The Czech Republic

Adjusting the Annual Debt Management Strategy

Dr. Jiri Franta
Director

Petr Pavelek, Ph.D.
Head of Funding & Portfolio Management
Agenda

Debt Strategy & Need for Flexibility

Trigger of Annual Adjustments

Implementation of Changes into Practice

Summary
Formulating debt management strategy in the Czech Republic

- Small open EU economy preparing for eurozone entry.
- Strong domestic currency appreciation and nominal convergence.
- Debt interest costs lower than 1.5% of GDP.
- Poor liquidity on the secondary domestic bond market.
- Strong domestic demand for fixed rate bonds to cover annual borrowing needs.
- Significant portfolio of protested contingent liabilities about 5% of GDP.

Borrowing Needs Structure (CZK bn)

- Stable annual borrowing needs below 5% of GDP.
- Constrained amount to issue a year (at around CZK 150 bn, i.e. EUR 5 bn).
- Scarce issuer on the international market.
- Increasing amount of debt to redeem.

Source: MF CR.
Debt Strategy & Need for Flexibility

Keystones of the Debt Management Strategy

- General objective is to cover the financing needs of the central government and its payment obligations while minimizing the economic debt cost over the long-term horizon and maintaining prudent risk exposure of state budget cash flows while taking into account the structure of contingent liabilities and state financial assets - financial ALM framework.

- Quest of opportunities for long term debt instruments across the currencies and markets.

- Foreign currency financing to create tension and competition on the domestic bond market.

- Strategic targets and financing programmes are published using absolute and relative ranges.

- Experiments with deficit and tax smoothing to design optimal state debt portfolio structure and benchmark targets in the small open economy.
### Debt Strategy & Need for Flexibility

**Macroeconomic ALM approach creates more flexibility for debt management**

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
<th>Gross State Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Balance</td>
<td>Marketable Securities</td>
<td>CZK 700 bn</td>
</tr>
<tr>
<td>Special-Purpose Funds</td>
<td>Direct Credits</td>
<td>CZK 30 bn</td>
</tr>
<tr>
<td>Reserve Funds</td>
<td>Credit Guarantees</td>
<td></td>
</tr>
<tr>
<td>Marketable Securities</td>
<td>Protested</td>
<td>CZK 310 bn</td>
</tr>
<tr>
<td>State Credits</td>
<td>Performing</td>
<td>CZK 20 bn</td>
</tr>
<tr>
<td>Shares (enterprises, international</td>
<td></td>
<td></td>
</tr>
<tr>
<td>institutions)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>PV of Tax Revenues</td>
<td>PV of Fiscal Primary Expenditures</td>
<td></td>
</tr>
<tr>
<td>Foreign Claims</td>
<td>Other Explicit CL</td>
<td></td>
</tr>
<tr>
<td>Infrastructure Investment</td>
<td>Implicit CL</td>
<td></td>
</tr>
<tr>
<td>Other Fixed Assets</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- **Beginning 2005** - Matching cash-flows and risk structure of financial assets with state debt structure and credit guarantees to determine strategic targets and risk management limits since 2006.

- **Broader macroeconomic framework is planned from 2007.**

Ministry of Finance of the Czech Republic – Debt and Financial Assets Management Department
Debt Strategy & Need for Flexibility

Annual financing programmes - sufficient ranges to perform

Programme for 2005 - Plan versus Reality

<table>
<thead>
<tr>
<th>Criterion</th>
<th>Guidelines for 2005</th>
<th>December 31, 2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>International financing</td>
<td>Max. 40% of the total annual gross financing requirement</td>
<td>25.0%</td>
</tr>
<tr>
<td></td>
<td>CZK 28.6 to 54.6 bn</td>
<td>CZK 30.1 bn</td>
</tr>
<tr>
<td>Gross T-Bonds issues</td>
<td>CZK 94.0 to 120.0 bn</td>
<td>CZK 112.5 bn</td>
</tr>
<tr>
<td>Net T-Bills issues</td>
<td>CZK – 24.0 to – 50.0 bn</td>
<td>CZK - 31.3 bn</td>
</tr>
<tr>
<td>Loans from EIB</td>
<td>CZK 11.78 bn</td>
<td>CZK 9.1 bn</td>
</tr>
</tbody>
</table>


Programme for 2006 - Plan versus Reality

<table>
<thead>
<tr>
<th>Criterion</th>
<th>Guidelines for 2006</th>
<th>June 30, 2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>International financing</td>
<td>Max. 50% of the total annual gross financing requirement</td>
<td>4.0%</td>
</tr>
<tr>
<td></td>
<td>CZK 0.0 to 77.7 bn</td>
<td>CZK + 6.25 bn</td>
</tr>
<tr>
<td>Gross T-Bonds issue</td>
<td>CZK 72.3 to 150.0 bn</td>
<td>CZK + 74.6 bn</td>
</tr>
<tr>
<td>Net T-Bills issue</td>
<td>CZK – 3.8 to – 25.0 bn</td>
<td>CZK - 14.9 bn</td>
</tr>
</tbody>
</table>

Debt Strategy & Need for Flexibility

Strategic targets/benchmarks - sufficient ranges to perform

- Consistent short term debt targeting.
- Explicit targets were set in Dec 2003.

