inflation is well under control and amounted to 2.5% (annual) in 2006 and 2.8% Y/Y in December 2006.

Slovenian convergence is sustainable

Economic growth has been strong over the last decade, up by about 4% on average and growth amounted even to 5.2% Y/Y in the first three quarters of 2006. Exports, but also domestic demand support overall growth. Especially encouraging is the high growth rate of investments. We expect economic growth to slow somewhat in 2007 and 2008, but without dropping below 4%, which is the sustainable longer-term growth rate.

The policy of recent years and the relative high per capita income has resulted in a strong convergence between the business cycles of Slovenia and the EMU area. This is reflected in a clear correlation of the respective growth rates (cf. graph below). The trend growth rate of Slovenia is of course higher (but lower than many other of the newcomers). The convergence of business cycles is important from a longer-term point of view, as it means that the ECB monetary policy that is by hypothesis modulated to the needs of the area should be consistent with Slovenia's needs in most cases.

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In a very long perspective, some of the current weaknesses in the economy may play havoc with the ongoing strong growth, if they aren't addressed. While macro-economic management has been strong, micro-economic reforms have been very shy and modest. Indeed, the Slovenian economy remains not very flexible and that might become a handicap if some asymmetrical shock would occur and monetary policy is unable to come to the rescue. In such an environment, wages and prices should facilitate the adjustment. Centralized wage negotiations, still some price controls and a relatively extensive public sector certainly make such an adjustment difficult.

Strong fiscal credentials

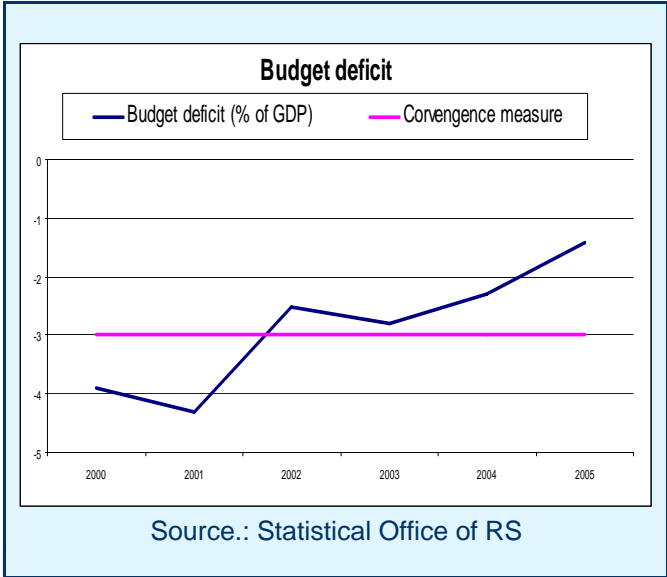
Slovenia showed a disciplined approach to public finances and this resulted in a steadily declining deficit-to-GDP ratio that amounted to 1.1% in 2006. The ECB and EU Commission recognized that Slovenia fully complies with the Maastricht deficit criterion on a sustained basis. Due to a relatively low and stable level of debt of the state sector (about 28% of GDP), public borrowing is sustainable in the mid-term.

In spite of meeting the fiscal criteria for the introduction of the euro, the principal goal of public finance policy in Slovenia remains the elimination of the structural fiscal deficit. Thus further reduction and restructuring of state expenditure is planned. With the streamlining of public expenditure, the tax reform will also continue with the aim of reducing the tax burden on labour, increase the employment rate and strengthen the economic growth. In accordance with the existing plans of the Government,

the budgetary deficit is expected to drop to 1.1% of GDP in 2006, to 0.9% in 2007 and to 0.8% in 2009. It is then expected to fall further so that budgetary balance is reached in 2011, subject to favourable economic growth. While this looks good, we have to see whether implementation will go smooth too and still have some problems with the still high level of state intervention in the economy (cf. above).

Similarly to the budgetary deficit, the debt of the state was build up in a previous era. It more or less stabilized in recent years at around 28%.

With the introduction of the euro, as monetary policy lies entirely within the competence of the ECB or is subject to common agreement, the fiscal policy shall become a key instrument for mitigating potential asymmetric shocks and maintaining a stable macroeconomic situation in Slovenia. The low level of debt and the balanced budget offers some room to use this weapon in harsh times.



Bond Market reform should drive yields lower

Slovenia was traditionally known for its small illiquid and shallow market of Government bonds. Consequently, bond yields were considerably higher than bond yields of other EU Member States, notably at about 20 basis points versus German Bunds in the 10-year segment. This remained the case after it has become clear that Slovenia would enter the Euro Area in 2007. An illiquid market was also reflected in a very wide bid/offer spread. **To increase the liquidity and widen the circle of potential customers** and so lower the cost of borrowing, the Ministry of Finance took a number of decisions regarding the primary and secondary markets. It is expected that these changes, the strong AA rating of the country and the entry of

Slovenia in the euro area will stimulate the appetite of foreign investors in Slovene government bonds and drive the spread with the German benchmark bond yield down.

One of the goals of the Ministry of Finance is to ensure benchmark interest rates for Slovenia. Since the critical volume of the issue of an individual bond is around EUR 1 billion (for trading on the electronic MTS platform) and Slovenia does not have such high needs for financing, most of the previously issued bonds will be repurchased early and replaced by more liquid benchmark issues.

