DEBT MANAGEMENT OUTLOOK

2003

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CONTENTS

INTRODUCTION

This is the fifth Debt Management Outlook of the Hungarian Government Debt Management Agency Ltd. (ÁKK) to the public.

The first part of the report provides a brief summary of the institutional framework and the underlying tasks of debt management in Hungary. The second part presents the borrowing requirement for the year 2003, and the third part sets out the actual plans for financing the borrowing requirement. The fourth part describes expected developments in forint and foreign currency denominated debt in 2003.

I. THE INSTITUTIONAL FRAMEWORK AND TASKS OF DEBT MANAGEMENT

Pursuant to the Act on Public Finances the Minister of Finance is responsible for financing the budget deficit and debt management. The Minister carries out these tasks through the ÁKK, according to the regulations of the Act on Public Finances.

The main objective of debt management in Hungary is to meet the borrowing requirements of the central government with the lowest possible costs in the long term while running acceptable risks.

In creating and developing a well-functioning domestic government securities market, which is vital for efficient debt management, ÁKK has three basic principles. These are to improve the *transparency* and *liquidity* of the government securities market, and to make the characteristics of government securities *simpler*.

- The transparency of the primary market is achieved by issuing government bonds and discount Treasury bills at regular auctions and by the announcement of the annual issuance calendar in advance. The issuance calendar includes the dates of auctions, the settlement dates, the dates of reverse auctions and redemptions as well.
- Improving liquidity of government securities in the secondary market is the result – among other factors – of building up large benchmark series by reopening earlier issues, and at the same time reducing the number of individual series outstanding.
- The transparency and liquidity of the government securities secondary market is improved also by the permanent two-way (bid and offer) price quotation of primary dealers for market participants. Currently there are 12 government securities primary dealers.
- The simplicity of government securities is enhanced by the fact that the maturity, coupon payments, dates of interest payments and the redemption of government securities issued are worked out on the basis of common principles.

The Republic of Hungary – or ÁKK acting for funding purposes in the name of the Republic – is active in the international capital markets as well. In this relation ÁKK intends to realise the main principles followed in the domestic market – maintaining liquidity, ensuring transparency etc. – in international markets as well.
Hungary intends to enter the EMU, which means that debt denominated in euro will become domestic debt. An important target is to establish a euro yield curve for Hungarian government securities, in order to achieve sufficient liquidity, which will contribute to the continuous widening of the foreign investor base for euro denominated Hungarian government securities.

II. THE BORROWING REQUIREMENT

The Act on the 2003 central government budget plans the deficit of the central government to total HUF 569 billion. The deficit of the Social Security Funds will amount to HUF 277 billion, whereas the annual surplus of the Extrabudgetary Funds is expected to be HUF 14 billion, making the total net borrowing position – which excludes the redemptions of government debt and certain extraordinary financing items – amount to HUF 832 billion, as targeted.

DEVELOPMENT OF THE GROSS BORROWING POSITION

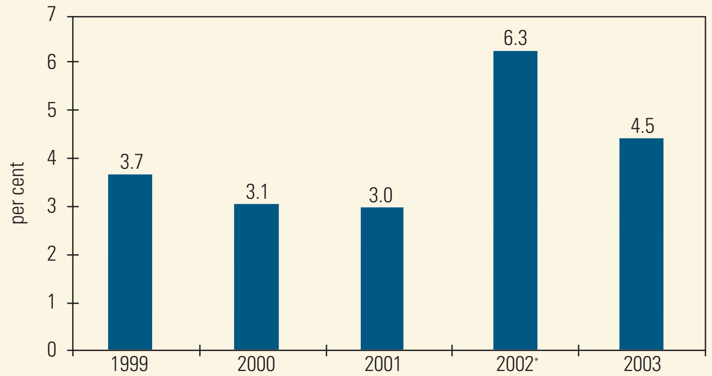
	HUF billion				
	1999	2000	2001	2002*	2003**
Deficit of the central government (excl. privatisation revenues)	-338.1	-330.0	-413.2	-962.65***	-569.0
Financing requirement of the Social Security Funds	-46.6	-70.0	-32.3	-101.3	-277.1
Financing requirement of the Extrabudgetary Funds	-40.4	0.0	-2.3	1.5	13.9
Net borrowing position	-425.1	-400.0	-447.8	-1062.5	-832.2
Funds covering the exchange rate losses of the NBH				-250.2	-18.0
Privatisation revenues	8.0	0.9	0.0	0.0	100.0
Debt redemptions	-2659.8	-3088.7	-2993.9	-3951.3	-4975.0
Gross borrowing position	-3076.9	-3487.8	-3441.7	-5264.0	-5725.2

