Debt Portfolio Management Quarterly Review

MARCH 2005

On 6 December 2004, the Ministry of Finance published its *Financing and Debt Management Strategy for 2005*. It covers the planned annual funding policy, quantitative medium-term strategic targets and additionaly, the Government Debt Management Unit committed itself to the integrated management of financial risks of state debt and risky state guarantees portfolio, including the effect of financial derivatives, starting from 2005. The first results and experience should be published at the end of the first quarter of 2005. So the first *Debt Portfolio Management Quarterly Review* is submitted. At the same time, this new report provides a replacement for the previous quarterly press releases about duration of state debt which were published in the years 2003 and 2004.

I. Review of Strategic Targets for 2005

The 2005 state debt management policy is guided by the set of quantitative absolut and relative limits and criteria approved by the Minister of Finance for issuance activities and the active management of debt portfolio. More details on these criteria and the ministry's performance are summarized in the table.

Criterion	Guidelines for 2005	March 31, 2005
International financing	Max. 40% of the total annual gross financing requirement	22%
	CZK 28,6 to 54,6 bn	CZK 30,1 bn
Gross T-Bonds issues	CZK 94,0 to 120,0 bn	+ CZK 16,3 bn
Net T-Bills issues	CZK -24,0 to - 50,0 bn	+ CZK 1,0 bn
Loans from EIB	CZK 11,78 bn	CZK 0,0 bn
Short-term state debt	24% and less	25,45%
Average time to maturity	5,5 to 6,5 years	5,64
Modified duration	3,8 ± 0,4 years	4,12

Note: EIB – European Investment Bank. Source: MF CR, Bloomberg.

As regards **international financing**, according to the debt strategy the Ministry issued successfully the second eurobond issue of the Czech Republic in March in the amount of EUR 1 billion. It represents approximately 22% of the maximal limit for the activity in the foreign capital market in 2005. Further operations of the Ministry on the foreign market will depend on the current market situation and on the decision of the Minister of Finance.

Regarding **domestic issuance activity**, the net issue of T-Bonds decreased by the amount of CZK 5,7 billion because of redemption on capital market bond of CZK 22 bn in February. The volume in issue of T-Bills is stabilised and increased absolutely by CZK 1 billion due to the temporary state's liquidity management needs. The announced plan to decrease the volume of T-Bills by minimally CZK 24 billion will continue in the following quarters of 2005.

The short-term state debt rose slightly above the level of 25% reached at the end of 2004. The planned drop to the level of 24% and less by the end of 2005 will be managed in close relation to the reduction programme of T-Bills.

Average time to maturity (new strategic benchmark from 2005) reached the level of 5,6 years. The main reason was one-shot impact of 15-year eurobond issue. This parameter got over the lower limit of announced target band for 2005. It has to be emphasized that the Ministry's aim is not to stay within the band over a full year but the target should be achieved at the end of the year.

Modified duration of state debt increased further to 4,1 years. It was caused by continuing decline in domestic and european interest rates in the comparison with the end of 2004 and by the eurobond issue and relating derivative operations. As a result, duration got very close to the upper limit of the announced target band for 2005.

II. State Debt Parameters at the end of March 2005

Debt Parameter	December 31, 2004	March 31, 2005
Total state debt (CZK bn)	**592,9**	**618,2**
Market value, inc. derivatives (CZK bn))	629,8	662,5
Short-term state debt (%)	25,0	25,5
Share of T-Bills (%)	21,2	20,5
Average time to maturity (years)	5,1	5,6
Interest rate refixing up to one year, inc. derivatives (%)	27,0	27,3
Variable-rate state debt (%)	3,5	3,3
Modified duration (years)	3,9	4,1
Mod. duration, exc. IRS (years)	3,4	3,6
Foreign currency state debt (%)	0,0	0,1
Foreign currency debt, exc. cross-currency swaps (%)	7,8	12,2
Nonmarketable state debt (%)	3,6	3,5
Marketable state debt (CZK bn)	**571,4**	**596,7**
Market value (CZK bn)	608,2	641,0
Short-term marketable debt (%)	25,8	26,2
Share of T-Bills (%)	21,9	21,2
Average time to maturity (years)	5,0	5,6
Interest rate refixing up to one year, inc. derivatives (%)	24,2	24,7
Variable-rate marketable debt (%)	0,0	0,0
Modified duration (years)	4,1	4,3
Mod. duration, exc. IRS (years)	3,5	3,7
Foreign currency marketable deb (%)	0,0	0,1
Foreign currency debt, exc. cross-currency swaps (%)	8,0	12,6

Notes: Interest rate refixing up to one year = T-Bills + Fixed-rate short-term debt + Variable-rate state debt + Effect of interest rate derivatives. Source: MF CR, Bloomberg.

