Ministry
of Finance

Debt and Financial Assets
Management Department

The Czech Republic Funding and Debt Management Strategy 2015

17 December 2014

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ISSN 2336-226X (Print)
ISSN 2336-2278 (On-line)

ISBN 978-80-85045-69-7 (Print)
ISBN 978-80-85045-70-3 (On-line)

Issued annualy, free distribution

Electronic archive:
www.mfcr.cz/statedebt

The Minister of Finance decided on 15 December 2014 about the structure and method of covering the financing needs of the central government in the budget year 2015 and approved the basic absolute and relative limits for issuance activity on the domestic and foreign markets and for active management of the net debt portfolio and liquidity of the treasury single account in the individual currencies (Ref. No. MF-77951/2014/2002-1).

This defined operational framework in the form of the submitted Funding and Debt Management Strategy for 2015 (hereinafter the "Strategy" or "2015 Strategy") enables the Ministry of Finance (hereinafter the "Ministry") to act flexibly on the domestic and foreign financial markets while actively securing cash resources for covering the financing needs of the central government and ensuring the daily solvent position of the state, meaning the creation of initial conditions for smooth implementation of budget and fiscal policy.

The Strategy is based on and is consistent with the State Budget Act of the Czech Republic for 2015, including the medium-term outlook to 2017, the Fiscal Outlook of the Czech Republic from November 2014 and the Macroeconomic Forecast of the Czech Republic from October 2014.

The Strategy is submitted via Debt and Financial Assets Management 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 treasury single accounts, and short-term and long-term investment of available cash resources of state financial assets and the treasury single accounts on financial markets.

Table of Contents

Introduction 9

Key Events in 2015 9

Rating of the Czech Republic 10

Financing Needs of the Central Government and State Debt Development 10

Issuance Activity and Secondary Market Operations in 2014 12
- Issuance of Treasury Bills on Money Market 12
- Issuance of Medium-term and Long-term Government Bonds 12
- Issuance of Savings Government Bonds 12
- Loans from the European Investment Bank 12
- Buy-backs of Government Bonds 12

Funding Programme and Issuance Activity in 2015 13
- Money Market Instruments 13
- Medium-term and Long-term Government Bonds 13
- Other Debt Instruments 14
- Buy-backs and Exchanges Auctions Programme on Secondary Market 14

Funding Programme and Issuance Activity in the First Half of 2015 15
- Money Market Instruments 15
- Medium-term and Long-term Government Bonds 15

Strategic Targets, Limits and Risk Parameters of the Debt Portfolio in 2015 16
- Refinancing Risk 16
- Interest Rate Risk 16
- Currency Risk 16

State Debt Service Expenditure 17
- Cash and Accrued Expression 17
- Cost-at-Risk of State Debt 18

Primary Dealers in Czech Republic Government Bonds 21

Calendar of Information Published in the First Half of 2015 22

List of Tables

Table 1: Czech Republic's Credit Rating in 2014 10
Table 2: Financing Needs 10
Table 3: Framework Issuance Plan of T-bonds on the Domestic Market in 2015 13
Table 4: Potential Auction Days of T-Bills in the First Half of 2015 15
Table 5: Potential Auction Days of T-Bonds in the First Half of 2015 15
Table 6: Net Interest Expenditure and Cost-at-Risk 19
Table 7: Primary Dealers in Czech Republic Government Bonds for 2015 21

List of Figures

Figure 1: Czech Republic's State Debt Development 11
Figure 2: Average Time to Maturity and Re-fixing of the State Debt and Re-fixing of the State Debt up to 1 Year 16
Figure 3: Net Expenditure on State Debt Service 17
Figure 4: Net Cash Expenditure and Accrued Costs on State Debt Service 18
Figure 5: Net Interest Expenditure and Cost-at-Risk 19

List of Abbreviations

CaR	Cost-at-risk
CNB	Czech National Bank
CZK	Currency code of Czech Koruna
CZSO	Czech Statistical Office
EIB	European Investment Bank
ESA 2010	European System of Account - 2010
EUR	Currency code of Euro
GDP	Gross domestic product
JCR	Japan Credit Rating Agency
MoF	Ministry of Finance
MTS	Mercato Telematico Secondario
PRIBOR	Prague InterBank Offered Rate
R&I	Rating agency Rating and Investment Information, Inc.
T-Bill	Treasury bill
T-Bond	Medium-term and long-term government bond

Introduction

Starting in 2015, the Ministry will bring a change and simplification of its communication with the public and presents a new, more compact format of the Funding and Debt Management Strategy, whose existing content will be divided into two publications: The Funding and Debt Management Strategy of the Czech Republic for 2015 and the Report on State Debt Management in 2014 (hereinafter the "Report").

In line with international practise, the Report will always be published during the first quarter of the year following the end of the respective year (in 2015, the publication of the Report is planned for the end of January) and will contain detailed review and description of events in the field of debt management in the respective year, evaluation of issuance activity, Czech Republic's state debt development and related interest expenditure of the state budget, the analysis of situation on primary and secondary government bonds market, fulfilment of strategic objectives in debt portfolio risk management. This Report will also include all the information previously contained in the Debt Portfolio Management Quarterly Review as of December, which will hereby cease to be published and will be merged with the Report. The Performance Evaluation of Primary Dealers for previous year will also become a part of the Report. Current Debt Portfolio Management Quarterly Review and Performance Evaluation of Primary Dealers as of March, June and September of respective year will be preserved in its current form, but will be merged into a single document published by the end of April, July and October (in 2015, the publication is planned for every third Friday of the month following the end of the quarter of the year).

The presented 2015 Strategy contains a basic framework for the state funding and sets limits and targets for each monitored state debt portfolio risk indicators for 2015 including a detailed description of funding in the first half of 2015. Based on the actual development of financing needs and the development of situation on financial markets the Ministry plans to publish the update of the Strategy for the second half of the year on the last Friday of the first half of the year.

Key Events in 2015

Financing needs of CZK 367.2 billion in 2015 and stabilized state debt.

