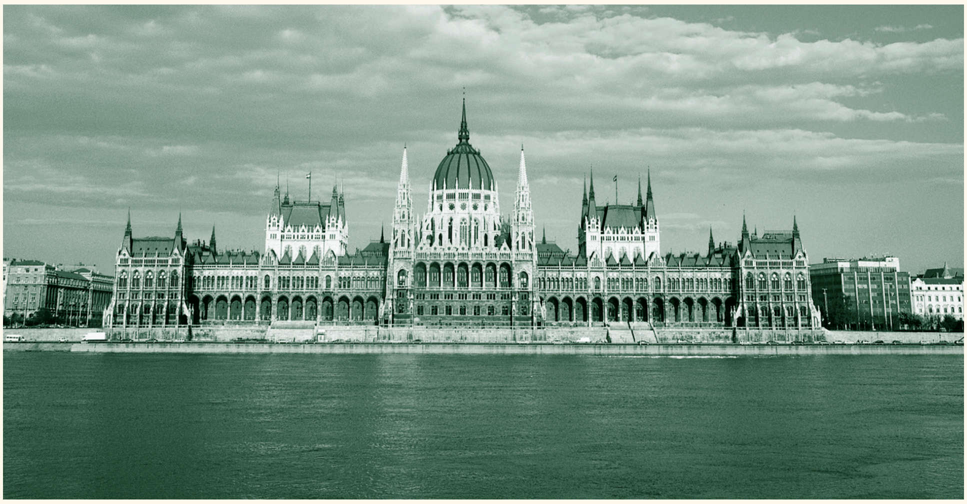
FINANCING OF THE CENTRAL GOVERNMENT BUDGET IN 2002



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CONTENTS

INTRODUCTION

This is the fourth annual report to the public on financing of the central government deficit. The first part provides brief information on the institutional framework of debt management in Hungary, the underlying tasks, and the characteristics of the domestic and international markets. The second part presents the borrowing requirement of the central government for the year 2002, as approved by Parliament, and the third part sets out the future plan for financing these borrowing requirements. The fourth part describes the expected development of foreign currency and forint denominated debt in 2002 and the fifth deals with possible modifications of the structure of issuance.

I. THE INSTITUTIONAL FRAMEWORK OF DEBT MANAGEMENT

CHARACTERISTICS OF THE DOMESTIC GOVERNMENT SECURITIES MARKET

Pursuant to the Act on Public Finances the Minister of Finance carries out debt management through the Government Debt Management Agency Ltd. (ÁKK) founded on March 1st, 2001. The most important objectives of the ÁKK in the last few years were to improve the transparency of the market, to make government securities simpler and to enhance the liquidity of the secondary market.

- The transparency of the primary market is improved by the sale of discount treasury bills and government bonds at regular auctions and by the elaboration and early announcement of an annual issuance programme which includes not only the dates of auctions and subscriptions but also a simple system for the underlying financial settlement with closing dates.

- 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 are worked out on the basis of common principles.

- The increase in the liquidity of government securities on the secondary market is the result – among other factors – of continuous increases in the size of individual series by reopening earlier issues, increasing the amounts offered for sale, and reducing the number of individual government securities series.

- 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.

II. THE BORROWING REQUIREMENT

Pursuant to the Act on the 2001 and 2002 central government budgets of the Republic of Hungary the deficit of the central budget in year 2002 is HUF 486 billion. The deficit of the Social Security Funds is HUF 17 billion, whereas the annual deficit of the Extrabudgetary Funds is HUF 2 billion. The total net borrowing position – excluding the redemption of government securities and loans and extraordinary financing items – is HUF 505 billion, as targeted.

In 2002 an additional borrowing requirement will be required to cover the forex losses in the balance sheet of the National Bank of Hungary (NBH) caused by the appreciation of the HUF against the Euro. The estimated amount is expected to be about HUF 160 billion.

In 2002 the total expected amount of the redemption of debt is HUF 3697 billion.

