MINISTRY OF FINANCE OF THE CZECH REPUBLIC

DEBT AND FINANCIAL ASSETS MANAGEMENT DEPARTMENT

Funding and Debt Management Strategy for 2009

1 December 2008

Contents

On November 26, 2008 the Minister of Finance decided on the structure and financing of the central government's gross borrowing requirement in the 2009 budget year and approved the basic absolute and relative limits for issues on the domestic and foreign markets and for the active management of the debt portfolio in relation to other government liabilities and the financial assets (ref. no. 20/95845/2008). The defined operating framework in the form of this Funding and Debt Management Strategy for 2009 (the "Strategy") is now a traditional contribution to the transparent implementation of government debt management policy and enables the Ministry of Finance (the "Ministry") to operate flexibly on the domestic and foreign financial markets when actively securing funding to cover the central government's borrowing requirement, which is a necessary condition for the smooth implementation of the government's budgetary and fiscal policy.

The Strategy is based on and consistent with the draft act on the Czech Republic's state budget for 2009, the Medium-term Outlook of the Czech Republic's State Budget for 2010 and 2011, the Medium-term Expenditure Framework for 2010 and 2011, the internal Issuance Plan of Government Bonds for 2009 to 2011 and the Czech Republic's Convergence Programme.

The Strategy is presented by the Debt and Financial Assets Management Department (the "Department"), which is in charge of operations linked to state funding, managing the debt portfolio, liquidity management of the state treasury and investing cash funds of state financial assets.

Introduction

In managing liabilities and conceiving the medium-term strategy for the funding of the central government, attention is focused on those segments of the government's financial balance sheet whose management is the direct responsibility of the Minister of Finance and whose structure has a direct impact on state budget cash flow as a result of the permanent fluctuation of both economic and financial risk factors. The principal financial item on the government balance sheet is the national debt, which accounts for 90% of the total gross government sector's debt of the national economy and will exceed 25% of gross domestic product in 2008.

The funding of the national debt in 2009 will be considerably affected by the global financial markets crisis, which began to have a significant impact on the domestic government bonds market in the fourth quarter of 2008 and will continue to do so in the coming year as well. This substantially undermines the predictability of demand for particular debt instruments, which in turn places constraints on the concretisation of the funding programme compared to previous years. Consequently, during 2009 the Ministry will react very flexibly to current developments in the demand for different types of government bonds and will adjust the implementation of the funding programme accordingly.

For these reasons the issuance calendar will be published monthly; the return to quarterly calendars will be conditional on the stabilisation of the domestic government bonds market. In the area of foreign issues, the significance of private placements off the public market is growing: in an unstable environment these may represent a more effective means of financing than the classic public syndicated issues. Even so, the Ministry plans to perform at least one benchmark issue of Eurobonds in 2009 provided that the market situation in the Eurozone stabilises.

1 Medium –Term Government Borrowing Requirements

Outlook for gross borrowing requirements

In the medium-term outlook, the government's gross borrowing requirements are determined by the planned state budget deficits and the growing value of the principals of mature benchmark government bonds, which will have to be refinanced by new issues on the domestic and foreign markets.

Table 1: Outlook for gross government borrowing requirements up to 2011 (CZK billions)

	2007	2008		2009	2010	2011
	Actual	*Planned*	Expected	Planned	Planned	Planned
State budget deficit excl. CCA	**66.4**	***70.8***	**60.0**	**38.1**	**37.6**	**37.0**
(Cost of national debt	34.1	*44.0*	37.5	42.9	50.3	51.7)
Planned finances for CCA	13.3	*0.0*	0.0	0.0	0.0	0.0
National debt repayments	44.7	*84.5*	84.5	89.0	74.0	67.8
Buy-back and exchange of government bonds	10.0	10.0	10.0	10.0	20.0	20.0
Addition to pension reserve	0.0	*10.0*	9.9	10.0	10.0	10.0
Other state financial asset operations	1.3	*-0.6*	0.6	1.3	0.0	0.0
Debt reserve funding, incl. EIB formation (+) / drawing (-)	9.5	*5.0*	14.7	0.0	5.0	5.0
Gross borrowing requirement	**145.2**	***179.7***	**179.7**	**148.4**	**146.6**	**139.8**
% of GDP	**4.1**	***4.7***	**4.7**	**3.9**	**3.4**	**3.0**
Net change in money market instruments Increase (-) / decrease (+)	9.8	*10.0*	9.0	-25.0	10.0	10.0
Gross borrowing requirement incl. net change in money market instruments	**155.0**	***189.7***	**188.7**	**123.4**	**156.6**	**149.8**
% of GDP	**4.2**	***5.0***	**5.0**	**3.3**	**3.6**	**3.2**