- budgeted state deficit of CZK 100.0 billion
- redemption of two CZK-denominated T-bond issues (Czech Republic Treasury Bond, 2005 - 2015, 3.80 % and Czech Republic Treasury Bond, 2010-2015, 3.40 %) in a total nominal value of CZK 113.0 billion
- redemption of variable-rate EUR-denominated foreign T-bond issue from 2009 in a total nominal value of EUR 300.0 million
- redemption of savings government bonds in a total nominal value of CZK 11.5 billion
- refinancing of T-bills issues in total nominal value of CZK 107.6 billion
- involvement of available cash resources of single treasury accounts of state treasury into covering of the part of financing needs in order to stabilize the state debt

Gross issue of T-bonds of CZK 130.0 to 180.0 billion.

- opening of three new fixed-rate CZK-denominated benchmark issues with maturity in 2023, 2026 or 2027 and 2030
- re-opening of existing fixed-rate and variable-rate CZK-denominated issues with maturity from 2018
- foreign issue of T-bonds in case of cost-favourable conditions
- tap sales of CZK-denominated T-bonds on secondary market up to CZK 20.0 billion

Primary and secondary government bonds market.

- number and composition of primary dealers remains unchanged as in 2014
- harmonisation of transactions settlement on the primary market within the European Union to the T+2 standard
- quoting obligation fulfilment of primary dealers on secondary market in 2015 will be carried out through MTS Czech Republic platform, which was designated and approved by the decision of Primary Dealers Committee
- buy-backs and T-bonds exchange auctions programme in the range from CZK 10.0 to 30.0 billion

Rating of the Czech Republic

The Czech Republic belongs among the exceptionally reliable issuers and enjoys considerable interest from domestic and foreign investors, as confirmed by its high credit rating with a stable outlook from all the major credit rating agencies. In fact, in March 2014 the Japan Credit Rating Agency improved the Czech Republic's credit rating to AA- with a stable outlook for long-term debt in foreign currencies, and to A+ with a stable outlook for long-term debt in the domestic currency. The Czech Republic has the highest total rating of all the countries in Central and Eastern Europe and has had a higher rating than the Euro area countries average for several years.

Table 1: Czech Republic's Credit Rating in 2014

Rating agency	Domestic long-term liabilities	Outlook	Foreign long-term liabilities	Outlook	Granted/ affirmed
Moody's	A1	Stable	A1	Stable	19/07/2013
Standard & Poor's	AA	Stable	AA-	Stable	25/07/2014
Fitch Ratings	AA-	Stable	A+	Stable	14/11/2014
JCR	AA-	Stable	A+	Stable	24/03/2014
R&I	AA-	Stable	A+	Stable	11/09/2013

Source: Moody's, Standard & Poor's, Fitch Ratings, JCR, R&I

Financing Needs of the Central Government and State Debt Development

The financing needs of the central government are determined by the standard components that must be financed by cash resources in a given year, i.e. the budgeted state budget cash deficit, and all redemptions, early redemptions, and buy-backs and exchanges of nominal values (principals) of state debt, including the related derivatives. Financing operations on the side of state financial assets and within the single treasury accounts then take place on the side of cash resources that can be involved in covering the financing needs simultaneously with the state borrowing operations on financial markets.

For 2014 it is expected that the cash budget deficit will not exceed CZK 80.0 billion, which is CZK 32.0 billion lower than budgeted deficit. The financing needs has been relative stable, its share in GDP since 2012 has ranged from 8 to 10% of GDP incl. the actual medium-term outlook to 2017.

Table 2: Financing Needs (CZK billion)

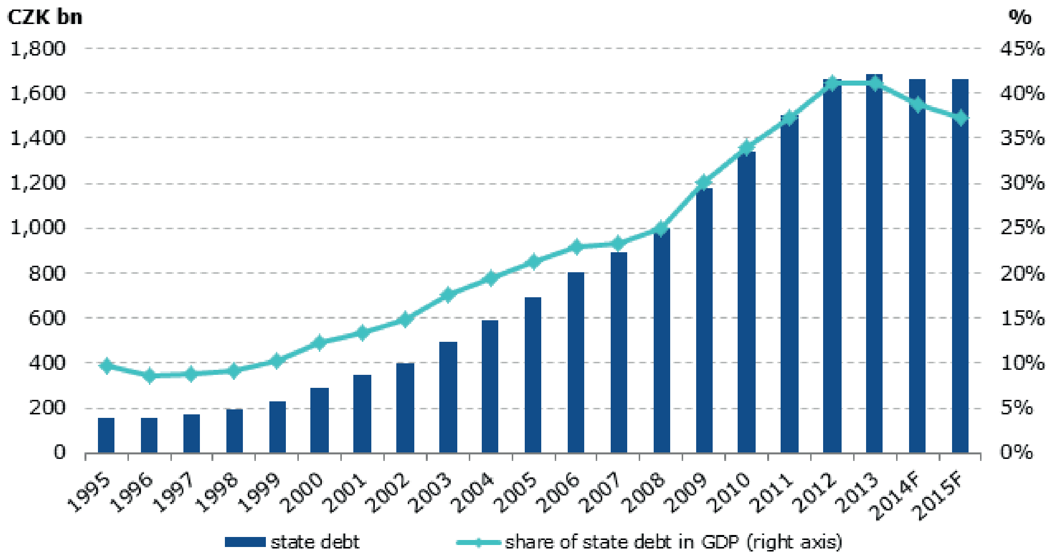
Financing needs	2012	2013	2014F	2015F	2016F	2017F
State budget deficit[1]	101.0	81.3	80.0	100.0	100.0	95.0
T-bonds redemption[2]	115.6	108.6	136.4	138.8	154.5	144.0
Buy-backs and exchanges of T-bonds from prior years	-2.0	-8.1	-4.0	-15.3	-20.4	-20.0
Buy-backs and exchanges of T-bonds due in coming years[3]	8.1	7.5	11.3	20.0	20.0	20.0
Redemptions and early redemptions on savings government bonds in the respective year	9.6	7.7	11.9	11.5	30.1	16.9
T-bills redemptions excl. roll-over[4]	162.6	189.1	120.9	107.6	110.0	110.0
Other money market instruments	0.0	0.0	0.0	2.5	10.0	10.0
Repayments on EIB loans	5.3	2.8	11.1	2.1	1.7	3.9
Total financing needs	**400.2**	**388.8**	**367.5**	**367.2**	**405.9**	**379.8**
Total financing needs (% of GDP)[5]	**9.9**	**9.5**	**8.6**	**8.2**	**8.8**	**7.9**

