MINISTRY OF FINANCE OF THE CZECH REPUBLIC

DEBT AND FINANCIAL ASSETS MANAGEMENT DEPARTMENT

Financing and Debt Management Strategy for 2006

1 December 2005

Contents

On the 18 November 2005, the Minister of Finance made a Decision on the structure and manner of financing the borrowing requirements of the central government for the 2006 budgetary year and approved the basic absolute and relative limits for issuance operations on the domestic and foreign market and for the active management of the State Debt portfolio (Ref: 20/107726/2005). An operational framework that is defined by the presented Financing and Debt Management Strategy for the year 2006 (hereinafter Strategy) contributes to a more transparent implementation of debt policy and allows for the more flexible functioning of the Ministry of Finance (hereinafter Ministry) on the financial market for the purpose of actively ensuring the financial requirements of the central government and achieving the set medium-term strategic objectives of state debt and state financial assets management policy.

The Strategy comes from and is consistent with the Draft Bill on the State Budget of the Czech Republic for the year 2006, the Medium-term Outlook for the State Budget of the Czech Republic for the years 2007 and 2008, the Medium-term Expenditure Frameworks for the years 2007 and 2008, the internal Issuance Plan of State Bonds for the years 2006 to 2008 and with the Czech Republic Convergence Programme for 2005.

This Strategy is presented by the Debt and State Financial Assets Management Department (hereinafter Department), which was introduced as a part of the new organisation structure of the Ministry valid from 1 October 2005, created by a Decision of the Minister of Finance based on the recommendations and results of an external organisation, function, personnel and information audit. On the same date the Government Debt Management Unit ceased to exist. This established, along with other things, the necessary organisational pre-requisites for the integration of the state debt, risky guarantees and state financial assets portfolios as part of a wider and centralised government financial balance sheet and thus defined a wider framework for the further technical improvement of state debt management and the optimisation of relations between the costs and financial risks of the central government. The leading of the new department remains in the direct competence of the First Deputy Finance Minister.

Introduction

From the point of view of liabilities management and conceiving the medium-term strategies for financing the central government, the centre of attention for the Department, are those segments of the government balance sheet, whose financing is the direct responsibility of the Ministry and whose structure has a direct impact on the financial flows of the State Budget due to the fluctuations in the variables of the domestic and foreign financial markets. The state debt makes up the main balance sheet item of these government liabilities (24.5% GDP). Then there are the liabilities that flow from covering the expected liquidity requirements of the Czech Consolidation Agency (CCA) for the period 2006 to 2010 (1.2% GDP) and for the provided state guarantees (8.6% GDP), which are not actually a part of the state debt but on the expenditure side of the state budget represent the same financial and credit risks as the state debt structure and the CCA balance.

Beginning in the year 2005, on the basis of the approved Strategy for that year, the integrated management of the above mentioned three segments was introduced from the point of view of relations between costs and risks and from the point of view of planning financing and issuance activities. An isolated view no longer has an economic justification due to the fact that CCA activities will cease at the end of the year 2007 and on the basis of an agreement with the Ministry, that institution has already ceased to operate on the capital bond market from 2005, and also due to the fact that the most of state guarantees are now already a part of the government sector debt and their coverage is a part of state budget expenditure and thus contribute to a higher deficit and predetermine growth of the state debt.

The preliminary results of the integrated view of the government liabilities portfolio have already been submitted in last years Convergence Programme of the Czech Republic and have become an integral part of the regular *Debt Portfolio Management Quarterly Review* made public from March 2005. The integrated management of government liabilities has thoroughly proved itself in the first year of its implementation and the next objective is the extension in the direction of linking up with the active portfolios of the government, to which end the necessary pre-requisites have been put in place by the newly re-organised Ministry's structure. The plan is therefore, from the beginning of 2006, to extend this portfolio integration towards the state financial assets side (4.3% GDP), which will allow for further improvement in state debt management as part of the wider government financial balance sheet and in closer ties to the budgetary process.

1 Medium Term Borrowing Requirements

The source of government borrowing requirements in the 2006 to 2008 outlook will be made up of not only by the state budget deficits and payments of CCA losses but also principally by the growing volume of redemptions of state bonds that will have to be covered by new issues on the domestic and foreign capital markets.

In comparison with the Eurozone countries, the gross annual borrowing requirements of the central government (without revolving and reducing the T-Bills outstanding) remain at a relatively low level, on the equivalent of EUR 5 to 6 bn and stabilised at 5% GDP. Therefore, their coverage particularly through issuance activities on the domestic and foreign markets and also the drawing of government loans from the European Investment Bank (EIB) should not represent a very serious risk to the implementation of government fiscal and budgetary policy or to the financial stability of the domestic economy in the medium-term horizon.

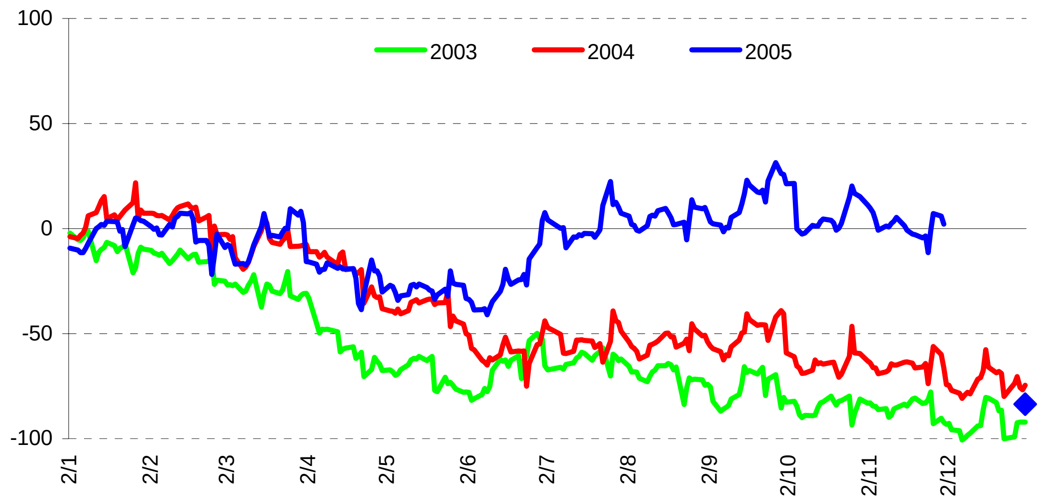
The favourable development of the state budget means that contrary to the December 2004 plan, there is a reduction in government borrowing requirements for the year 2005. In the documentation to the Draft State Budget for the year 2006, this reduction is estimated to be about CZK 16 bn; the current estimate arising from predictions in state treasury liquidity management, makes it a reduction of about CZK 34 bn. These are relatively conservative estimates, because even as late as the end of November, the state budget was in a surplus of about CZK 2 bn.