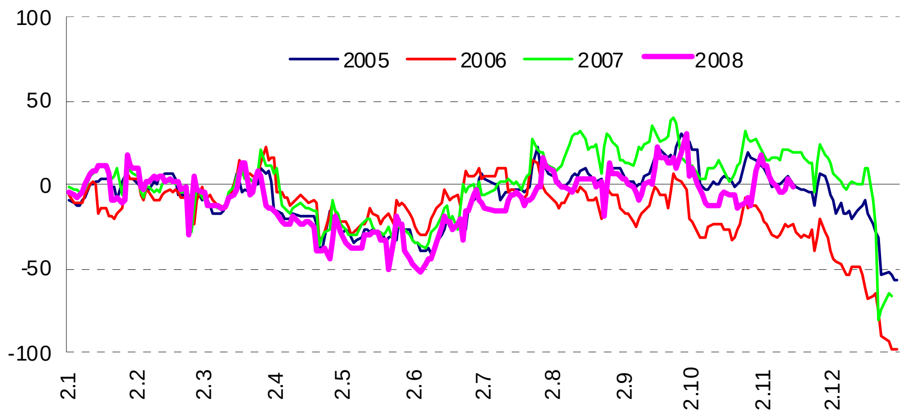
NB: Starting in 2008, the cost of national debt is on a net basis, i.e. after including revenues from the investment of idle funds of the state treasury account on the money market; the gross borrowing requirement does not include money market instruments revolving within the budget year.
Source: Czech Statistical Office and Ministry of Finance of the Czech Republic.

The central government's annual gross borrowing requirements, without revolving money market instruments in circulation, are stabilised at a relative level of between 3% and 5% of GDP in the 2007 to 2011 period. Starting in 2008, there is no more off-budget liquidity transfer to the Czech Consolidation Agency ("CCA"), which was wound up without liquidation as of the end of 2007, and the refinancing of buy-backs and exchanges of government bonds on the secondary market before they reach original maturity.

Gross borrowing requirement in 2008

During 2008 the government's gross borrowing requirement decreased in consequence of more favourable state budget results, whereby the expected fall in the deficit is CZK 10.8 billion.

Figure 1: Current daily position of the state budget in the years 2005 to 2008 (CZK billion)



Source: Ministry of Finance of the Czech Republic.

At the same time, an increased addition of the funding reserve is planned during 2008 so that the total annual gross borrowing requirement corresponds to the planned amount of CZK 179.7 billion, or CZK 188.7 billion, including the planned fall in the value of money market instruments in circulation.

2 Annual Funding Programme 2009

Implementation of the Funding Programme in 2008

The basis for defining the funding programme for 2009 is the implementation of the funding programme in 2008. That is influenced primarily by the situation on the domestic and foreign financial markets, which necessitates a flexible response from the Ministry as regards issuances and the choice of debt instruments.

Table 2: Implementation of the funding programme in 2008 (CZK billion)

	Planned as of 3.12.2007	Expected as of 30.11.2008
Government's gross borrowing requirement	**179.7**	**179.7**
Increase in national debt	**90.2**	**90.2**
Direct loans from international financial institutions	**14.7**	**12.6**
Issues of medium-term and long-term government bonds[1]	**165.0** to **185.0**	**176.1**
Issues of medium-term and long-term bonds on the domestic market	75.1 to 165.0	127.9
Issues of medium-term and long-term bonds on the foreign market	0.0 to 89.9	48.2
Net change in money market instruments	**0.0 to –20.0**	**-9.0**

NB: [1]including direct sales on the secondary market.
Source: Ministry of Finance of the Czech Republic.

The negative impact of the financial crisis was mainly felt in the fourth quarter of 2008, when the government bonds market froze and there was a spike in credit and swap spreads with medium-term and long-term maturities.

More than 25% of the government's gross borrowing requirement was secured by the third June issue of Eurobonds worth EUR 2 billion, which thus made it possible as of the year end to reduce the offer of fixed-rate government bonds on the domestic market; the primary auction of these bonds was cancelled entirely in the fourth quarter of 2008.

Despite the re-orientation of the Ministry's issuance activities towards the government treasury bills market, it will probably be possible to fulfil the planned funding programme and slightly reduce their quantity in circulation. In part, that is made possible by the relatively high demand for the variable-rate government bond that was included among government funding instruments in October 2008 in response to the requirement of institutional investors. The final parameters of implementation of the funding programme will depend on the actual state budget results and developments on the domestic primary and secondary market in government bonds.

Gross borrowing requirement in 2009

The planned government gross borrowing requirement, without net change in and the revolving of money market instruments, will be **CZK 148.4 billion** in 2009.

Table 3: Government gross borrowing requirement in 2009 (CZK billions)

State budget expenditure	1 152.1
State budget incomes	- 1 114.0
State budget deficit	**38.1**
Planned off-budget financial requirement	0.0
Government's net financing requirement	**38.1**
Redemptions on medium-term and long-term government bonds	88.2
Buy-backs and exchanges of government bonds	10.0
Payments on non-tradable national debt	0.8
Government's gross financing requirement	**137.1**
Pension insurance special account	10.0
Other operations on state financial asset accounts	1.3
Addition to (+) / drawing of (-) financing reserve	0.0
Government's gross borrowing requirement	**148.4**

Source: Ministry of Finance of the Czech Republic.

This sum is composed of the planned state budget deficit of **CZK 38.1 billion**, the formation of a reserve for the possible transfer of the positive difference between insurance premium incomes and expenditures on pension insurance for 2008 to the special pension insurance account in state financial assets pursuant to Section 36 (3) of Act No. 218/2000 Coll., worth **CZK 10.0 billion**; the refinancing of mature medium-term and long-term government bonds which, after factoring in buy-backs in 2008, amount to **CZK 88.2 billion**; the refinancing of buy-backs of government bonds in 2009 to the value of **CZK 10.0 billion**; and **CZK 0.8 million** in repayments on loans from the European Investment Bank. At the same time, the government's net borrowing requirement is increased by the planned increase of **CZK 1.3 billion** on the state financial asset accounts.