[1] For 2014 expected state budget deficit, for 2015 budgeted state budget deficit and for 2016 and 2017 medium-term outlook fo state budget deficit
[2] Including hedging operations
[3] Excluding operations with government bonds due in the respective period
[4] Within the respective period
[5] Source for GDP in ESA 2010 methodology for 2012 and 2013 is the CZSO, for 2014 to 2017 the MoF Macroeconomic Forecast – October 2014.
Source: MoF, CZSO

The resulting gross borrowing requirement of central government, which is derived from the financing needs and represents that part of financing needs, whose coverage must be secured through borrowing operations on financial markets, especially government bond markets, is dependent on the involvement of financial assets, i.e. in particular the available state treasury resources, into covering the financial needs. In case of involvement of these liquid assets to cover the financing needs, the resulting gross borrowing requirement is lower than total financing needs in respective period, which occurred in 2013 and 2014. In the opposite case, when there is an accumulation of financial assets, the gross borrowing requirement is higher than financing needs, which occurred e.g. in 2011 and 2012.

While in 2013, the Ministry proceeded to use cash reserve accumulated in previous years from pre-financing by issuance of government bonds, starting in 2014 the Ministry has actively involved external resources of state treasury by means of refinancing mechanism to cover financing needs of Czech Republic. Although they are state's cash resources, in terms of covering the financing need, these resources are considered to be external resources, which enable the reduction of borrowing operations scope and lower gross and net borrowing requirement in a given year. It results in savings in interest expenditure of state budget as well as absolute and relative stabilization of CZK-denominated nominal value of gross state debt, or even its decline.

Figure 1: Czech Republic's State Debt Development



Source: MoF

By involving the available state cash resources within the treasury single account operated by the CNB, the decline of CZK-denominated nominal value of gross state debt by approx. CZK 20 billion in 2014 in comparison to the end of 2013 will be achieved, thereby there will be a year-on-year decrease in state debt for the first time since 1995. The state debt will also decline below the value as of the end of 2012 and is expected to decline below the level of 39% of GDP in 2014. In 2015, the stabilization of state debt development in absolute terms and the decrease relative to GDP is expected to continue.

Issuance Activity and Secondary Market Operations in 2014

Issuance of Treasury Bills on Money Market

The expected balance of money market instruments outstanding at the end of 2014 is CZK 110.2 billion, of which CZK 107.6 billion is represented by T-bills. The rest is represented by expected cash resources received within the lending facility for providing CZK-denominated T-bonds in the form of short-term repo operations, in which CZK-denominated T-bonds act as collateral.

The gross T-bills issue amounted to CZK 114.9 billion in 2014, of which CZK 50.6 billion is represented by 9-month T-bills and CZK 64.3 billion is represented by 12-month T-bills. The roll-over of T-bills amounted to CZK 7.3 billion.

Issuance of Medium-term and Long-term Government Bonds

The nominal value of gross issue of T-bonds in 2014 amounted to CZK 153.3 billion, of which CZK 144.3 billion is represented by CZK-denominated T-bonds sold in primary auctions, and CZK 9.0 billion is represented by tap sales of CZK-denominated T-bonds from the Ministry's own portfolio on the secondary government bond market through the transparent electronic trading platform MTS Czech Republic.

The average maturity of the gross issue of CZK-denominated T-bonds in 2014 related to the date of issue was 9.1 years, which represents the increase of 0.9 years compared to 2013. The share of fixed-rate CZK-denominated T-bonds in the total gross issue of CZK-denominated T-bonds in 2014 amounted to 74.6%, while the share of variable-rate CZK-denominated T-bonds was 25.4%.

In the course of 2014, there was no issue of T-bonds on foreign markets due to the relatively low gross borrowing requirement and also higher costs related to the issue on foreign markets compared to the comparable issue on the domestic market after taking into account the costs of hedging of the currency risk.

Issuance of Savings Government Bonds

The gross issue of savings government bonds in 2014 amounted to CZK 2.1 billion, of which CZK 1.4 billion is represented by the nominal value of savings government bonds sold within the "spring" series of issues of savings government bonds and CZK 0.7 billion is represented by tranches issued in the form of reinvestment of yields. Within the "spring" series of issues of savings government bonds, 5-year reinvestment, 6.5-year variable-rate and 6.5-year inflation-linked savings government bonds were offered. The Ministry did not carry out "Christmas" series of issues due to the intention to reduce the total gross borrowing requirement on financial markets in this year and achieve absolute and relative year-on-year decrease in state debt.

Loans from the European Investment Bank

In the course of 2014, no further tranches of loans provided by the EIB were drawn, and principals of loans received from EIB totalling CZK 11.1 billion (incl. scheduled and early repayments) were repaid due to the decrease of total borrowing requirement in 2014 and the possibility to issue T-bonds on domestic market at favourable conditions.

Buy-backs of Government Bonds

In the second half of 2014, the Ministry executed buy-backs of CZK-denominated T-bonds in a total nominal value of CZK 11.3 billion. CZK-denominated T-bonds with a maturity date in 2015 and 2016 were bought back, namely Czech Republic Treasury Bond, 2005 - 2015, 3.80 % in total nominal amount of CZK 2.5 billion, Czech Republic Treasury Bond, 2010 - 2015, 3.40 % in total nominal amount of CZK 8.3 billion, and Czech Republic Treasury Bond, 2001 - 2016, 6.95 % in total nominal amount of CZK 0.4 billion.

Funding Programme and Issuance Activity in 2015

Money Market Instruments

For 2015, the Ministry plans to maintain the total nominal value of T-bills outstanding at a minimal level of CZK 100.0 billion at the end of 2015 in case of sufficient demand from primary dealers.