DEVELOPMENT OF GROSS BORROWING POSITION

	HUF billion				
	1998*	1999	2000	2001**	2002***
Deficit of the central government budget (excl. privatisation revenues)	-370.2	-338.1	-330.0	-413.2	-486.1
Social Security Fund's financing requirement	-88.9	-46.6	-70.0	-32.3	-17.2
Extrabudgetary Fund's financing requirement	-12.5	-40.4	0.0	-2.3	-2.2
Net borrowing position	-471.5	-425.1	-400.0	-447.8	-505.5
Funds covering exchange rate losses of the NBH					-160.0
Privatisation revenues and the balance of capital market operations	-13.1	8.0	0.9	0.0	0.0
Total redemptions	-1843.3	-2659.8	-3088.7	-2993.9	-3697.4
Gross borrowing position	-2327.9	-3076.9	-3487.8	-3441.7	-4362.8

* excluding the costs of Postabank consolidation and the transfer of government bonds to the privatisation agency (ÁPV Rt.)
** preliminary
*** target

REDEMPTIONS

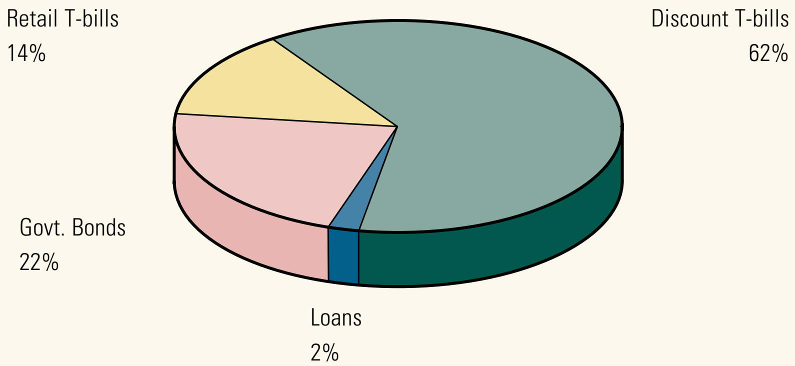
Of the amount of total redemptions above HUF 3457 billion will be the repayment of forint denominated debt, and the remaining HUF 240 billion the redemption of the foreign currency denominated debt. As in previous years, the high proportion of maturing forint debt which is refinanced is basically the result of the current short-term maturity structure of the outstanding forint debt on the market.

The financing need is increased by

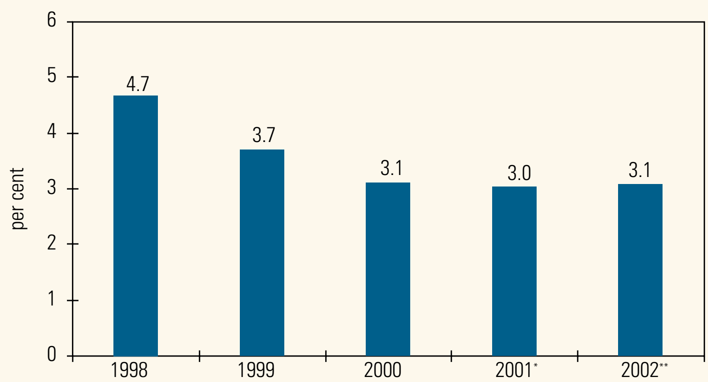
- maturing FX debt, and
- covering the forex losses in the balance sheet of the National Bank of Hungary (NBH) caused by the appreciation of the HUF against the Euro.

II. THE BORROWING REQUIREMENT

THE BRAKEDOWN OF HUF DEBT REDEMPTION BY INSTRUMENTS IN 2002



THE NET BORROWING POSITION IN PERCENTAGE OF GDP 1998–2002



* provisional data
** budgeted

The introduction of the new pension system contributed to the central government deficit to GDP ratio by 0.5 per cent each year, but this increase in the net borrowing position – because of the shortfall of revenues – was automatically financed by pension funds through their government securities purchases.