As in the past, the Strategy does not envisage major payments due to the realisation of the non-standard guarantee for IPB in favour of the Czech National Bank: the guarantee amounted to CZK 157 billion as of the end of 2008 and its maximum maturity is in 2016.

Funding programme for 2009

The funding programme for 2009 is based on the planned government gross borrowing requirement of CZK 148.4 billion and the problematic situation on the financial market, which the subsequent absolute and relative issuance limits may be adjusted in line with.

Foreign market financing will account for at most 50% of the planned annual government gross borrowing requirement, free of the planned net change in money market instruments in circulation and the revolving of such during the budget year.

In 2009 the Ministry will analyse developments in the financing conditions on the domestic and foreign markets and will operate within the framework of the given relative limit, which remains the same as in 2006, 2007 and 2008. The Ministry aims to perform at least one public benchmark issue of Eurobonds during the year. Nevertheless, as the primary market in these instruments is currently almost entirely lacking in effective demand, the Ministry will not attempt to perform this issue in the very first months of 2009. In the current unstable market environment, the performance of cost-effective private placements of government bonds with selected investors is an alternative channel. Whilst respecting a prudent approach to currency risk management, foreign operations are not constrained by any explicit limits in terms of currency structure.

CZK 15.8 billion of the borrowing requirement will be covered by long-term loans drawn from the European Investment Bank.

Taking out these loans intended solely for infrastructure projects is conditional on the relevant acts being passed by the Parliament of the Czech Republic. As in previous years, the drawdown of loans for the special-purpose financing of the appropriate ministries' expenditure in the state budget is explicitly included in the draft state budget for 2009.

The value of medium-term and long-term government bonds issued on the domestic market will not exceed CZK 125.0 billion.

This maximum value will be attained if no public or non-public foreign issues are performed during 2009. Given the planned gross borrowing requirement, the value of medium-term and long-term government bonds offered by the Ministry will thus in any case be lower next year than in 2008, which should help stabilise the domestic market.

The Ministry will offer both fixed-rate and variable-rate government bonds in 2009. In the first case, secondary direct own-portfolio sales to primary dealers will initially be performed and, depending on the development of demand for particular maturities, primary auctions will be held. In 2009, new issues maturing in 2012, 2014, 2019 and 2024 may be opened, but in particular new 10-year and 15-year bonds will only be issued if domestic demand revives and once the planned volumes of existing issues maturing in 2017 and 2022 are achieved – increasing existing issues will take precedence over new issues.

At the same time, variable-rate government bonds will be sold on both the primary and secondary market, whereby issue maturing in 2016 will be re-opened in the first half of 2009 up to the planned volume, in line with the issuance conditions. A new issue of this instrument may be opened in the second half of the year, with the understanding that its maturity will be determined according to the prevailing market conditions.

The Ministry will also continue to analyse the possibilities of an issue of capital inflation-indexed government bonds. The opening of a retail channel for the sale of government bonds, which remains an alternative should the banking market in government bonds continue to have limited functionality, could also be the focus of attention.

In 2009, the Ministry will manage the volume of money market instruments in financing the government's long-term liabilities so that short-term national debt continues to be kept below the 20% limit during 2009.

The forecast for the structure of the debt portfolio as of the end of 2009 shows that maintaining the indicator limit for short-term national debt, with maturity of up to 1 year, requires money market instruments to account for approximately 10% of the debt portfolio. The funding programme envisages an increase of money market instruments in circulation up to CZK 50.0 billion in 2009 in response to domestic investor demand's re-orientation towards the short segment of the yield curve. At the given borrowing requirement, the said refinancing risk limit will be complied with even if this maximum increase is realised. Government treasury bills with standardised maturities of 3, 6, 9 and 12 months will also be issued in 2008. The Ministry may also introduce a 1-month maturity if the market develops unfavourably. Government treasury bills will also be sold on the secondary market from the Ministry's own portfolio through the Department's trading systems.

Based on the structure and scope of the set limits, the following programme for financing the government's gross borrowing requirement is defined for 2009. This programme determines the planned structure of the debt portfolio and thereby unequivocally determines the boundaries within which management of the national debt operates.

Table 4: Funding programme for 2009 (CZK billions)

Government's gross borrowing requirement	**148.4**
Direct loans from international financial institutions	**15.8**
Loans from the European Investment Bank	15.8
Other	0.0
Issues of medium-term and long-term government bonds[1]	**82.6 to 132.6**
Issues of medium-term and long-term government bonds on the domestic market	40.0 to 125.0
Issues of medium-term and long-term government bonds on the foreign market	0.0 to 74.2
Net change in money market instruments in circulation	**+50.0 to 0.0**

NB: [1] including direct sales on the secondary market.
Source: Ministry of Finance of the Czech Republic.

3 Strategic Targets and Financial Portfolio Management

Publicly defining the strategic benchmark debt portfolio by declaring strategic targets is the principal means for enhancing the transparency of the Ministry's debt policy in line with international best practice. Targets are set on the basis of the requirements ensuing from a prudent approach to managing financial and credit risks, whilst minimising economic costs in the long-term horizon. Refinancing and interest rate risks are the main risks the debt portfolio is exposed to in the long term.