In the course of 2015, the Ministry plans to continue using the lending facility for providing CZK-denominated T-bonds. This facility can be used by primary dealers to borrow CZK-denominated T-bonds for a period of up to 90 days within the repo operations. Although the primary objective of these operations is to increase the liquidity of government bonds on the secondary market, due to the very low repo rates the Ministry considers these operations to be a suitable resource in the segment of short-term financing. These operations thus contribute also to savings in net interest expenditure on state debt. The acquired cash resources are invested for higher yields on the money market within the state treasury liquidity management, leading to increased yields from the Ministry's investment activity. The amount of lending facilities executed in 2015 will depend primarily on demand from investors for this instrument, the Ministry will be ready to satisfy this demand flexibly based on the availability of government bonds in Ministry's portfolios.

Medium-term and Long-term Government Bonds

In 2015, the Ministry plans a gross issue of T-bonds on domestic and foreign markets in a total nominal value ranging from CZK 130.0 to 180.0 billion.

As in the previous year, the issuance in 2015 will focus on the segment of remaining time to maturity of 10 to 15 years. The planned share of variable-rate CZK-denominated T-bonds in total gross issue in domestic market in 2015 will amount to maximum of 25% depending on further development of fixed-rate government bond yields, which corresponds to share in 2014.

Table 3: Framework Issuance Plan of T-bonds on the Domestic Market in 2015 (CZK billion)

	Framework scope of sale
T-bonds auctions	**130 to 180**
Maturity segment 0 to 5 years	
Issue 88, CZGB 0.85/18	5 to 15
Issue 76, CZGB 1.50/19	15 to 30
Maturity segment 5 to 10 years	
Issue 61, CZGB 3.85/21	0 to 15
Issue 52, CZGB 4.70/22	0 to 15
Issue XX, CZGB x.xx/23	10 to 35
Issue 89, CZGB 2.40/25	5 to 30
Maturity segment 10 to 15 years	
Issue XX, CZGB x.xx/26 or 27	10 to 35
Issue 78, CZGB 2.50/28	10 to 30
Issue XX, CZGB x.xx/30	5 to 25
Maturity segment 15 to 50 years	
Issue XX, CZGB x.xx/35	0 to 20
Variable-rate T-bonds	
Issue 91, CZGB VAR/20	10 to 35
Issue 90, CZGB VAR/27	10 to 35
Tap sales on domestic market	**0 to 20**
TOTAL	**130 to 180**

Source: MoF

In 2015, the Ministry plans to issue three new fixed-rate CZK-denominated T-bonds with maturity in 2023, 2026 or 2027 and 2030 on domestic market. In case of cost-favourable conditions and sufficient demand, the Ministry could issue CZK-denominated fixed-rate T-bonds with maturity in 2035, or eventually replace the benchmark issue maturing in 2030 with this issue. The reason for issuing these new issues is the prevailing situation on financial markets, where the yields of government bonds of Czech Republic across the yield curve are on their historic lows and there is a significant disproportion between the yield to maturity and coupon rate of the government bonds. By issuing these government bonds, the coupon rates of government bonds issued in the course of 2015 will be set closer to the current market conditions. These new issues will also enable maintaining the average maturity of debt portfolio within the target band of 5.0 to 6.0 years.

If there is an unexpected sharp increase in yields of Czech Republic government bonds, the Ministry reserves the option of not issuing these new benchmark bonds or only some of them. The Ministry will also consider the option of supplementing the issue of CZK-denominated T-bonds on the primary market in the course of 2015 with tap sales of T-bonds from its own portfolio on the secondary market, if investor interest in using these government bonds within lending facilities drops. In this case, the Ministry will proceed to sell off CZK-denominated T-bonds from its own portfolio. Furthermore, tap sales of T-bonds with a long time to maturity may be used to manage the average time to maturity of the debt portfolio.

The execution of the issue of T-bonds on foreign markets in 2015 will depend mainly on current market conditions on the domestic and foreign markets, which the Ministry will monitor and evaluate intensively throughout the year in the cooperation with contractual primary dealers. The condition for executing foreign issues is lower costs related to the issue on foreign markets compared to the comparable issue on the domestic market after taking into account the costs of hedging of the currency risk.

Other Debt Instruments

In the course of 2015, the Ministry will analyse the possibilities of implementing the new concept of direct selling of the savings government bonds to citizens, which would allow their regular availability during the calendar year and would bring the costs related to the issuance of these government bonds closer to the costs of issuance of other government bonds. This concept may be launched into pilot operation earliest during the second half of 2015, while in the course of the first half of 2015, the test sales may be executed primarily via the electronic distribution platform operating from November 2013. For 2015, no quantitative objective regarding the nominal value of the gross issue of savings government bonds was set. However, it is assumed that in terms of total funding programme it will represent an insignificant part of resources covering the financing needs.

In 2015, the Ministry does not plan to draw any further loan tranches from the EIB or other international financial institutions.

Buy-backs and Exchanges Auctions Programme on Secondary Market

The planned scope of buy-backs of government bonds in 2015 is CZK 10.0 to 30.0 billion. This figure does not include the potential buy-backs of government bonds maturing in 2015. The Ministry plans to buy back Czech Republic Treasury Bond, 2001 - 2016, 6.95 % and Czech Republic Treasury Bond, 2007-2017, 4.00 %. The Ministry will consider including other possible government bonds into exchange auctions depending on the market situation in respective segment of the yield curve. In case of lower interest in buy-backs from primary dealers, the above-mentioned government bonds originally planned for buy-backs may be included into the exchange auctions.

Funding Programme and Issuance Activity in the First Half of 2015

Money Market Instruments

T-bills will be issued on traditional auction day of Thursday with the settlement on Friday during the first half of 2015.

The issuance calendars of T-bills with a specific maturity offered in individual auctions will be published on a monthly basis, always on the second or third working Monday of the month preceding the respective month, unless announced otherwise by the Ministry. The offered total nominal value will be published in the predefined range. However, the Ministry reserves the right to change the specific total nominal value according to current needs and the market situation. On the second or third working Monday of the month before the start of the respective quarter of the year, the Ministry will also publish the maximum expected nominal value in auctions for the upcoming quarter within the T-bills issuance calendars.