Although the figure of gross redemptions is a significant amount, the overwhelming majority of the volume of maturing government securities will be refinanced almost automatically.

II. THE BORROWING REQUIREMENT

REVERSE AUCTIONS

With the issuance of more liquid government security series, the importance of reverse auctions is increasing. Reverse auctions are beneficial for the issuer because they help in smoothing out the repayment profile over the year, in creating additional cash management tools and in standardising the gross issue amounts. For investors, these auctions provide an opportunity to reinvest their funds ahead of redemption in other long-term government securities, especially auctioned benchmark instruments. Similarly to last year, the practice of organising reverse auctions will continue alongside the frequent regular auctions in 2002. The announcement of these reverse auctions will be made in the same way as for regular auctions. In 2002, it is expected that 10 to 15 reverse auctions will be held for government securities, and an amount of approx. HUF 10–15 billion repurchased each time. This volume, however, may change, depending on the bids submitted, which may thus affect the total volume of debt maturing during the year.

III. THE GOVERNMENT SECURITIES ISSUANCE IN 2002

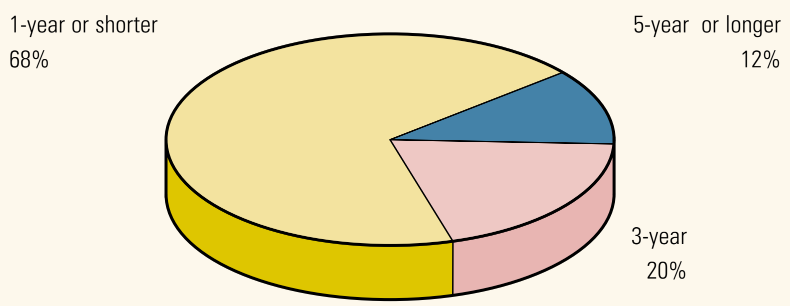
In elaborating the financing plan four main principles were taken into consideration:

1. The financing of the budget deficit of the current year is done through the domestic money and capital market, out of domestic savings, consistent with economic policy targets.
2. The repayment of the maturing FX debt and the covering of the forex losses of the NBH, just like the redemption of the maturing forint debt, will be financed from the domestic forint market.
3. The active participation in the development of instruments of monetary policy (gradual cutting back of the volume of 3-month NBH bonds and channelling this into government securities).
4. The maintenance of a sufficient balance in the Treasury Single Account.

THE STRUCTURE OF GROSS ISSUANCE

Compared to the gross forint market issuance of HUF 3349 billion in 2001, about HUF 4349 billion of government securities will be issued in 2002. Within the gross issuance the share of 5-year or longer maturity securities is expected to be around 12 per cent, the share of 3-year securities 20 per cent and the proportion of 12-month T-bills or those with shorter outstanding maturity 68 per cent. It is important to note that the two-year bond, which accounted for 25 per cent of the total volume of bonds in 2001, will not be offered in 2002; it will be replaced in the financing by a stepped-up volume of three-year bonds.[1]

BRAKEDOWN OF GROSS ISSUES BY MATURITY IN THE HUF MARKET IN 2002



THE STRUCTURE OF NET ISSUANCE

Unlike in previous years, government securities issued on the forint market have – in addition to meeting the borrowing requirement (HUF 505 billion) – to finance the forex losses of NBH and the redemption of FX denominated debt.

In order to finance the last two items the central bank simultaneously cut back the volume of its 3-month bonds: the reinvestment of essentially liquid savings released from NBH bonds into government securities covers these two items automatically. The immediate effect will be to increase the volume of government securities with less than 12-months maturity.

1 Consequently, the bond auction calendar will be modified. 3-year bonds will be auctioned every second week (on Thursdays) together with either 5-year or 10/15-year government bonds.