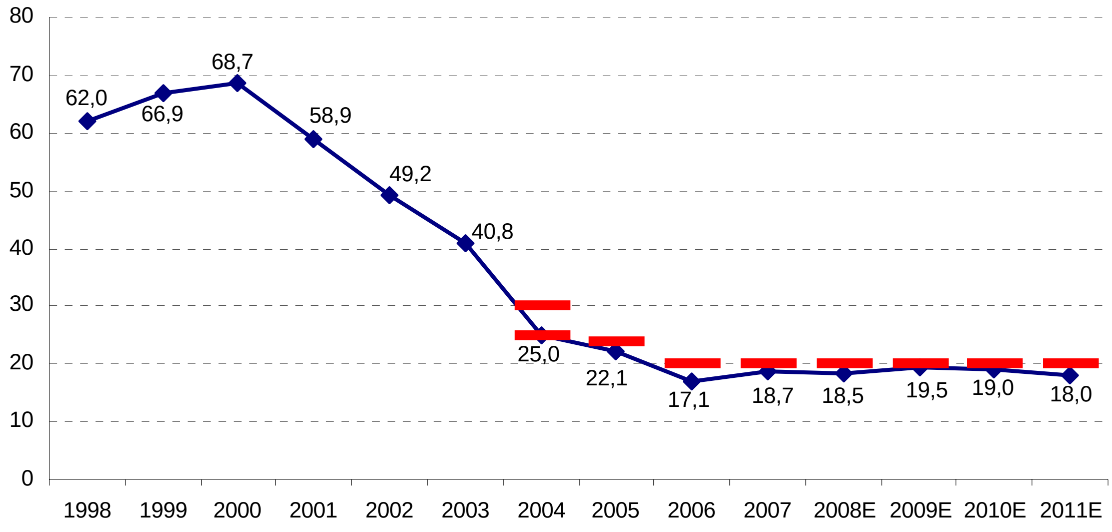
Managing refinancing risk

The stabilisation of refinancing risk forms the core of the Ministry's planning of issues. Since 2004, the **share of short-term national debt** (i.e. debt with a maturity of up to one year as a proportion of total debt) has been the key indicator that the Ministry targets in this context. In the first half of 2004 the Ministry, further to the minister's decision to commence regular issues on the foreign market, declared a gradual, three-year trajectory for reducing this indicator as follows: 2004 – 25.0% to 30.0%; 2005 – 22.5% to 27.5%; 2006 – 20.0% to 25.0%.

The successful launch of foreign financing in June 2004 made it possible to redefine the strategy for the further acceleration of this reduction programme. A value exactly at the lower limit of the declared corridor – 25% – was achieved as of the end of 2004. The goal of 24% and less was also achieved in 2005, with the indicator equalling 22.1% at year end. Then, in the first quarter of 2006, the planned final and long-term targeted limit of 20% had already been achieved, with the figure falling further to 17.1% by year end. In 2007 there was a slight increase to 18.7%.

In line with the long-term strategy, in 2009 the ceiling of **20% of total debt** remains the fundamental limit for the Ministry's issuance activity and the management of the Czech debt portfolio's financial risks. At the end of 2008 this indicator is expected to be below 19%. The possible growth in money market instruments in circulation up to CZK 50.0 billion by the end of 2009 is also consistent with the 20% ceiling.

Figure 2: Development and targets of short-term national debt, 1998 to 2011 (% of total debt)

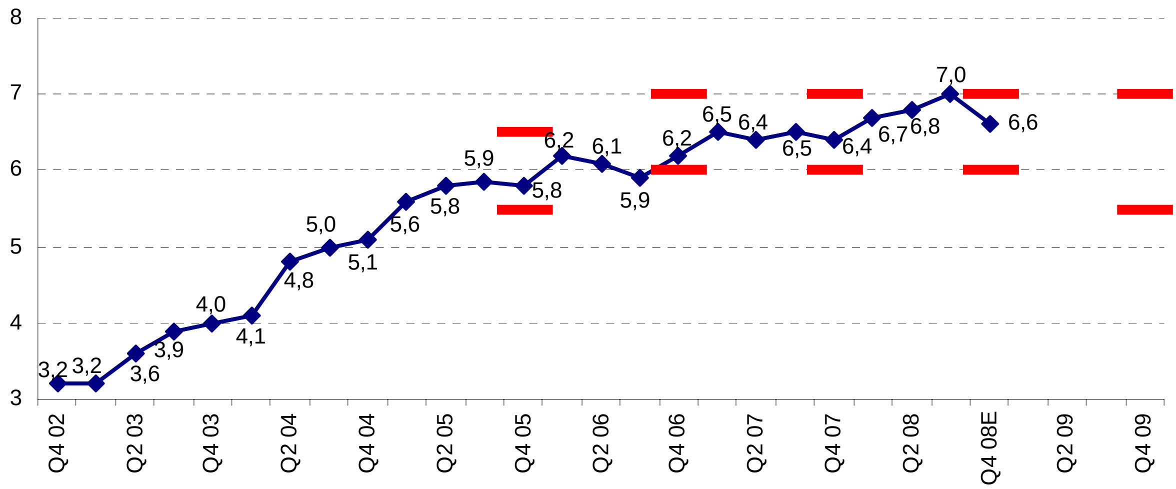


Source: Ministry of Finance of the Czech Republic.