For the first half of 2015, the Ministry plans the gross issue of T-bills in the range of CZK 40.0 to 60.0 billion, depending on demand from primary dealers. 9-month and 12-month T-bills will be offered.

Table 4: Potential Auction Days of T-Bills in the First Half of 2015

1st quarter	2nd quarter
-	02/04/2015
-	09/04/2015
-	16/04/2015
-	23/04/2015
-	30/04/2015
05/02/2015	07/05/2015
12/02/2015	14/05/2015
19/02/2015	21/05/2015
26/02/2015	28/05/2015
05/03/2015	04/06/2015
12/03/2015	11/06/2015
19/03/2015	18/06/2015
26/03/2015	25/06/2015

Source: MoF

Medium-term and Long-term Government Bonds

The primary auctions of CZK-denominated T-bonds in the course of the first half of 2015 will be held on the traditional auction day of Wednesday with the settlement on Friday according to the T+2 standard for settling operations on the primary market.

In the first half of the year, new fixed-rate benchmark issues of CZK-denominated T-bonds with maturity in 2026 or 2027 and 2030 (or alternatively depending on the slope of yield curve in 2035) will be issued. Again, it applies that in the event of an unexpected sharp increase in yields of Czech Republic government bonds, the Ministry will reserve the option of not issuing these new benchmark issues or issuing only some of them. The planned scope of the gross issue of CZK-denominated T-bonds in first half of 2015 is CZK 60.0 to 110.0 billion.

Table 5: Potential Auction Days of T-Bonds in the First Half of 2015

1st quarter	2nd quarter
-	01/04/2015
-	08/04/2015
-	15/04/2015
-	22/04/2015
-	29/04/2015
04/02/2015	06/05/2015
11/02/2015	13/05/2015
18/02/2015	20/05/2015
25/02/2015	27/05/2015
04/03/2015	03/06/2015
11/03/2015	10/06/2015
18/03/2015	17/06/2015
25/03/2015	24/06/2015

Source: MoF

Strategic Targets, Limits and Risk Parameters of the Debt Portfolio in 2015

Refinancing Risk

The expected share of short-term state debt (debt due within 1 year) in the total state debt at the end of 2014 amounts to 14.9% and thus remains below the stipulated limit of 20.0% of total state debt. For 2015, the Ministry will retain the limit for the share of short-term state debt at a level of 20.0% of the total state debt.

The expected share of medium-term state debt (debt due within 5 years) in the total state debt at the end of 2014 amounts to 55.7% and thus remains below the stipulated limit of 70.0% of total state debt. For 2015, the Ministry will retain the limit for the share of medium-term state debt at a level of 70.0% of total state debt.

The expected average time to maturity of the state debt at the end of 2014 amounts to 5.5 years and thus remains in the middle of the target band of 5.0 to 6.0 years. For 2015, the Ministry will retain the target band for average time to maturity of state debt in the range of 5.0 to 6.0 years.

Interest Rate Risk

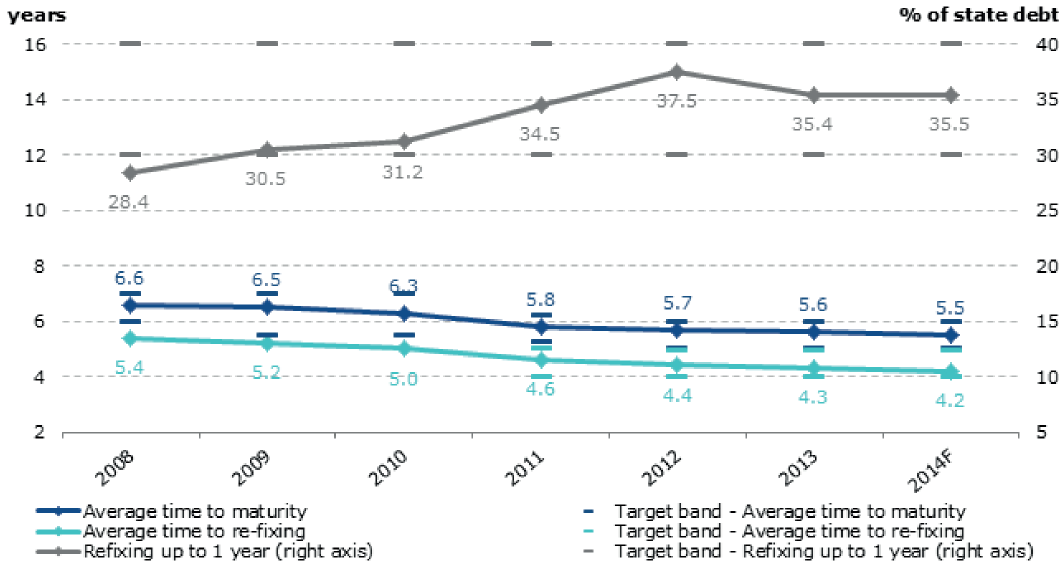
At the end of 2014, the expected value of interest re-fixing of the debt portfolio within 1 year amounts to 35.5% of the total state debt and thus remains in the middle of the target band of 30.0 to 40.0% of total state debt. For 2015, the Ministry will retain the target band for interest re-fixing of the debt portfolio within 1 year in the range of 30.0 to 40.0% of total state debt.

The expected average time to re-fixing of state debt at the end of 2014 amounts to 4.2 years and thus remains within the stipulated target band of 4.0 to 5.0 years. For 2015, the Ministry will retain the target band for the average time to re-fixing of state debt in the range of 4.0 to 5.0 years.

Currency Risk

At the end of 2014, the expected value of the net foreign-currency exposure of state debt, which takes into account the foreign-currency exposure of state financial assets, amounts to 10.4% of the total state debt and thus remains below the stipulated limit for 2014 of 15.0% (up to 17.0% in the short-term) of total state debt. For 2015, the Ministry will retain the limit for net foreign-currency exposure of state debt at 15.0% (up to 17.0% in the short-term) of the total state debt.

