Ministerstvo financí
ČESKÉ REPUBLIKY

Debt and Financial Assets
Management Department

The Czech Republic Funding and Debt Management Strategy

2012

12th December 2011

The minister of finance decided on 7th December 2011 about the structure and method of financing the gross borrowing requirements of the central government in the budget year 2012 and until 2014 and approved the basic absolute and relative limits for issuance activity on the domestic and foreign market and for active management of the net debt portfolio and liquidity of the state treasury (ref. No. 20/106782/2011).

This defined operational framework in the form of the submitted Funding and Debt Management Strategy (hereinafter the „Strategy") for 2012 enables the Ministry of Finance (hereinafter the „Ministry" or „MoF") to be flexible on the domestic and foreign financial market while actively ensuring resources for covering the gross borrowing requirement of the central government and ensuring the daily solvent position of the state, meaning creation of ideal conditions for the smooth implementation of the budget policy of the government of the Czech Republic.

The Strategy is based on and conforms with the draft bill regarding the state budget of the Czech Republic for 2012, the medium-term outlook of the state budget of the Czech Republic for 2013 to 2014, the medium-term expenditure frameworks for 2013 to 2014, the Fiscal Outlook of the Czech Republic from November 2011 and the Macroeconomic Forecast for the Czech Republic from October 2011.

The Strategy has been submitted via the Debt and Financial Assets Management Department (hereinafter the "Department"), which is responsible for operations related to the funding of the state, active management of the net debt portfolio, management of the liquidity of the State Treasury liquidity management account and short-term and long-term investment of available financial resources originating from state financial assets.

Contents

Summary

The funding and debt management strategy is focused in a mid-term outlook on the segments of the government financial balance whose management is the direct responsibility of the minister of finance and whose structure has a direct impact on monetary flows of the state budget as a result of the fluctuation of economic and financial risk factors, particularly interest rates and foreign exchange rates.

The main financial item of the government balance is **state debt**, which represents more than 90% of the total gross indebtedness of the sector of government institutions and in 2011 reached about 39% of gross domestic product (GDP). In the mid-term, the growth of the state debt is expected to decline sharply and will not exceed 42% of GDP in 2014.

The conception of the strategy for the period from 2012 to 2014 is based on an expectation of moderate economic growth, a stable domestic banking sector, external macroeconomic balance, trustworthy monetary policy of the central bank and a stable majority government with a programme of stabilization of the public budget system through structural reforms with an aim of reducing the budget deficit of the government sector to below 2% of GDP by 2014 and achieving a balanced budget of the government sector no later than by 2016, under the assumption that economic growth will occur in the particular period.

The consolidation of public budgets continued in 2011 more quickly compared to the original trajectory set up by the government of the Czech Republic, and in **2011** a **budget deficit of the government sector of 3.7% of GDP** is expected, which contrasts with the original government target of 4.6%. The positive evaluation of the government‘s reform efforts also was reflected by the increase in the Sovereign Credit Rating and an average yearly decline of government bond yields, which in 2011 helped bring about significant savings in interest costs related to the state debt compared to budgeted expenditures, like in the previous year.

The Ministry expects that state budget deficit for 2011 will reach **CZK 130 billion**. As a result of delays in EU transfers withdrawals, the final result might be from CZK 10 to 15 billion worse. As such, it is not worsening of government finance balance but merely a technical effect created by the delay. From a mid-term perspective, the delay should have no effect on cumulative state budget balance in the years 2011 and 2012. State budget expenditures and income from domestic sources evolved more favorably than expected.

Current outlook on state budget deficit for 2012 can be possibly revised upwards in relation to GDP growth development of the Czech Republic which is highly dependent on economic development abroad, particularly in the euro-area. In case of non-favourable macroeconomic development, state budget deficit outlook could be revised upwards which will create a necessity to amend the Act on State Budget for 2012. However, the funding programme is designed flexibly enough in order to let the Ministry react to possible changes in state budget deficit.

The negative development of the euro-area debt crisis and the resulting significant uncertainty regarding the development of the real economy and the bond market have prompted a revision of the Ministry’s aim regarding tapping of financial reserves planned for 2011 to 2013. In 2011, there was a slight increase in the reserve, compared to a decline by CZK 35.7 billion, which was planned in the Strategy for 2011, and this also contributed to the increase in both net and gross borrowing requirement during this year. Particularly for this reason, the plan of issuance activity for 2012 and 2014 was slightly adjusted upward.

The gross borrowing requirement for 2011 is expected to reach CZK 255.7 billion, which is CZK 36.2 billion more than was planned in the Strategy for 2011. In **2012**, the **gross borrowing requirement** is expected to reach **CZK 243.4 billion**, which is CZK 24.6 billion more than was in the plan from the previous year, and in 2013 it is expected to reach CZK 230.9 billion, which is CZK 23.9 billion more than was planned in 2010. In 2014, the gross borrowing requirement is expected to reach CZK 231.9 billion

Gross issuance of medium-term and long-term government bonds on the domestic and foreign market in 2012 is planned in the range of CZK 157.5 billion to CZK 177.5 billion, which in view of redemptions on government bonds, including buy backs, in the amount of CZK 123.6 billion represents **net issuance of medium-term and long-term government bonds**, excluding government savings bonds, in the amount of **CZK 33.9 billion to CZK 53.9 billion**.

On the domestic market in 2012, the Ministry will again issue fixed rate bonds and floating rate notes, while 2.75/2014, 3.40/2015, 4.60/2018, 3.85/2021 and VAR/2023 issues will be reopened, and the only new VAR/2017 issue with a reference rate of 6 months PRIBOR will be opened. Issuance on the foreign market will cover a maximum of 30% of the gross borrowing requirement for 2012.

In 2012 there is planned **net issuance of money market instruments** in the range of CZK **40.0 billion to CZK 60.0 billion**, which reflects the absolute necessity of the Ministry's reaction to the growing aversion of investors to medium-term and long-term instruments. Due to the expected stability of money market rates, this increase will also contribute to the further reduction of interest costs while respecting the long-term goal for the share of state debt due within one year, which will not exceed 25% of state debt during the period until 2014.

During this year, all of the technical and institutional goals for state debt management set in the Strategy for 2011 were successfully achieved. First of all, the Ministry successfully implemented the historic project of pilot issuance of **government savings bonds**, which confirmed the expected high interest among citizens of the Czech Republic in saving through investment in state debt. The total sold volume of these bonds reached CZK 20.4 billion, which contrasts with the originally anticipated amount of CZK 10 billion. Starting in 2012, the long-term savings programme will become an integral part of strategic state debt management planning, and households and non-profit organizations will become a full-fledged and key source of financing for the state, which was taken into consideration during the planning of the issuance activity and the overall funding programme. The sale of government savings bonds in the total amount of **CZK 20.0 billion to 40.0 billion**, is planned in 2012, which will represent net issuance in the amount of CZK 10 to 30 billion.

By 1st July 2011, the Ministry in cooperation with EuroMTS Ltd also implemented the operation of the pan-European electronic platform **MTS Czech Republic** in the Czech Republic for trading on the domestic secondary bond market and by 1st October 2011 with the mutual signing of the respective agreements set up a new more effective business strategy between the Ministry and the Primary Dealers for Czech government bonds, which is routinely used in other developed EU member countries and which will bring standardization and professionalization of cooperation in the area of funding and debt management as well as absolute transparency. In this new framework and based on consensually agreed rules, in 2012 the Ministry following a two-year pause will again be active on the secondary market particularly by buying back government bonds before their maturity dates and directly selling government bonds from the Ministry's own portfolio.

1 - Fiscal outlook and financial markets

Economic development and management of the government sector

The worldwide recovery that began as of the 3rd Quarter of 2009 continued in 2010 with the growth of real GDP by 2.7%, and a positive development was also registered at the beginning of 2011. In the second half of this year, the July prediction of 2.5% growth showed itself to be too optimistic, and the expectation of real growth of 2.1% was closer to the prediction of 2.0% from October of last year, with which the Strategy for 2011 worked. In 2012, growth is expected to slow to 1.0%, and further worsening of this outlook can be expected at the beginning of 2012. In view of the development of the debt crisis in the Euro-area, the possibility of a repeat of the recession from 2008 and 2009 cannot be ruled out either.

Table 1: Main macroeconomic indicators of the Czech Republic economy for 2010 to 2014

	2010	2011	2012	2013	2014
Real GDP Growth (%)	2,7	2,1	1,0	2,0	3,3
Government Expenditure Growth (%)	- 0,1	- 1,2	- 0,5	- 0,2	0,8
Inflation Rate (%)	1,5	1,9	3,2	1,6	2,1
Unemployment Rate (%)	7,3	6,9	6,5	6,1	5,5
Nominal Wage Growth (%)	1,2	2,3	2,7	2,9	4,7
Current Account Balance on GDP (%)	- 3,2	- 3,1	- 3,3	- 3,8	- 3,8
CZK/EUR Exchange Rate	25,3	24,3	23,9	23,4	22,9
Euro-area Real GDP Growth (%)	1,8	1,7	1,0	1,6	2,0

Source: Czech Statistical Office, MoF

Since the first half of this year, uncertainty has been on a growing path, particularly in relation to euro-area peripheral countries development. Contagion and spill-over effects on other euro-area member countries and inability of political representation to reach a consensus has led to lack of trust in peripheral countries governments' ability to meet their financial commitments and overall rise of nervousness on the financial markets. The euro-area banking sector has also lowered its activity on inter-bank market and many banks have been downgraded due to their high exposure to peripheral countries government bonds.

On the government bonds market, two contradictory trends have been occurring in relation to increasing spreads between member states. The peripheral countries have become risky, while countries with high sovereign credit ratings have registered their historically lowest level of yields. The aversion to risk and the reaction to new reports have substantially contributed to increasing volatility on the financial market. The development of the Czech economy, with fiscal consolidation taken into consideration, is so far regarded as trustworthy, which was also reflected by the increase in the Czech Republic sovereign credit rating and in the relatively low yields of government bonds during 2011 compared to the original expectation in the Strategy for 2011. However, in view of the openness of the Czech economy, the development of the real economy will continue to depend particularly on the economic development of the main export partners as well as on the effect of the government's consolidation programme on domestic demand.

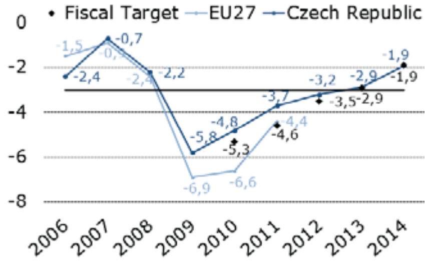
The deficit of the sector of government institutions reached CZK 182.7 billion in 2010, which represented 4.8% of GDP. Results were also better by approximately CZK 7.2 billion compared to the fiscal outlook with which the Strategy for 2011 worked and which expected a deficit share of GDP of 5.1% Compared to the sharp decline from 2009, government sector revenues picked up and in 2010 grew by 1.5% This was visible mainly in contributions for social security, VAT and consumer taxes. However, there was a decline in individual and corporate income taxes. As for spending, austerity measures were apparent both in the operation of the state administration and in relation to investment expenditures and subsidies provided to entities outside of the government sector. The significant interest savings on state debt management also contributed to the reduction in expenditures. Government sector expenditures fell by 0.9% in 2010.

For 2011, the general government budget deficit is estimated at CZK 142 billion, which represents 3.7% of GDP, which is by significantly lower than the original government target of 4.6% of GDP with which the Strategy for 2011 also worked. The positive development can also be attributed to lower than budgeted costs for state debt management, which traditionally were based conservatively on simulated growth of interest rates, which occurred only during the first quarter, after which a repeat decline was registered. The sharp rise in government bond yields in November 2011 no longer had a major effect on interest expenditures for this year and will be reflected only later in 2012.

The government's fiscal goal for the deficit of the government sector for 2012 amounts to 3.5% of

GDP, which is in line with the fiscal consolidation with which the Strategy for 2011 also worked. The current macroeconomic prognosis and fiscal outlook work with a possible result of 3.2% of GDP, which creates certain room for in case of a more pessimistic development of the real economy, to which the government would be able to react by adopting additional consolidation and austerity measures in order to achieve its goal.

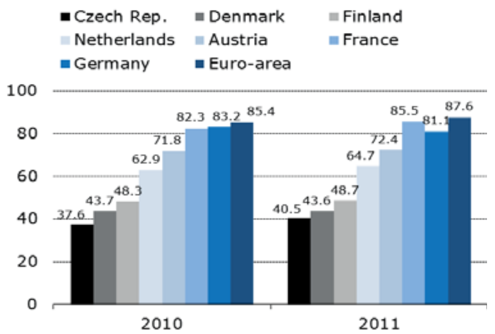
Figure 1: Deficit of government sector and government targets until 2014 (% of GDP, ESA95)



Source: Eurostat, MoF

The debt of the government sector as calculated based on the ESA95 method reached the value of CZK 1.418 trillion in 2010, which represents 37.6% of GDP. At the end of 2011, the debt is expected to amount to CZK 1.560 trillion, which represents 40.5% of GDP and therefore based on an international comparison it will remain at a relatively low level below the weighted average of the euro-area countries and EU member states and below the boundary of the Maastricht convergence criterion.

Figure 2: Government sector debt in selected EU states (% of GDP, ESA95)

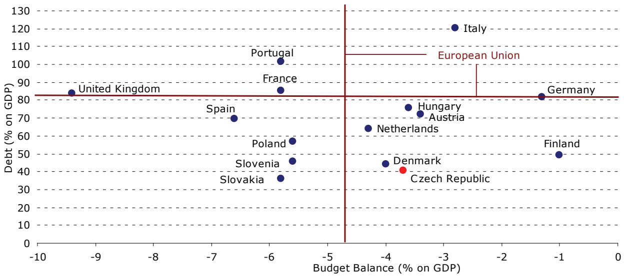


Source: Eurostat, MoF

The main factor of growth of the debt quota is the primary balance, followed by interest payments on the state debt. The mid-term outlook of the budget for 2012 to 2014 anticipates further gradual improvement of the government sector deficit, and the targeted deficit trajectory predicts a balanced budget of the sector of government institutions in 2016. For this purpose, further tightening of mid-term spending framework by the central government has been proposed.

Without an active approach to fiscal consolidation by the government, the balance of public budgets and the dynamics of indebtedness would be very alarming from a long-term point of view and would complicate the smooth financing of state debt in an environment of extreme instability on the international financial markets. However, in an international comparison, the Czech Republic still ranks among the EU member countries with the lowest indebtedness of the government sector and has a budget deficit that is comparable with the European countries with the best economies.

Figure 3: Debt and budget deficit of the government sector in 2011 (% GDP, ESA95)



Source: Eurostat, MoF

In 2011, it is estimated that the debt of the government sector of the Czech Republic in proportion to GDP will equal approximately 47.1% (41.7) below the average of the Euro-area countries (EU) and the budget deficit of the government sector in proportion to GDP will be 0.3% (0.7) lower.

The sub-sector of central government institutions has an approximately 90% share of the total resulting government sector budget deficit, with the state budget decisive for calculation. When determining the borrowing requirement of the central government and the planning of operations on the financial market, it is necessary to use the state budget deficit based on the method of examining monetary flows as the difference of aggregated revenue and expenditure accounts maintained in the Czech National Bank. Therefore, there will be no occurrence of consolidation with other government sectors and/or cleaning with a so-called clean loan, which, although they represent financing balance operations on the side of assets, affect state budget revenues and expenditures and therefore must be financed via debt operations.

In relation to the economic results of the government sector, in 2009 a record high state budget deficit was reported in the amount of CZK 192.4 billion. Based on the plan of austerity measures, a deficit of CZK 162.7 billion was budgeted for 2010, and the final deficit of CZK 156.4 billion was reported. For 2011, a budget deficit was approved in the amount of CZK 135 billion. The fiscal goals set by the current government for government sector budgeting are reflected in the essential reduction of state budget deficits using the method of monetary flows in the years 2012 to 2014.

From the structure of consolidation measures in 2012 to 2014, it is apparent that measures on the revenue side will have substantial weight, accompanied by the impact of increasing the reduced rate of VAT as a source of covering the transformation costs of pension reform. In 2013, growth of expenditures is expected in the form of welfare benefits, which to a great extent thanks to valorization will be the result of separate growth of pensions. The effect of the act on injury insurance will have an effect both on revenues and on expenditures, but the overall effect is expected to be positive. Savings in the public sector are also expected to have a positive effect in 2013, primarily connected with the new act on public contracts. In 2014, the Ministry expects the start of several major reforms, which will include a single payment location and reforms related to direct taxes and deductions.