III. THE GOVERNMENT SECURITIES ISSUANCE IN 2002

THE NET HUF MARKET BORROWING AND FINANCING IN 2002

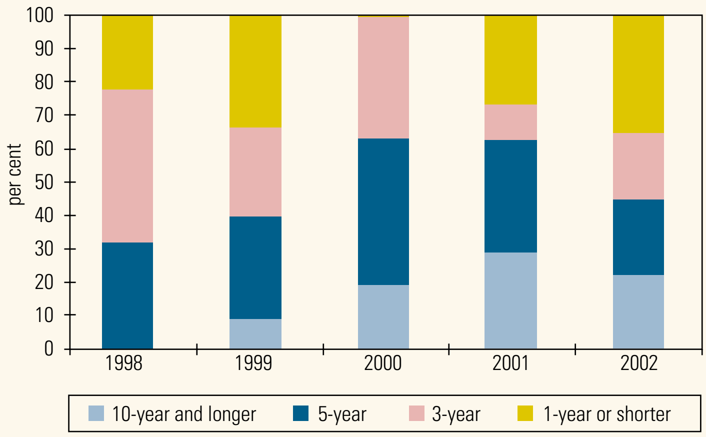
	HUF billion		HUF billion
Central government borrowing	505	5-year or longer government securities	438
Covering forex losses of NBH	160	Govt. securities with 3-year maturity	191
Repayment of loans to NBH*	76	12-month or shorter government securities	342
Repayment of FX debt*	230		
Net forint market borrowing requirement	971	Net forint market financing	971

*In the table in chapter II. among redemption items

Of this total net amount to be financed on the market just under half will be met by issuance of 5-year or longer government securities. The planned amount of net issuance of 5-, 10- and 15-year bonds will be HUF 438 billion in 2002, half of which is represented by 5-year bonds. Expiring two-year bonds will be replaced by the issuance of three-year bonds in an amount of HUF 191 billion. The increasing share of short-term government securities in the total – HUF 342 billion in 2002 – is mainly due to the extraordinary financing needs of the budget.

In the structure of net issuance, with the exception of the year 2000, the share of short- and long-term securities is broadly balanced. It is medium-term bonds which play a decisive role in meeting the net borrowing requirement.

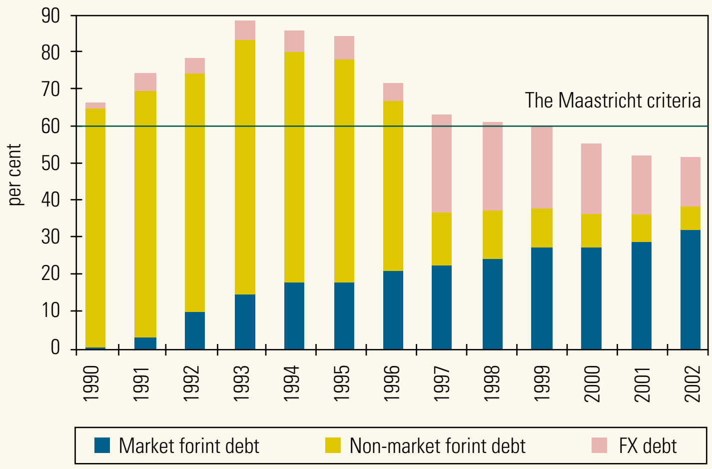
NET SALES OF GOVERNMENT SECURITIES ON THE HUF MARKET



IV. THE DEVELOPMENT OF DEBT IN 2002

The gross debt of central government amounted to HUF 7720 billion at the end of December 2001. Hungarian government debt[2] compared to GDP has been continuously declining since 1993 and at the end of 1999 it reached the level stipulated in the Maastricht criteria (60 per cent). This debt/GDP ratio diminished to 52.4 per cent in 2001 and it seems likely that this trend will continue in 2002 also.

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 budget deficit/GDP ratios. These two factors are closely related to each other since a high deficit means a high borrowing requirement, thus increasing total debt. Correspondingly, interest payments as a consequence of high indebtedness have a negative impact on the central budget.