Figure 2: Average Time to Maturity and Re-fixing of the State Debt and Re-fixing of the State Debt up to 1 Year



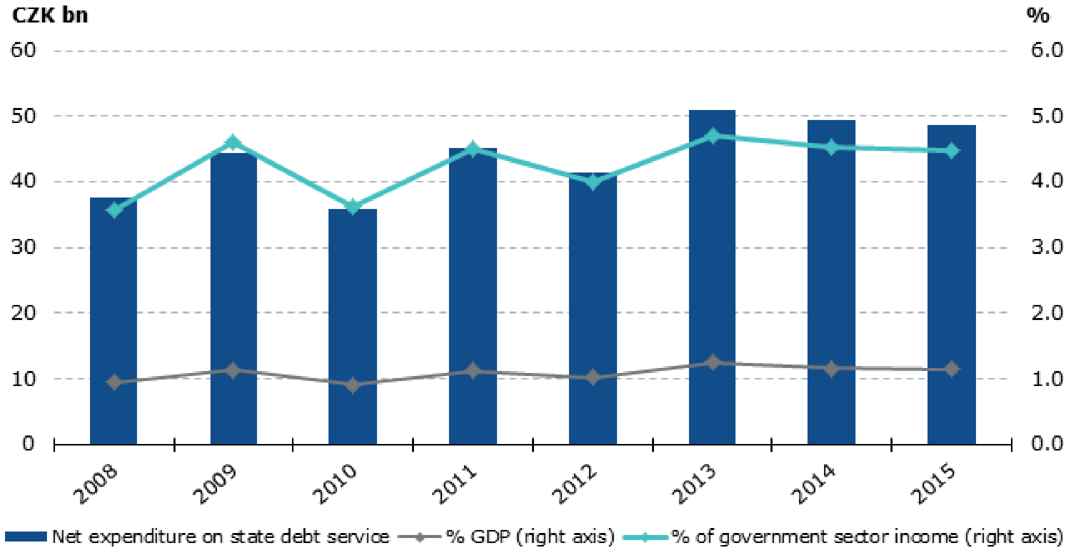
Source: MoF

State Debt Service Expenditure

Cash and Accrued Expression

Since 2008, the net expenditure on state debt service is represented by the difference of gross expenditure on state debt service and revenue, which is cash-based (like the entire state budget); hence, it is not accrued according to the ESA 2010 methodology, which takes place while preparing data for the notification. The share of net expenditure on state debt service in revenue of state budget and also in the GDP has been relatively stable over the past years.

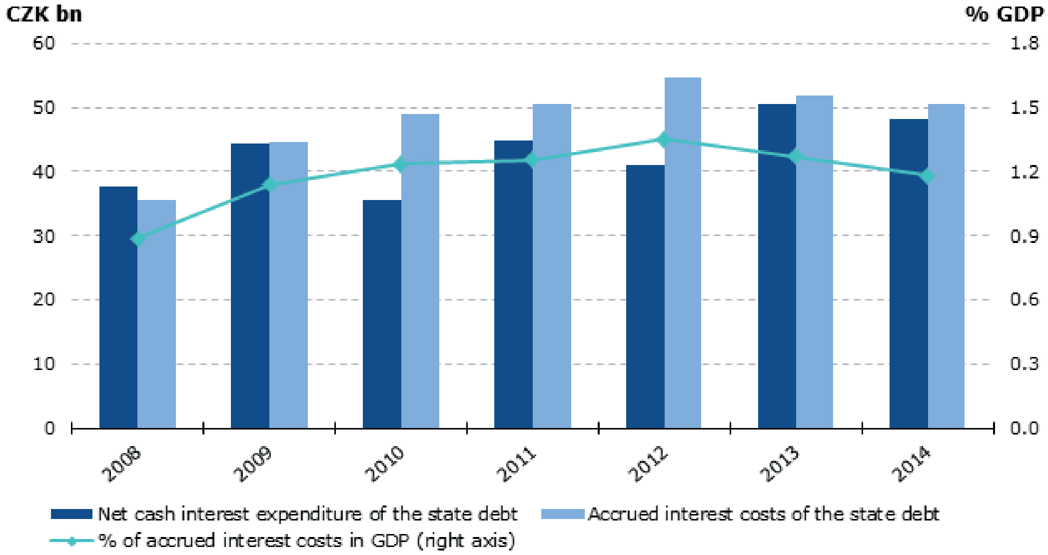
Figure 3: Net Expenditure on State Debt Service



Note: Net expenditure for 2008 to 2013 represent actual data, data for 2014 the expected actual data and data for 2015 expected value of expenditure given by the model. The revenue of state budget is adjusted for the revenue of budget chapter 396 – State Debt. Source for GDP in ESA 2010 methodology for 2008 to 2013 is the CZSO, for 2014 and 2015 the MoF Macroeconomic Forecast – October 2014. The source for revenue of state budget for 2015 is State Budget Act of the Czech Republic for 2015
Source: MoF, CZSO

Monitoring of the development of revenue and expenditure, or net expenditure on state debt service, does not always provide entirely accurate information on which costs are really linked to state debt in the given period. This purpose is better served by the accrued-based expression of costs, which is based on the gradual accumulation of interest costs on a daily basis. The development of accrued interest costs has a tendency to show much lower volatility than development of interest on the cash basis because it is not affected by time disproportions between the time of creation of given interest cost and the date of realization of related expenditure or revenue. Until 2012, accrued costs grew steadily and the share of accrued costs in GDP developed accordingly. The decline in accrued costs in 2013 and 2014 is due to the concurrence of a very slight increase/stagnation in state debt and a decline in yields of government bonds to historical lows.

Figure 4: Net Cash Expenditure and Accrued Costs on State Debt Service



Note: Source for GDP in ESA 2010 methodology for 2008 to 2013 is the CZSO, for 2014 the MoF Macroeconomic Forecast – October 2014. Figures in 2014 are expected values.
Source: MoF, CZSO

Among the factors affecting the relation between cash expenditure and accrued costs is the development of the balance of individual debt instruments. When the balance increases, interest payments paid at the end of calculation period (i.e. mainly coupon of domestic T-bonds, EIB loans interest, and swap interest) have an impact on costs on accrual basis at first and then on cash basis at the end of this period. When the state debt increases, the accrued costs in the given period outweighs cash expenditure for this reason. On the contrary, for discounted instruments (T-bills), interest is settled with the state budget on the issue date, i.e. discounts have an impact on expenditure on cash basis at first and then have gradual impact on costs on accrued basis throughout the duration of the instrument. A similar principle applies to discounts and premiums on T-bonds.