Table 2: State budget deficit of the Czech Republic for 2006 to 2014

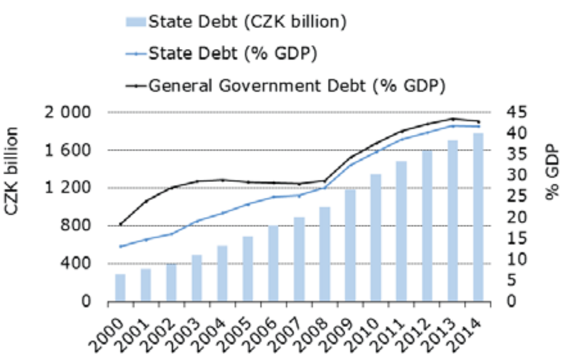
	2006	2007	2008	2009	2010	2011	2012	2013	2014
CZK billion	- 97.6	- 66.4	- 20.0	-192.4	-156.4	- 135.0	-105.0	-110.0	-75.0
% GDP	- 3.0	- 1.9	- 0.5	- 5.3	- 4.1	- 3.5	- 2.7	- 2.7	-1.8

Source: MoF

State budget deficit is the main source of growth of the state debt, which has been occurring since 1996 in both an absolute amount and in relation to GDP. By 2014, the absolute growth of the state debt and the debt of the government sector will become more moderate and will decline in proportion to GDP as a reflection of the government's continuing consolidation measures and the revival of economic activity.

The other parts of the submitted Strategy work exclusively with the categories of non-consolidated state debt and the state budget based on the principle of monetary flows, which are decisive for determining the government's borrowing requirements and for the subsequent drafting of the funding strategy and issuance activities on the domestic and foreign financial markets and for measuring and managing financial risks

Figure 4: Development of Czech state debt and government sector debt from 2000 to 2014



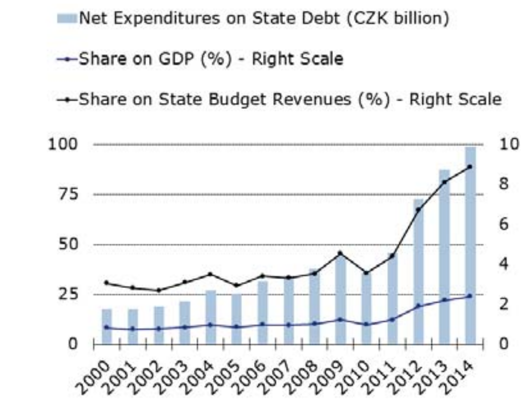
Source: MoF

Financial markets and costs on the state debt

Since 2001, the costs for the management of state debt have been budgeted and implemented as part of the separate budget chapter 396 - State debt. Until 2007, this chapter contained only expenditures, which also represented costs for the management of state debt. As of 2008, a change occurred in the method of budgeting, and monetary flows originating from debt instruments are categorized based on their material character also on the side of revenues. Since 2008, costs on the state debt management have been presented based on the difference of expenditures for state debt management and revenues, which represents net expenditures for the state debt management.

During the period from 1993 to 2009, the total net expenditures for the management of state debt nearly tripled from CZK 14.1 billion to CZK 44.5 billion, and then in 2010 they declined temporarily to CZK 35.8 billion. In relation to economic performance, net expenditures oscillated around 1% of GDP and in 2009 reached 1.2% of GDP. In relation to total state budget revenues, up to now they have hovered between 2 and 5%, and the hitherto maximum was reached during the crisis year of 2009.

Figure 5: Net expenditures for management of state debt from 2000 to 2014



Source: MoF

Net expenditures for management of state debt do not include expenditures for transfers for projects financed by loans from the European Investment Bank, and although these were budgeted in the "State debt" chapter from 2008 to 2011, through budget measures these expenditures were handled by the materially relevant chapters responsible for infrastructure projects, which are financed by these loans. The deficit of the "State debt" chapter therefore needs to be cleaned of these expenditures during each analysis during those years. Beginning in 2012, these expenditures will be budgeted directly by relevant chapters of cabinet ministries, particularly the ministries of transport, agriculture and education. This will increase the transparency of the budget process, reduce the number of budget measures and enable easier evaluation of the effectiveness of state debt management by the public.

Table 3: Budgeted and actual net expenditures for state debt management from 2001 to 2014

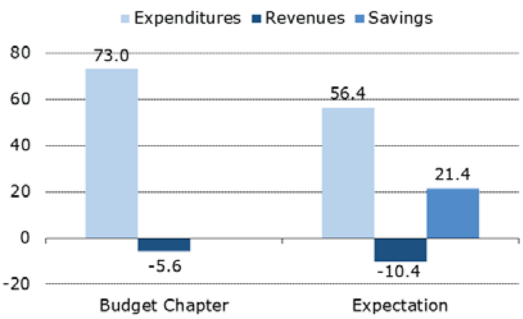
CZK billion	2001	2002	2003	2004	2005	2006	2007
Expenditures on State Debt	21.3	22.0	23.5	27.0	33.7	34.2	38.1
Revenues on State Debt	-	-	-	-	-	-	-
Budgeted Net Expenditures	21.3	22.0	23.5	27.0	33.7	34.2	38.1
Actual Net Expenditures	17.6	18.9	21.6	26.8	25.4	31.6	34.1

CZK billion	2008	2009	2010	2011	2012	2013	2014
Expenditures on State Debt	45.5	48.2	63.7	73.0	79.4	94.5	105.5
Revenues on State Debt	1.5	6.7	6.9	5.6	6.5	7.0	6.3
Budgeted Net Expenditures	44.0	**41.5**	56.8	67.4	72.9	87.6	99.2
Actual Net Expenditures	37.7	**44.5**	35.8	46.0	-	-	-

Source: MoF
Note: In 2011, these amounted to the expected actual net expenditures.

In 2011, like in 2010, substantial **savings of net expenditures on state debt** in an amount exceeding **CZK 21 billion** can be expected compared to the budgeted net expenditures in the amount of CZK 67.4 billion. These expenditures will reach the expected amount of CZK 46 billion, which represents approximately 1.2% of GDP and 4.4% of expected total budget revenues. These savings have contributed to better than expected economic results in the government sector. However, compared to 2010, costs have risen by approximately 28.3%.

Figure 6: Expected savings of net expenditures for date management in 2011 (CZK billion)

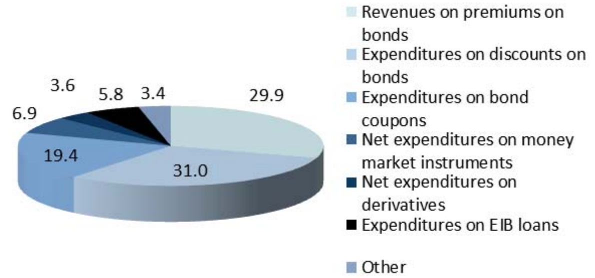


Source: MoF

The extremely high savings can be attributed mainly to the prevailing low level of short-term and long-term interest rates, which is in contrast with the essentially conservative expectation of significant growth of interest rates in the approved budget of chapter 396 – State debt for 2001. Risk premium on Czech government bonds in comparison to the majority of EU member countries remained relatively stabilized during 2011. The international confidence in the Czech Republic`s ability to meet its financial obligations is reflected particularly by the ongoing consolidation programme of the coalition government and the planned structural reforms, which are resulting in significant reduction of budget deficits, the net borrowing requirement and the net issuance of government bonds in a mid-term outlook. The expected savings in 2011 compared to the budgeted revenues and expenditures represent an increase in revenues by CZK 4.7 billion and a reduction in expenditures by CZK 16.6 billion.

The distribution of expected savings in interest costs to individual parts based on the sources of savings is documented by the following figure. It is apparent that the most savings were achieved in the area of increased revenues from premiums on government bonds and lower expenditures on discounts related to medium-term and long-term government bonds, which amount together to more than three fifths of the expected savings in interest costs. This source of savings is logical, since the auctions of these bonds occur via reopening of existing issuance, and the impact of the decline in interest rates is achieved via the prices of bonds and not via coupons.. Savings were also achieved with coupons related to fixed interest government bonds, mainly because payments issued in relation to coupons were carried out from a lower than expected volume of bonds.

Figure 7: Sources of savings of net expenditures for management of state debt in 2011 (in %)



Source: MoF

Savings were achieved with all state debt floating-rate instruments, mainly net expenditures for money market instruments, even though lower than budgeted revenues were achieved from the investment of the balances of the the State Treasury liquidity management account and even though there will be net growth of money market instruments by CZK 48.7 billion as a source of financing of the government's borrowing requirement during this year. Major savings were also registered in relation to expenditures for floating-rate note coupons and for loans from the European investment bank, which are mostly floating-rated. Certain savings also occurred with floating currency swaps, via which bonds issued on foreign markets were hedged against currency risk and thus synthetically transformed to floating-rate CZK instruments.

The reduction of costs on the state debt in 2011 was caused mainly by a further drop in the yield curve of Czech government bonds related to the positive perception of the Czech Republic as a reliable borrower and the general decline in yields on the capital market, including swap curve. Thanks to a further decline in yields on Czech government bonds, in 2011 the Ministry achieved an average yield from CZK medium-term and long-term bonds in domestic auctions of **3.09 %**, which is more than 0.2 percentage points less than in 2010.

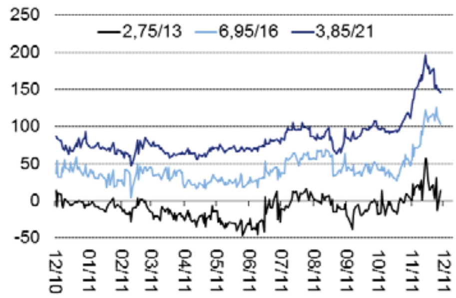
During the period from 1/2011 to 10/2011, the development of yields on Czech government bonds was very stable with nearly the lowest level of volatility of all markets in the EU. A major increase in yields began occurring in November 2011 as a result of the deepening euro-area debt crisis and the traditional uncertainty with the approaching end of the calendar year.

Figure 8: Development of Czech government bond yields from 2006 to 2011 (% p.a.)

Source: ThomsonReuters

The development of the risk premiums measured through the asset-swap-spread also indicates the impact of the increase of the risk aversion related to the situation in the euro-area up to the end of this year.

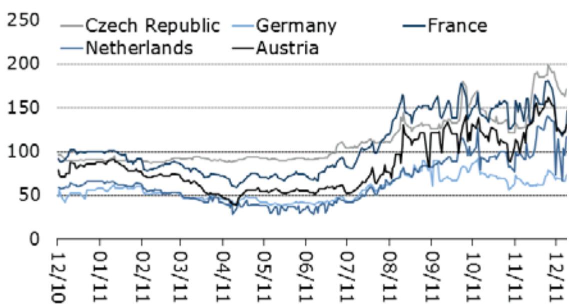
Figure 9: Risk premiums of Czech government bonds from 2010 to 2011 (basis points)



Source: ThomsonReuters

The perception of the Czech Republic on the international market as a reliable borrower is illustrated by the situation on the markets of credit default swaps (CDS), where the Czech Republic has a position comparable with core countries of the Euro-area, i.e. with countries with the highest AAA rating.

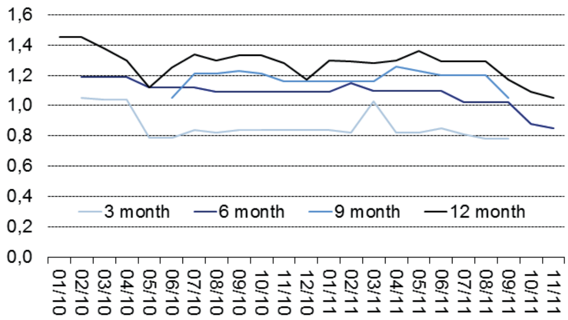
Figure 10: Credit default swaps (CDS) from 2010 to 2011 (10 years, basis points)



Source: ThomsonReuters

The T-bill market was very stable during all of 2011. T-bills were successfully placed in auctions with very low yields, which further contributed to the decline in the costs on state debt in 2011. The average auction yield of T-bills was 1.10 %, in 2011 which is 4 basis points less than in 2010.

Figure 11: T-bills yields from 2010 to 2011 (% p.a.)



Source: ThomsonReuters

Czech Republic Sovereign Credit Rating

The Czech Republic belongs to Sovereign Issuers with very strong capacity to meet their financial obligations which is much appreciated by both local and foreign investors. It is also rewarded for its credible fiscal consolidation programmeme by major Credit Rating Agencies. The latest Credit Rating Action on the Czech Republic was on 24th August 2011 when Standard & Poor's **upgraded** the Czech Republic **by two notches** to **AA** with regard to Domestic Long Term Rating and AA- with regard to Foreign Long Term Rating, respectively. Another respected Credit Rating Agency Fitch Ratings changed outlook on the Czech Republic Credit Rating to **positive outlook** with regard to both Domestic and Foreign Long Term Ratings.

Table 4: Czech Republic - Sovereign Credit Rating (2011)

Credit Rating Agency	Domestic Long Term	Outlook	Foreign Long Term	Outlook
Fitch Ratings	AA-	Positive	A+	Positive
Moody's	A1	Stable	A1	Stable
Standard & Poor's	AA	Stable	AA-	Stable

Source: Fitch Ratings, Moody's, Standard & Poor's

The excellent Sovereign Credit Rating position of the Czech Republic is well documented in comparison with other European Union member countries. The Czech Republic is level on notch with Belgium. There are currently only nine AAA-rated countries such as Germany and the United Kingdom with better Sovereign Rating Credit than the Czech Republic. In addition to this, the Czech Republic has the **highest Sovereign Credit Rating in the CEE region** and also of all new European Union member countries. Moreover, the Czech Republic belongs to only nine member countries that have not been put on a negative outlook.

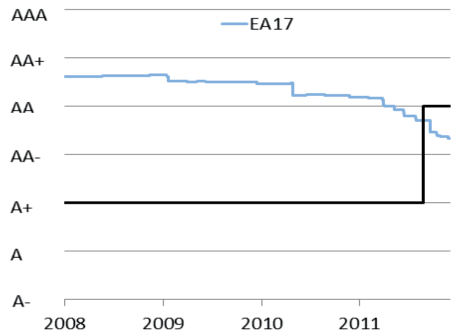
Table 5: European Union Sovereign Credit Rating (EU27) in 2011

Rating	EU member countries
AAA	Austria, Denmark, Finland, France, Germany, Luxembourg, Netherlands, Sweden, UK
AA+	
AA	Belgium, Czech Republic
AA-	Estonia, Slovenia, Spain
A+	Slovakia
A	Italy, Malta, Poland
A-	
BBB+	Ireland
BBB	Bulgaria, Cyprus, Lithuania
BBB-	Hungary, Portugal, Romania
BB+	Latvia
CC	Greece

Source: Standard & Poor's
Note: Domestic Long Term Credit Rating, Negative Outlook (red), Stable or Positive Outlook (green)

When compared to euro-area, the Czech Republic also stands very well while it has **better Sovereign Credit Rating than ten euro-area member countries**, same as Belgium and worse only in comparison with six elite AAA-rated euro-area member countries such as the Netherlands or Finland. The Czech Republic Sovereign Credit Rating stands slightly above the euro-area Sovereign Credit Rating average weighted by gross general government debt of respective member countries. In addition to this, all euro-area member countries were put on a negative outlook on 5th December 2011 while the Czech Republic retained stable outlook.

Figure 12: Euro-Area (EA17) and the Czech Republic Sovereign Credit Rating Development (2008-2011)



Source: Standard & Poor's, Eurostat, European Commission, own calculations

2 - Borrowing requirement and state debt up to 2014

The net borrowing requirement and change in the state debt

The net borrowing requirement of the central government is in the mid-term outlook determined mainly by state budget deficits. The final amount of the net borrowing requirement is also reflected by operations on the side of state financial assets, lending and on-lending and a change in the amount of financial reserve generated by issuance activity.

The net borrowing requirement is also the main factor for the change in the nominal value of the gross state debt. Since part of the state debt is denominated in foreign currencies, its change is also influenced by fluctuations in the exchange rates of the Czech Koruna against those currencies.

Table 6: The net borrowing requirement of the central government and change in state debt

	2010	2011		2012	2013	2014
	Actual	Planned	Predicted	Planned		
Gross state debt as of 1st January	**1 178.2**	**1 344.1**		**1 494.6**	**1601.8**	**1 713.9**
Primary balance of state budget, excluding on-lending	120.6	66.5	89.0	32.1	22.4	-24.2
Net expenditures on state debt[1]	35.8	68.5	46.0	72.9	87.6	99.2
Extra-budgetary borrowing requirement	0.0	0.0	0.0	0.0	0.0	0.0
Net borrowing requirement, net of assets operations	**156.4**	**135.0**	**130.0**	**105.0**	**110.0**	**75.0**
State financial assets operations[2]	3.0	2.1	2.4	2.2	2.2	2.1
On-lending (net change)[3]	1.7	4.9	0.0	0.0	0.0	0.0
Financial reserve (net change)[4]	7.1	-35.7	18.1	0.0	0.0	0.0
Net borrowing requirement	**168.2**	**106.3**	**150.5**	**107.2**	**112.2**	**77.1**
Changes in nominal state debt[5]	-2.4	0.0	0.0	0.0	0.0	0.0
Gross debt change	**165.8**	**106.3**	**150.5**	**107.2**	**112.2**	**77.1**
Gross state debt as of 31st December	**1 344.1**	**1 448.8**	**1 494.6**	**1 601.8**	**1 713.9**	**1 791.0**
(% on GDP)	**(35.6)**	**(37.6)**	**(38.8)**	**(40.5)**	**(42.0)**	**(42.0)**

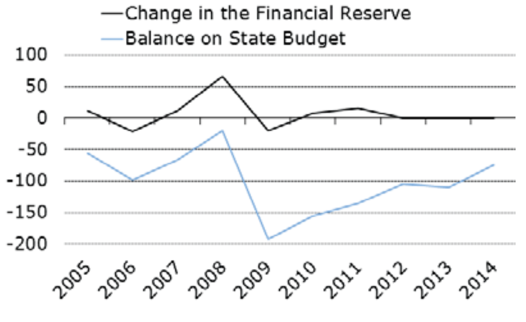
[1] *balance of budgetary chapter 396 – State debt excl. expenditures – Transfers on projects financed by loans from EIB*
[2] *balance of budgetary chapter 397 – State Financial Assets Operations*
[3] *on-lending to other states and enterprises with full state-backed guarantee on their core business*
[4] *financial reserve generated by bonds issues according to the Act No. 218/2000*
[5] *exchange rate changes due to re-evaluation of foreign currencies denominated debt and state debt amortization within budgetary chapter 396*

Source: MoF

In 2011, the net borrowing requirement is expected to be approximately CZK 44.2 billion higher, which can be attributed in particular to the higher than planned generation of financial reserves by CZK 53.8 billion. The generation and tapping of financial reserve has been an important item of the net borrowing requirements since 2008 and are related to the Ministry's cautious approach during the financial and economic crisis and the high amount of uncertainty regarding the smooth securing of issuance activity by the state stemming from the potential risk of freezing of the financial markets. Due to the continuing uncertainty regarding the development of the euro-area debt crisis, the Ministry amended its plan for tapping from financial reserve from the net decrease of CZK 35.7 billion to net growth of CZK 18.1 billion.