Another indicator used in managing refinancing risk is **the national debt's average time to maturity**. The Ministry first announced an explicit target for this indicator for 2005 – the target of 5.5 to 6.5 years was met, with an average maturity of 5.8 years. For 2006 the target bracket was shifted upwards by half a year to 6.0 to 7.0 years, and a value of 6.2 years was attained. The same bracket applied for 2007 and 2008.

For the end of 2009 the Ministry is changing the target range for the average maturity of the national debt to **5.5 to 7.0 years**. The widening of the range by shifting the lower limit down by half a year is linked to the increased uncertainty on the financial markets and the reduced predictability of demand for individual types and maturities of government bonds. Achieving this target determines the time and volume structure of government bond issues on the domestic and foreign market and the repayment calendars for the drawing of European Investment Bank loans.

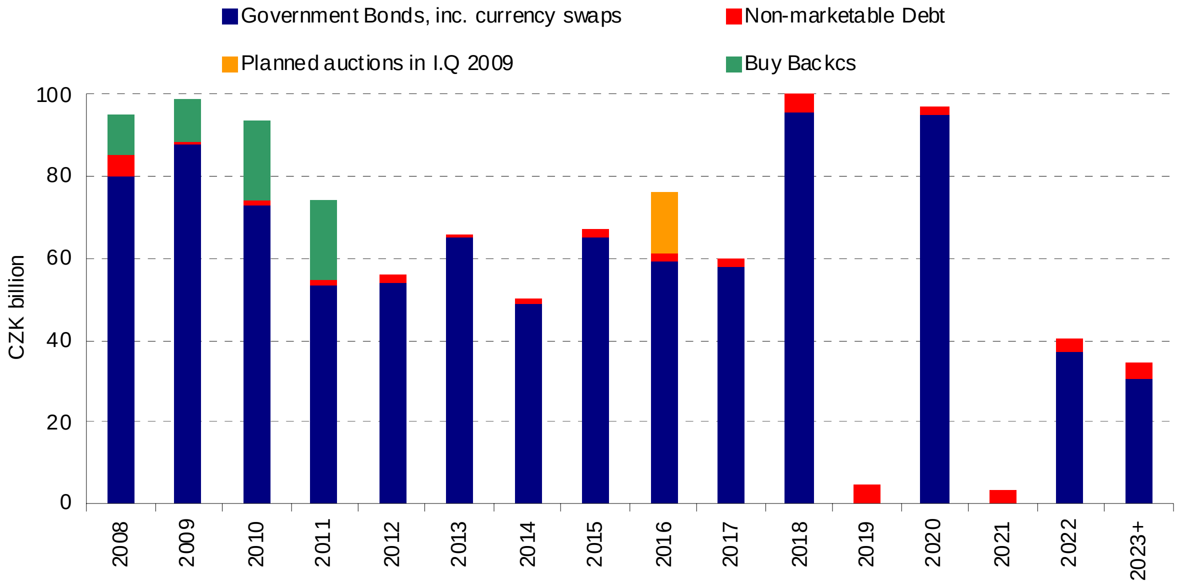
Figure 3: Average maturity of the national debt and target, 2002 to 2009 (number of years)



Source: Ministry of Finance of the Czech Republic.

New issues of government bonds and the drawing of long-term EIB loans will continue to be managed in line with progress in achieving the key goal of **stabilising and smoothing the maturity profile of the national debt over time**, which has been pursued and planned on an integrated basis since 2005. The active management and fine-tuning of the maturity profile also takes place via government bond operations on the secondary market that were commenced in 2007 and will continue in 2009. Annual payments of state commitments will not exceed CZK 100 billion in the medium-term outlook.

Figure 4: Expected maturity profile of the national debt as of the end of 2008

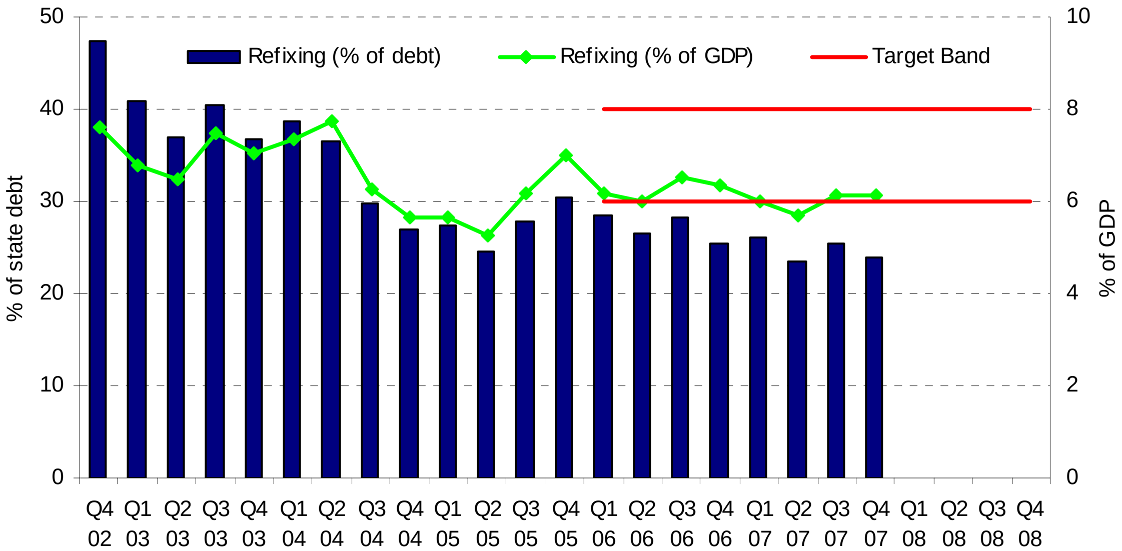


NB: not including money market instruments in circulation.
Source: Ministry of Finance of the Czech Republic.