A key role in the proportion between cash expenditure and accrued costs is also played by the development of interest rates. In case of their growth, there is a prevalence of accrued costs over cash expenditure for payments made at the end of the calculation period, and in the case of interest expenditure at the beginning of the instrument's duration, cash expenditure prevails over accrued costs. The similar principles apply in opposite sense in case of the interest rates decline.

Similarly, there may be a significant disproportion between cash expenditure and accrued costs in the given period, if an instrument with a high interest rate is due in the period, which is fully projected in cash interest but only partly in accrued interest, and is replaced with an instrument with a low interest rate, whose accrual cost starts being continually accounted from the issue or acceptance date, which may not be reflected in cash interest at all in the given period.

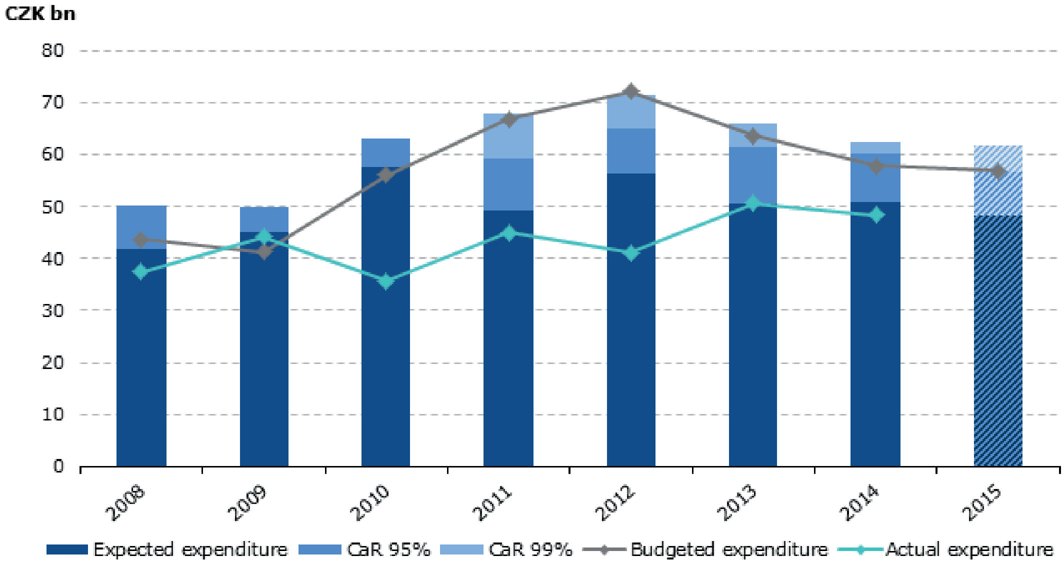
Cost-at-Risk of State Debt

The Ministry applies a sophisticated model framework known as Cost-at-Risk (CaR) for measuring and managing interest rate risk, which is based on the Value-at-Risk methodology and simulates future expected and maximum interest expenditure for 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 deterministic element is the dynamic structure of the portfolio of state debt, which is based on the base case scenario of the funding programme while respecting the set strategic goals for managing financial risks.

The primary goal of the model is to determine the maximum interest expenditure on state debt, which with 95% or 99% probability will not be exceeded (CaR 95% and CaR 99%). The secondary goal of the model is to estimate the actual interest expenditure on state debt. The simulation framework operates separately with the interest expenditure and interest revenue. The outcome of aggregation of interest expenditure and interest revenue are the net interest expenditure on state debt. Compared to gross expenditure on state debt service, gross interest expenditure does not include fees related to state debt service, which are of a deterministic nature.

Over all the years the CaR methodology being applied, the model has fulfilled the primary goal, since the predicted maximum interest expenditures were not exceeded in any of those years.

Figure 5: Net Interest Expenditure and Cost-at-Risk



Note: In 2008 to 2014, the figures represent the originally approved budget, in 2015 budgeted net interest expenditure in State Budget Act of the Czech Republic for 2015. Figure in 2014 is expected value.
Source: MoF

Table 6: Net Interest Expenditure and Cost-at-Risk (CZK billion)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Budgeted expenditure[1]	43.7	41.3	56.1	66.7	72.1	63.6	57.8	56.8	63.3	72.9
Actual expenditure[2]	37.5	44.1	35.6	45.0	41.1	50.6	48.3	-	-	-
Expected expenditure	41.7	44.9	57.5	49.1	56.4	50.6	50.9	48.2	49.0	52.0
CaR 95%	50.2	49.9	62.9	59.2	64.9	61.3	60.0	56.6	62.4	67.4
CaR 99%	-	-	-	67.8	71.5	65.9	62.3	61.7	67.8	75.9

[1] In 2008 to 2014, the figures represent the originally approved budget, in 2015 budgeted net interest expenditure in State Budget Act of the Czech Republic for 2015, in 2016 and 2017 medium-term outlook.
[2] Figure in 2014 is expected value.
Source: MoF

Budgeted net interest expenditure on state debt service for 2015 is at the 95% percentile of the CaR indicator and therefore will not be exceeded with the probability of 95%. The gross interest expenditure is budgeted at the 99% percentile of simulations of the gross interest expenditure. As for budgeting, the revenue of budget chapter 396 – State Debt, the Ministry continues to apply the revenue expected by the model.