* preliminary
** appropriation
*** not including HUF 512 billion worth of loan assumptions and bond transfers at the end of December 2002

As in 2002, an additional borrowing requirement emerges this year to cover the forex losses in the balance sheet of the National Bank of Hungary (NBH) caused by the appreciation of the forint against the euro. The estimated amount is expected to be about HUF 18 billion.

For the financing of infrastructural development projects the Budget Act estimates privatisation revenues of HUF 100 billion in 2003, which reduce the borrowing requirement.

THE NET BORROWING REQUIREMENT AS PERCENTAGE OF GDP 1999–2003



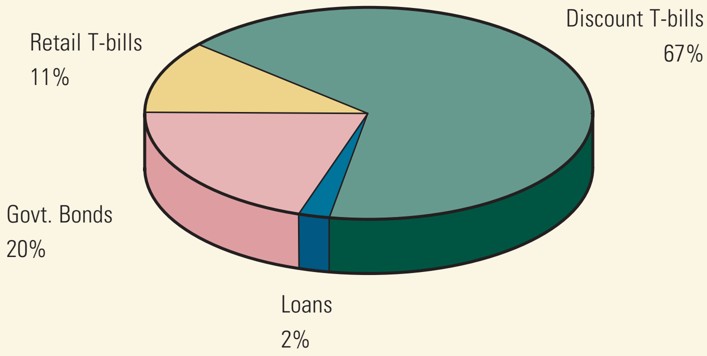
*not including HUF 512 billion worth of loan assumptions and bond transfers at the end of December 2002

II. THE BORROWING REQUIREMENT

REDEMPTIONS

In 2003 the total expected amount of debt redemptions is HUF 4,975 billion, including within-the-year maturities.

THE BREAKDOWN OF HUF DEBT REDEMPTIONS IN 2003 BY INSTRUMENTS



Out of the amount of total redemptions, repayment of forint debt will total HUF 4,458 billion, while redemption of foreign currency denominated debt will reach HUF 517 billion. The high amount of redemptions in 2003 is the result of the short average term-to-maturity of the forint market debt and the significant increase in the issuance of Discount Treasury Bills in 2002.

Reverse auctions form an important part of total government securities redemptions. As ÁKK aims to build up liquid government security series, the importance of reverse auctions is increasing. Reverse auctions help the issuer in smoothing out the redemption profile over the year, and in creating additional means of cash management.

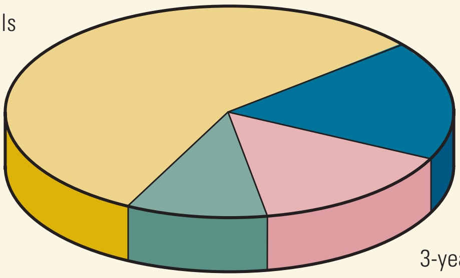
For investors, on the other hand, these auctions provide an opportunity to reinvest their funds ahead of redemption into longer term government securities, especially into on-the-run benchmark instruments. In 2003 government bond reverse auctions are planned on ten occasions during the year, each time two different bonds will be offered for repurchase in amounts of up to HUF 10–15 billion. This volume, however, may change depending on the amount of bids submitted, which consequently may affect the total volume of debt maturing during the year.

III. GOVERNMENT SECURITIES ISSUANCE IN 2003

The annual issuing structure reflects the principles laid down in the debt management strategy.
In 2003 ÁKK returns to its strategy of financing the redemptions of foreign currency debt from the international capital markets, in foreign currency, and meeting all other financing requirements in the forint market. ÁKK has also set a target value for the balance of the current account of the State Treasury which ensures that cash reserves are sufficient.