Managing interest rate risk

Interest rate risk remains the most important market risk for the management of the national debt. Starting in 2006, the declaration of the strategic goals for this area of national debt management was changed. **Interest rate re-fixing of the debt portfolio up to 1 year**, which is not sensitive to fluctuations of interest rates on the money market, became a new explicit target. A medium-term target range of 30% to 40% of total national debt was set for the years 2006, 2007 and 2008.

Figure 5: Interest re-fixing of the national debt up to 1 year and medium-term target, 2002 to 2009



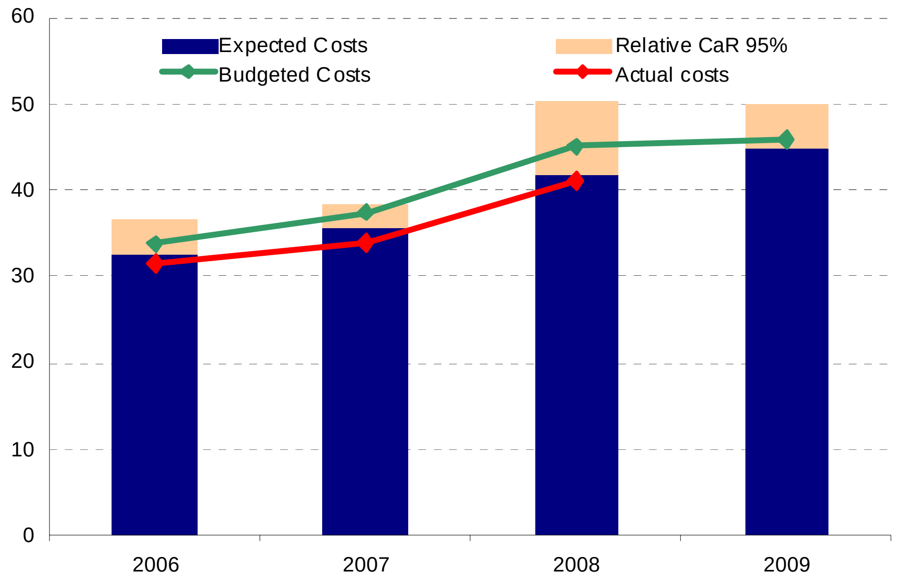
Source: Czech Statistical Office and Ministry of Finance of the Czech Republic.

As macro-financial modelling continues to indicate a positive cost-versus-risk trade-off in the medium-term horizon, for 2009 the Ministry is retaining the target for the debt portfolio's exposure to a change in interest rates up to 1 year, including derivatives operations, in the form of a range of **30% to 40% of total national debt**. The limits of this range correspond to approx. 8% to 10% of GDP. This exposure is expected to grow by the end of 2008 as a result of the retroactive increase of money market instruments in circulation and the re-opening of the variable-rate government bond issue.

Since 2005 the Ministry has applied a more sophisticated model framework when measuring and managing interest rate risk, namely Cost-at-Risk (**CaR**), which is based on the VaR methodology and simulates future expected and maximum interest costs at a given risk level that is derived from the volatility of the time structure of interest rates. The yield curve is thus the stochastic element in the CaR model. In the CaR model, the development of the national debt portfolio is regarded as deterministic and is based on the basic scenario of the financing of the government's borrowing requirement, which ensures that the funding programme and strategic targets of risk management for 2009 are achieved.

In the years 2006 to 2008 the utilised model framework for simulating interest costs displayed relatively reliable values of the CaR indicator that were consistent with the enacted state budgets and described the actual development of the servicing costs of the national debt. In 2006 the expected costs were overvalued by 2.9%; in 2007 by 5.0%; and for 2008 an undervaluing by 1.5% compared to the actual state is expected. In all three years, the realisation of costs was always below the maximum value determined by an absolute CaR 95%.