The expected value of net interest expenditure amounts to CZK 49.0 billion in 2016 and CZK 52.0 billion in 2017, which is given primarily by the use of less conservative model for risk premium on government bonds, and yields of government bonds on historic lows. In medium-term outlook of state budget for 2016 and 2017, the expenditure frameworks of budget chapter 396 – State Debt are consistent with CaR 99% and CaR 95% indicators. For 2016 the expenditure framework amounts to CZK 63.3 billion and corresponds to approx. 96% percentile of interest expenditure. For 2017 the expenditure framework amounts to CZK 72.9 billion and corresponds to approx. 98% percentile of interest expenditure. The increasing trend of budgeted interest expenditure is given primarily by the volatility of interest rates, which increases with longer prediction horizon. Due to the fact that the state budget is compiled only for the following year, the prediction horizon of interest expenditure for the budget compilation for following year will be shorter, and therefore, given the market condition remain unchanged, the values of CaR 95% and CaR 99% indicator will decrease due to the lower volatility of the interest rates prediction.

In 2014, the actual gross interest expenditure are expected to reach approximately CZK 55.7 billion, while the expected gross interest expenditure in 2014 predicted by the model amount to CZK 58.3 billion. The expected actual interest revenue of the state debt in 2014 amounts to CZK 7.4 billion, thus corresponding to the expected revenue predicted by the model. The expected net interest expenditure of the state debt in 2014 amounts to CZK 48.3 billion, while the net interest expenditure predicted by the model amounts to CZK 50.9 billion.

The expected net interest expenditure will thus remain below the CaR 95% and CaR 99% level even in 2014, having been set at CZK 60.0 billion and CZK 62.3 billion, respectively. The primary goal of the model was thus fulfilled, as the actual interest expenditure of the state debt remained below the CaR 99% level and the fulfilment of the state budget balance for 2014 approved by the Chamber of Deputies was not jeopardized by the budget chapter 396 – State debt. The expected gross interest expenditure predicted by the model is approximately CZK 2.6 billion higher compared to the predicted actuality, which is fully reflected in the difference in the prediction of expected net interest expenditure.

The difference in expected gross interest expenditure is given primarily by the lower yields from CZK-denominated T-bonds, which lasted practically throughout the year 2014 and brought yields of government bonds to their historic lows. As a result, the difference amounts to CZK 2.0 billion and is due primarily to a change in the structure of the issuance calendar for government bonds and lower-than-expected discounts. Another significant factor was the lower level of the PRIBOR reference rate, which continued to slightly decrease in 2014. Due to the lower-than-expected reference rate values, the difference in the prediction is approximately CZK 0.4 billion. Given the lower-than-expected yields from state treasury bills, the difference is approximately CZK 0.2 billion.

Primary Dealers in Czech Republic Government Bonds

CZK-denominated T-bonds and T-bills will be offered in auctions to the primary dealers group, who concluded the Primary Dealer Agreement for Czech Government Securities with the Ministry. The number of primary dealers for 2015 is 13 and thus remains unchanged. The list of primary dealers is presented in following table.

Table 7: Primary Dealers in Czech Republic Government Bonds for 2015

Primary dealers	
Barclays Bank PLC	ING Bank N.V.
Citibank Europe plc	J. P. Morgan Securities plc
Erste Group Bank AG / Česká spořitelna, a.s.	Morgan Stanley & Co International PLC
KBC Bank NV / Československá obchodní banka, a.s.	Société Générale / Komerční banka, a.s.
Deutsche Bank AG	PPF banka a.s.
Goldman Sachs International	UniCredit Bank Czech Republic and Slovakia, a.s.
HSBC Bank plc	

Source: MoF

Calendar of Information Published in the First Half of 2015

January

Mo	Tu	We	Th	Fr	Sa	Su
			1	2	3	4
5	6	7	8	9	10	11
12	13	14	15	16	17	18
19	20	21	22	23	24	25
26	27	28	29	30	31	

February

Mo	Tu	We	Th	Fr	Sa	Su
						1
2	3	4	5	6	7	8
9	10	11	12	13	14	15
16	17	18	19	20	21	22
23	24	25	26	27	28	

March

Mo	Tu	We	Th	Fr	Sa	Su
						1
2	3	4	5	6	7	8
9	10	11	12	13	14	15
16	17	18	19	20	21	22
23	24	25	26	27	28	29
30	31					

April

Mo	Tu	We	Th	Fr	Sa	Su
		1	2	3	4	5
6	7	8	9	10	11	12
13	14	15	16	17	18	19
20	21	22	23	24	25	26
27	28	29	30			

May

Mo	Tu	We	Th	Fr	Sa	Su
				1	2	3
4	5	6	7	8	9	10
11	12	13	14	15	16	17
18	19	20	21	22	23	24
25	26	27	28	29	30	31

June

Mo	Tu	We	Th	Fr	Sa	Su
1	2	3	4	5	6	7
8	9	10	11	12	13	14
15	16	17	18	19	20	21
22	23	24	25	26	27	28
29	30					

Publication of the Report on State Debt Management in 2014
- on last working day of the first month of the calendar year

Publication of the Czech Republic Funding and Debt Management Strategy for the second half of 2015
- on the last Friday of the first half of 2015

Publication of Debt Portfolio Management Quarterly Review and Performance Evaluation of Primary Dealers in Czech Government Securities
- every third Friday of the month following the end of the respective quarter

Publication of statistics of the Central Government Debt and Fiscal Data for the Czech Republic
- in March and June

Publication of the annual statistics on Development and Structure of the State Debt, Financing Needs and Sources of the Central Government and Interest Expenditure on the State Debt
- on the last working day of the month of March

Publication of the Statistics on government bonds by type of instrument, Statistics on government bonds by type of holder and Statistics on government bonds by maturity
- on the last working day of the month

Publication of the Issuance calendars of treasury bills and medium-term and long-term government bonds for next month
- second or third Monday in the month prior the month of auctions

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The publication was prepared based on the information and data available on 15 December 2014. The Ministry reserves the right to promptly respond to the actual development of funding requirement using its tools over the course of first half of 2015. The fulfilment of the funding programme and announced strategic goals in first half of 2015 will depend of the development of the situation on domestic and foreign financial markets in terms of the minimization of expenditure on state debt service and financial risk management. The Ministry will publish the update of Strategy for the second half of 2015 based on the actual development of financing needs and the development of financial market situation.

This publication is also available on the following website:

www.mfcr.cz/statedebt

www.sporicidluhopisycr.cz

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