However, a slight decline in the net borrowing requirement compared to the plan by CZK 4.9 billion will occur as a result of not using the planned amount of bilateral aid provided to Latvia. As far as other operations related to lending and on-lending to other countries and domestic entities are concerned, the Ministry does not plan any transactions outside of the budget during the particular period that would have an impact on the borrowing requirement of the central government.

Figure 13: Additions to and drawing on the financial reserve from 2005 to 2014 (CZK billion)



Source: MoF

The change in the amount of financial reserve is directly related to the development of the state budget. The reduction in the state budget deficit compared to the originally expected development while maintaining the issuance plan is causing an increase in financial reserve without affecting the net borrowing requirement. The reserves can also be used within financing to limit changes to the net borrowing requirement during a higher deficit than anticipated in the budget.

After involving the reserve funds in the state budget revenues in 2008, the budget deficit sharply declined, and therefore the financial reserve during that year reached their historic maximum. These resources were subsequently used during financing of the state in the crisis year 2009, which made it possible to ensure the smooth course of financing at a time when major turbulence was occurring on the financial markets.

Although the gradual implementation of fiscal reforms is reducing the uncertainty surrounding the state debt funding and management, the reduction of the cumulative financial compared to the original expectations cannot be resorted to, due to the situation on the global financial markets.

The prevailing uncertainty regarding the developments in the euro-area is also influencing developments in the Czech Republic, which as a small, open and export-oriented economy is subjected to the effects of developments abroad. Although the credit of the Czech Republic as an issuer has grown, there has also been a major increase in uncertainty surrounding developments on European as well as global financial markets.

Gross borrowing requirement and financing of the central government

The net borrowing requirement is the first part of the gross borrowing requirement that determines the volume of the state's borrowing operations in a particular year. The second is represented by redemptions on state debt (without revolving money market instruments during the year) in the particular year and buy-backs and exchanges of government bonds prior to their original maturity.

Table 7: Gross borrowing requirement and instruments for funding of the central government

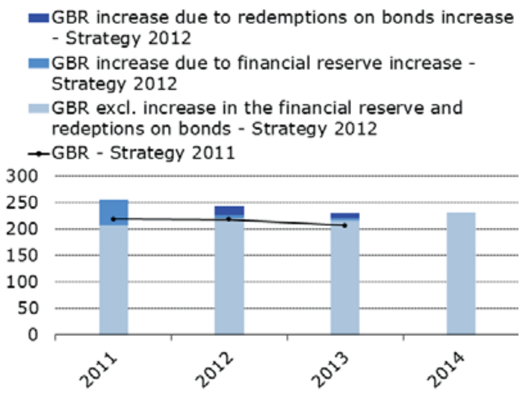
CZK billion	2010	2011		2012	2013	2014
	Actual	Planned	Predicted		Planned	
Net borrowing requirement	**168.2**	**106.3**	**150.5**	**107.2**	**112.2**	**77.1**
Redemptions on state debt, incl. buy-backs and switches within a budgetary year[1]	83.0	102.1	102.1	123.1	107.6	143.1
Redemptions on loans from the EIB	1.1	1.1	1.1	3.1	1.1	1.7
Buy-backs and switches of bonds due in following year[2]	0.0	10.0	2.0	10.0	10.0	10.0
Gross borrowing requirement	**252.6**	**219.5**	**255.7**	**243.4**	**230.9**	**231.9**
Net money market issuance[3]	25.1	30.0	48.74	50.0	40.0	40.0
Gross government bonds issuance[5]	217.1	184.0	181.2	167.5	163.5	167.2
Gross savings government bonds issuance	-	-	20.4	20.0	20.0	20.0
Loans from EIB	10.4	5.5	5.4	5.9	7.4	4.7
Net loans from the State Treasury	0.0	0.0	0.0	0.0	0.0	0.0
Funding of borrowing requirement	**252.6**	**219.5**	**255.7**	**243.4**	**230.9**	**231.9**

[1] including redemptions on savings government bonds
[2] excl. operations with government bonds due within a budgetary year
[3] excl. revolving within a budgetary year
[4] net money market issuance on the market reached CZK 31.4 billion. The remaining CZK 17.3 billion was invested in the state financial assets
[5] nominal amount, ie. premiums and discounts are included in net costs on state debt not entering into net borrowing requirement
Source: MoF

In 2011, a CZK 36.2 billion higher gross borrowing requirement is expected compared to the original plan. This growth is caused particularly by the growth of the net borrowing requirement due to a change in the plan of tapping financial reserve and higher redemptions on state debt due in 2012 issued in 2011.

When comparing the amount of the gross borrowing requirement for 2011 to 2013 planned in the Strategy for 2011 with the current Strategy for 2012, it is obvious that this plan was slightly revised upward, which is related mainly to the Ministry's cautious approach during the creation of sufficient financial reserve during a period of major uncertainty on the global financial market, particularly in view of the development of the debt crisis in the euro-area.

Figure 14: Change in gross borrowing requirement (GBR) outlook for 2011 - 2013 (CZK billion)



Source: MoF

The financing of the gross borrowing requirement is being implemented via three traditional basic instruments and one new instrument, with which the Ministry began working as of 2011. Tapping of **loans from the European Investment Bank** (EIB) as the first of these is closely tied to the implementation of investment expenditures from the state budget. In the outlook for 2012 and 2013, in comparison to the Strategy for 2011, there was a substantial increase in lines of credit from the EIB, which is caused mainly by a change in the method of budgeting expenditures for projects co-financed from EIB lines of credit, which were budgeted until 2011 in the "State debt" chapter and as of 2012 will be budgeted in the chapters of the respective cabinet ministries, which have differing expenditure frameworks.

During the particular period, the Ministry plans during the financing of the gross borrowing requirement to continue with the increase in the issuance of money market instruments, particularly **T-bills**. This plan corresponds to the goal of achieving the reduction of interest costs while simultaneously maintaining acceptable levels of refinancing risk. The growth in the share of these instruments has been planned in a manner that will ensure that the basic limit of state debt due within one year, which has been set at 25% for 2012, is not exceeded. The share of money market instruments in state debt therefore will rise from approximately 10.8% at the beginning of 2011 to approximately 16.3% at the end of 2014.

The gross issuance of **government bonds** on the domestic and foreign market in the particular period hovers at the annual level of approximately CZK 160 to 170 billion annually, and net issuance of government bonds remains at a level of up to CZK 70 billion. These issuance volumes do not include planned sales of savings government bonds for households and non-profit institutions, the issuance of which is planned in the amount of CZK 20 billion to 40 billion annually, depending on demand from households and non-profit institutions.

Net loans from the state treasury are so far conservatively planned in a zero amount. Although in 2011 the draft amendment to act No. 218/2000, on budget rules, was not approved, which is a necessary legislative condition for involving resources from the accounts of multiple government sector organizations in the state treasury and in the short-term financing of the state, this financing item will probably increase in importance during the particular period in connection with the development of a technical mechanism for short-term involvement of client resources in the state treasury. The involvement of these resources in the mid-term horizon will enable the minimization of financial reserve and will be one of the sources of savings of interest costs on the state debt.

Net debt portfolio

Monetary flows originating from net and gross borrowing requirements and from released financing instruments of the central government are reflected in the amount and structure of the balance of state debt and state financial assets and/or the net debt portfolio.

The calculation of the net debt portfolio for the requirements of this strategy is based on international practice in developed countries, and against the gross debt portfolio stand those financial assets that are closely connected with financial operations of the debt management and budget operations involving state financial assets. Financial assets based on this definition do not include balances outside of the budget in accounts that are also outside of the system of the collective account of the state treasury (such as a privatization account left over from the former National Property Fund). They also do not include other financial property such as shares, other ownership interests and receivables of the state towards foreign entities or originating from provided refundable financial assistance or implemented state guarantees.

The method of the net debt portfolio provides a more realistic overview of the financial position of the state and related risk parameters. Financial assets and their structure slightly reduce the refinancing, liquidity and interest risk of state debt, and therefore they are monitored within the system of risk management.

These financial assets also include investment portfolios, which are administered by the Ministry and represent **portfolios held until maturity**. The investment of balances of the nuclear account, the **nuclear portfolio**, is carried out by the Ministry within state financial assets based on the provisions of Section 27 of Act No. 18/1997, the nuclear act, and investment of balances of the separate reserve account for pension reform the **pension portfolio**, based on the provisions of Section 36 of Act No. 218/2000, the budget rules.

The balances of these accounts are invested conservatively exclusively into domestic government bonds through direct purchases and/or via reverse repo operations, where the collateral are T-bills or Czech National Bank bills. The returns from investment are the direct budget chapter "Operation of state financial assets". In the future, the cumulative resources from these portfolios will cover part of the purposeful expenditures from the state budget for handling radioactive waste and for pension reform.

Table 8: State and structure of net debt portfolio and financial sources of the State Treasury

CZK billion	2010	2011		2012	2013	2014
	Actual	Planned	Predicted		Planned	
Gross state debt as of 31st December	**1 344.1**	**1 448.1**	**1 494.6**	**1 601.8**	**1 713.9**	**1 791.0**
Money market instruments	113.3	143.2	162.0	212.0	252.0	292.0
Medium-term and long-term bonds	1 163.3	1 233.4	1 260.8	1 315.2	1 381.1	1 415.2
Loans from EIB	67.2	71.6	71.5	74.3	80.5	83.5
Bills of exchange[1]	0.3	0.6	0.3	0.3	0.3	0.3
Short-term liabilities to the Treasury	0.0	0.0	0.0	0.0	0.0	0.0
State financial assets as of 31st December	**114.0**	**85.3**	**134.5**	**136.7**	**138.9**	**141.0**
Nuclear investment portfolio	15.1	16.5	16.7	18.2	19.6	20.5
Pensions investment portfolio	21.6	22.0	22.0	22.5	23.0	23.5
Special-purpose financial assets account	10.2	10.2	10.6	10.8	11.1	11.8
Lending and On-lending[2]	1.7	6.6	1.7	1.7	1.7	1.7
Financial reserve[3]	65.4	30.0	83.5	83.5	83.5	83.5
Net debt portfolio as of 31st December	**1 230.1**	**1 362.8**	**1 360.1**	**1 465.0**	**1 575.1**	**1 650.0**

[1] Bills of exchange to cover equity holdings of the Czech Republic with international financial institutions
[2] lending to other states and to enterprises with full state-backed guarantee on the core business
[3] disposable cash balance built up by issuance of government debt according to the Act No. 218/2000, Section 35.
Source: MoF

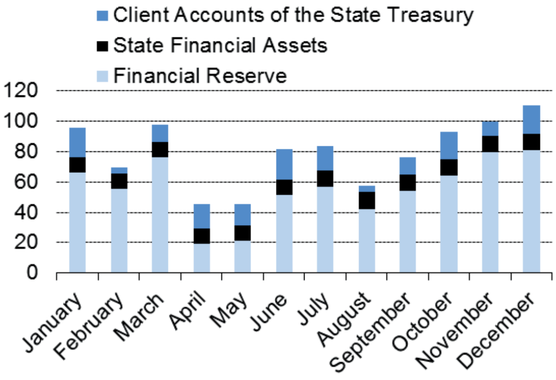
The balances on **special-purpose accounts of state financial assets** are not actively directly invested in the financial market, but in the future could also cover part of the purposeful expenditures from the state budget. However, these balances are part of the collective account of the state treasury and are invested over the short term via direct operations on the money market. Although the balances of these accounts are financial assets of the Ministry, from the point of view of financing the borrowing requirement, they are borrowed resources, and this portion of state financial assets holds the role of a quasi client of the state. However, in the event of an unexpected crisis development, these resources can be activated via a decision by the Chamber of Deputies, and therefore their position against the current gross debt position is economically justifiable.

Financial reserve is created by the continuous issuance of government bonds for pre-funding of the future borrowing requirement and by the particular date logically reduce the gross value of the state debt. Over the short term, they are invested on the money market as part of the collective account of the state treasury.

Lending and on-lending is provided from issuance activity and effectively do not increase the value of the net debt portfolio, under the assumption that the respective borrowers fulfill their obligations stemming from loans.

The central liquidity position of the state is further stabilized by s**hort-term outside sources of the state treasury**, which are not part of the state financial assets of the Ministry, but which are represented by balances on accounts maintained as part of the collective account of the state treasury at the Czech National Bank and therefore can be involved over the short term in the financing of the borrowing requirement or invested on the money market, which brings savings of interest costs on the state debt and contributes to the reduction of the refinancing and liquidity risk of the central government. Currently as part of these resources, only balances in tax and customs offices, in accounts of reserve funds of organizational units of the state and in accounts of funds for cultural and social requirements of organizational units of the state are obligatorily available.

Figure 15: Development of liquid parts of the state treasury in 2011 (CZK billion)



Source: Czech National Bank, MoF

If during 2012 the respective amendment to Act No. 218/2000, on budget rules, is approved during 2012, the collective account of the state treasury will be expanded particularly to include all accounts of state funds, the National Fund, state contributory organizations and accounts intended for revenues from the state budget, state funds and the National Fund at territorial self-governing units and voluntary associations of municipalities, regional councils of regions of cohesion, public research institutions and public universities.

3 - Funding programme and issuance activity in 2012

Implementation of the funding programme in 2011

The basis for defining the financial programme for 2011 was the planned financing programme from 2010. Against the plan, an increase of the gross borrowing requirement occurred by CZK 36.2 billion to 255.7 billion. This change is related particularly to the revision of the plan for tapping financial reserve in view of the current euro-area debt crisis.

Table 9: Funding Programme for 2011

CZK billion	Plan as of 2nd December 2010	Expectation as of 12th December 2011
The government' s gross borrowing requirements	**219.5**	**255.7**
Issuance of medium-term and long-term bonds1	**174.0 to 194.0**	**181.2**
Issuance of medium-term and long-term on the domestic market	86.0 to 194.0	180.3
Issuance of medium-term and long-term on the foreign markets	0.0 to 88.0	0.9
Issuance of savings government bonds	**-**	**20.4**
Loans from EIB	**5.5**	**5.4**
Net issue in money market instruments	**20.0 to 40.0**	**48.7 (31.4)[2]**

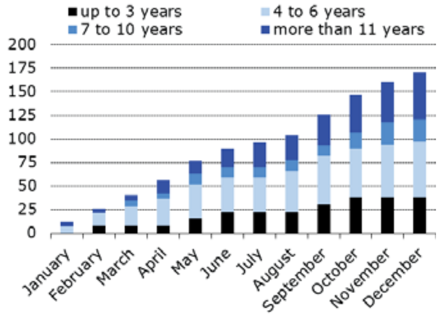
[1] including direct sales from own portfolio on the secondary market and to the European Investment Bank
[2] net issuance on the market, excl. operations of the Ministry with state financial assetss
Source: MF

Foreign public issuance will no longer be carried out in 2011. The gross borrowing requirement of the government was 8% secured by the successful pilot issuance of savings government bonds for individuals and non-profit legal entities in the total amount of CZK **20.4 billion**. These activities along with primary auctions on the domestic market of government bonds added to the offer of CZK denominated medium-term and long-term government bonds, and a new source and method of financing was set up based on a direct relationship between the citizen and the state. This year on the domestic market, a total of 25 primary auctions were held. The volume of bonds sold via primary auctions for all of this year is CZK **163.1 billion**. The tap of the euro-denominated VAR/15 note from the Ministry's own portfolio was executed via a mini auction in a volume of CZK **0.9 billion**.

Direct sales to the EIB amounted to CZK **8.4 billion**. The Ministry's purchases in the nuclear and pension portfolios were carried out in the collective amount of CZK **8.8 billion**. During this year, the Ministry did not carry out any trading on the secondary market of government bonds.