THE STRUCTURE OF GROSS FORINT ISSUANCE

BREAKDOWN OF GROSS ISSUANCE IN THE HUF MARKET IN 2003



Compared to the gross forint market issuance of HUF 4,912 billion in 2002, forint denominated government securities issuance will reach about HUF 5,242 billion in 2003. The share of bonds with 5-year and longer maturities is expected to be around 18% within gross issuance, the share of 3-year securities around 16%, Discount T-Bills will account for 57%, while the share of retail government securities will reach 10% in 2003.

CHANGES IN THE ISSUANCE CALENDAR

According to market responses, auctions of the 3-year bonds held every fourteen days in 2002 proved to be too frequent compared to market needs. Conversely, the four auctions in 2002 of the 15-year bond, issued in 2001 for the first time, were considered too rare. Thus, in 2003 ÁKK returns to holding an auction once every four weeks in the case of the 3-year bonds. The 15-year bond will be auctioned every two months. This means that the 3-year bond will be auctioned either on its own or – in every other month – coupled with the 15-year bond. 5- and 10-year bonds will regularly be auctioned together once a month, two weeks after the 3-year bond auction. Thus the 10-year bond will be also issued more frequently than in 2002, when it was auctioned alternately with the 15-year bond.

See the issuance calendar at the end of the publication.

III. GOVERNMENT SECURITIES ISSUANCE IN 2003

NET FORINT ISSUANCE

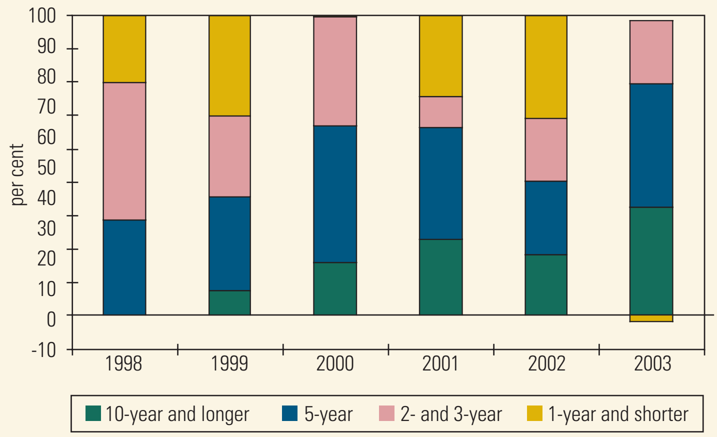
Government securities issued in the domestic market in addition to meeting the net borrowing requirement (HUF 832 billion) also have to finance the forex losses of the NBH and maintain a sufficient level of the cash reserves of the central government (see table). Privatisation revenues and net foreign currency issuance will reduce the net financing requirement from the domestic market.

NET DOMESTIC MARKET BORROWING REQUIREMENT AND FINANCING IN 2003

	HUF billion		HUF billion
Deficit of the central government, Social Security and Extrabudgetary Funds	832	10-year and longer government bonds	337
Funds covering the foreign exchange losses of the NBH	18	5-year government bonds	378
Privatisation revenues	-100	3-year government bonds	196
Repayment of loans to the NBH and net foreign currency issuance	-3	Government securities with 1-year and shorter maturities	-17
Change in the cash position of the State Treasury	147		
Net domestic market borrowing requirement	**894**	**Net domestic market financing**	**894**

Long-term government bonds will play an important role in 2003. 5-year bonds will have a 42% share out of the planned HUF 894 billion net issuance, the proportion of 10- and 15-year bonds will reach 38%, while 3-year bonds will account for 22%. Discount T-Bills will not take part in the deficit financing, but they will play an important role in covering temporary financing needs and offer an alternative form of funding beside bond and retail government security sales if an unforeseen extra borrowing requirement turns up.