Bold 2007 issuance plan

The Ministry of Finance will, according to plan, borrow an additional EUR 1.18 billion in 2007, split into EUR 918 million long-term borrowing and EUR 200 million short-term borrowing (Treasury bills). To be able to establish liquid 1 billion EUR benchmark bonds, the Ministry of Finance will recall most existing bonds.

In more detail, the Ministry plans to recall the RS 47 callable linked to the base interest rate (TOM) for an amount of approximately EUR 290 million. Beside this bond, the Ministry will repurchase other existing non-callable bonds, with the exception of RS 59, that will become a benchmark after being re-opened. The final volume of bonds issued in 2007 will depend on the successfulness of bond repurchase, but we have the strong feeling that the government will do some price concessions to guarantee the success of the reform.

Summarizing, Slovenia plans to issue the following bonds in 2007:

- Reopening of the RS 59 up to the amount of EUR 1 billion in January 2007,
- Issue of long-term standardised bond with the maturity of 10.5 to 11 years in the amount of EUR 1 billion in the beginning of March,
- Issue of five-year standardised bond up to the nominal value of EUR 1 billion at the end of June; the final amount of the value of the issue will nevertheless depend on the successfulness of the repurchasing of the existing bonds.

Table of planned issues of Slovene government bonds in 2007

Maturity	Time of issue	Exp. amount (mio EUR)
5	jun.07	1000
9	jan.07	300
10-11	mar.07	1000

Source: Ministry of finance of RS

Furthermore, the Ministry of Finance plans to issue 3- and 6-month short-term Treasury bills. The amount of individual issues will be about EUR 50 million. The Ministry of Finance has not yet published the auction dates.

Primary and the secondary market in 2007

From now on, government bonds will be issued through a **syndicate**. The Ministry of Finance will select from 8 to 10 primary subscribers of which 4 domestic and 4-6 foreign who will be bound to manage the official market of government securities on the MTS Slovenia platform. Of these 8 to 10 primary subscribers, the Ministry of Finance will select three lead managers for the primary issue. The other primary subscribers shall be co-managers of the syndicate and can together buy or sell from 10 to 20% of the issued bonds.

Trading on the secondary market shall be carried out through MTS Slovenia. The TUVL (market makers) trading platform which was until now the principal market for the Slovene tolar bonds and treasury bills will probably be cancelled.

Slovene bonds in the euro bond universe

Slovenia has joined the euro zone and so its government bonds are part of the European government bond market. **From that point on, Slovenian government bonds will be priced in comparison with other European government bonds.** Based on the credit rating of Slovenia (Aa2/AA), Slovenian government bonds will be mainly compared to Belgian (Aa1/AA+), Italian (Aa2/A+) and Portuguese (Aa2/AA-) government bonds. However compared to these peers, there are still some differences that need to be taken into account and that may affect pricing.

First of all, even after the re-alignment of the Slovenian government bond market, the liquidity of the three remaining benchmarks (EUR 1 B) will still be very low from a European perspective, as most European benchmark bonds have an amount outstanding of EUR 5 B. That makes that Slovenian government bonds are mainly suited for end investors, but less so for trading accounts, which reduces the potential pool of investors and heightens the liquidity premium required by the investors.

Secondly, from a fundamental point of view the Slovenian economy is likely to continue outperforming the euro zone. Sustained strong economic growth will enable the government to keep its public finances on a sound footing. In this context, it's worth noting that Slovenia's GDP-to-debt ratio is amongst the lowest within the euro zone at around 28%, while its budget deficit is in line with the euro zone average below the 3% limit for the forecast period.

Concluding, taking into account the above-mentioned pros and cons, we expect the spread between Slovenian and German government bonds to narrow further. On the European bond market, we expect Slovenian government bonds to be priced in between Belgian on the one hand and Portuguese government bonds on the other hand, even while closer to the latter than the former due to the lower rating. In the table below, a preview of where we see the RS 59 (4% Feb 16) trading on the European bond market is offered. Currently, the RS59 is trading at a spread of about 20 basis points above the German 10-year benchmark (4.12% vs. 3.92%). This is likely to narrow to around 10-12 basis (4.03%) points once the realignment has taken place. **As such, there is still some room for investors that want to benefit from the convergence story.**

Conclusion

The reform of the government bond market and the adoption of the euro bring the Slovenian bonds into the Euro bond universe. One might expect Slovene bonds to become more attractive, especially for end-investors like ALM-bank portfolios and Central Banks. This means smaller spreads with other euro government bonds; Also the repurchase of outstanding issues might offer opportunities.

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Country	Moody's	S&P	Coupon	Maturity	Amount outstanding	Yield to maturity
Finland	Aaa	AAA	4.25	04/07/2015	5	3.91
Germany	Aaa	AAA	3.5	04/01/2016	23	3.92
Ireland	Aaa	AAA	4.6	18/04/2016	5.9	3.93
Austria	Aaa	AAA	3.5	15/07/2015	7.1	3.94
Spain	Aaa	AAA	3.15	31/01/2016	11.1	3.94
France	Aaa	AAA	3.25	25/04/2016	20.5	3.95
Netherlands	Aaa	AAA	4	15/07/2016	10.1	3.95
Belgium	Aa1	AA+	3.75	28/09/2015	11.3	3.96
Portugal	Aa2	AA-	3.35	15/10/2015	5.8	4.04
Slovenia	Aa2	AA	4	17/02/2016	1	4.12 → 4.03
Italy	Aa2	A+	3.75	01/08/2016	24.4	4.18
Greece	A1	A	3.6	20/07/2016	7.8	4.19

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