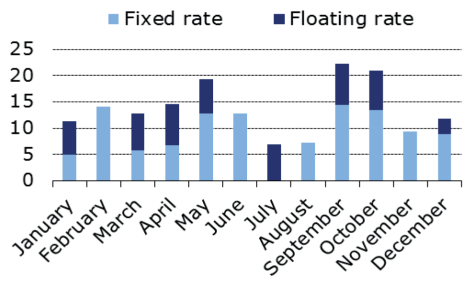
Based on the strategy for 2011, a plan was conceived for the sale of at least 30 % of the total issued volume of floating rate notes in primary auctions on the domestic market. The Ministry offered fixed and floating rate notes in primary auctions equally during all of 2011. The share of both instruments by the end of 2011 is expected to reach **67.7 % of fixed interest-bearing bonds** and **32.3 % of floating rate notes** sold via primary auctions.

Figure 16: Supply of medium-term and long-term bonds in 2011 (CZK billion)



** primary auctions and sales to EIB included*
Source: Czech National Bank, MoF

Figure 17: Supply of medium-term and long-term bonds in 2011 (CZK billion)



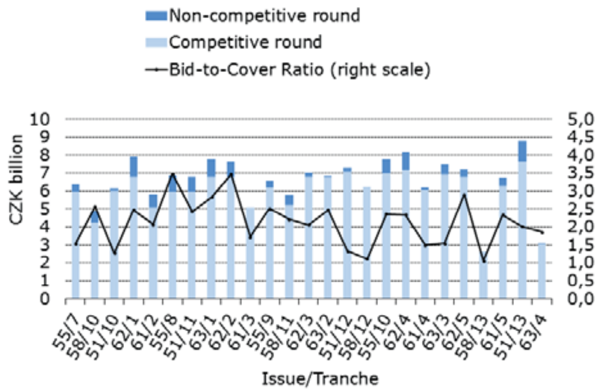
** primary auction*
Source: Czech National Bank, MoF

As of August 2010 and during all of 2011, the Ministry returned to its usual practice of underwriting domestic auctions in indicated volumes. This change was received positively by the market. The Ministry will maintain transparent behaviour on the primary market, but in the future will reserve the option of deviating from the indicated volumes should non-standard conditions arise on capital markets or other extraordinary circumstances occur.

During 2011, relatively stable demand for CZK denominated medium-term and long-term bonds in domestic auctions was observed. An exception was the primary auction of the government bond 5,70/24 on 2nd November 2011, during which the demand was half compared to the offered volume. The reduced demand was caused particularly by the escalating euro-area debt crisis and the increased nervousness of investors in the financial market related to the announcement by the then Greek prime minister about the intention to hold a referendum one day before the auction.

There were two subsequent very successful auctions of government bonds 3,85/21 and 4,00/17, in which the demand in the competitive part of the auction was more than double compared to the indicated offered issued volume. The stable demand for CZK denominated medium-term and long-term government bonds in 2011 is illustrated by the ratio of the overall demand to satisfied demand (Bid-to-Cover Ratio).

Figure 18: Primary auctions of medium-term and long--term bonds in 2011 (CZK billion)



Source: Czech National Bank, MoF

The net issuance of money market instruments in the form of T-bills will be carried out during the planned range at the level of CZK **31.4 billion** for the entire year 2011, while CZK **17.3 billion** in T-bills were invested within the nuclear and pension portfolios. The overall net issuance of money market instruments reached CZK **48.7 billion** and is contributing to nearly 20% of the financing of the gross borrowing requirement.

Loans from the European Investment Bank will be realized slightly below the level of the anticipated volume, in the amount of CZK **5.4 billion**, which is approximately 2.1% of the annual gross borrowing requirement of the government.

Funding programme for 2012

The funding programme for 2012 is based on the planned gross borrowing requirement of the government in the amount of CZK **243.4 billion**. The Ministry will execute the crucial part of its financial programme on the domestic market. In 2012, the Ministry will continue to evaluate the current development of the conditions for financing on the foreign market.

The share of financing on the foreign market will equal a maximum of 30% of the planned annual gross borrowing requirement of the government.

The Ministry's aim is to issue one publicly syndicated government bond in 2012 on the foreign market based on the development of market conditions. A necessary condition in particular for such issuance is improvement of the situation on the euro-area market of government bonds during 2012. The Ministry will also analyze other possible sources of funding through private placements in available currencies as long as these bring about lower interest costs than public issuance or as long as they contribute to stabilization of re-financing risk thorough for instance, lengthening the maturity profile.

The borrowing requirement in the value of CZK 5.9 billion will be secured via CZK denominated long-term loans drawn from the European Investment Bank.

The drawing of these long-term loans intended exclusively for infrastructure projects is based on respective credit legislation approved by the Parliament of the Czech Republic. The use of resources from lines of credit is closely tied to specific investment projects and programmes and like in previous years is explicitly contained in the draft state budget for 2012. Individual credit agreements offer both an extensive tenors of 3 to 40 years and the option of selecting between fixed and floating rates. In view of the exceptional position of the European Investment Bank on the financial market, more favourable rates are offered in comparison with market rates. In 2013 and 2014, drawing of lines of credit from the European Investment Bank is expected in the total amounts of CZK 7.4 billion and CZK 4.7 billion respectively. The outlook shows significant growth in comparison with data from 2010, which is caused mainly by the fact that as of 2012 expenditures for projects will no longer be co-financed from EIB loans in the "State debt" chapter, but in the chapters of materially relevant cabinet ministries that have differing expenditure frameworks. In 2014 at the latest, all existing loans from the European Investment Bank will be exhausted.

The nominal amount of issued CZK denominated medium-term and long-term government bonds on the domestic market will not exceed CZK 177.5 billion.

Given the planned gross borrowing requirement, during next year the supply of mid-term and long-term government bonds issued by the Ministry will be lower than in 2011, which should contribute to the stabilization of the domestic market.

The time span for auctions of medium-term and long-term bonds on the domestic market will be governed by the indicative plan of auctions, and a relatively evenly distributed span of domestic issuance is planned in maturity segments of 2 to 6 years and 9 to 11 years, while a **minimum of 30% of the issued volume on the domestic market will be comprised of floating rate notes**.

Instruments and indicated volumes of individual auctions will be published in 2012 **monthly** always on the second working Monday of the month preceding the particular month. The indicated volumes will no longer be published in 2012 for the entire auction volume, meaning collectively for both the competitive and **non-competitive round**, but only for the competitive part of the auction. The Ministry also reserves the right not to publish the specific indicated volume offered for the auction, but only the limit range. On the second working Monday of the month preceding the start of the quarter, the Ministry will also publish the quarterly maximum offered volume for the auctions.

Table 10: Indicative schedule of auctions of medium-term and long-term bonds in 2011

2012	Auction date (dd.mm.yyyy)	Issue date (dd.mm.yyyy)	Additional auctions (dd.mm.yyyy)[1]	Issue date (dd.mm.yyyy)
1st Quarter	04.01.2012	09.01.2012	11.01.2012	16.01.2012
	18.01.2012	23.01.2012	08.02.2012	13.02.2012
	01.02.2012	06.02.2012	22.02.2012	27.02.2012
	15.02.2012	20.02.2012		
	29.02.2012	05.03.2012		
	07.03.2012	12.03.2012		
	21.03.2012	26.03.2012		
2nd Quarter	04.04.2012	10.04.2012	25.04.2012	30.04.2012
	11.04.2012	16.04.2012	09.05.2012	14.05.2012
	18.04.2012	23.04.2012	30.05.2012	04.06.2012
	02.05.2012	07.05.2012		
	23.05.2012	28.05.2012		
	06.06.2012	11.06.2012		
	13.06.2012	18.06.2012		
3rd Quarter	18.07.2012	23.07.2012	04.07.2012	09.07.2012
	15.08.2012	20.08.2012	01.08.2012	06.08.2012
	05.09.2012	10.09.2012	29.08.2012	03.09.2012
	19.09.2012	24.09.2012	12.09.2012	17.09.2012
4th Quarter	03.10.2012	08.10.2012	24.10.2012	29.10.2012
	17.10.2012	22.10.2012	14.11.2012	19.11.2012
	07.11.2012	12.11.2012	12.12.2012	17.12.2012
	21.11.2012	26.11.2012		
	05.12.2012	10.12.2012		

[1] possible extension of the Issuance calendar
Source: MoF

In 2012, the Ministry will offer for sale both fixed and floating rate notes.

In the case of fixed rate bonds, the Ministry will re-open the government bond 2,75/14 in the total volume of up to CZK 12 billion up to the amount of the issuance limit, CZK 50 billion, of the government bond 3,40/15 in the total volume of up to CZK 18 billion up to the issuance limit, CZK 65 billion, and government bond 4,60/18 in the total volume of up to CZK 28 billion up to the issuance limit, CZK 75 billion. The government bonds 3,85/21 and VAR/23 will be sold in the total volume of CZK 30 billion to 45 billion for each issuance. The Ministry also plans the opening of a new issuance of the five-year floating rate government bond VAR/17 with a semi-annual coupon payment tied to the 6-month PRIBOR interest rate in the total volume of CZK 25 billion to 40 billion.

In 2012, the Ministry can offer up to two government bonds through a single auction.

As part of the process of increasing the flexibility of financing the state in reaction to the increase in the volatility and uncertainty on the financial markets as a result of the euro-area debt crisis, in 2012 the Ministry may resort to the inclusion of up to two government bonds with various characteristics (e.g. a fixed and floating rate or a medium-term or long-term bond) sold through a single auction. This type of auction strategy will provide investors with a wider selection of offered instruments and the option of reacting flexibly to the changing market environment. The aim of the Ministry is to accommodate the needs of market participants as much as possible during a time of increased uncertainty.

Table 11: Issuance strategy of medium-term and long-term bonds for 2012 (CZK billion)

Domestic Issue	Outstanding volume as of 31st December 2011*	Issue limit	Planned Supply in 2012
2,75/14	38	50	12
3,40/15	47	65	18
VAR/17	0	-	25 to 40
4,60/18	47	75	28
3,85/21	37	120	30 to 45
VAR/23	25	100	30 to 45
Domestic Retail Programme			**Planned supply in 2012**
Savings government bonds (spring)		-	10 to 20
Savings government bonds (autumn)		-	10 to 20
Foreign Public Issue			**Planned supply in 2012**
5 to 30 years			0 to 73
Foreign Private Placement			**Planned supply in 2012**
5 to 30 years	-	-	0 to 30

** incl. bonds held in the Ministry's own porfolio*
Source: MoF

Part of the issued volume of medium-term and long-term bonds on the primary market will also be complemented by the sale of bonds from the Ministry's own portfolio on the secondary market. With the introduction of the new electronic trading system MTS Czech Republic, the Ministry plans to carry out direct secondary sales of CZK denominated bonds, as is described in chapter 5 in the section entitled "Treasury Operations on the secondary market". The Ministry can also use its own bonds held in reserves when performing repo operations, lending facilities and direct sales of bonds to the European Investment Bank.

Table 12: Ministry's own portfolio of government bonds (CZK billion)

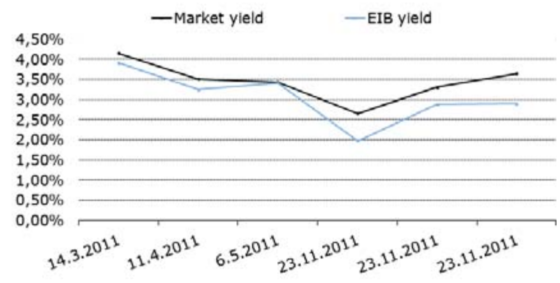
Issue	ISIN	Expected portfolio as of31st December 2010
VAR/16	CZ0001002331	2.260
4,00/17	CZ0001001903	2.774
4,70/22	CZ0001001945	0.476
VAR/23	CZ0001003123	3.964
5,70/24	CZ0001002547	4.897
4,85/57	CZ0001002059	13.240

Source: MoF

Part of the sale of CZK denominated mid-term and long-term bonds is being carried out as part of the cooperation with the European Investment Bank. This cooperation has been going on since 2010 together with drawing of loans also through sales of government bonds into the portfolio of the European Investment Bank and their holding until maturity, which is a legislatively less demanding equivalent of loans. The Ministry has participated substantially in the preparation of this mechanism, which is innovative from the point of view of the European Investment Bank, and the Czech Republic has become the first EU member state to apply this mechanism to specific projects. The Ministry is also currently using them for drawing of resources to finance elimination of the damage caused by the floods in 2009 and 2010.

An interest advantage corresponding to the currently offered rates of the European Investment Bank is being applied to each sale for a market price, as a result of which in 2011 savings of approximately CZK **327 million** were achieved from the sale of bonds in the total nominal amount of CZK **8.4 billion**. Each sale has been and will continue to be published within five business days on the Ministry's website following settlement.

Figure 19: Yield of bonds sold into the portfolio of the European Investment Bank in 2011



Source: MoF

In 2012, the Ministry plans, corresponding to the realized state budget expenditures for particular programmes, to sell government bonds to the European Investment Bank in a nominal value of up to CZK 6 billion. This volume is included in the item entitled gross issuance of government bonds. The Ministry is not currently negotiating with the European Investment Bank about entering into additional funding agreements or agreements regarding buying up of bonds.

In 2012 due to the refinancing risk, the Ministry will maintain short-term state debt below the limit of 25%.

Since it is advantageous to use the relatively low yields at the short end of the yield curve, in 2012 net growth of the volume of money market instruments outstanding to approximately **CZK 50 billion** is planned, where there is still no risk of exceeding the safety limit of 25% of short-term debt within the debt portfolio, meaning an undesired increase in refinancing risk, and the option of relatively advantageous financing of the state debt will be utilized to the maximum possible extent.

The indicative plan of the auctions has been set with consideration for the planned net increase in money market instruments in the amount of CZK 50 billion in 2012, and there has been an effort to increase the volume of individual issuances continuously while reducing their number in order to ensure that there is room for the inclusion of additional auctions in the issuance plan in the event of increased requirements for financing via money market instruments.

Table 13: Indicative plan for T-bills auctions in 2012

2012	Auction date (dd.mm.yyyy)	Issue date (dd.mm.yyyy)	2012	Auction date (dd.mm.yyyy)	Issue date (dd.mm.yyyy)
I. Quarter	05.01.2012	06.01.2012	**III. Quarter**	12.07.2012	13.07.2012
	12.01.2012	13.01.2012		19.07.2012	20.07.2012
	02.02.2012	03.02.2012		26.07.2012	27.07.2012
	09.02.2012	10.02.2012		16.08.2012	17.08.2012
	01.03.2012	02.03.2012		23.08.2012	24.08.2012
	15.03.2012	16.03.2012		30.08.2012	31.08.2012
	22.03.2012	23.03.2012		06.09.2012	07.09.2012
II. Quarter	05.04.2012	06.04.2012		13.09.2012	14.09.2012
	12.04.2012	13.04.2012	**IV. Quarter**	11.10.2012	12.10.2012
	19.04.2012	20.04.2012		18.10.2012	19.10.2012
	03.05.2012	04.05.2012		25.10.2012	26.10.2012
	10.05.2012	11.05.2012		01.11.2012	02.11.2012
	24.05.2012	25.05.2012		15.11.2012	16.11.2012
	31.05.2012	01.06.2012		29.11.2012	30.11.2012
	07.06.2012	08.06.2012		06.12.2012	07.12.2012
	28.06.2012	29.06.2012		13.12.2012	14.12.2012

Source: MoF

T-bills will also be issued in 2012 in standardized tenors of 3, 6, 9 and 12 months. In the event of unfavorable market developments, the Ministry can even implement 1 month tenor.

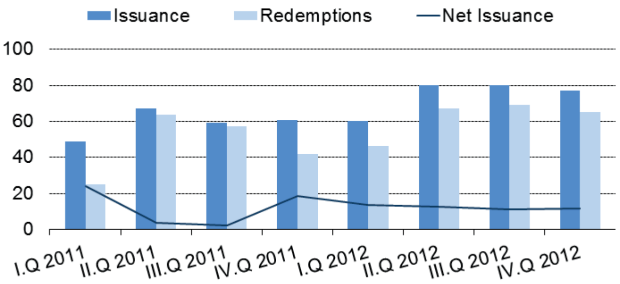
Table 14: Planned volumes of issuance of T-bills in 2012 (CZK billion)

Issue	3-month	6-month	9-month	12-month	Total
Issues maturing in 2011	35	34	17	-	**86**
Issues maturing in 2012	18	19	77	97	**211**
Gross Issues	53	53	94	97	**297**
Redemptions on 2011 Issues	-	22	39	100	**161**
Net issues	18	-3	38	-3	**50**

Source: MoF

The planned volume of net issuance of T-bills should be evenly distributed into individual quarters during 2012.

Figure 20: Overview of issuance and redemptions on T--bills in individual quarters of 2011 and plan for 2012 (CZK billion)



Source: MoF

The planned volume of gross issuance of savings government bonds for the entire year 2012 has been set at a maximum of CZK 40 billion.