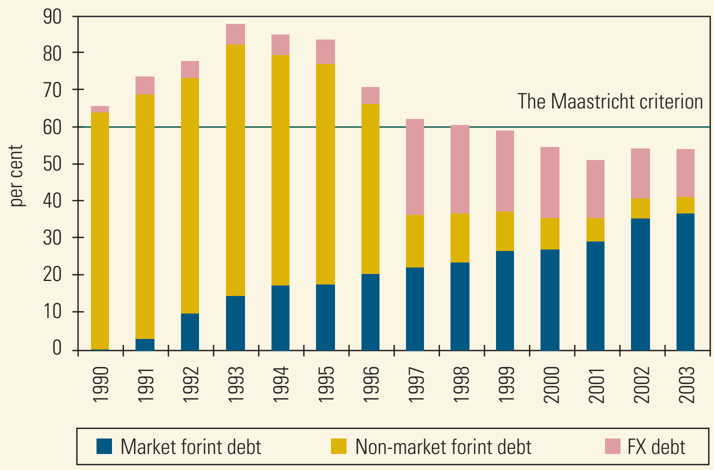
NET ISSUANCE OF GOVERNMENT SECURITIES IN THE HUF MARKET



IV. THE DEVELOPMENT OF DEBT IN 2003

The gross debt of the central government amounted to HUF 9,224 billion at the end of December 2002, accounting for a 55.9% debt to GDP ratio. This ratio for Hungarian government debt[1] was continuously declining between 1993 and 2001, and has remained under 60 per cent since 1999, meeting the Maastricht criterion. A temporary increase was seen in 2002 due to extraordinary transactions. The ratio will not change in 2003, but will further decrease from 2004 on.

GOVERNMENT DEBT/GDP



One of the most important targets of macroeconomic policy continues to be the reduction of the total debt/GDP and the central government deficit/GDP ratios. These two factors are closely related to each other since a high deficit creates a high borrowing requirement and thus an increasing total debt. Correspondingly, interest payments as a consequence of high indebtedness have a negative impact on the central budget.

In 2003 interest payments of HUF 715 billion will be about 13 per cent of the total expenditures of the central government. The proportion of interest payments compared to GDP has been continuously declining for the last five years; it was 4.3 per cent in 2002 and is expected to fall below 3.8 per cent in 2003.

THE DEVELOPMENT OF FOREIGN CURRENCY DEBT IN 2003

Foreign currency debt maturing in 2003 will be financed by foreign currency issuances – similar to the practice prior to 2002. This decision affects the currency structure of the overall financing, and as a consequence, 24 per cent of the total debt will be denominated in foreign currency by the end of the year. This will show a small decrease compared to the 25% ratio as at end of 2002. According to the debt management strategy the currency composition of foreign currency debt is to be the same as the currency basket of the forint (100 per cent euro). In order to achieve this, ÁKK either issues debt in euros or in case of other currencies uses cross-currency swaps to keep the composition of the foreign debt in line with the currency benchmark.

[1] Government debt here means the gross debt of the central government.

IV. THE DEVELOPMENT OF DEBT IN 2003

FOREIGN ISSUANCE IN 2003

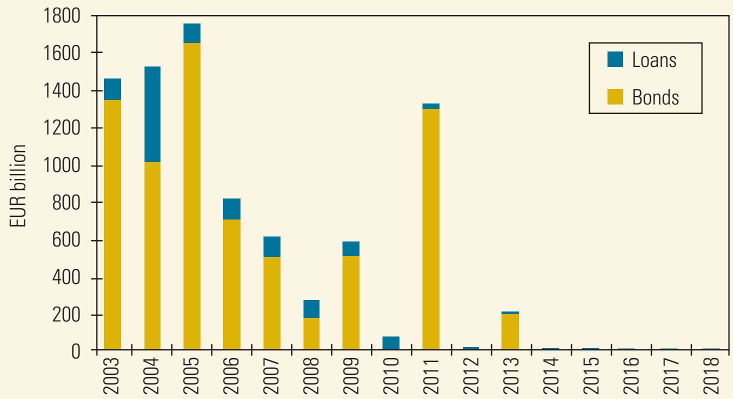
When raising funds in the international capital markets ÁKK's objectives are:

- to issue mainly in the euro bond market, and to sell large and sufficiently liquid government security series;
- to create a euro yield curve for Hungarian government securities;
- to create a wide investor base.

In 2003 HUF 517 billion (approx. EUR 2,150 million) debt denominated in foreign currency is expected to fall due, of which EUR 1,850 million is the redemption of foreign currency bonds (this figure includes bonds maturing in early 2004). The prepayment and redemption of loans will account for the remaining EUR 300 million.