III. Integrated portfolio of state debt and risky state guarantees at the end of March 2005

From the perspective of management of financial risk of expenditure flows of the State Budget, not only the structure of state debt is relevant, but also the structure of the portfolio of provided state guarantees, for which the State Budget pays effectively principle repayments, interest payments and FX loss. These high-risk guarantees have already been transferred according to ESA95 methodology prescribed for the calculation of the Maastricht criteria into the government sector deficit and debt, nevertheless, they are not a part of state debt. Therefore, based on data delivered by the State Budget Department of the ministry and by the Czech-Moravian Guarantee and Development Bank, the Government Debt Management Unit started to automate regular monitoring of this portfolio according to the debt management policy and the budget-at-risk framework.

By the end of 2004 the analysis had covered guarantees amounting approximately to **CZK 95 bn**, excluding specific IPB guarantee (CZK 160 bn) where the schedule and amount structure of future payments remain unknown and guarantees that do not represent any major source of fiscal risk for the state, because the debtors have been duly repaying their loans, including the interest (see *Convergence Programme of the Czech Republic (an updated version) – November 2004* Annex 9.2).

Measures of the integrated portfolio of state debt and risky state guarantees

	Nominal amount (CZK bn)	Market value (CZK bn)	Foreign currency liabilities (%)	Variable-rate liabilities (%)	Short-term liabilities (%)	Interest rate refixing (%)	Average life (years)	Modified duration (years)
Total state debt	618,2	662,5	0,1	3,3	25,5	27,3	5,6	4,1
Risky state guarantees	93,8	94,6	29,4	25,3	12,9	30,9	4,7	2,9
Portfolio total	**712,0**	**757,1**	**3,9**	**6,2**	**23,8**	**27,8**	**5,5**	**4,0**

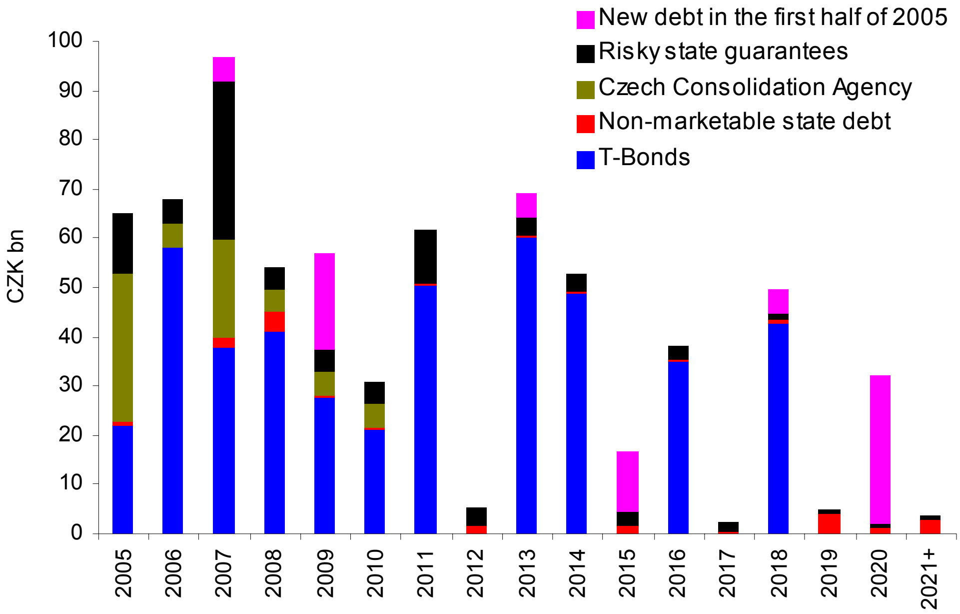
Note: including currency and interest rate derivatives of the MF and CMZR Bank.
Source: MF CR, Czech-Moravian Guarantee and Development Bank, Bloomberg.

Analyses have shown that the risky state guarantees have a positive effect because they reduce the share of short-term liabilities (thereby contributing to the achievement of the medium-term target in this area) but at the same time reduce the average maturity slightly. On the other hand, state guarantees include relatively higher share of debt instruments in a foreign currency and with variable interest rates in comparison with state debt. It increases market risk but at the same time it makes possible for state budget to participate on relatively low money market interest rates and strengthening of the Czech currency.

It is important to mention that the integration of both portfolios has not led to any significant deviations, when it comes to parameters for which quantitative criteria have been set (i.e. share of short-term debt, average life and modified duration).

The time structure of redemptions of state guarantees has to be taken into account during the process of planning and design of domestic and foreign issuance policy, drawing on loans from international institutions and funding the loss of the Czech Consolidation Agency to stabilize and smooth the total redemtion profile of all government liabilities as the main measure of refinancing risk.

Redemption profile of state debt, risky state guarantees and outlook of the CCA's funding (End-2004; updated on 8 April 2005, excl. T-Bills outstanding)



Source: MF CR, Czech Consolidation Agency, Czech-Moravian Guarantee and Development Bank.

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