Table 1: Government Financing Requirements Outlook (CZK bn)

	2004 Actual	2005 Plan	2005 Expectation*	2006	2007	2008
State Budget Deficit, excl. funding the CCA	75.5	*83.6*	50.0	74.4	88.0	71.2
Of this: State Debt gross expenses	26.8	*33.7*	28.2	34.2**	40.7**	45.7**
Of this: State Guarantees Fund	20.4	*22.2*	22.2	12.2	14.0	10.0
Planned funds for the CCA	18.2	*30.0*	30.0	20.0	9.0	3.0
Redemptions on State Debt	39.7	*22.0*	22.0	58.1	44.8	84.0
Funding the guarantee for the CNB	0.0***	*0.0*	19.0***	0.0	0.0	0.0
Special Pension Account	0.0	*5.8*	8.3	3.0	0.0	0.0
Other financial assets deposit accounts	0.3	*0.8*	0.6	0.0	0.0	0.0
Add to (+) /Cut back (-) funding reserves	5.7	*-5.8*	-7.3	0.0	0.0	0.0
Total gross requirements (without revolving T-Bills)	**139.4**	***136.4***	**122.6**	**155.5**	**141.8**	**158.2**
% GDP	**5.1**	***4.7***	**4.2**	**5.0**	**4.3**	**4.4**
Change of T-Bills outstanding	**-35.0**	***-24.0***	**-29.0**	**–25.0**	**-11.0**	**-6.0**
Total gross requirements incl. change of T-Bills outstanding	**174.4**	***160.4***	**151.6**	**180.5**	**152.8**	**164.2**
% GDP	**6.3**	***5.5***	**5.2**	**5.8**	**4.6**	**4.6**

Note: *Expected at the end of the year; **Budgeted fees make up CZK 300 mil; in the previous Ministry's draft for expenditure in the state debt chapter for the year 2006 this was CZK 37.2 bn, but the Chamber of Deputies decreased the budgeted amount by CZK 3 bn on 16 November; ***Initially non-budgeted payments of CZK 0.5 bn in 2004 and 3.0 bn in 2005 were carried out from the surplus of the State Guarantees Fund.
Source: MF CR, CCA.

Figure 1: Daily Position of the State Budget in the Years 2003 to 2005 (CZK bn)



Note: Excl. payments into the CCA. Source: MF CR.

Budgetary development has allowed the Minister of Finance and the Cabinet to make a Decision in July of this year, in Government Decree no. 992/2005 on the Draft Bill of the State Bond Programme for the Repayment of Liabilities out of State Guarantees, on the consolidation and stabilisation of the banking sector and the financial consequences of the separation of the Czech and Slovak Federal Republics, in the amount of CZK 22 bn and before the due date of the middle of 2007, for the Czech National Bank (CNB). This government draft was presented to the Chamber of Deputies, which pursuant to the reading of approved amendment proposals, expressed its agreement with it on the 19th October 2005 by Decree no. 1912 and passed it on to the Senate on the 1st November (print no. 165/0). At the same time, this additional borrowing requirement does not cause any growth to the total gross financing requirement planned for the year 2005. Also at the same time, this Decision allows for the acquisition of new funds to cover this liability at a historically all time low interest rates, the substitution of a non-tradable government guarantee with a standardised financial market instrument and reduction the refinancing risk of state debt management in the medium-term horizon.

An important consideration when planning the Ministry's issuance activities is also the expected requirement of new sources arising from the anticipated outlook of the liquidity requirements of the CCA. The outlook for this requirement of financing is regularly up-dated at joint discussions between the Ministry and the CCA. Up to the date of the CCA's closure without liquidation, i.e. 31 December 2007, the Ministry will ensure these resources by the issue of state bonds pursuant to a special State Bonds Programme for the payment of a part of the CCA's losses (Act no. 5/2005 Coll.) up to CZK 63.3 bn. The remaining available legal framework for the period 2006 to 2007 is CZK 33.3 bn. After dissolution of the CCA, its assets and liabilities will be explicitly transferred to the state financial balance sheet and will be administered as a part of standard budgetary process and the financial portfolio management and issuance policy of the Ministry. The final coverage of CCA financial needs in the next two years will arise out of the further close co-ordination between the Ministry and the CCA in accordance with the government's other borrowing requirements in those years and in conjunction with the needs of risk management of the existing financial balance sheet and state debt.

As far as the CCA's own activities on the domestic financial market are concerned it will not issue its own medium-term and long-term bonds, as it did not in 2005. Nevertheless, it may finance short-term supplementary liquidity needs by means of the money market by issuing short-term bonds and loans on the inter-bank market. At the same time it is the aim of the CCA to raise financial resources in the abovementioned manner up to a volume of CZK 15 bn.

The borrowing requirements of the central government may, contrary to the already mentioned outlook, also be influenced by the additional needs of non-budgetary State and Privatisation Funds and the public health insurance system. Starting on the 1st January 2006, the National Property Fund (NPF) will cease to exist and its sphere of authority will pass to the Ministry. The year 2006 will already see a significant worsening of financial position arising from NPF activities and a deficit of CZK 30.7 bn has been budgeted. This will be covered, in the main, by a reduction in financial assets, so that in the year 2006 the NPF's expenditure plans and other operations do not mean any additional burden on the central government financing. As far as the financial result of health insurance companies is concerned, a moderate deficit is expected in only the amount of approximately CZK 0.04 bn, i.e. the predicted impact on the central Government's borrowing requirements is inconsequential. Nevertheless, the risk of possible subsequent extra-ordinary Government stabilisation measures in the manner of the payment of the insurance companies' selected obligations after the due date for payment, remains. A payment of this kind took place in 2005, in the amount of CZK 3.8 bn in the form of assigning the relevant claims to the CCA. This operation, therefore, increased the future borrowing requirements of the Government in as much as, considering the small probability of the payment of these obligations by the insurance companies themselves, this operation increased the liquid needs of the CCA, which will have to be re-financed by the Ministry after the CCA's closure.

Neither does the outlook consider any more significant payments because of the enforcement of the guarantee on behalf of the IPB to the CNB, the status of which at the end of 2005 is CZK 157.5 bn and whose maximum due date is in the year 2016. In the state budget expenditure and therefore also as part of the approved deficits there is a total of only CZK 12 bn budgeted for the next three years. Also, the Ministry, on the basis of conclusions drawn from communications with representatives from the central bank, does not anticipate, in the above mentioned outlook to the end of 2008, any operations for the purpose of resolving the accumulated accounting losses of the CNB, which at the end of the year 2004 reached the value of approximately CZK 125.7 bn. At the same time, not even the part payment of that part of the losses, whose sources were the quasi-fiscal operations for the coverage of expenses for the stabilisation of the banking sector, which at the end of last year came to approx. CZK 73.8 bn, is expected. The accumulated loss should be eliminated, according to the CNB's own simulation, through future profits in the up-coming 15 to 20 years, which should be mainly generated by the growing gains from seignorage after the Czech Republic joins the Eurozone. Despite this existing official stance by the CNB and the Ministry, the financial position of the central bank remains a potential fiscal risk, which from the point of view of circumspect long-term state debt management, needs to be systematically monitored and analysed.

2 Financing Requirements for 2006

The total planned government gross borrowing requirements without the revolving of T-Bills in the year 2006 is approximately **CZK 155.5 bn**.

Table 2: Gross Government Requirements for Financing in 2006 (CZK bn)

Gross financing requirements (excl. T-Bills revolving)	155.45
Expenditure by the state budget	958.79
Receipts to the state budget	-884.39
State budget deficit, excl. funding the CCA	**74.40**
Planned funds covering the liquid needs of the CCA	11.00
Reserve for pre-payment a part of CCA's liabilities in the form of exchange bills and loans	9.00
Net government borrowing requirements, incl. the CCA	**94.40**
Special Pension Account	3.0
Other financial assets deposit accounts	0.0
Add to (+) /Cut back (-) funding reserves	0.0
Net government borrowing requirements, incl. the CCA and financial assets operations	**97.40**
Redemptions on domestic T-Bonds	58.00
Maturing non-marketable debt (notes to cover EBRD subscription)	0.05
Gross borrowing requirements (excl. T-Bills revolving)	**155.45**

Source: MF CR, CCA.