This year the Republic of Hungary plans to issue two fixed rate bonds in foreign currency in a total volume of EUR 2 billion, each with a maturity of 5 to 10 years. The issuance of the first EUR 1 billion bond, with a 10-year maturity, has already taken place in February.
In addition, project financing loans will also be raised from international financial institutions.

MATURITY PROFILE OF THE CENTRAL GOVERNMENT FOREX DEBT END OF 2002



IV. THE DEVELOPMENT OF DEBT IN 2003

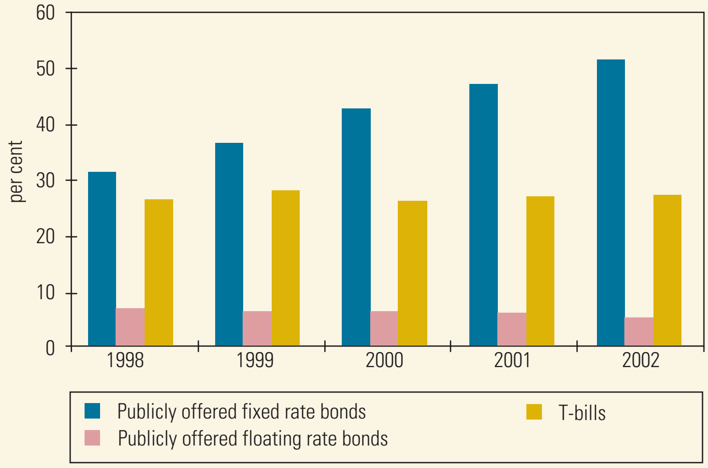
THE DEVELOPMENT OF FORINT DEBT IN 2003

The following are the objectives behind ÁKK's forint issuing strategy in 2003:

A. TO INCREASE THE SHARE OF FIXED RATE MARKETABLE FORINT DENOMINATED BONDS

Fixed rate forint denominated bonds represented 51 per cent of total forint debt at the end of 2002. Despite the continuous improvement this ratio is still lower than that of EU countries. A higher proportion of long-term fixed rate government bonds reduces refinancing risk, so it has been the aim of debt management to increase the duration of the forint market debt by issuing fixed rate bonds. (The duration rose to 2.0 years as at the end of 2002 from 1.66-years in December 2001). In addition, a higher proportion of fixed rate debt supports the development of the secondary market. Consequently, ÁKK will issue only fixed rate government bonds throughout 2003.

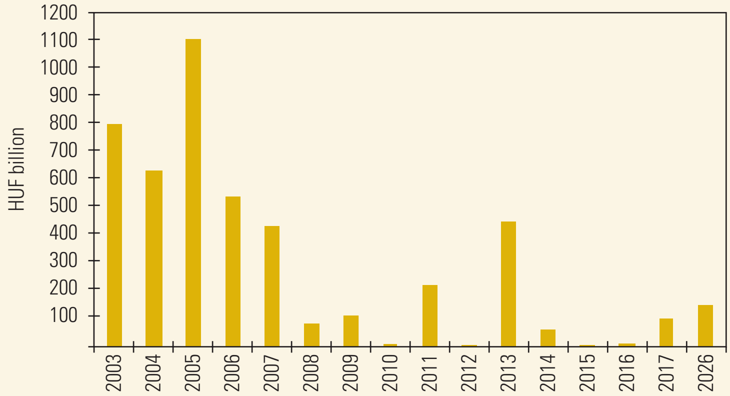
SHARE OF FIXED RATE GOVERNMENT BONDS WITHIN THE FORINT DEBT



IV. THE DEVELOPMENT OF DEBT IN 2003

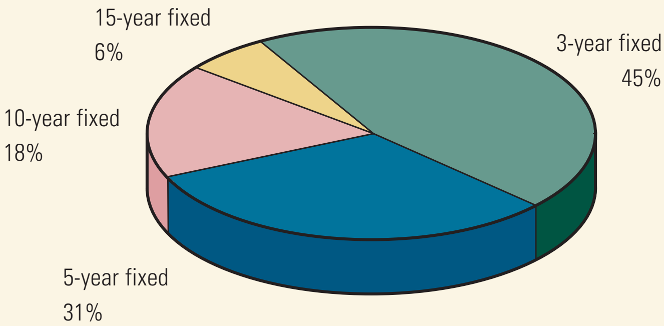
B. TO IMPROVE THE MATURITY PROFILE OF MARKETABLE FORINT DEBT AND TO LENGTHEN THE AVERAGE TERM-TO-MATURITY OUTSTANDING