In 2012, the Ministry plans to proceed based on the very successful issuance of savings government bonds intended for individuals and non-profit organizations from November 2011. Due to the very strong demand, as a result of which the subscription of the bonds had to be ended prematurely, the Ministry plans for 2012 to include immediately two series of issuance of savings government bonds, one for the spring and one for the autumn of 2012. The planned volume of each series is CZK 10 billion to 20 billion, and in total for the entire year 2012, the planned sale of savings government bonds amounts to CZK 20 billion to 40 billion.

Table 15: Financial programme for 2012 (CZK billion)

Gross borrowing requirement of the central government	**243.4**
Direct loans from international financial institutions	**5.9**
Loans from the European Investment Bank	5.9
Miscellaneous	0.0
Issuance of mid-term and long-term government bonds	**177.5 to 197.5**
Issuance of mid-term and long-term government bonds on the domestic market	64.5 to 177.5
Issuance of mid-term and long-term government bonds on the foreign market	0.0 to 73.0
Issuance of savings government bonds	20.0 to 40.0
Net change of money market instruments in circulation	**40.0 to 60.0**

Source: MoF

4 - Risk management and portfolio strategy

Public defining of the strategic benchmark debt portfolio via declaration of strategic objectives is the main tool for increasing the transparency of the Ministry‛s debt policy in line with the best international practice. The objectives have been set up based on the requirements stemming from the cautious approach to the management of financial and credit risks while minimizing economic costs over the long term. The main risks to which the debt portfolio is subjected over the long term are refinancing, interest and currency risks. All of the objectives and limits defined below are being applied to the portfolio of the state debt as a whole, including derivative operations. Since the start of 2011, the Ministry has been monitoring and from the point of view of market risks also managing the portfolio of related state financial assets, which are included in the composition of the net debt portfolio.

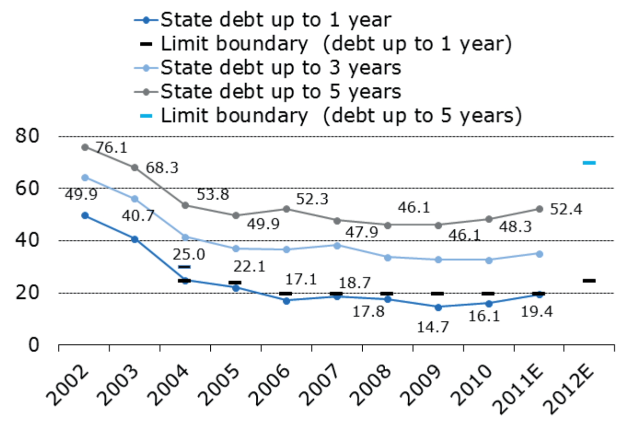
Refinancing risk

The stabilization of the refinancing risk forms the central point of the Ministry‛s concept for issuance planning. The key indicator on which the Ministry has been focusing since 2004 is the **share of short-term state debt** (i.e. the share of debt payable within one year out of the total debt). In relation to this indicator, the Ministry introduced limits, which have not been exceeded in any year of their existence. Since 2006, the Ministry has applied a long-term targeted limit of 20%. Beginning as of 2012, the Ministry will also begin actively managing mid-term state debt. The key indicator, which the Ministry is introducing in relation to this, is the **share of mid-term state debt** (i.e. the share of debt repayable within five years out of the total debt), for which the Ministry has set up a limit. The system of these two fundamental limits enables the distribution of refinancing risk between short-term and mid-term state debt. Beginning as of 2012, the Ministry will include in the process of setting limits for the debt portfolio also the portfolio of state financial assets. The Ministry is setting up these limits in line with international practice and respects the estimated absorption capacity of the domestic money market.

For the year 2012, the Ministry is increasing the limit for the **share of short-term state debt payable within one year to 25% of the total state debt**. Several factors are the reason for this limit increase. The first factor is related to the active management of the net debt portfolio, which the Ministry has been applying since the start of 2011. The Ministry generates financing reserves, which serve for the elimination of short-term refinancing risk and which are part of the state financial assets. The estimated share of state financial assets available within one year in 2011 was 7.1% of the total state debt. Compared to 2010, the share of state financial assets available within 1 year out of the total state debt has decreased by approximately 0.4 percentage points. The current uncertain situation in the Eurozone and the lack of interest among investors in investing in long-term bonds is another factor, which is leading to the increase of the limit for short-term state debt. The increase in the limit has also been brought about by the very successful issuance of state savings bonds for citizens, mainly the discounted bond. The Ministry expects interest in these types bonds in the future as well, but it does not want due to interest in state savings bonds to reduce the volume of issued state treasury bills or restrict their auctions. By the end of 2011, the value of this indicator is expected to reach 19.4%, and therefore it will remain below the limit valid for this year. The growth in the share of short-term state debt compared to 2010 can be attributed mainly to the clean issuance of state treasury bills in a value of approximately CZK 48.7 billion in 2011 and the successful issuance of the discounted state savings bond in the volume of CZK 9.5 billion. Over the longer term, the Ministry plans to increase the share of short-term state debt gradually up to the limit of 23%. The clean increase of money market instruments in circulation, which in 2012 is planned by up to CZK 50 billion, is also related to this increase in the share of short-term state debt.

In connection with the increase of the limit for the share of short-term state debt, the Ministry is beginning to manage mid-term state debt actively. The key indicator of this refinancing risk, the **share of mid-term state debt payable within five years**, has been set by the Ministry for 2012, like for the mid-term horizon, at the level of **70 %** of total state debt. This limit will enable partial elimination of the increase in refinancing risk caused by an increase in the limit related to the share of short-term debt. The value of the share of mid-term state debt out of the total state debt is expected to be 52.4% by the end of 2011.

Figure 21: State debt based on maturity from 2002 to 2012 (% of state debt)



Source: MoF

Table 16: Share of assets available within one year out of the total state debt 2004 to 2011

Year	2004	2005	2006	2007	2008	2009	2010	2011E
Share of assets up to one year of total debt (%)	3.9	4.8	2.0	3.3	10.9	7.9	7.5	7.1

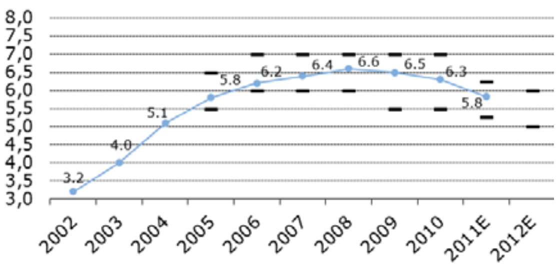
Source: MoF

Another indicator used during the management of refinancing risk is the **average period until the maturity of state debt**. The goal for this indicator was first explicitly declared for 2005. The reported goals were fulfilled in each completed year. The span of the goal range was 1 year during the years 2005-2008, and in 2005 it amounted to 5.5 to 6.5 years and for 2006-2008 it was increased by half a year to 6.0 to 7.0 years. For 2009 and 2010, the Ministry adjusted the goal range by half a year, adjusting it down to 5.5 to 7.0 years. For 2011, the Ministry narrowed the goal range and again moved it down to 5.25 to 6.25 years.

For 2012, the Ministry is adjusting the goal range for the average maturity of state debt down by a quarter of a year to **5.0 to 6.0 years**. The downward adjustment of the goal range was again the result of the increased uncertainty related to the future development of the Eurozone and related uncertainty on capital markets, which is forcing investors to buy only short-term financial instruments. The average period until maturity is expected to reach 5.8 years by the end of 2011 and therefore is within the goal range valid for this year. The decline in the value of this indicator can be attributed, like in the case of the share of short-term state debt, to positive clean issuance of state treasury bills in 2011 and the successful issuance of discounted state savings bonds. Maintaining the average period until maturity in the goal range determines the time and volume structure of issuance of state bonds on the domestic and foreign market and the setting of repayment calendars for loans drawn from the European Investment Bank.

The expected average periods until the maturity of individual parts of state debt besides money market instruments by the end of 2011 are above the average period until the maturity of the total debt portfolio and document the effect of money market instruments on this indicator. Specifically by the end of 2011, the average period until the maturity of domestic state bonds, including savings bonds, is expected to reach 6.2 years, the average period until the maturity of foreign state bonds, including securing, is also expected to reach 6.2 years, and the average period until the maturity of non-marketable state debt is 11.9 years.

Figure 22: Average time to maturity of state debt and reported goals from 2002-2012 (years)



Source: MoF

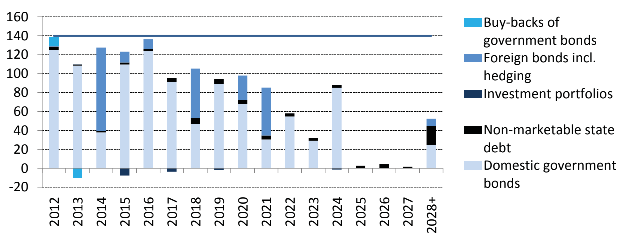
Table 17: Average time to maturity of individual parts of state debt from 2002 to 2011 (years)

Year	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011E
Domestic government bonds incl. savings bonds	5.2	5.7	6	5.7	6.3	6.6	6.5	6.6	6.3	6.2
Non-marketable debt	10.5	8.6	10.3	10.3	9.7	9.3	12	12.2	12.5	11.9
Foreign bonds incl. hedging	-	-	9.5	10.6	10.7	9.6	9.2	7.3	7.1	6.2
Money market instruments	0.3	0.3	0.3	0.4	0.4	0.2	0.3	0.4	0.4	0.4

Source: MoF

The new issuance of state bonds, like drawing from long-term lines of credit from the European Investment Bank, will continue to be managed in line with the fulfillment of the key goal in the form of **stabilization and depletion of the redemption profile of state debt in time**. In the mid-term outlook, yearly repayments of state debt after taking into consideration buying back range at around CZK 140 billion.

Figure 23: Expected redemption profile of state debt and financial assets by the end of 2011 (CZK billion)



Note: Without inclusion of money market instruments in circulation on the side of liabilities and assets. On the positive vertical axis, liabilities are shown, and on the negative vertical axis, state financial assets and buy-backs planned for 2012 are shown.
Source: MoF

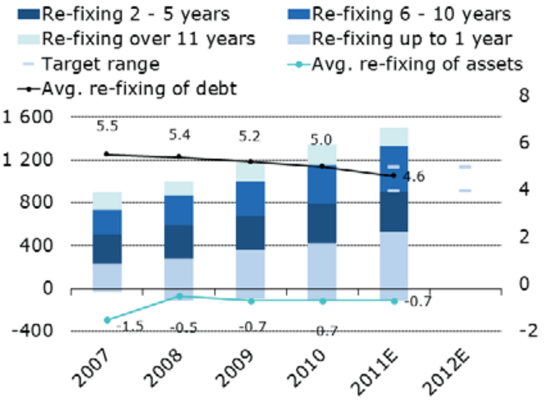
Interest rate risk

Interest risk remains the most important market risk affecting the management of state debt. At the beginning of 2011, the Ministry announced a new strategic goal related to the management of market risk, the **average period until re-fixing of state debt**. For 2011 and also for the longer term, the Ministry set the explicit goal for this indicator at a value in an interval of 4 to 5 years. The goal was set in line with international practice, with the optimization of costs of state debt and risks stemming from the re-fixing of rates taken into consideration.

The average period until re-fixing of state debt in an interval of **4 to 5 years** remains preserved in line with the longer-term strategy also for 2012. The primary tool for fulfilling this goal also in 2012 will be issuing activity and drawing of lines of credit from the European Investment Bank. However, the Ministry is monitoring the situation in both the Eurozone and the Czech Republic with concern, and as a result of the uncertainty there has been a noticeable shift of investors to the shorter end of the yield curve. Nonetheless, the Ministry is confident that it will manage to achieve the set goal. Should the average period until the re-fixing of state debt deviate beyond the target interval, the Ministry is prepared to actively ensure the fulfillment of this goal also with the help of derivative operations. The expected value of the average period until the re-fixing of state debt ranged by the end of 2011 at around 4.6 years and therefore is within the target interval. Compared to previous years, there has been a decline in the average period until the re-fixing of state debt, as a result of which costs for the management of state get have on average been generated for a shorter end of the yield curve. Therefore, the Ministry expects relative savings of interest costs over the long term.

An evaluation of the success while achieving these savings will be conducted in 2012 in relation to the benchmark portfolio, which will be replicated synthetically based on fixed interest-bearing bonds with the target average period until maturity.

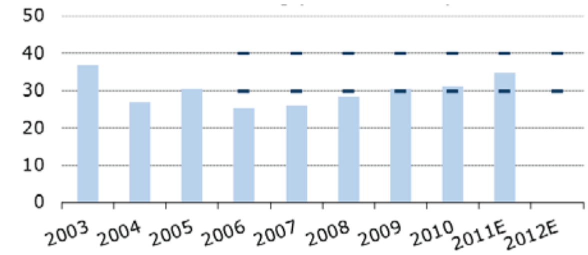
Figure 24: Re-fixing of state debt and state financial assets from 2007-2012 (CZK billion)



Note: The positive vertical axis shows the debt portfolio, the negative vertical axis shows state financial assets. The unit of the main vertical axis is billions of CZK and the unit of the next vertical axis is years.
Source: MoF

Each year since 2006, the Ministry has also been setting the strategic goal for **interest re-fixing of the debt portfolio within 1 year**, meaning the share of the debt which is sensitive to the fluctuation of interest rates on the financial market in the following year. For 2011, the Ministry is leaving the goal range at the level of **30 to 40% of the total state debt** with an outlook in the upper half of that interval. This goal is in line with the introduction of the goal of average re-fixing in the range of 4 to 5 years and will lead to equal consequences for the portfolio of the state debt. The goal range was first achieved in 2009. The average value of the interest re-fixing of the debt portfolio within 1 year by the end of 2011 is 34.8% of the total state debt and therefore ranges in the middle of the goal range.

Figure 25: Interest re-fixing of state debt within 1 year from 2003-2012 (% of state debt)



Source: MoF

Within the net debt portfolio, the Ministry is also monitoring the development of the basic risk parameters of state investment assets. The value of the indicators is caused mainly by the volume of resources management on the pension account which are invested, due to the difficulty in predicting future costs, mainly into instruments with maturity within 1 year.

Table 18: Risk figures and yield of state investment assets incl. on-lending 2007-2011

Year	2007	2008	2009	2010	2011E
Average yield (%)	3.8	2.9	2.1	1.9	2.1
Average time to maturity (years)	5.1	2.0	1.9	2.0	2.3
Modified duration (years)	4.2	1.8	1.7	1.8	2.1

Source: MoF

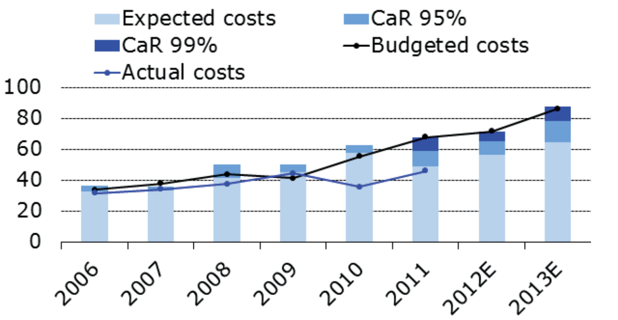
Cost-at-Risk

Since 2005, the Ministry has applied when measuring and managing interest risk a more sophisticated model framework known as **Cost-at-risk (CaR)**, which is based on VaR methodology and simulates future expected and maximum interest rates during a particular degree of risk, which is derived from the volatility of the time structure of interest rates. The stochastic element of the CaR model is the yield curve, and the determining factor is the dynamic structure of the portfolio of state debt, which is based on the planned method of financing the government's gross borrowing need while respecting the set strategic goals for management of financial risks.

The primary model entails setting the maximum costs of state debt, which with 95% or 99% probability will not be exceeded (**CaR 95% and CaR 99%**). The secondary goal of the model involves estimation of the actual interest costs of state debt. The simulation framework works with the **net interest costs of state debt**, which in comparison with net expenditures for management of state debt does not include fees related to debt management, which are determining in nature.

The following graph shows a comparison of net interest CaR and expected and budgeted net interest costs with net interest costs actually incurred. From 2006 to 2011, the model fulfilled the primary goal, since the predicted maximum costs were not exceeded in any of those years. From 2006 to 2009, the model also fulfilled a secondary goal, which was that with relatively exact accuracy it predicted the actual interest costs, which except in 2009 were lower than budgeted costs.

Figure 26: Net interest costs and CaR during 2006-2013 (CZK billion)



Note: In 2009 originally budgeted costs and in 2011 an estimate of actual costs by the end of the year.
Source: MoF

For 2011, the Ministry replaced the model used for the simulation of yield curves with a model that was much more sophisticated and more suitable for the completely new market reality. Thus compared to 2010, in 2011 a more exact estimate of expected costs was achieved.