This amount is made up of the planned state budget deficit of CZK 74.4 bn, the planned resources for the CCA in the amount of CZK 20.0 bn, the planned transfer of the positive difference between pension insurance revenue and pension insurance expenditure for the year 2005 to a special pension account in the state financial assets in the expected amount of approx. CZK 3.0 bn and the refinancing of due medium-term and long-term state bonds (T-Bonds) and the non-tradable debt in the amount of CZK 58.1 bn. The gross financing requirements (without the revolving of T-Bills) for the year 2006, are increased by a further CZK 14.82 million pursuant to Section 2, para. (3) of the Draft Bill on the State Budget of the Czech Republic for 2006.

The planned payment of part of the CCA losses for the year 2006 arises from up-dated estimates. The current liquidity requirements of the CCA are planned at the level of CZK 11 bn, a value that does not differ very much from the expected sum of CZK 10 bn stated in the Draft State Budget for 2006 and in the State Budget Medium-term Outlook for the period 2007 and 2008.

What is more, the state debt management will create a reserve in order to finance the buy-back of CCA's exchange bills that are due in the years 2006 to 2008 and the early repayment of some loans that are held by main Czech banks against the CCA and due in 2009 in a total amount of CZK 9.0 bn. These additional financial requirements are motivated by the Ministry's effort to substitute some specific non-tradable debt instruments that are part of the overall liabilities in the government sector with standardised issues of state bonds on the domestic and foreign markets at a time of relatively favourable interest rates and with the aim of further supporting the restricted liquidity of state securities with attainable means. At the same time, the above mentioned operations of refinancing CCA liabilities with state bonds do not have any impact on the overall level of indebtedness of the government sector just as the creation of a financial reserve for the repayment of guarantees to the CNB does not. The special State Bond Programme provides the Ministry with sufficient flexibility in the implementation of these operations and in financing the possible additional CCA requirements in the years 2006 and 2007.

3 Annual Financing Programme

Financing Programme Fulfilment in the Year 2005

A summary of the Ministry's performance in the planned financing programme in 2005 is provided in the following review.

Table 3: Financing Programme Performace in 2005 (CZK bn)

	Plan at 6.12.2004	Expectation at 30.11.2005
Gross financing requirements (excl. T-Bills revolving)	**136.38**	**122.6**
Of this: reserve T-Bills issue for the pre-payment of guarantee to the CNB	0.0	19.0
State debt growth	**114.38**	**100.6**
Long-term loans from the international institutions	**11.83**	**9.1**
European Investment Bank	11.78	9.08
Notes to cover EBRD subscription	0.05	0.04
Gross T-Bonds issues	**148.55 to 174.55**	**142.1**
Domestic capital market	94.00 to 120.00	112.0
International capital market	28.55 to 54.55	30.1
Net T-Bills issues	**-24.00 to –50.00**	**-29.0***

Note: *Without the unplanned reserve T-Bills issue, the net drop in T-Bills outstanding would be CZK 48 bn. Source: MF CR.

The year 2005 saw foreign financing through the March eurobond issue in the volume of CZK 30.1 bn, i.e. only about 24.6% of the gross annual financing requirements. The volume of Czech crown T-Bonds will also not exceed the announced maximum limit of CZK 120 bn. A favourable budgetary development and the following decline in borrowing requirements would lead the Ministry to a more significant than planned for cut back in the volume of announced issues of T-Bonds and T-Bills in the fourth quarter of the year 2005. Considering the above mentioned Decision by the Minister to pre-pay the liability from the guarantee to the CNB this cut back was not introduced on a larger scale at the beginning of the fourth quarter and instead of that the Department began the creation of financial reserve for the early repayment of liability to the CNB, so that the relevant additional resources might be at the disposal of the Minister of Finance by the end of the year and could, in the event of the Act being approved by the Senate and signed by the President, be used to pay off the central bank.

The financial reserve is created by the issue of T-Bills, i.e. the decrease of T-Bills outstanding will be lower by the end of the year 2005 than would otherwise be allowed by a more favourable development of the state budget. Therefore, in accounting terms, the liability from the guarantee will already become a part of the state debt in 2005 and the subsequent liquidity payment to the CNB will no longer have any influence on the state debt level, without regard to whether the payment still takes place this year or at some other time in the future in the event that the Bond Programme is not approved by the end of the year. Considering that the above mentioned guarantee has already been classified in its total sum by Eurostat into the government sector debt at the end of 2004, neither the creation of financial reserves nor a subsequent payment, has any impact on the level of the government sector debt and therefore not even on the fulfilment of the fiscal convergence criteria. The conversion of these reserve T-Bills into CZK T-Bonds or foreign bonds will be carried out during 2006.

In the event of an even more favourable development of the state budget, the Ministry will begin, in December, to cut back the planned issues of T-Bills so that their final drop in circulation will be more than the stated expectation of CZK 29 bn, which apart from other things will contribute to the drop of the share of short-term debt to below the targeted level of 24% by the end of the year. Concurrently, part of the resources would be used as a financial reserve to cover the borrowing requirements for 2006.

Planned Financing Programme for the Year 2006

The planned financing programme for the year 2006 arises from the following limits that are the determining factors in using individual debt instruments ensuring the government financing requirements in the year 2006.

> **The share of financing on a foreign capital market will be no more than 50% of the total annual gross financing requirement without the planned net decrease of T-Bills in circulation and without the revolving of T-Bills.**

This maximum limit allows for the Ministry's flexible response to the actual conditions on the domestic and foreign financial markets. This means a limit restricting foreign issuance activities from above and therefore, in the case of given conditions on the foreign market, compared to the domestic market trends, it does not always have to be fully used exploited, which was already the case in 2005. When acquiring foreign resources the Ministry will aim mainly, from the point of view of issued volume and similarly to 2004 and 2005 at strategic operations on the Eurozone markets. The possibility of entry onto any other currency world market is only imaginable in the case of a more significant and documented cost efficiency or other advantage in comparison with the Czech crown or Euro market conditions.

Financial requirements of approximately CZK 9.2 bn will be ensured through long-term loans drawn from the European Investment Bank.

Drawing on these loans that are exclusively assigned for infrastructure projects is approved by the Government and decided upon directly by the Minister of Finance and are also explicitly contained, the same as in previous years, in the Draft State Budget for 2006. The management of arranging these loans is not in the competence of the Debt and Financial Assets Management Department at present; it is only accountable for their subsequent recording, debt servicing, classifying into the debt portfolio and from the year 2003 it also drafts their instalment calendars.

By the end of the year 2005, the share of non-tradable state debt will exceed the level of 4.4% and it is possible to expect that by the end of 2006 it will have grown further and exceeded the 5%. This means that it is an additional financing instrument in so far as its further use should not, in the medium-term period, clash with the Ministry's issuing and debt management strategies on the domestic and foreign markets. The government's current plans presently indicate that the portion of non-tradable instruments in the debt portfolio will not exceed the level of 10% till the end of 2008.