MATURITY STRUCTURE OF THE FORINT DENOMINATED GOVERNMENT BONDS AT END 2002



The maturity profile of forint denominated government bonds is uneven, being concentrated in the first few years. The volume of government bond redemptions is very high in the year 2003–2007 period. At the end of 2002, 41% of the forint denominated market debt was due within one year, 10% in two years and 35% in 3 to 5 years. Although the share of short-term debt has been declining for several years, the objective of debt management remains to create a more even maturity profile.

BREAKDOWN OF GROSS HUF BOND OFFERINGS BY INSTRUMENTS IN 2003



The average term-to-maturity of government bonds issued in 2002 was 5.0 years. In 2003 a further increase is expected, reaching 5.6 years, and will result in the forint bond portfolio's duration rising from 2.8 to 3.2 years. However, the share of longer term bonds can only be increased with the continuous development of the domestic government securities market.

C. TO MAINTAIN THE SHARE OF RETAIL SECURITIES SO AS TO ENSURE A STABLE INVESTOR BASE

Direct sales of government securities to households is an important way of funding. In order to appeal to household investors, ÁKK uses

- special selling channels (certain primary dealers, the branch network of the Hungarian Post Office and of the Hungarian State Treasury);
- special government securities tailored to the requirements of households (Interest Bearing T-bills, Treasury Savings Bills);
- easily understandable and readily available offering methods for households (continuous sale, subscription).

Household funds are of relatively short-term (generally of one-year maturity); however, a considerable part of these funds is reinvested due to the conservative investment behaviour of households. ÁKK expects this tendency to remain in 2003; thus the volume of household securities will be maintained and its share within total debt will be about 7 per cent by the end of 2003.

D. TO USE THE CONVENTIONS OF THE PRIMARY AND SECONDARY MARKETS IN THE EURO-ZONE IN HUNGARY

Entering the capital market of the European Union is a most important objective in the strategy of ÁKK. Pursuant to the preparations for that event ÁKK has introduced the conventions of the primary and secondary markets used in the euro-zone.

CALCULATION METHODS INTRODUCED IN 2003

As of January 1, 2003 the yield-price calculation method based on the recommendations of the International Securities Market Association (ISMA) was introduced for all existing Hungarian Discount T-bills. According to this modification Discount T-bill prices and yields are calculated using the actual/360 method.

Moreover, as of January 1, 2003 the calculation of accrued interest on floating rate Hungarian Government Bonds has also changed. In the case of bonds with coupon payments linked to Discount T-bill yields the calculation follows that of the T-bills (actual/360), taking effect from the first coupon payment day of the bond in 2003. In the case of bonds with coupon payments linked to the consumer price index, the method used in the calculation of the accrued interest is the same as in the case of fixed rate Hungarian Government Bonds (actual/actual).

With the above mentioned modifications the harmonisation of financial calculation in the Hungarian government securities market has been completed, the calculation method for all Hungarian government securities now being consistent with those used in the EMU government securities markets.

An obvious intention of the ÁKK with these measures was to create a competitive Hungarian government securities market that is attractive both to domestic and international investors. The steadily growing importance of European investors in the domestic market of Hungarian government securities confirms the effectiveness of earlier efforts in this direction.

V. THE MOST IMPORTANT FACTORS THAT MAY CHANGE THE ISSUING STRUCTURE

The financing programme for the financial year 2003 was prepared on the basis of information available at the end of December 2002. It may happen therefore that the structure of issuance will change during the year. The issuer will respond flexibly to changes in the net borrowing requirement and in investor demand (by changes in the auctioned volumes of government securities of different maturities). This, however, will not modify the pre-announced issuance calendar.

Information on current developments and the likelihood of consequent changes to the financing plan is readily available to all participants in the government securities market and to the public generally.

For further information please visit our website www.akk.hu.

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