Table 19: Net interest costs and CaR during 2006-2013 (CZK billion)

Year	2006	2007	2008	2009	2010	2011*	2012E	2013E
Budgeted costs	33.9	37.8	43.7	41.2	56.1	66.7	72.1	86.8
Actual costs	31.5	34.0	37.6	44.2	35.6	45.9	-	-
Expected costs	32.4	33.3	41.7	44.9	57.5	49.1	56.4	64.4
CaR 95%	36.6	35.8	50.2	49.9	62.9	59.2	65.1	78.2
CaR 99%	-	-	-	-	-	67.8	71.5	87.0

Note: In 2011 the values are an estimate of actual interest costs by the end of the year. CaR 99% was first applied in 2011.
Source: MoF

In 2011, the actual net interest costs of state debt are expected to reach approximately CZK 45.9 billion. The expected net interest costs in 2011 predicted by the model are at the level of 49.1. The actual net interest costs therefore remain also in 2011 at below the level of both CaR 95% and CaR 99%, which were set at CZK 59.2 billion and CZK 67.8 billion respectively. Therefore, the primary goal of the model was fulfilled. The model estimated the actual costs as approximately CZK 3 billion higher. The reason for this difference was the decline in the overall yield curve, which we witnessed mainly during the second and third quarters of 2011. During this period, the Ministry received higher than expected auction bonuses for reopened issued bonds. However, the values of all market rates and the actual costs remained in the predicted interval during all of 2011.

For 2012, the Ministry is introducing for the first time in history a **two-year simulation horizon**, which is major progress in the management of interest risk also due to the correspondence to the prediction of interest revenues and expenditures of the state debt chapter as part of the state budget. A simulation of the net interest costs of the state debt was carried out with the use of an identical interest model, which proved effective during the estimation of the costs of the state debt in 2011 and which the Ministry evaluated as the best quality tool of the tested interest models. The interest model used for the construction of the CaR indicator for 2012 is based on the modeling of the aggregate yield curve. Another important characteristic of the model is its non-underestimation of the volatility of the long end of the curve. The model was first defined and applied in Yacine-Ait Sahalia: Testing Continuous Time Models of the Spot Interest Rate, The Review of Financial Studies, 9, 2, 385-426,1996. The model is characterized by "mean reversion" properties, meaning convergence of the expected rates towards their equilibrium value and has been modified by the Ministry in order to satisfy the specifics of the Czech market. The parameters of the model have been estimated from historic daily observations of the Czech yield curve beginning as of 25 August 2000. For each of the required maturity dates, 10,000 daily simulations of interest rates are carried out for the time span of 15 November 2011 to 31 December 2013.

As of 2012, the Ministry is fully switching when setting maximum costs of state debt from the indicator CaR 95% to the indicator **CaR 99%**, which was first used during the estimation of the costs of state debt in 2011. The reason for this change is not only the current developments in the Eurozone and the resulting increased uncertainty on the financial markets, but also the need for harmonization with the risk management practices used in developed financial institutions. The indicator CaR 95% will be further perfected, but it will no longer be used for managing the interest risks related to state debt.

In 2012, the expected net interest costs of state debt as generated by the model is **CZK 56.4 billion**. CaR 99% amounts to **CZK 71.5 billion** (CaR 95% CZK 64.9 billion). Therefore, the actual net interest costs in 2012 with 99% probability will not be more than CZK 15.1 billion higher compared to expected costs (with 95% probability CZK 8.5 billion higher). The budgeted net interest costs for state debt for 2012 amount to **CZK 72.1 billion** and therefore correspond to the level of the indicator CaR 99%. The following table illustrates in detail the development of the cumulative expected net interest costs of the state debt in 2012 always by the end of each month. It also shows the critical values of CaR 95% and CaR 99%.

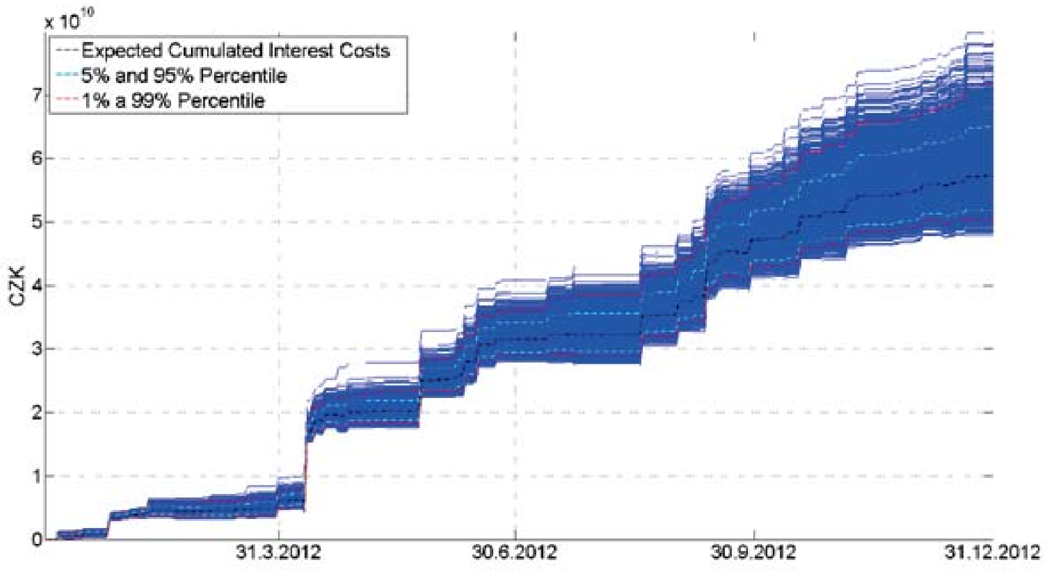
Table 20: Development of cumulative net interest costs in 2012 (CZK billion)

Month of the year 2012	1.	2.	3.	4.	5.	6.	7.	8.	9.	10.	11.	12.
Expected value	3.6	4.2	5.9	19.8	24.8	31.1	31.7	40.0	46.6	50.8	54.0	56.4
CaR 95%	4.0	5.1	7.1	21.7	26.9	34.1	35.6	41.0	51.7	57.3	61.3	64.9
CaR 99%	4.2	5.6	7.7	22.9	28.2	36.1	38.4	44.0	55.5	62.0	66.5	71.5

Source: MoF

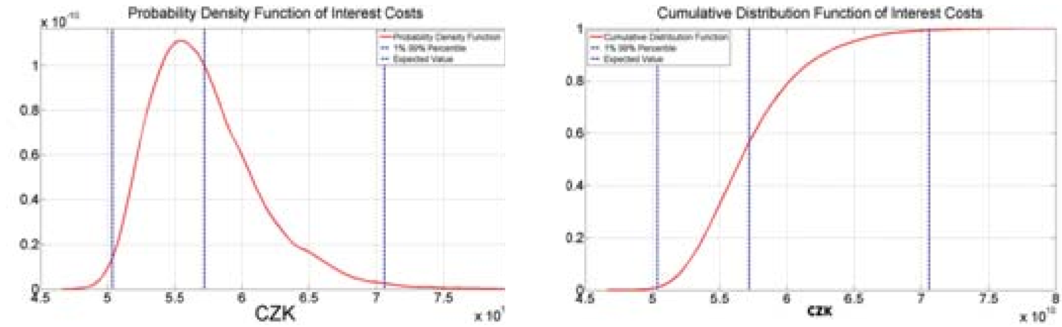
A graphic presentation of the simulations of the cumulative net interest costs of state debt in 2012 calculated on a daily basis is shown in the following image. The image also shows the expected values of costs and the corresponding 5% and 95% and 1% and 99% of the quantiles of simulated values. The probability distribution of the interest costs of the state debt by the end of 2012 described with probability density function and the cumulative distribution function of costs, like with the simulation of 3-month PRIBOR rates and the 10-year swap rates for 2012 and 2013, is shown by following images.

Figure 27: Simulation of net interest costs of state debt during 2012



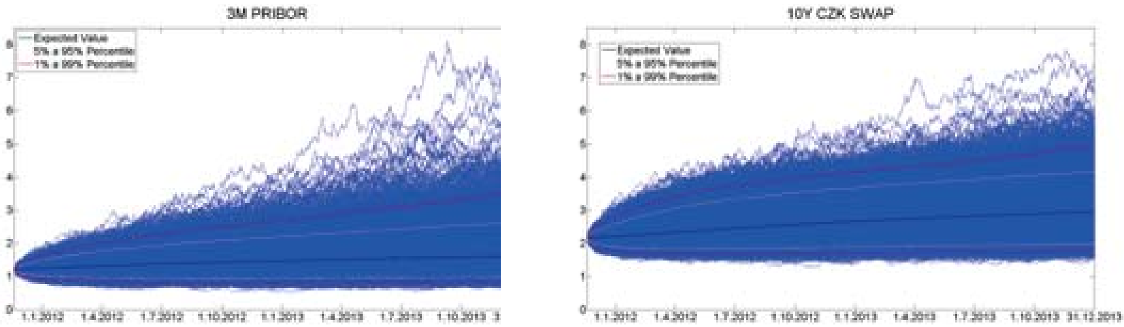
Source: MoF

Figure 28: Probability distribution of net interest costs by the end of 2012



Source: MoF

Figure 29: Daily simulation of CZK interest rates in 2012 and 2013

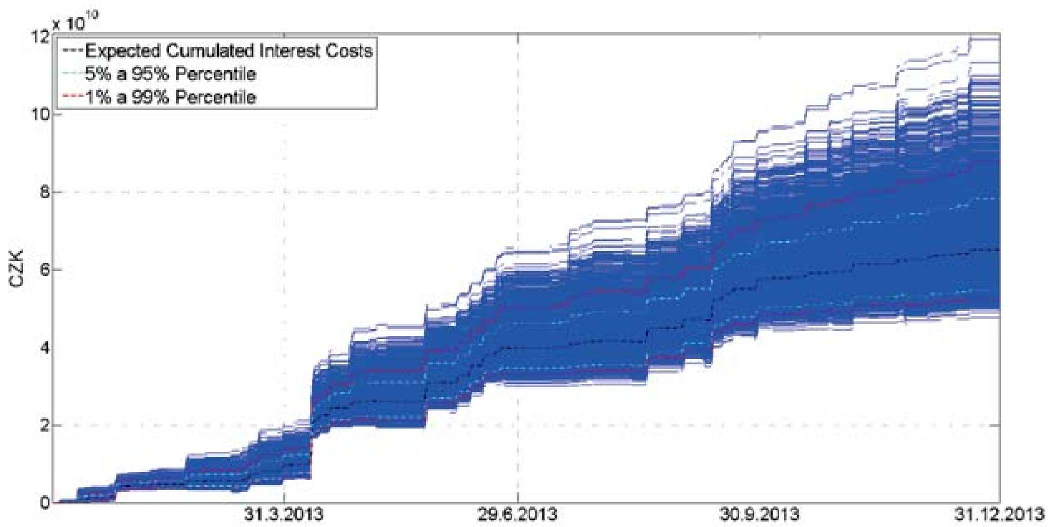


Source: MoF

Within a two-year simulation horizon, the Ministry is also constructing CaR indicators for 2013. In 2013, CaR 99% amounts to **CZK 87.0 billion**. CaR 95% for 2013 is at the level of CZK 78.2 billion. The actually achieved net interest costs in 2013 thus should not exceed this limit with 99% probability. The budgeted net interest costs for 2013 equal **CZK 86.8 billion** and range by CZK 0.2 billion below the indicator CaR 99%. The expected net interest costs of the state debt in 2013 have been predicted by the model as CZK 64.4 billion. The difference between CaR 99% and the expected costs is greater in 2013 than the same difference in 2012. The reason is more uncertainty about longer-term predictions, which is increasing the volatility of rates.

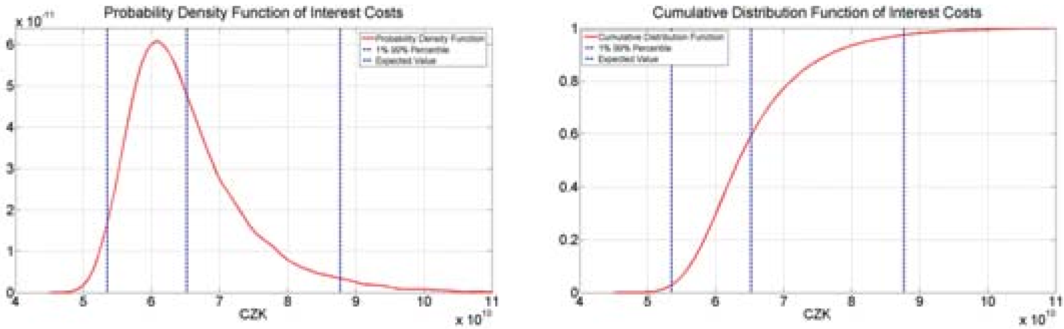
The following images show a simulation of the cumulative net interest costs of the state debt in 2013 calculated on a daily basis together with the corresponding 5% and 95% and 1% and 99% of the quantiles and the expected value and the probability distribution of net interest costs of the state debt by the end of 2013.

Figure 30: Simulation of net interest costs of state debt during 2013



Source: MoF

Figure 31: Probability distribution of net interest costs by the end of 2013



Source: MoF

Currency risk

Currency risk is another market risk to which the portfolio of state debt is subjected. Since the beginning of 2011, the Ministry has been actively managing this risk. The key indicator introduced in relation to this is the **share of foreign currency debt** in the total state debt, for which a strategic limit was set for 2011 equal to 15% + 2 percentage points.

For 2012, the Ministry will leave this limit unchanged at the level of **15% + 2 percentage points**, and therefore it will remain in line with the longer-term strategy. It is also true that long-term exceeding of 15% is not possible, but the share of foreign currency debt in the total state debt can reach 17% in the short term. However, this limit serves only for short-term overcoming of temporary depreciation of the domestic currency. The expected share of foreign currency debt in the total state debt by the end of 2011 is 8.9% and is therefore below the limit. The decline of the indicator compared to the end of 2010 is caused by the non-occurrence of any foreign issuance of state bonds in 2011 with the exception of selling off of a variably interest-bearing bond denominated in Euros from the Ministry's own portfolio in the amount of EUR 37.5 million.

Table 21: Currency exposure of state debt in € in relation to currency exposure 2005-2011

Year	2005	2006	2007	2008	2009	2010	2011E
Foreign-currency state debt (%)	0.1	0.7	0.6	4.6	8.6	10.4	8.9
Share € of foreign-currency debt (%)	79.5	5.9	6.2	5.7	84.3	87.9	86.7

Source: MoF

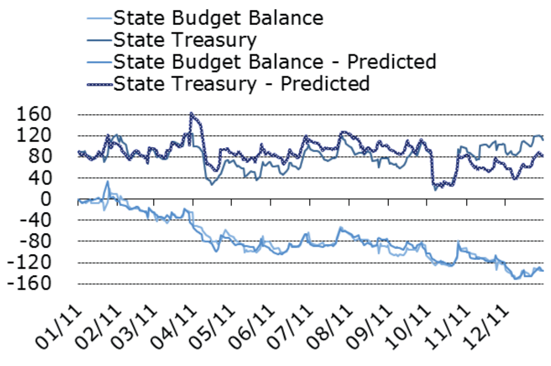
The Ministry has further observed the share of currency exposure of state debt denominated in euros in relation to overall currency exposure. In 2009, the euro became the dominant currency in the total currency exposure. This trend has also been apparent in 2011, when the expected share of currency exposure denominated in euros in relation to overall currency exposure reached 86.7% by the end of the year. Over the long term, the Ministry does not anticipate a dramatic change in the grouping of the proportions of currencies in the currency exposure of the state debt.

Risk of liquidity of the State Treasury

The development of the balance of the state treasury is influenced by all of its components, but the greatest amount of uncertainty is related to the development of the state budget deficit and the success of bond issuing activity for covering the state budget deficit and state debt repayments. A prerequisite for the effective management of the liquidity of the state treasury and the basic tool for managing the risk of blocking the smooth implementation of the government's budget policy consists of the predictions of all parts of the state treasury, including the state budget deficit and debt reserves.

A comparison of the prediction regarding the development of the deficit of the state treasury and the state budget deficit from November of last year with the situation including the predictions until the end of this year is shown in the following figure. The difference between the prediction and the situation related to the development of the deficit of the state treasury at the beginning of April. Another difference between the prediction and the situation at the beginning of November was caused by an increase in the financial reserve during the year compared to the originally planned decrease for the purpose of stabilization and boosting of the liquidity position of the state during a period of increased uncertainty on the financial markets during the second half of the year.

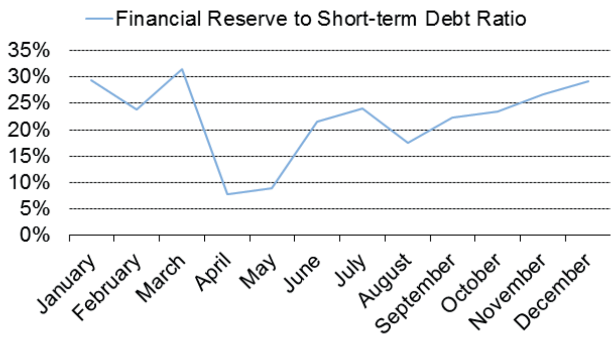
Figure 32: Development of State Budget Deficit and the State Treasury Balance in 2011 (CZK billion)



Source: MoF

The development of the debt reserves in individual months of this year and their ratio to the short-term debt due within 1 year is illustrated by the following figure. The financial reserve ranges from 10 to 30% of the short-term debt, and the largest fluctuation in April was caused mainly by the payment for a benchmark domestic bond and deferring of the originally planned foreign issuance. By the end of the year, the accumulation of debt reserves will occur, which will be used to finance the state debt during the first months of 2012.