The amount of issued Czech crown medium-term and long-term bonds on the domestic market shall not exceed the value of CZK 150 bn. At the same time, the planned volume of issues makes CZK 110 bn ± 10%.

The stated maximum volume would only be implemented if, in the year 2006, the Ministry did not enter the foreign capital market at all. This situation would occur in the event of an extraordinarily favourable development on the domestic market and a significant surplus of demand over supply of Czech crown state bonds during the year. Should this situation not occur, the Ministry will endeavour to operate on the foreign market in such a manner as to secure that the maximum supply of T-Bonds in the year 2006 will remain on a level comparable to the years 2004 and 2005. The final annual volume of issues will depend particularly on the size of the final resources acquired on the foreign market. In the event of a lower than the maximum allowed volume of foreign issue, the same amount will be increased in the volume of domestically issued T-Bonds, and possibly the planned dis-issue of T-Bills will be reduced.

The issue of T-Bonds and their subsequent re-opening on the domestic market will still continue in the maturities of 3, 5, 10 and 15 years and this will mean a fixed interest instrument. In this way the Ministry will continue in the creation a restricted number of tradable liquid benchmark issues so that their equivalent in the future domestic currency, the Euro remains at a level of approx. EUR 1 to 3 bn.

In the year 2006, the Ministry plans to introduce only one new issue on the domestic market, which will mature in 2009. At the same time, the re-opening of existing issues maturing in the years 2008, 2010, 2015 and 2020 will take place.

In the year 2006 the Ministry will still continue in its programme of reducing the share of T-Bills on the financing of long-term state liabilities in such a way so that by the end of 2006 the drop in the short-term state debt has reached the final limit of 20% and less.

The debt portfolio structure projection to the end of the year 2006 shows that in order to achieve the final targeted value of indicator of short-term debt repayable in one year, it is minimally necessary to stabilise the volume of T-Bills in circulation to the level that is expected at the end of 2005. The financing programme shows that the Ministry will nevertheless continue to try and reduce the volume so that the maximum expected absolute reduction can be supposed to be within CZK 25 bn, i.e. the T-Bills portion of the state debt at the end of 2006 will be below the 15% mark. The Programme for the stabilisation or reduction of T-Bills in circulation will depend above all on the actual management of the State Budget and the Ministry's success in the issues of State Bonds on the domestic and foreign markets. Issues of T-Bills with the maturities of 3, 6, 9 and 12 months will still continue.

Table 4: Planned Financing Programme for the Year 2006 (CZK bn)

Gross financing requirements (excl. T-Bills revolving)	**155.45**
Long-term loans from the international institutions	**9.22**
European Investment Bank	9.22
Other	0.00
Gross T-Bonds issues	**150.00 to 171.23**
Domestic capital market	72.27 to 150.0
International capital market	0.00 to 77.73
Net T-Bills issues	**-3.77 to –25.00**

Source: MF CR.

4 Strategic Targets and Financial Portfolio Management

Announcing strategic objectives and targets serves to publicly define the strategic or rather benchmark portfolio of government liabilities and financial assets to which the Ministry with the aid of its available instruments, tries to emulate in the actual structure of the government financial balance sheet. The targets are taken from the requirements arising from the circumspect approach to managing the financial and credit risk while minimising debt costs in the long-term horizon. At the same time, the communication of these targets to the public increases the Ministry's responsibility in the area of the state debt management policy and allows feed-back to the Ministry from the public, which should increase the credibility of Czech debt managers even in today's institutional arrangement in which the relevant accountable Department is an integral part of the organisation structure of the Ministry.

In the Financing Strategy for the year 2005, the Ministry committed itself to the integrated management of the state debt portfolio together with risky state guarantees that have already been transferred according to ESA95 methodology prescribed for the calculation of the Maastricht criteria into the total government sector debt even though they are not part of the state debt. The Ministry informs the public of the results of this approach in the regular *Debt Portfolio Management Quarterly Review*. The integrated view allows for the more effective management of the state debt and the setting up of debt portfolio parameters with the help of available debt and derivative instruments aimed at the announced strategic objectives whilst bearing in mind the financial and credit risks in the structure of the state guarantees that have been provided. The next logically planned step in improving the management of financial flows and risks is also the explicit integration of the state financial assets portfolio, for which the necessary organisational pre-requisites were given as of 1st October 2005. Thus, the management of the state debt will be implemented whilst taking the risk structure of the wider government financial balance sheet into consideration.

Only the strategic targets for the state debt portfolio will continue to be formally announced in the future, however, fulfilment of the criteria will be assessed in relation to risky state guarantees and state financial assets. As in the year 2005, the practical management of the debt during the year will be run so that should it happen, that the structure itself of the risky state guarantees portfolio and what is more, the state financial assets portfolio begins to significantly veer off the course of monitored criteria on the integrated basis, in an undesirable manner and off the announced targets, the Ministry can make use of its available instruments, especially issuance activities and financial derivatives, to reverse these trends and ensure the stabilisation of the criteria back towards an acceptable levels.

Table 5: Aggregate Assets of the State Financial Balance Sheet (CZK bn)

Deposit bank accounts	14,5
Government foreign claims	36,3
State ownership	12,1
State loans provided and repayable financial assistance	14,3
Claims from implemented State Guarantees	39,6
Securities and other financial assets	7,6
Total	124,4
% GDP	**4,3**

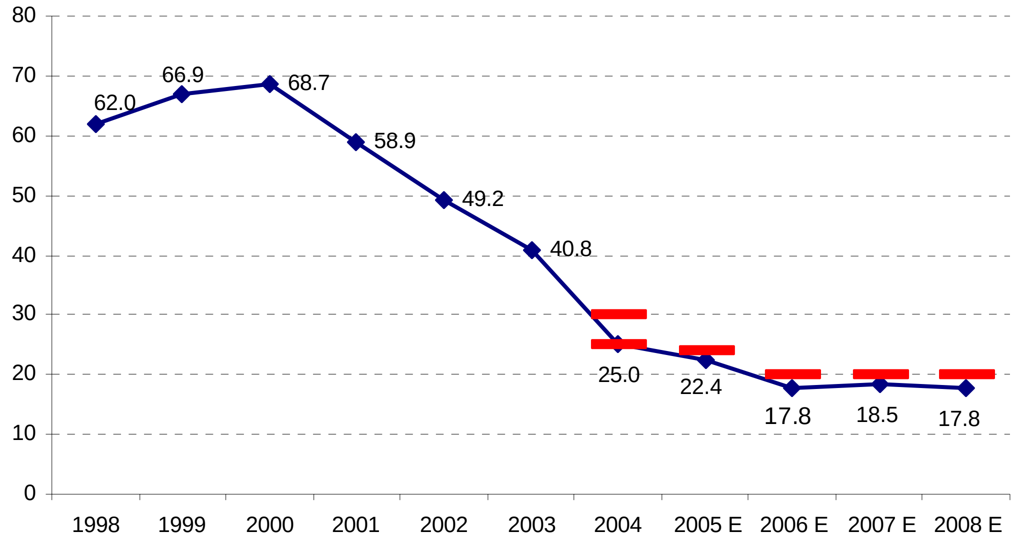
Note: Expected status at 31. 12. 2005; Excl. the effect of NPF's financial assets integration. Source: MF CR.