Figure 6: Interest costs and Cost-at-Risk in 2006 to 2009 (CZK billions)



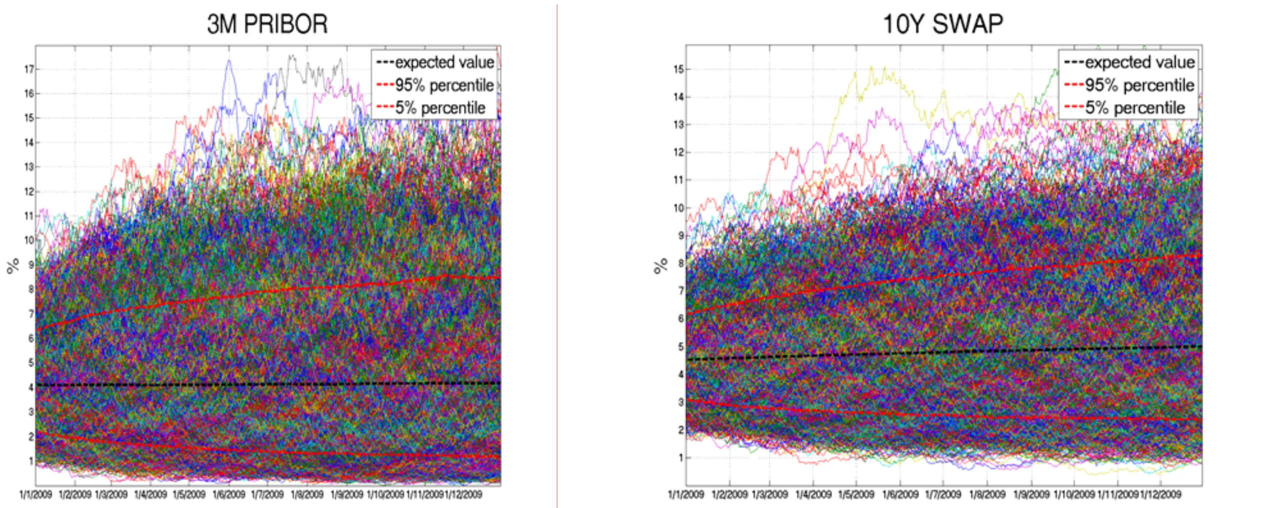
NB: Interest costs are simulated without revenues from the investments of idle funds of the state treasury account on the money market, which are income of the national debt chapter of the state budget.
Source: Ministry of Finance of the Czech Republic.

Cost-at-Risk of the national debt for 2009

Unlike in 2008, in 2009 a CIR model combined with an adjusted Wiener Process was used to simulate the time structure of interest rates. The details may be found in, for example James & Weber: Interest Rate Modelling, John Wiley & Sons, 2002.

The model's parameters are estimated from daily observations of the Czech yield curve since 1.1.1999. 15,000 interest rate simulations for the coming fourteen months, starting on 1.11.2008, are performed for each of the required maturities. The model is again characterised by "*mean reversion*" which indicates that the current values of interest rates are around their long-term equilibrium level, so expected rates remain approximately constant. The performed simulations of the 3-month interbank interest rate (3M PRIBOR) and 10-year interest rate swap rate (10Y SWAP) on a daily basis in the period from 1.1.2009 to 31.12.2009 are shown in Figure 7.

Figure 7: Daily simulations of the development of Czech interest rates in 2009



Source: Ministry of Finance of the Czech Republic.

Interest rate simulations are an input for the calculation of interest rates of the floating part of the debt portfolio during 2009, which include discounts from revolving and new issues of state treasury bills, new coupon rates from the revolving of medium-term and long-term government bonds and direct loans, discounts/premiums from the re-openings of medium-term and long-term government bonds, re-fixing of interest rates on European Investment Bank loans and on the floating part of derivative contracts. Table 5 shows the deterministic change in the structure of the national debt, to which simulated interest rates are linked and the interest costs of the national debt are subsequently calculated.

Table 5: Basic model development of the debt structure up to the end of 2009 (CZK billions)

State as of	Capital bonds	Financial instruments	Non-tradable	Total
31.10. 2008	841.4	59.9	47.4	948.7
31.12. 2009	852.2	98.0	61.8	1 012.0

Source: Ministry of Finance of the Czech Republic.

Simulations of the interest costs of the national debt portfolio are thus obtained from interest rate simulations. The mean of interest cost simulations is an estimate of the expected value of interest costs and the *p*% quantile of interest cost simulations is an estimate of the *p*% quantile of the probability distribution of interest costs. The value of 95% of the quantile of the simulation gives 95% of CaR, i.e. the absolute amount of interest costs that will not be exceeded with a 95% probability. Table 6 shows the development of the expected value of cumulative interest costs and 95% CaR for 2009.

Table 6: Development of cumulative interest costs of the national debt in 2009 (CZK billions)