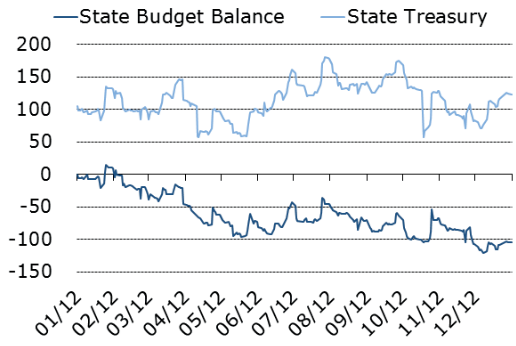
Figure 33: Development of financial reserve in proportion to short-term debt in 2011 (CZK billion)



Source: MoF

Based on currently available data, a prediction was generated regarding the development of the state treasury balance and the budget deficit for 2012.

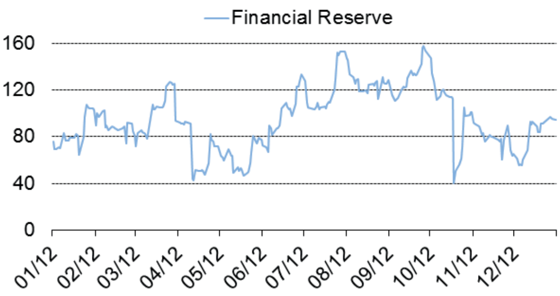
Figure 34: Daily predictions of the State Budget Deficit and the State Treasury Balance for 2012 (CZK billion)



Source: MoF

The volume of financial resources for the daily financing of the state budget deficit is illustrated by the prediction of the development of the financial reserve for 2012.

Figure 35: Daily prediction of the development of financial reserve for 2012 (CZK billion)



Source: MoF

5 - Primary and secondary market of government bonds

Primary market and system of Primary Dealers

On 1 October 2011, the Primary Dealer Agreement for Czech Government Securities (hereinafter the "Agreement") became valid. The agreement changes the status of the direct participants in auctions of government bonds to Primary Dealers, whose rights and obligations are further specified. In line with the best international practice, the implementation of a standardized institutional and organizational framework for the Ministry's cooperation with financial institutions on funding of the state and state debt management occurred. Only a Primary Dealer who has entered into this Agreement with the Ministry will have the right as of 1 January 2012 to participate in auctions in accordance with the Rules for the Primary Sale of Medium-term and Long-term Government bonds organized by the Czech National Bank.

The Primary Dealer's obligation is to purchase during one year at least 3% of the total nominal value of government bonds sold in auctions of medium-term and long-term government bonds (including non-competitive parts of auctions). Another important obligation is that the participant must also act as an market-maker on a secondary market through the Designated Electronic Trading System (DETS) with the aim of achieving as highly liquid secondary market for government bonds as possible.

The Primary Dealer is granted an exclusive access to primary auctions of government bonds and the Ministry's operations on the secondary market, such as buy-backs, switches, direct secondary sales, lending facilities and/or repo operations. Primary Dealers are also preferred by the Ministry as counter-parties as to foreign issues, private placements and other financial operations. Primary Dealers also have an exclusive right to participate in regular meetings with officials from the Ministry, at least once per quarter, and to participate in the preparation of issuance calendars for government bonds and propose alternative instruments for financing the state's borrowing requirement.

In relation to the implementation of the MTS Czech Republic trading platform and the conclusion of the specified Agreement, a new method of evaluating the performance of Primary Dealers was created and replaced the previous evaluations of direct participants on the primary and secondary markets of government bonds, which the Ministry announced on 1 December 2005 as part of the Strategy for 2006 and which it further formalized through the document Conduct of Cooperation and Performance Evaluation of the Activities of Primary Dealers in the Czech Government Bonds. Due to the non-existence of an electronic platform for the secondary market, the evaluation in group B. depended on regular reporting by Primary Dealers about their activities on the secondary market. Until this year, the Ministry did not have any tools at its disposal which would enable it to reliably verify the sending of information and, for example, the compliance with the obligations of the creator of the market, enshrined in Section 6, paragraph (3) d) of the rules for the primary sale of medium-term and long-term government bonds, could not be monitored in practice or evaluated at all.

The new evaluation method is based on three categories for the purpose of achieving an overall and objective evaluation. The application of scales for groups A and B takes into consideration the strengthening of the importance of the secondary market, which enables the evaluation of active market-makers in relation to their performance in primary auctions of government bonds. The maximum evaluation of each Primary Dealer can reach 100 points, and this score is calculated on a relative basis. The activities of Primary Dealers is therefore evaluated quarterly for last four consecutive quarters. Current evaluation is published on the last working day in a month following the end of corresponding quarter.

Table 22: Criteria for evaluation of Primary Dealers valid by 1st October 2011

A. Primary Market Participation	45 pts	B. Secondary Market	40 pts	C. Quantitative Criteria	15 pts
A.1. Primary Auctions Share	25 pts	B.1. Market-making Obligations on DETS	10 pts	C.1. Derivatives Pricing and Credibility	5 pts
A.2. Dependability	5 pts	B.2. Qualitative Performance on DETS	10 pts	C.2. Marketing & Sovereign Advisory	10 pts
A.3. Auction Pricing Strategy	5 pts	B.3. Traded Volume on DETS	10 pts		
A.4. Auction Participation	2.5 pts	B.4. Treasury Operations	10 pts		
A.5. Primary Auctions Share - T-Bills	7.5 pts				

Source: MoF

As part of the evaluation of the activities on the primary market, the share of the particular Primary Dealer on the primary market of government bonds, meaning the share of accepted bids in auctions of government bonds for the evaluated period, is monitored. Using the ratio of the accepted bids to total bids, the Ministry monitors the willingness of investors to hold Czech government bonds. The important aspects of the evaluation of participation on the primary market include the auction price strategy, where the Ministry evaluates the willingness of Primary Dealers to pay the highest volume-weighted price in an auction of government bonds. In another sub-category, the Primary Dealer is evaluated with more points if that dealer is a regular participant in auctions, regardless of the evaluation period. The maximum number of points in sub-category A.5 is received by the Primary Dealer who subscribes the largest share of T-bills sold by the Ministry during the particular period.

The quantitative criteria of group B, which is based particularly on available statistics and monitored tools of the MTS Czech Republic platform, which was selected as the DETS, is focused on quotation activity, its quality, traded volumes and transactions with the Ministry. The evaluation of the fulfillment of the market creator‛s obligations is also a subject of the secondary market sub-chapter. The quality of quotation activity is understood as an evaluation of the average quoted spread weighed by time and volume, and the time to maturity of the particular bond is also taken into consideration. Similarly also in relation to other criteria, the traded volumes are weighted based on the time to maturity of the bond. For criteria B.4, the Primary Dealer is evaluated based on the ratio of the volume of conducted transactions (type of repo operation, buy/sell operation, depo, direct sale of government bonds on the secondary market or buy-backs) to the overall volume of conducted transactions for the evaluated period.

The qualitative criteria are focused on derivative operations, marketing and consulting. The Primary Dealers are evaluated gradually depending on their provided prices of various derivative instruments. The Ministry of Finance further evaluates the quality of consulting activities, cooperation and sharing of information, human and technical resources related to risk management and optimization of the debt portfolio.

Table 23: Primary Dealers for Czech government bonds

Direct Participants of Czech government bonds Auctions on 31st December 2010	Primary Dealers for Czech government bonds as of 1st October 2011
Barclays Bank PLC	Barclays Bank PLC
Citibank Europe plc	Citibank Europe plc
Česká spořitelna, a.s. / ERSTE Bank	Česká spořitelna, a.s. / ERSTE Bank
ČSOB	ČSOB
Deutsche Bank AG	Deutsche Bank AG
HSBC Bank plc	Goldman Sachs International
ING Bank N. V.	HSBC Bank plc
Komerční banka, a.s.	ING Bank N. V.
PPF banka, a.s.	J. P. Morgan Securities Ltd.
The Royal Bank of Scotland N. V.	Komerční banka, a.s.
UniCredit Bank Czech Republic, a.s.	PPF banka, a.s.
	The Royal Bank of Scotland N. V.
	UniCredit Bank Czech Republic, a.s.

Source: MoF

The essential modification of the rules for the primary sale of medium-term and long-term government bonds and T-bills organized by the Czech National Bank, which can be summarized as follows, corresponds to the formalization of the system of Primary Dealers.

(1) Option of including up to two bonds in one competitive part of the auction

(2) Conditions for access to the competitive part of the government bond auction

a. Change in maximum limit for a Primary Dealer to submit bids not exceeding 50 % of the auctioned amount. This limit will be applied only in auctions of first three tranches of particular bond.

b. Auctioned amount can possibly be set in a range, rather than specific number

(3) Conditions for access to the non-competitive part of the government bonds auction

a. Criteria based on previous participation in the competitive parts of the auction

b. Criteria based on the secondary market performance, i.e. performance on DETS

c. Lengthening of the non-competitive part of the auction to 12 a.m. CET on the day following the competitive part of the auction.

Rules for the Primary Sale of Medium-Term and *Long-Term Government Bonds and Rules for the Primary Sale of Treasury Bills* will be unified in one document **Rules for Primary Sale of Government Bonds organized by the Czech National Bank** (hereinafter the „Rules"). Terms used in the Rules and in the Agreement will be unified, too. Both the Rules and the Agreement will use a common term „Primary Dealer".

Secondary market and MTS

An effective and transparent domestic market for government bonds is a necessary condition for the realization of the issuing activity of the state and for ensuring smooth and cost effective financing over the long term. Since at least 80% of the state debt is usually financed on the domestic market, the transparent price discovery on the secondary market of CZK denominated government bonds is also an important factor, which affects the amount of interest costs for debt servicing.

In accordance with the strategic goal for 2011, as of 1st July 2011 the market rules of the national electronic platform **MTS Czech Republic** for the secondary market of CZK denominated government bonds became valid. The fulfillment of that objective also made it possible to expand the range of Primary Dealers to include new foreign market-makers. The pilot operation of this platform was launched on 11th July 2011 for the period lasting until 30th September 2011, and as of the fourth quarter of 2011, hot operation was launched amounting to the fulfillment of the quotation requirements related to the signing of the Agreement.

The most effective variant from the point of view of costs and the period of implementation proved to be the establishment of an independent Czech market division within the central London-based EuroMTS Ltd., which is providing the necessary infrastructure. Thus the Czech Republic became the 14th EU member state that under the patronage of national debt managers has implemented the MTS technological platform, which is used by all major global and European financial institutions. The technical and organizational solution for the implementation of MTS in the Czech Republic is the result of an agreement between the Ministry, the Czech National Bank and the previous direct participants of the primary auctions of government bonds as well as current Primary Dealers, i.e. market-makers. The MTS platform also enables clear monitoring of the behavior of market participants and compliance with the set rules in real time as a basis for the subsequent evaluation of their performance and point awarding.

The participation in the MTS Czech Republic system and the active generation of the secondary market based on defined rules is now one of the main conditions for inclusion in the group of Primary Dealers who carry out the role of **market-makers**. In 2011, attention was focused on the implementation of the system and full involvement of Primary Dealers, i.e. market-makers. In the future, the participation of **market-takers**, meaning participation in trading on the secondary market of MTS in the role of price-takers, for entities outside of the group of Primary Dealers, cannot be ruled out.

The Czech division of MTS is managed by representatives of the Ministry and the Czech National Bank together with representatives of the Primary Dealers through the **MTS Czech Republic Market Committee** in accordance with the valid market rules. The main task of this committee is to implement and further update market rules and monitor compliance with them by market participants. The implementation has required a major redefinition of the conditions for participation in the trade system, definition of the rights and obligations of Primary Dealers and the Ministry, setting of the quotation obligations of market-makers, subsequent monitoring of market activity and its evaluation. Also related to this is the restoration of the status of benchmark issues of Czech government bonds, which newly as of 1st October 2011 are the subject of majority voting within the MTS Czech Republic Market Committee.

Table 24: Benchmark bonds subject to quoting obligations on the MTS Czech Republic

Issue No.	Issue	ISIN	Coupon	Maturity Date (dd.mm.yyyy)
59	2,80/13	CZ0001002729	2,80 %	16.09.2013
62	2,75/14	CZ0001002869	2,75 %	31.03.2014
60	3,40/15	CZ0001002737	3,40 %	01.09.2015
55	VAR/16	CZ0001002331	PRIBOR 6m	27.10.2016
51	4,00/17	CZ0001001903	4,00 %	11.04.2017
56	5,00/19	CZ0001002471	5,00 %	04.11.2019
61	3,85/21	CZ0001002851	3,75 %	29.09.2021
58	5,70/24	CZ0001002547	5,70 %	25.05.2024

Source: MoF

The Primary Dealer who fulfills the role of market-maker quotes the bid and offer prices for all bonds subject to quoting obligations **in the minimum quoted volume**, which varies depending on the time to maturity and **at least 5 hours** during a single trading day. However, the quoted prices must be within the **competitive spread**, which is set on a daily basis for each bond subject to quoting obligations as the average of the quoted spreads of all Primary Dealers multiplied by the coefficient k = 1.5. This method and the quantitative criteria were set up following mutual discussion, and the respective calculations are available to all participants in the system. The evaluation of the performance and activity of participants occurs on a monthly basis.

Table 25: Czech Republic maturity buckets for bonds subject to quoting obligations

A	**Bonds maturing within 1.25 to 3.5 years**	CZK 50 million
B	**Bonds maturing within 3.5 to 6.5 years**	CZK 50 million
C	**Bonds maturing within 6.5 to 13.5 years**	CZK 40 million
D	**Bonds maturing later than 13.5 years**	CZK 30 million

Source: MoF

The market average spread (MAS) of the particular bond subject to quoting obligations is calculated as the scale of the average time weighted spread (S) during the best five hours quoted by the particular Primary Dealer during the particular trading day:

$$MAS = \frac{\sum_{i=1}^{p} (S \times t)}{\sum_{i=1}^{p} t} \qquad \left[t \leq \frac{5}{24} \right]$$

The market competitive spread (MCS) of the particular bond subject to quoting obligations is calculated as a multiple of the market average spread. The setting of the coefficient k occurs in cooperation with the Primary Dealers. Due to the initial phase of the operation of the electronic trading platform, the value of the coefficient k is currently set at 1.5 and provides certain potential for the regulation of quoted spreads in the future.

$$MCS = k \times MAS$$

For the particular bond subject to quoting obligations, the fulfilled quotation obligation (Compliance Ratio – CR) ranges between 0 and 1 (0 to 100%, respectively), depending on the number of quoted hours during the particular trading day, when the particular Primary Dealer quotes the prices of the particular bond subject to quoting obligations within the MCS for the particular bond subject to quoting obligations and in the minimum quoted volume:

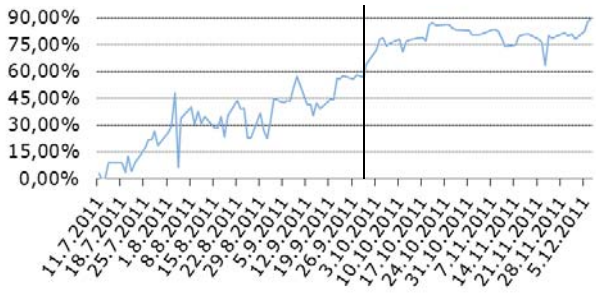
$$CR = \sum \left[IF \left(S \leq MCS ; \frac{t}{\frac{5}{24}} ; 0 \right) \right] \qquad \left[t \leq \frac{5}{24} \right]$$

The daily fulfillment of the quotation obligations (Daily Compliance Ratio - DCR) is set based on the fulfillment of the quotation obligations for all bonds subject to quoting obligations for the particular Primary Dealer and for the particular trading day. Similarly the monthly fulfillment of the quotation obligations (Monthly Compliance Ratio – MCR) for the particular month is calculated as the average of the DCR for the particular Primary Dealer. The Primary Dealer fulfills the quotation obligations as long as **MCR ≥ 0,9**. This key parameter for evaluation of the obligations of Primary Dealers based on the Agreement was approved at the first MTS Czech Republic Committee meeting on 20th September 2011.

$$DCR = \frac{\sum_{o=1}^{BOND} CR}{BOND} \qquad MCR = \frac{\sum_{d=1}^{D} DCR}{D}$$

Due to the strong volatility of the bond markets during the second half of 2011, the Primary Dealers when fulfilling their obligations as market-makers did not achieve the results that the Ministry had expected. Nevertheless, even in the mentioned unstable conditions and thanks to the pilot operation during the third quarter, a satisfactory trend in the development of the quotation obligations of Primary Dealers was achieved. Beginning as of 1st October 2011, when the Ministry began fully monitoring the fulfillment of the quotation obligations based on the Agreement, the level of fulfillment was approximately 80 %. The developments of the final days of November show a repeat of negative instability and turbulence on the financial market. However, positive trend of return of compliance towards the 90 % level was seen at the beginning of December 2011.