In 2002 interest payments of HUF 730 billion are expected to represent 16 percent of the total expenditure of the central budget. Out of total interest payments the cost of forint debt is HUF 570 billion (HUF 19 billion higher than in 2001), and that of FX debt HUF 160 billion (HUF 4 billion less than in 2001). Similarly, the proportion of interest payments as compared to GDP is continuously declining. This indicator was 6 per cent in 2000 and it fell back below 5 per cent in 2001.

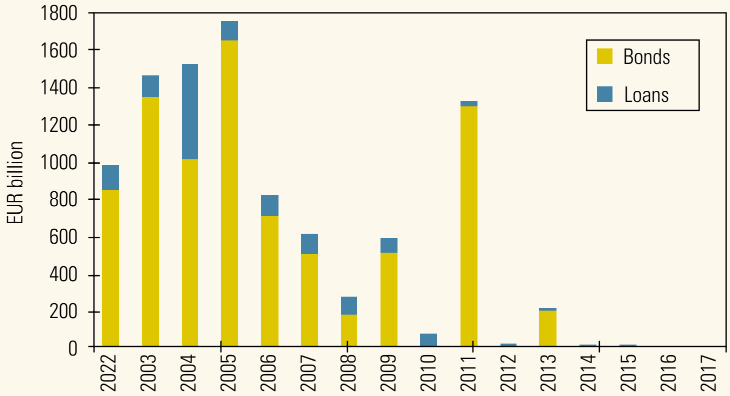
THE DEVELOPMENT OF FOREIGN CURRENCY DENOMINATED DEBT IN 2002

The development of government debt denominated in foreign currency depends not only on the borrowing requirement but also on the economic policy targets and reserves management policy of the NBH. Thus, in specifying issues denominated in foreign currency the development of the current account is an important factor. As is shown in the chart below, the total share of foreign currency denominated debt in total government debt was 30 per cent at the end of 2001. In 2002 this share is expected to decline to 26 per cent due to the refinancing on the domestic market of HUF 240 billion (about EUR 950 million) of foreign currency denominated debt maturing this year.

[2] Government debt here means the gross debt of the central budget.

IV. THE DEVELOPMENT OF DEBT IN 2002

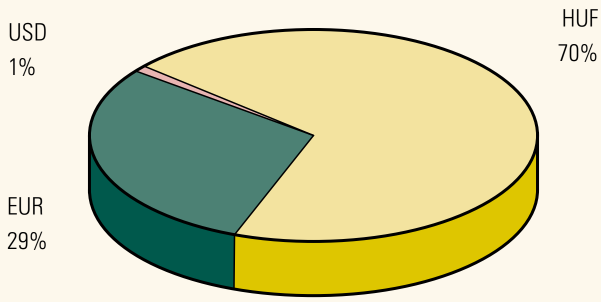
MATURITY PROFILE OF THE CENTRAL GOVERNMENT FOREX DEBT END OF 2001



BENCHMARKING

According to the debt management strategy aiming at limiting the exchange rate risk represented by the net foreign currency debt, a currency benchmark was set up mirroring the structure of the currency basket of the forint (100 per cent Euro). In this way the effect of cross-currency movements on the value of the forex debt portfolio was eliminated and the exchange rate risk reduced to the fluctuation within the ± 15 % band. In order to limit interest rate risk an interest rate benchmark was also created, which currently consists of approximately 80% fixed and 20% floating rate. There is a 5% tolerance band attached to both benchmarks.

FOREX COMPOSITION OF THE CENTRAL GOVERNMENT GROSS DEPT AT END 2001



IV. THE DEVELOPMENT OF DEBT IN 2002

THE DEVELOPMENT OF FORINT DENOMINATED DEBT IN 2002

Due to significant net forint market issuance the share of forint denominated debt increases to 74 per cent of total debt as at the end of 2002. The composition of the issuance is governed by the following goals:

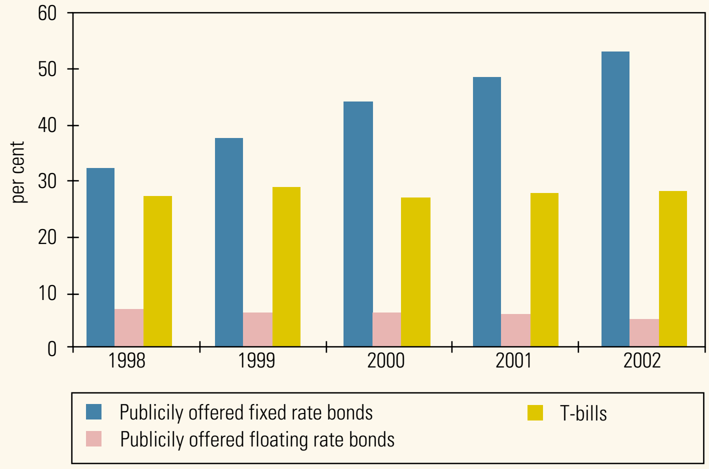
- increasing the share of fixed-rate, publicly issued instruments in the total debt portfolio,
- improving the maturity profile of the publicly issued HUF debt, achieving more evenly spread redemptions, and lengthening of the average term-to-maturity of publicly issued instruments,
- maintaining the share of retail securities that ensure a stable investor base, and
- introducing the Euro convention.

In order to maintain the results achieved so far this year ÁKK will issue only fixed rate government securities.

A. THE RISE OF THE PROPORTION OF FORINT DENOMINATED FIXED RATE GOVERNMENT BONDS

Fixed rate forint denominated bonds represented 52 per cent of the total forint debt at the end of 2001. Despite the improvement this share is still far behind the general indicator for countries with developed government securities markets. The still relatively short (1.66-year) duration of the forint denominated gross debt (though at end 2000 it was 1.34-year) means that this element of debt reacts relatively quickly (within less than a year and a half) to changes in market interest rates. Although given declining interest rates and a reducing rate of inflation in Hungary the consequent rapid readjustment of bond prices has not generated unfavourable market conditions, the optimal strategy for an issuer must be to try to achieve this repricing over a period in order to manage the interest and refinancing risk of the total forint denominated debt. At present this can be done most efficiently with long-term fixed rate government securities.

THE SHARE OF FIXED RATE GOVERNMENT BONDS WITHIN THE FORINT DEBT



Moreover, the increase in the proportion of fixed rate debt supports trading, so assisting the development of the secondary market; it is also beneficial for investors since the cash flow from their investments is more predictable.

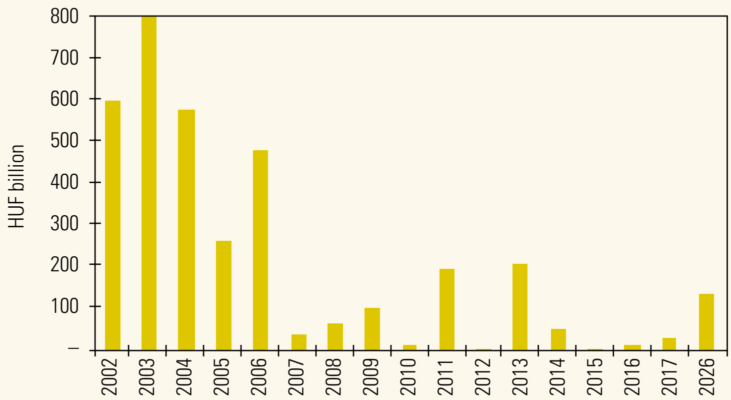
An important characteristic of the present structure of issuance is that all of the four on-the-run bonds are fixed rate bonds. Due to this structure of financing instruments the share of fixed rate bonds within total debt is also increasing.

B. THE IMPROVEMENT OF THE MATURITY PROFILE OF MARKETABLE FORINT DEBT AND THE LENGTHENING OF THE AVERAGE TERM-TO-MATURITY OUTSTANDING

The maturity profile of forint denominated bonds is uneven, i.e. it is concentrated in the first few years. Consequently, as at the end of 2001 48 per cent of the forint denominated market debt was maturing within one year, 19 per cent in two years, and 32 per cent beyond two years. Although the proportion of short-term debt declined by 9 per cent compared to 1998, by comparison with similar indicators for the OECD countries the maturity structure is still unfavourable, since in this group of countries 28 per cent of the debt is maturing within one year and 62.5 per cent beyond two years.