Short Term Debt Targeting since 2004 (%)

- Average life benchmarking since 2005.
- Focus on long dated instruments is followed separately from market risk management.

Average Life Targeting since 2005

Source: MF CR.
Agenda

Debt Strategy & Need for Flexibility

Trigger of Annual Adjustments

Implementation of Changes into Practice

Summary
Trigger of Annual Adjustments

Main drivers of annual adjustments

- Financing requirements - change of the structure.
- Financing requirements - change of the total amount.
- Policies related to contingent liabilities and financial assets.
- Market conditions - change of trend, significant deviations from the core path expected in the simulation framework.
- Coordination between debt and monetary policy of the central bank - Agreements between Governor and Minister of Finance.
- Operational issues to implement strategy.
Active interest rate risk management.

Explicitly adopted duration targeting in November 2002 replaced by interest rate re-fixing targeting from 2006.

Full range of derivatives used to meet market risk objectives.

Q2 2005 debt duration got over the upper limit due to downward shift of yield curve; after taking into account the risky state guarantees the range was hit!

Minister’s decision to issue no eurobond in 2006 + implementation of new information system for debt management tie up reaching the minimum limit for IR re-refixing benchmark planned in 2006.
Agenda

Debt Strategy & Need for Flexibility

Trigger of Annual Adjustments

Implementation of Changes into Practice

Summary
Implementation of Changes into Practice

Towards financial market

- Transparent relationship with market participants is crucial.

- A logical explanation of main items of current year financing needs to Primary Dealers on regular meetings and via informal communication.

- The text of annual debt management strategy revealed for public on Ministry‘s website.

- Changes of strategy are revealed via Debt Portfolio Management Quarterly Review on Ministry’s website.
Implementation of Changes into Practice

Towards financial market

- Issuance calendar published **quarterly** – it creates flexibility for changes within current year on the domestic market.

- **General possibility to issue foreign currency bonds** but no factual information is revealed for public – **‘Just in Time‘ tactics gives flexibility to the Czech Ministry.**

- No factual information about derivative operations are revealed even after their executions.
Implementation of Changes into Practice

Towards debt manager

- Flexibility for smooth financing execution is crucial.

- **Gentlemen’s (unwritten) agreement** with Primary Dealers = in/de/crease of planned amount of issuance +/- 10% without public announcement is possible and generally accepted.

- Use this agreement to exploit a bit market opportunity(-ies) and create funding reserves for bad events.
Agenda

Debt Strategy & Need for Flexibility

Trigger of Annual Adjustments

Implementation of Changes into Practice

Summary
Summary

**Keys for flexibility to adjust the published Strategy without curtailment of the transparency and general predictability**

- “Surprise” the market only within the target bands.
- Set up the targets and the risk limits based on the debt, contingent liabilities and financial assets structure.
- Make public ‘escape clauses’ as an integral part of the annual Strategy.
- Quarterly issuance calendars for domestic Bonds and Bills.
- No details about financial derivatives and private placement operations.
Summary

FORTHCOMING INFORMATION ON DEBT STRATEGY IN THE CZECH REPUBLIC

- The Financing and Debt Management Strategy for 2007 will be published on December 1, 2006 together with the Issuance calendar for the 1st quarter 2007.

- Debt Portfolio Management Quarterly Review
  - has been released since March 2005,
  - published regularly the eight working day after the end of the quarter,
  - the next issue will be published on October 9, 2006 at 2 p.m.

CONTACT DETAILS
Debt and Financial Assets Management Department, Ministry of Finance
Letenska 15, 118 10 Prague 1 - Mala Strana

Key Personnel
Mr. Eduard Janota, First Deputy Minister of Finance - eduard.janota@mfcr.cz
Dr. Jiří Franta, Director - jiri.franta@mfcr.cz
Petr Pavelek, Ph.D., Head of Funding and Portfolio Mng. - petr.pavelek@mfcr.cz

VISIT OUR WEBSITE
www.mfcr.cz/statedebt