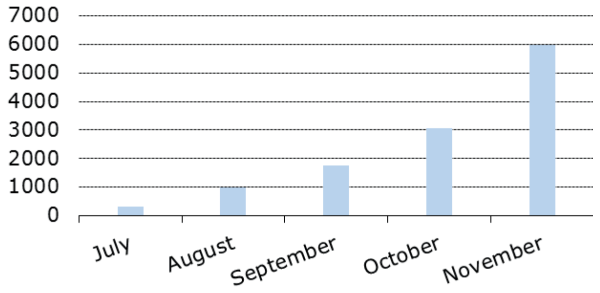
Figure 36: Primary Dealers'Average Daily Compliance Ratio



Source: EuroMTS, MoF

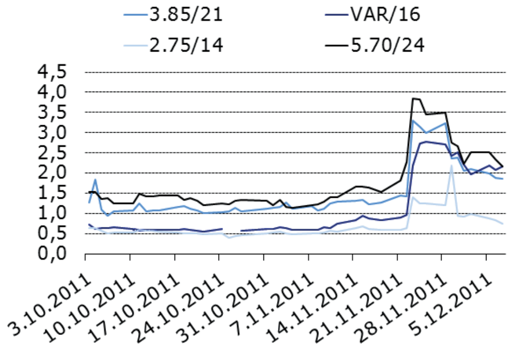
Also as far as traded volumes are concerned, there is an apparent growth trend for concluded transactions, especially following the end of the pilot operation of the MTS platform.

Figure 37: Volume of transactions executed by Primary Dealers on MTS CR (CZK million)



Source: EuroMTS, MoF

Figure 38: Average quoted bid-offer spreads on selected quoted bonds on MTS CR



Source: EuroMTS, MoF

The range of bid-offer spreads points to a relatively stable level, but nonetheless during the second half of November the situation worsened dramatically. This was due to the increased uncertainty on the European bond market, which is affecting market fluctuations, and therefore investors are reacting intensively to market impulses. However, stabilization of the market could be observed at the beginning of December and bid-offer spreads began to tighten. The stabilization occured also thanks to adjustable obligatory quoted spreads that are based on market average. This helped, as opposed to fixed spreads, market participants to adapt to changing market environment.

The strategy in relation to the development of the secondary market via MTS is focused particularly on the ensuring the full functioning and smooth running of the system. The Ministry views as promising the developments related to the fulfillment of quotation obligations from Primary Dealers, where attempts will be made to help achieve greater liquidity through interventions. Lending facilities, buy-backs and direct sales will be tools actively used by the Ministry during its direct participation on the secondary market.

Ministry's operations on the secondary market

The Ministry's plan following the completion of testing transactions in December 2011 during the year 2012 is to actively use the available functionality of „Treasury Operations" on the MTS Czech Republic platform for carrying out buy-backs of government bonds and direct sales of government bonds from the Ministry's own portfolio.

Such operations might significantly contribute to re-financing risk management and support liquidity and effectiveness of the secondary market functioning. For instance, when a particular bonds is squeezed, re-opening of such a bond is an extremely powerful tool to restore normal market conditions.

Operations by the Ministry on the secondary market are in accordance with the Agreement. The Ministry's aim was announced at the first meeting of the Committee of Primary Dealers held on 29 November 2011, and none of the participants in the meeting presented any objections to the Ministry's aim.

The Ministry can carry out these transactions every Wednesday between 11 AM and noon and between 2 and 3 PM Central European time. The Ministry is also authorized to perform these transactions on another business day if it informs the Primary Dealers of such intention no later than by 4 PM Central European time on the business day prior to the date of the transaction. The Ministry will not also carry out the direct sale of a particular government bond during a week when the particular government bond is being sold in an auction or during the week preceding or following the week of such auction.

Buy-backs and direct sales on the secondary market will occur in a transparent manner. As a matter of practice, the Ministry will inform all Primary Dealers about the intention to conduct a transaction one business day prior to the date on which the transaction is to occur. The Primary Dealers will be notified about:

1) the type of transaction (buy-back or direct sale),

2) the government bond (demanded within a buy-back or offered for direct sale),

3) the maximum total volume of the transaction with particular government bonds,

4) the time when bid or offers from Primary Dealers can be submitted via the system,

5) the date of settlement,

6) the contact person at the Ministry.

At the time when offers are accepted from Primary Dealers, the Primary Dealers may enter into the system their prices and the volume of each buy-back or direct sale. Afterward, depending on the price and the volume, the Ministry will either accept or reject the offer. The Ministry may accept offers from more than Primary Dealer, but is not obligated to accept any Primary Dealer's offer. The submission of offers via the system is anonymous, and before each transaction the Ministry will not have any information about which Primary Dealer is participating in the submission of offers or information about the price and volume offered by a particular Primary Dealer. The Ministry will publish the result of the transactions (a summary of the volume of realized transactions within one buy-back or direct sale and the average price) on its website by the date of settlement of the transactions. Therefore, the process of conducting the transactions will be entirely transparent.

Depending on the Ministry's ability to built-up a sufficient stock of government bonds in its own portfolio during 2012, the Ministry intends to start its lending facility for Czech government bonds for Primary Dealers.

6 - Savings bond programme

Pilot issuance of savings government bonds in 2011

On 11 November 2011, the Ministry launched the pilot issue of savings government bonds intended for domestic and foreign individuals and non-profit institutions. The Ministry's primary aim was to map the interest of this segment of small investors in the specified instrument and test the ability to technically and institutionally set up a distribution channel via domestic banking institutions. In connection with this activity, the Ministry began maintaining independent records of these state bonds via the Central Securities Depository (CDCP) as of 1 September 2011, when the first version of the operational rules for these records also took effect.

The conditions for sale and the details regarding the offered savings government bonds were published on 15 September 2011, and the subscription period was set by the issuance conditions as 3 October to 1 November 2011. However, due to the huge amount of interest from potential investors in bonds, applications for subscription were accepted only until 7 October 2011. Even despite the significant shortening of the subscription period, bonds were sold in the total nominal value of CZK 20.4 billion, which means that the original expectation in the Strategy for 2011, which worked with the value of up to CZK 10 billion, was significantly exceeded.

The large amount of interest among the public can be attributed to the high attractiveness of this instrument, which represents safe and conservative method of saving, based on guaranteed interest yields and a guarantee of repayment of the owed amount by the Czech Republic.

As far as bond holders are concerned, the structure of the Czech Republic's state debt represents a relatively low share of households and non-profit institutions. The pilot issue in 2011 contributed to the historic overcoming of a 2% share of these sectors of the national economy in the ownership of CZK denominated state bonds.

The final parameters of the three pilot issues of savings government bonds corresponded with the indicative conditions, which the Ministry presented to the public on 2 December 2010 in the Strategy for 2011, including the nominal value of 1 unit set as CZK 1, which made it possible to offer a reinvestment savings bond, in which a large number of investors expressed interest in line with the Ministry's expectations.

Table 26: Pilot issue of savings government bonds in 2011

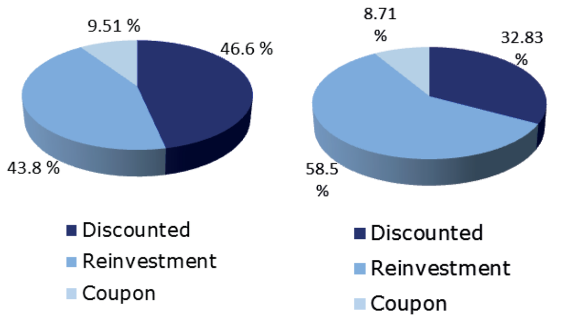
	Discounted	Coupon	Reinvestment
Issue No.	64	65	66
Purchased Amount	CZK 9,519,641,831	CZK 1,942,090,085	CZK 8,966,798,933
Number of owners	11 775	3 125	20 962
Maturity Date (dd.mm.yyyy)	12. 11. 2012	11. 11. 2016	11. 11. 2016
Issue Price	98 %	100 %	100 %
Type of Interest	discount	step-up fixed	step-up fixed
Payment of Interest Yield	by maturity	annually	by maturity
Early Redemption	YES interest not included	YES after 1 year	YES after 1 year

Source: MoF

The Ministry registered increased interest from potential investors in the 1-year discounted and 5-year reinvestment bond. The 1-year discounted bond comprised 46.6% of purchased savings bonds, followed by the 5-year reinvestment bond, comprising 43.9%. The 5-year coupon bond was the least purchased, comprising 9.5% of purchased savings bonds. The largest number of people invested in the 5-year reinvestment bond and comprised 58.5% of the total number of bond owners, followed by the 1-year discounted bond with a share of 32.8% and the 5-year coupon bond with a share of 8.7% investors.

Figure 39: Structure of savings government bonds based on individual issues (%)

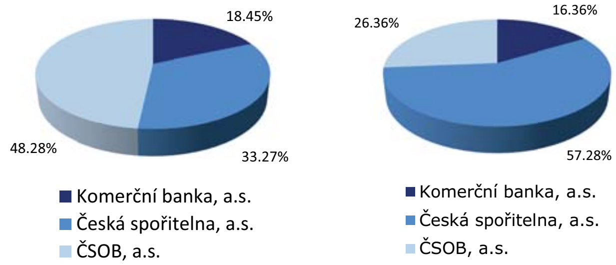
Number of sold savings government bonds | Number of owners of savings government bonds



Source: MoF

Figure 40: Structure of savings government bonds based on individual distributors (%)

Number of sold savings government bonds | Number of owners of savings government bonds



Source: MoF

The subscription of savings government bonds was offered to investors during the pilot issues based on an agreement on provision of distribution services through the three most important Czech commercial banks, Česká spořitelna a.s. (ČS), Československá obchodní banka a.s. (ČSOB) and Komerční banka a.s. (KB).

The largest number of bonds was subscribed through ČSOB, which ensured the distribution of 48.3% of the number of bonds. A total of 33.3% were sold through ČS, and 18.5% were sold through KB. The largest number of subscribers submitted their orders and paid for them via the ČS network of branches, ČS then ensured the subscription for 57.3 % of all investors. ČSOB ensured the distribution of bonds to 26.4% and KB to 16.4% of the total number of bond owners.

Savings government bonds were subscribed by 32,977 domestic individuals in the total amount of 20.1 billion units, 68 foreign individuals in the total amount of 0.04 billion units and 57 non-profit organizations in the total amount of 0.3 billion units. The Ministry's aim was to offer savings government bonds to small investors, who prefer conservative methods of investing. The minimum order of bonds was therefore set at CZK 1,000. The specified aim also corresponds with the fact that the age of more than half of the bond owners ranges between 51 and 70, which is a group of conservative investors with a negative attitude to risk. The fact that the pilot issue appealed primarily to small investors has been confirmed also by the final statistics according to which more than 40% of the owners subscribed bonds in an amount of between 1,000 and 100,000 units. The average owner holds 200,000 savings government bonds of the Czech Republic.

Medium term savings bond program

The result of the pilot issue of savings government bonds is the ownership of more than 1% of the Czech state debt by Czech citizens by the end of 2011. This is clearly a source of state financing, and its development and systematic operation can bring significant mid-term stabilization of the management of the refinancing risk of the state, reduce the uncertainty surrounding the functioning of European financial markets and bring desired institutional diversification of holders of state debt towards the strengthening of the conservative segment of domestic investors.

The aim of the mid-term savings bond program is to define a basic framework for the Ministry's issuance activity in the area of non-tradable domestic state bonds with an outlook to 2014 from the point of view of the type of offered bonds and securing of technical operation and distribution infrastructure. In order to be able to react on the demand and the preferences of households and the fluctuations on bond markets, the Ministry is also leaving sufficient room for flexible adaptation in this area of financing of the state.

The quantitative framework for annual gross issuance of savings bonds amounts to CZK 20 billion to 40 billion.

The Ministry plans to offer savings government bonds in two public series during the calendar year, meaning a spring series and an autumn (Christmas) series.

Table 27: Issuance strategy of savings government bonds for 2012

	Spring Series	Autumn Series
Subscription Period From	May	November
Indicative Issue Date	June 2012	December 2012
Offered Total Nominal Amount (CZK billion)	10 to 20	10 to 20

Source: MoF

Two series are expected also in the following years, provided that the current distribution infrastructure is maintained. Making the process of issuing savings government bonds more flexible would require more significant investments into information systems on the Ministry's side, which currently not planned due to the anticipated value added and will be the subject of analysis during 2012, which will be the first year of the full operation in this area.

The fulfillment of the specified quantitative framework should contribute to covering at least 10% of the annual gross borrowing need by this source of financing. If there is continuous interest among small investors, the share of households and non-profit institutions holding of Czech state debt could reach 5% in 2014.

As of the fourth quarter of 2012, the issuance calendars for savings government bonds will be set up so that the issue date always corresponds to or follows the maturity date of the previously issued bonds, in order to enable the **reinvestment of the paid nominal value** of held savings bonds into new issues.

The product framework of savings bonds will be gradually expanded based on demand.

The positive experience from the pilot issue confirmed by the high demand and interest among the target group of investors show that the main parameters of the savings government bonds in the form of their **non-tradability** and **limited transferability** did not limit demand, but in fact investors appreciated the zero market risk and the guarantee of their investments when using the option of early repayment of the subscribed savings bonds.

The basic parameters of non-tradability and limited transferability, the guaranteed option of early repayment as well as the nominal value of 1 unit equal to CZK 1, the minimum number of subscribed bonds equal to 1,000 units and the limit on early repayment to a maximum of 500,000 units and 50% of owned bonds above that amount by one date of early repayment will remain part of the issuance conditions of the savings government bonds also in 2012.

In 2012, the Ministry will again offer all three types of savings government bonds known from the pilot issue, including the coupon bond, since although it registered lower demand compared to the discounted and reinvestment bonds, its absolute subscribed amount is a reason to keep it in the offering at least for the spring series of publicly issued bonds. While extending the product offering, the Ministry will focus mainly on alternative methods of setting interest yields and on the extension of available repayment periods for savings government bonds.

Table 28:Basic alternatives to the offering of savings government bonds in 2012

	Discounted	Coupon	Reinvestment
Series	Spring / Autumn	Spring / Autumn	Spring / Autumn
Maturity	1 to 2 years	5 years	5 years
Type of interest	discount	step-up fixed	step-up fixed
Interest Payment	by maturity	annually	by maturity
Early Redemption	YES interest not included	YES after 1 year	YES after 1 year
Reinvetsment of interest/principal	NO / YES	NO / YES	YES / YES
Face Value (unit)	CZK 1	CZK 1	CZK 1

Source: MoF

The technical, operational and distribution framework will respect the principles of pilot issuance.

The distributors of the pilot issue were the three banks named above. The activities of these banks during the subscription period were evaluated and in the middle of 2012 an evaluation of the quality of the other distributor's services will also be conducted (changes in details in asset accounts kept in separate records at the Ministry, obtaining of asset account statements at owner's request, ensuring of early repayment, transfers, etc.).

For 2012, the basic guideline that a framework agreement will be signed with potential new distributors will remain in effect, on the basis of which a partial agreement will be concluded for each individual issue of bonds. However, this does not mean that the selected entity will participate in the distribution of all future issues of savings government bonds.

The option of concluding an agreement for future issues of savings government bonds will be open to all entities who fulfill the technical and other requirements and accept the cost conditions of the Ministry. In the future, the open competitive environment will be maintained along with the option to further develop the distribution process and make it more effective based on experience from the pilot issue in this year and the full-fledged operation of the system in 2012.

Another basic principle of the distribution system is the maintaining of absolute flexibility, meaning that the subscription of savings government bonds through a specific distributor is not bound to that distributor for the provision of other services or the subscription of new savings government bonds. Therefore, the future owners can apply for services related to the management of savings government bonds and asset accounts through all current and potential future distributors. This will also leave open in the future the possibility of the development of additional distribution infrastructure, particularly in the form of electronic channels or involvement of non-banking entities in the project.

Therefore, the range of entities that will provide distributor services for future issuance of savings government bonds is not clearly defined and any entity that fulfills the conditions for this activity may enter into negotiations with the Ministry. The main condition by the current technical configuration of the distribution of savings government bonds is fulfillment of the technical conditions of the CDCP, which provides the Ministry with technical services while maintaining independent records of state bonds. Another condition is an offering of competitive price conditions about which parties interested in distribution will be able to negotiate with the Ministry.

The Ministry is also considering introducing a direct distribution channel, in which no distribution entity would figure between the Ministry as the issuer and the subscriber. A favorable method for direct distribution is purchase via a website, through which the owner could also obtain an overview of his/her asset account and take care of basic services. Due to the need for technical preparation of this channel, on which the Ministry will cooperate primarily with the CDCP, its use can be expected at the soonest in time for the issuance of the autumn series of savings government bonds in 2012.

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This publication was prepared based on information available as of 9th December 2011. The Ministry reserves the right during 2012 to react flexibly with the help of other instruments to the actual development of the government‘s gross borrowing requirement. The fulfillment of the planned programme of financing and announced strategic goals will depend on the development of the situation on the domestic and foreign market from the point of view of minimization of costs for the management of the state debt and management of financial risks.

This publication is also available on the Internet at:

www.mfcr.cz/statedebt

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