The future should see the explicit formalisation of the strategic targets for the overall government financial balance sheet or rather, a fully integrated financial portfolio. An essential condition for this step is to finish the implementation of an appropriate IT system, which will allow for an automatic, centralised database, computing procedures and the introduction of common financial accounting processes.

Refinancing Risk Management

The stabilisation of the refinancing risk is the blazon stone behind the philosophy of the Ministry's issuance strategy. The key indicator, which in this regard, the Ministry has been targeting since the beginning of 2004, is the short-term state debt (i.e. debt due within one year). In the first six months of 2004 the Ministry announced, in connection with the Minister of Finance's Decision to introduce a regular issuance activity on the foreign market, a gradual three year trajectory of the reduction of this indicator in this form: 2004 – 25.0 to 30.0%, 2005 – 22.5 to 27.5%, 2006 – 20.0 to 25.0%. The successful introduction of foreign financing in June 2004 allowed for the redefinition of the strategy aimed at the further speeding up of this reduction programme. At the end of the year 2004, the value precisely at the level of the bottom limit of the announced corridor of 25.0% was achieved. At the end of this year we now anticipate a value of approx. 22.4% and less, which will mean the fulfilment of the announced target of 24% and less for the year 2005. At the end of the year 2006, the Ministry should already achieve the planned final and long-time targeted limit of **20%**, which at the beginning of 2007 will become one of the fundamental limits of issuance policy and financial risk management.

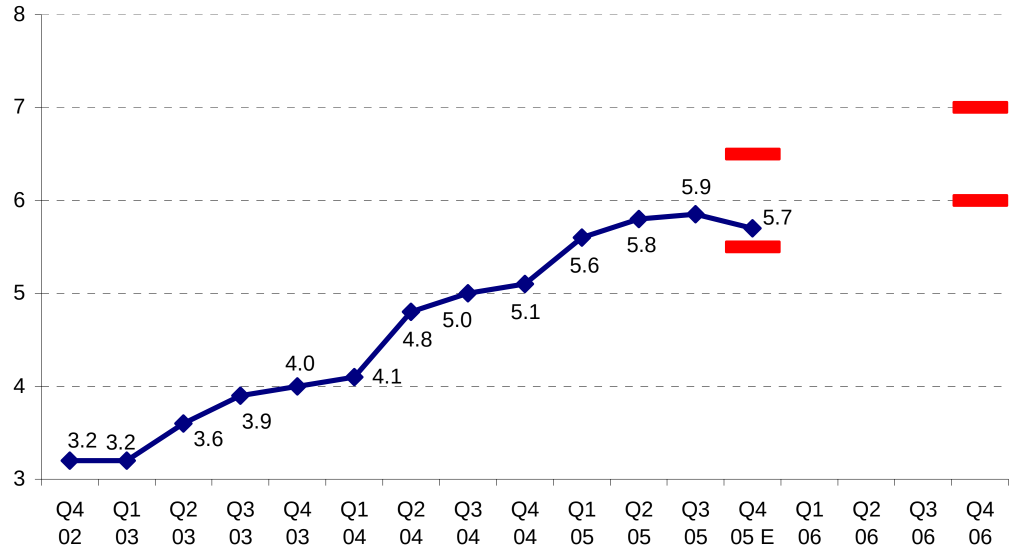
Figure 2: Short-term State Debt Development and Targets 1998 to 2008 (% total state debt)



Source: MF CR.

Another indicator used in refinancing risk management is the average time to maturity of the state debt. For the first time for this indicator, the Ministry announced an explicit target for the year 2005 of 5.5 to 6.5 years. We expect the fulfilment of this range by the end of the year with the final value being around 5.7 years. For the end of the year 2006 we are announcing a new target **6.0 to 7.0 years**, i.e. a shift upwards of the targeted range by 0.5 years. The achievement of this objective will also be determined by the time and volume structure of the issues of state bonds on the domestic and foreign markets and the setting up of instalment calendars for loans drawn from the EIB.

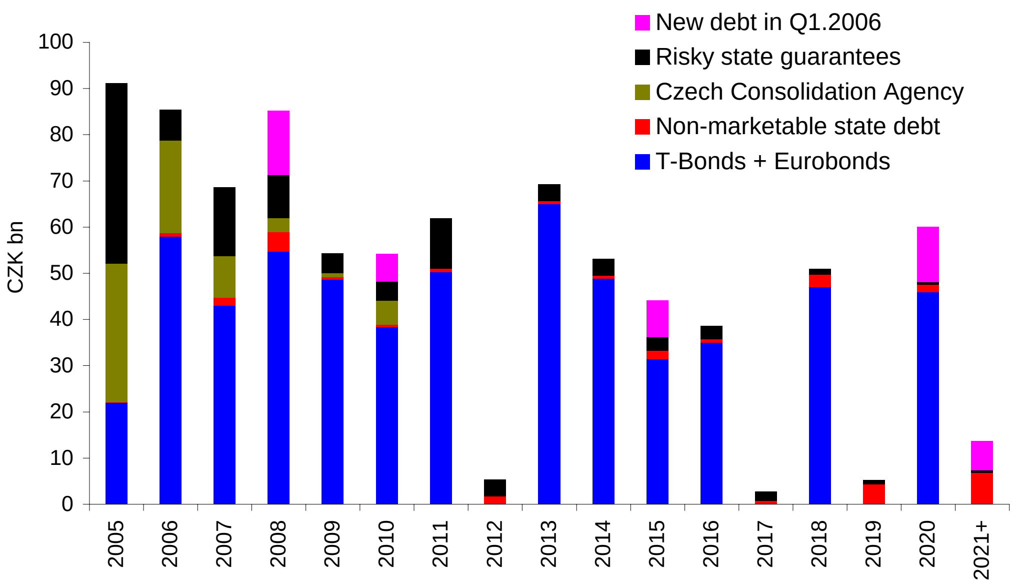
Figure 3: Average Time to Maturity of the State Debt and Annual Targets (years)



Source: MF CR.

New state bond issues, as well as the drawings of long-term loans from the EIB, will be managed principally in accordance with the fulfillment of the key objective in the form of stabilization and smoothing the redemption profile of explicit state liabilities in a time period that has been monitored and planned on an integrated basis since the year 2005.

Figure 4: Expected Redemption Profile of State Debt, CCA's Funding and Risky State Guarantees



Note: Excl. T-Bills outstanding. Source: MF CR, CCA, Czech-Moravian Guarantee and Development Bank.