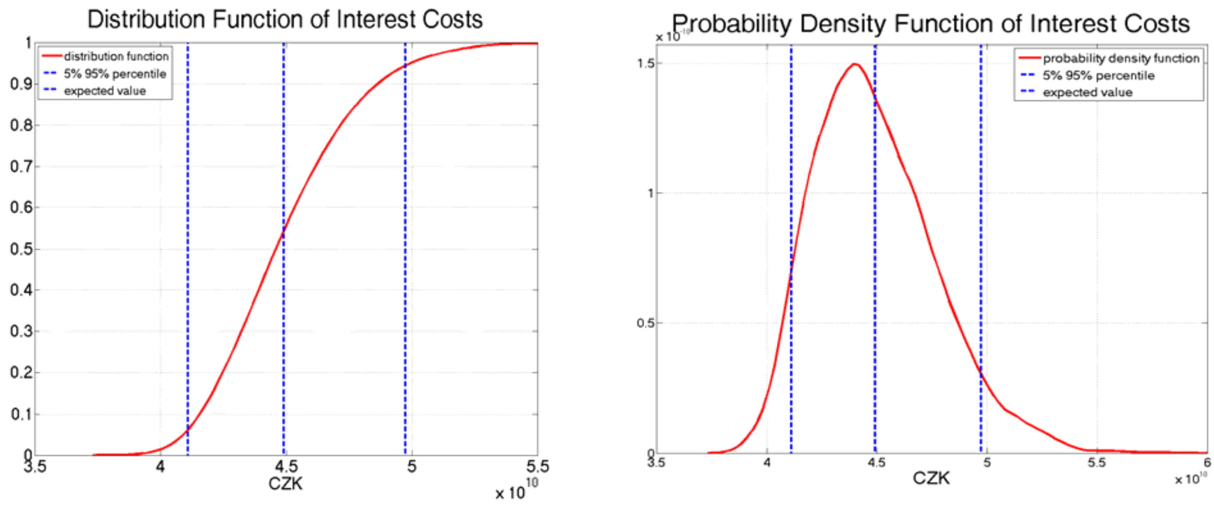
Months of 2009	1.	2.	3.	4.	5.	6.	7.	8.	9.	10.	11.	12.
Expected costs	3.5	3.9	7.7	15.9	16.2	22.7	23.2	25.9	31.4	40.2	42.5	44.9
Absolute CaR 95%	3.9	4.5	8.5	17.0	17.3	24.2	25.1	28.1	34.3	44.3	46.8	49.9

Source: Ministry of Finance of the Czech Republic.

The expected interest costs of the national debt portfolio for 2009 are **CZK 44.9 billion**. Cost-at-Risk, i.e. absolute CaR 95%, is **CZK 49.9 billion**. Actual interest costs thus will not exceed expected costs by more than CZK 5.0 billion with a 95% probability.

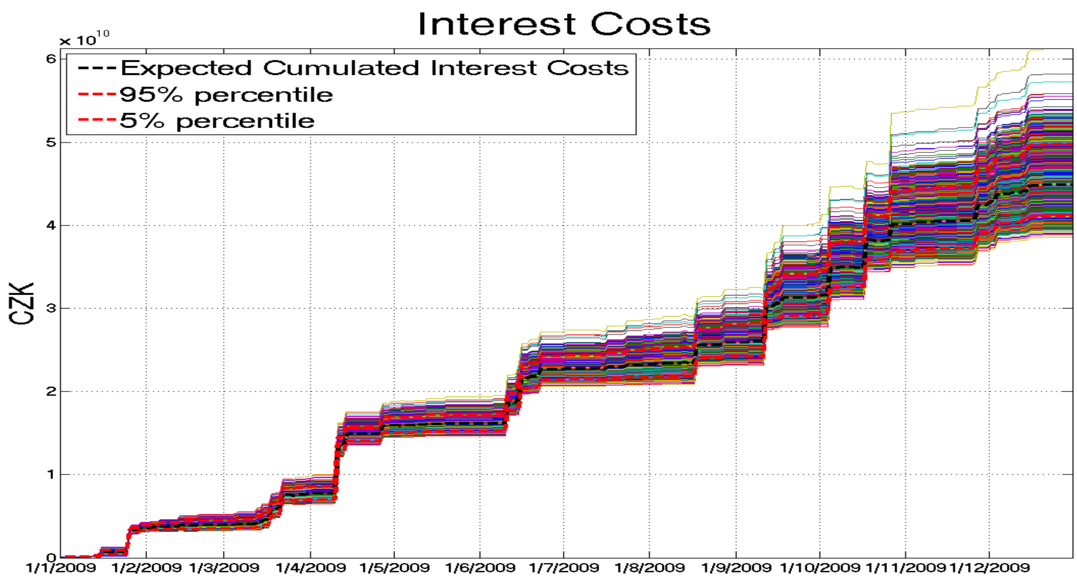
The probability distribution of cumulative interest costs at 31 December 2009 is fully described through density and distribution functions which are shown in Figure 8, which shows the expected value, 5% and 95% percentile of simulated interest costs as well. The daily behavior of simulated interest costs during 2009 is shown in Figure 9.

Figure 8: Distribution of interest costs in 2009 (CZK billions)



NB: Interest costs are calculated on basis of the cash principle relevant for the state budget methodology.
Source: Ministry of Finance of the Czech Republic.

Figure 9: Interest costs simulation in 2009 (CZK billion)



NB: Interest costs are calculated on basis of the cash principle relevant for the state budget methodology.
Source: Ministry of Finance of the Czech Republic.

The budgeted expenditure of the national debt chapter should thus be sufficient to cover actual interest costs, provided that the basic scenario of the model development of the national debt structure is fulfilled in 2009. Model framework is complicated due to market uncertainty as for the basic scenario of funding programme to cover borrowing requirement in the course of 2009.

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This publication was prepared on the basis of information available as of 30 November 2008. The Ministry reserves the right to respond flexibly in the course of 2008 and with help of its instruments to the genuine evolution of the gross borrowing requirement of the Government in the area of the State budget, extra-budgetary funds, health insurance, and settlement of exposed State guarantees. The fulfilment of the planned financing programme and of the declared strategic targets will depend, in particular, on the developments on both domestic and international financial markets in view of the minimisation of the costs of debt service and financial risk management.

This publication is also available on the website:

www.mfcr.cz/statedebt

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