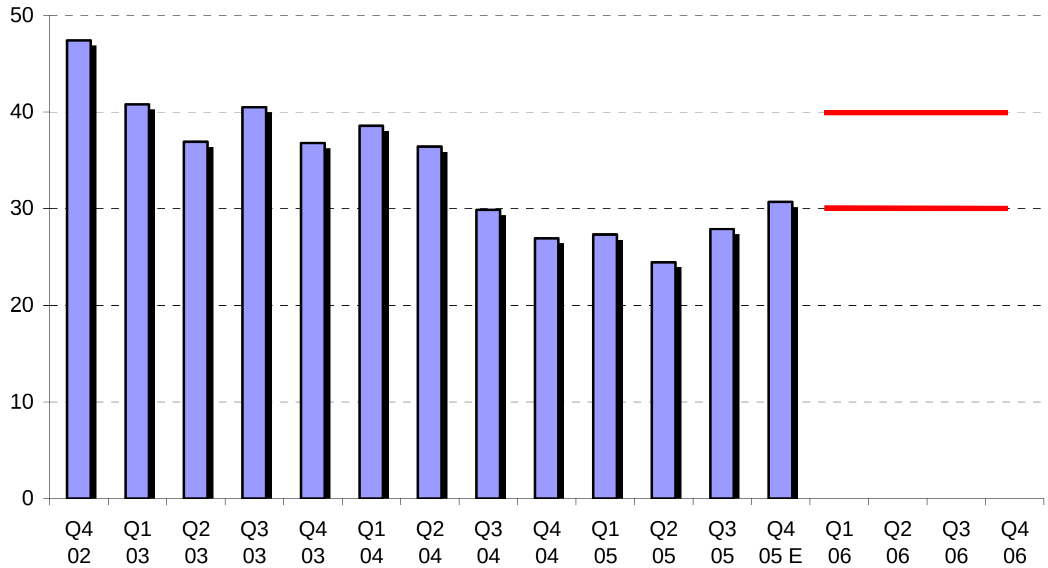
Interest Rate Risk Management

Interest rate risk remains the most important market risk in state debt management. Beginning with the year 2006, there will be a change in the field of announcing the strategic targets for this area of state debt management. The new explicit target will continue to be interest rate re-fixing of the debt portfolio up to one year. This parameter is not sensitive to interest rate fluctuation and thus is fully under the Ministry's control as opposed to the existing targeting of a modified duration, which was introduced in conjunction with interest exposition management through financial derivatives at the end of 2002. What is more, there are no doubts when quantifying the impact of various derivative products on these parameters, whereas the approximation of modified duration, particularly in options products in the debt portfolio, on the basis of market sensitivity of options premiums and with the help of the delta equivalent, is not fully consistent with the traditional concept and the definition of bond duration.

The Ministry will continue to publish the expected annual development of modified duration and their quarterly values, during which this expectation will be derived from the targeted values of the debt portfolio interest rate re-fixing parameters and from the basic model scenario of the development of interest rates but it will not react, due to the aid of its instruments, to deviations in duration from the expected range caused by an unexpected development in interest rates.

On the basis of quantitative analyses and simulations in the medium-term outlook, the Ministry announces the target for the debt portfolio exposition to the change in interest rates up to one year, including derivatives operations, so called, interest rate re-fixing amount-at-risk, which should, on an average, in the year 2006 range between **30% and 40%**. At the same time, this indicator has, from the end of the third quarter of 2004, stabilised under the level of 30%. Therefore, the aim in 2006 is the slight increase of interest rate exposition, which should contribute to softening the effect of the expected growth in interest rates on the costs of the State Debt. This reduction in interest costs is on average connected with a smaller growth in up to one year interest variability.

Figure 5: Interest Rate Re-fixing up to 1 year and Target Band for 2006 (% total state debt)



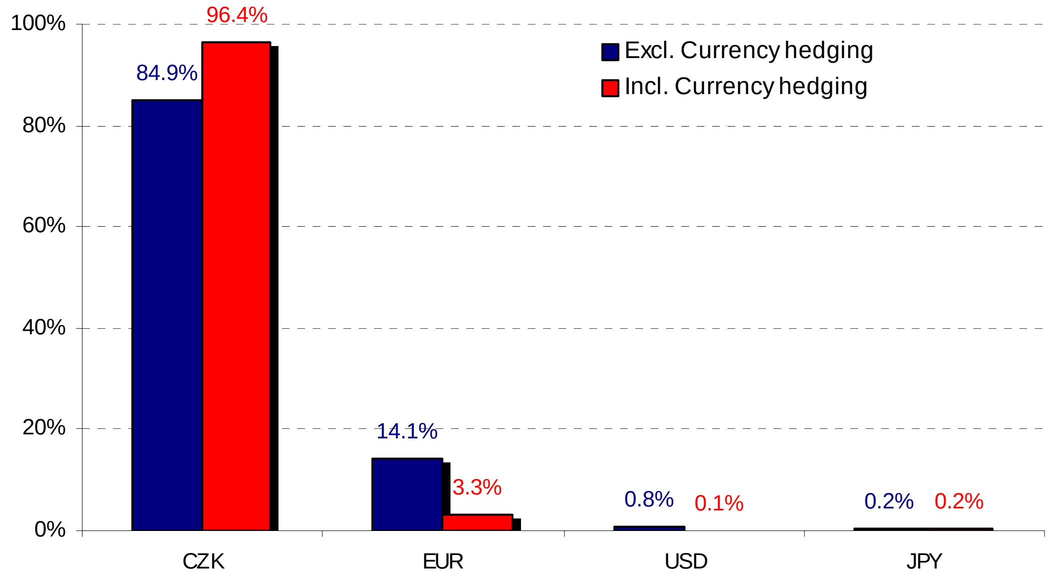
Note: Incl. effects of financial derivatives. Source: MF CR.

For the year 2006, the Ministry expects that the development of modified duration of the state debt, including the approximation of the effect of financial derivatives will continue to further develop in the range of **3.8 ± 0.4 years**, i.e. the same as in the year 2005. Therefore, even in the year 2006, the Ministry does not expect any further increase in modified duration, but rather its stabilisation in a narrower range.

Currency Risk Management

The state debt (without taking into consideration the risky guarantees) is not, at present, put at the relevant risk flowing from exchange rate fluctuations. The state guarantees themselves show a currency exposition of around 30%.

Figure 6: Currency Exposure of State Debt and Risky State Guarantees (% total portfolio)



Note: As at the end of the third quarter 2005; Hedging is related to the principal.
Source: MF CR, Czech-Moravian Guarantee and Development Bank.

Finding the optimal currency structure of the state debt in the period prior to the country's entering the Eurozone remains an important subject of quantitative research whose preliminary output we will try to publish during 2006. That is the reason why we are still not announcing any concrete quantitative objectives for the year 2006. Nevertheless, management of the financial portfolio currency risk will still continue, linked to the co-ordination and joint approach of the Government and central bank in the area of exchange rate state policy.

5 Cost-at-Risk of the State Debt for 2006

The interest costs of the state debt are determined by not only the composition of the state debt portfolio and the connected derivatives portfolio but also by the development of interest rates. The development of the state debt portfolio is given by the T-Bonds and T-Bills issuance calendars, the anticipated drawing of loans from the EIB and the prospective issues on the foreign market. In our analysis, we do not consider the possibility of new derivative contracts, which would change the exposition of the state debt portfolio against interest rates. At the same time, we assume that foreign issues will be hedged against the exchange rate risk. All of the interest cost values mentioned are without the budgeted fees in the amount of CZK 300 mil.

Table 6: Basic Model Scenario of the State Debt Structure Development (CZK bn)

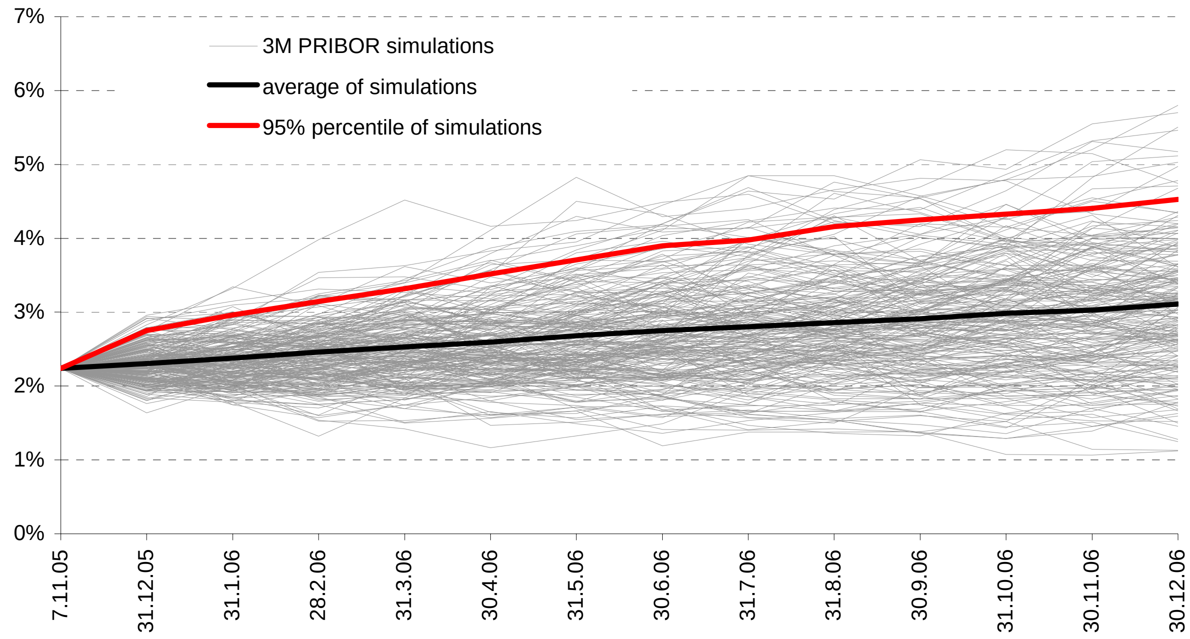
As at	T-Bonds + Eurobonds	T-Bills	Non-marketable	Total
31 October 2005	546.4	92.2	29.2	667.8
31 December 2006	680.0	84.0	39.0	803.0

Source: MF CR, own calculations.

Interest rate development is determined by the stochastic model of interest rates, which attempts to underpin the process by which interest rate development is ruled. The model or rather, its parameters is estimated from the historical time series of interest rates. The knowledge of the parameters of the model allows us to simulate the development of interest rates in the future. We use the single factor CIR model, which was described in more detail in the *Debt Portfolio Management Quarterly Review* of June 2005 and released on the Ministry's website.

All together one thousand possible paths for the development of interest rates for all the necessary maturities for the future 13 months (December 2005 to December 2006) have been simulated. For the current value of interest rates, the CIR model implies the growth of their expected values. For instance, the expected value of the 3M PRIBOR on the 31.12.2006 equals approximately 3.11%. The model further implies that with a 5% probability the rate for 3M PRIBOR on the 31.12.2006 will exceed 4.53% (95% percentile). On the other hand, with about 14% probability on the 31.12.2006, 3M PRIBOR will be under the current value by 2.24% (i.e. on 7.11.2005).

Figure 7: Selected Simulations for the 3M PRIBOR



Note: Figure shows 240 selected from a total number of 1000 undertaken simulations.
Source: Bloomberg L.P., MF CR, own calculations.

The individual paths of the development of interest rates subsequently determine the interest costs of the floating part of the state debt portfolio: T-Bills, loans from the EIB and the floating legs of interest rate derivatives. Furthermore, it determines capital premiums/losses resulting from the new tranches of re-opened T-Bonds issues. Therefore, the simulations of interest costs for the state debt portfolio flow from the interest rate simulations. The average of the simulations of interest costs is the estimate for the expected value of interest costs. Percentile of the simulations of interest costs is the estimate of the percentile of the probability distribution of interest costs. 95% percentile of simulations gives the value, which the interest costs, with a 95% probability, will not exceed and thus determine the interest costs at risk, so called **95% CaR** (Cost-at-Risk).

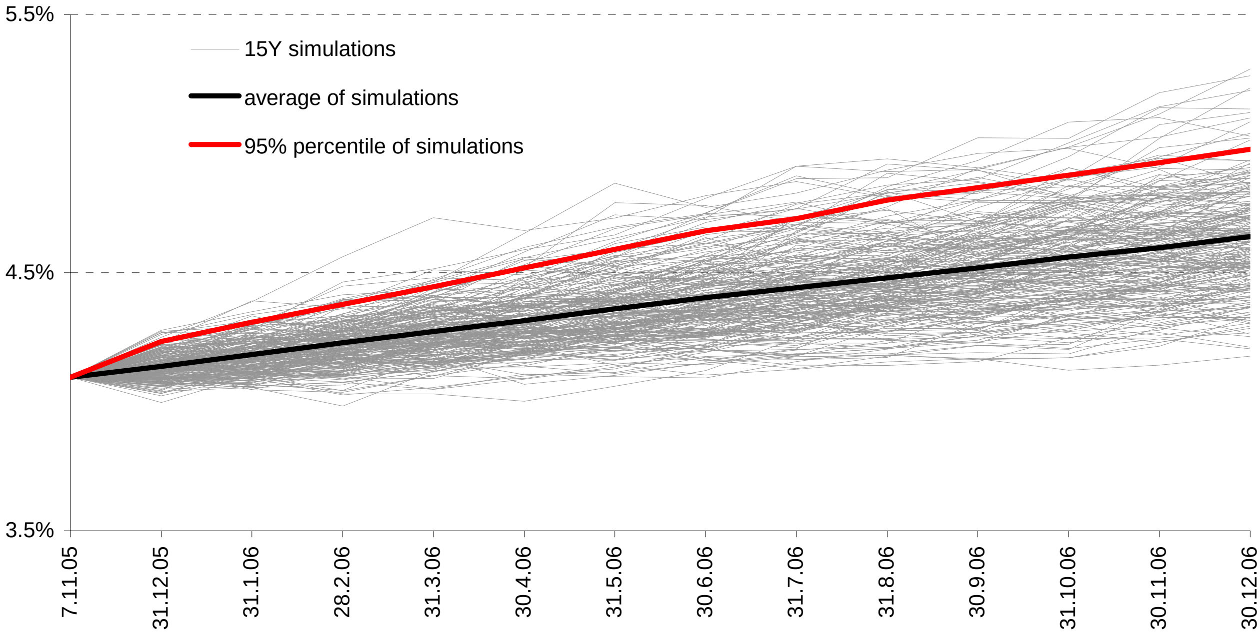
The expected interest costs for the state debt portfolio in the year 2006 are CZK 32.4 bn. Costs at risk (95% CaR) are CZK 36.6 bn.

Table 7: Monthly Cumulative Interest Costs of the State Debt in 2006 (CZK bn)

Months of the year 2006	1.	2.	3.	4.	5.	6.	7.	8.	9.	10.	11.	12.
Expected costs	3.6	4.3	9.7	13.0	13.3	17.5	18.5	21.7	25.2	30.4	30.7	32.4
95% CaR	3.8	4.8	10.5	14.1	14.6	19.5	20.7	24.1	28.1	33.5	34.0	36.6

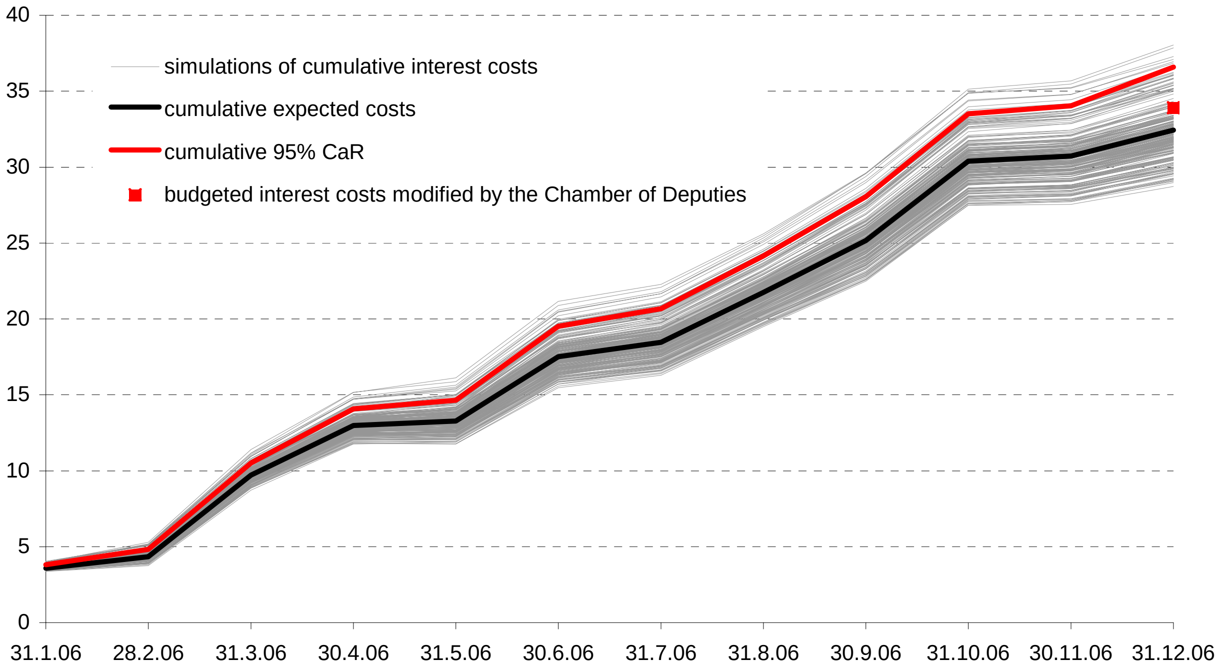
Source: MF CR, own calculations.

Figure 8: Selected Simulations of 15 year Interest Rate



Note: Figure shows 240 selected from a total number of 1000 undertaken simulations.
Source: Bloomberg L.P., MF CR, own calculations.

Figure 9: Selected Simulations of Monthly Cumulative Interest Costs in 2006 (CZK bn)



Note: Figure shows 240 selected from a total number of 1000 undertaken simulations.
Source: Bloomberg L.P., MF CR, own calculations.

6 New Performance Evaluation of Primary Dealers

On the 27th October 2004 a significant supplement to the Rules for the Primary Sale of Medium-term and Long-term State Bonds (Rules) was undertaken. For the first time it was possible, on the basis of an agreement between the Ministry and the CNB, for a foreign entity with headquarters in the European Union, that is a bank, bank branch, a securities dealer or a branch of a securities dealer that has a licence to provide investment services nominated in Sect. 4 para. 2 letter a) to c) and letter e) of the Act no. 257/2004 Coll., on Capital Market Enterprise, in the European Union, to become a member of a group of direct participants or primary dealers.

As well as that, as part of the new Rules valid from 1st January 2005, a so called transition period of 1.1.2005 to 31.12.2005 was announced which allowed for becoming a direct participant of primary auctions, in a shortened version, with the aim of attracting foreign banking houses and already allowing them to take part on the domestic primary market during the year 2005. The Ministry also announced that beginning 1st January 2006 it would select the lead managers of its foreign public Eurobond issues exclusively from the group of direct participants and also that for the Ministry's operations with financial derivatives, members from this group will be approached preferentially, of course, still taking into consideration their capacity in these areas and under the conditions finalised in the ISDA Agreement.

Up to 30 November 2005, the above mentioned steps of the Ministry attracted two foreign entities which thus became direct participants of primary auctions without needing to establish branches in the Czech Republic and increased the number of direct participants to 11. From the beginning of the year 2006, the standard procedure for the qualification of new interested parties to the group of direct participants will again apply, which among other things means that these new applicants can begin to participate in primary auctions after meeting the stipulated requirements, at the beginning of 2007.

These institutional changes to the primary market also called for the necessity, on the part of the Ministry, of a more systematic and transparent evaluation of the performance of the direct participants on the primary and secondary State Bond markets and for more intensive communications in these areas, in accordance with the best practices of European Union countries. This performance will be assessed on the basis of individual quantitative criteria from which the **Overall Performance Index (ICV)** will be constructed. Annex contains a summary of these criteria. The criteria are divided in four main groups A: Domestic primary market participation, B: Domestic secondary market participation, C: Eurobonds secondary market participation and D: Ministry's operations on the secondary market.

The construction methods of the indicators of individual criteria, their weights and their subsequent aggregation into the form of a single ICV will be in accordance with the best practices of European Union.

The aim of the Ministry is to publish the **League Table** to show the best five direct participants for each previous quarter and then for the whole previous year. The ranking of the other places will not be published but the Ministry will always send the exact placing to these individual participants, without however, advising them of the names and placing of the other participants on the unpublished list.

This regular evaluation of the overall performance will also, from the year 2006, become the starting point in the selection of the lead managers of Czech Republic's Eurobonds. The appointed Selection Committee will naturally make its own recommendation taking into account additional characteristics of the direct participant's capability in this area. Of course, the final decision will be made by the Minister of Finance.

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This publication is based on information available up to 30 November 2005. The Ministry has the right to react flexibly to changes in the real needs of the Government resulting from state budget, CCA's liquidity funding, and risky state guarantees. The Ministry will follow the planned financing programme and medium-term targets subject to the conditions on the domestic and foreign financial market in relation to the cost minimizing objective and financial risks management.

This publication is available also on the website:

www.mfcr.cz/statedebt

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Annex Quantitative Criteria for Performance Evaluation

Groups / Criterion
A: Domestic primary market participation (Source: Primary auctions)
A.1: Share in the amount of T-Bonds placed at the primary auctions A.2: Realized share of competitive bids in auctions A.3: Average weighted deviation of bids below the average auction price A.4: Share of realized above-average bids in the total realized auction expenditures A.5: Regularity in competitive biding (excl. auctions with share below 1.5%) A.6: Share in the amount of T-Bills placed at the primary auctions
B: Domestic secondary market participation (Source: Quarterly reporting of primary dealers)
B.1: T-bonds traded volumes B.2: Geographical distribution of T-Bonds (incl. primary auctions) B.3: Investor distribution of T-Bonds (incl. primary auctions) B.4: Compliance with quoting obligations (spread, quantity, hours)
C: Eurobonds secondary market participation – NewEuroMTS (Source: MTS)
C.1: Monthly average traded volumes (Filler side) C.2: Monthly average traded volumes (Order side) C.3: Price ticks average bid/offer spread C.4: Average number of hours quoted C.5: Percentage compliance with quoting obligations
D: Ministry's operations on the secondary market (Source: Ministry of Finance)
D.1: Money market operations D.2: Buybacks or switching programmes D.3: Derivative operations (saving index, incl. capability to deliver products and pricing)