ÁKK's strategy is to prevent any substantial increase in and progressively to reduce the share of (6- and 12-month) T-bills issued with the purpose of financing the budget deficit, and for government bonds to promote the importance of longer term government securities (10- and 15-year fixed rate instruments). It is expected that the corresponding figures as at the end of 2002 will be around 48 per cent maturing within one year, 11 per cent within one to two years and 41 per cent beyond two years.

MATURITY SRUCTURE OF THE FORINT DENOMINATED GOVERNMENT BONDS AT END 2001



As a consequence of this specific maturity profile a large refinancing need is created each year. The best way of moderating this problem is to increase the share of longer term government securities. Due to the development of the market five-year or longer term government securities now have a higher weighting in the net financing than in previous years. Consequently, in 2001 42 per cent of bonds sold were five-year or longer maturity securities.

As a result of the growing volume of issuance of government securities with ever-longer initial maturities the average term-to-maturity of government bonds issued up to the end of 2001 was 4.11 years. In 2002 we expect a further increase in term-to-maturity for government bonds reaching 4.68 years. Beyond this one has to expect that the average term-to-maturity may be extended only slowly in line with the likely future development of the domestic government securities market.

IV. THE DEVELOPMENT OF DEBT IN 2002

LONG-TERM (15-YEAR) FIXED-RATE BONDS DENOMINATED IN FORINT

The issuance of a 15-year fixed rate government bond on a regular basis was an important step in the strategy of issuing at lengthening maturities. It was offered for sale for the first time by the ÁKK in an auction on November 8, 2001 and issues of 15-year bonds are now auctioned on a regular quarterly basis.

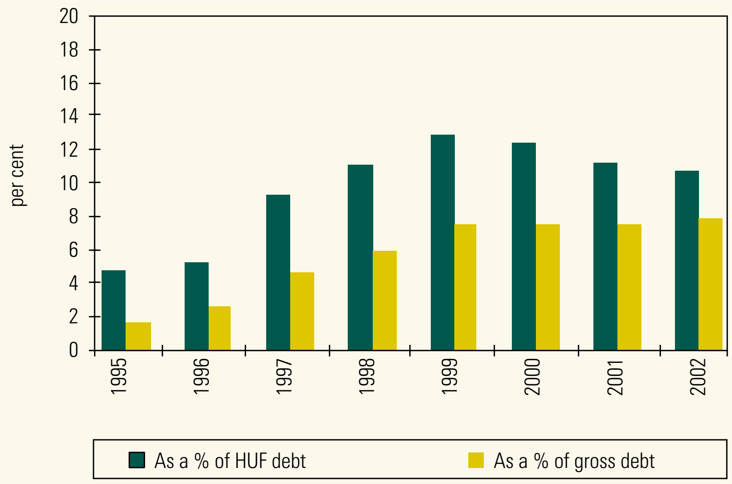
The 15-year bond offers the possibility for the institutional investors (insurers, pension funds etc) who play an increasingly dominant role among financial intermediaries in Hungary to meet their requirements, i.e. to get an appropriate financial asset in the cash market to cover at least partially their long-term liabilities. Further, as the series of such bonds develops it will assist primary dealers to quote firm prices for the 15-year maturity. Finally, based on international experience the issuer expects that the issuance of a 15-year instrument will influence constructively the demand for other long-term securities, notably the demand for the 10-year bond.

Although the maturity of the bond is November 24, 2017, it will be auctioned (i.e. reopened) for the next 2–3 years as a 15-year benchmark issue. It is a fixed-rate bond, and pays interest annually (just like the new series of bonds issued after 2002), which is closer to the convention of the Euro region than previous issues of domestic bonds which had semi-annual interest payments. (See point D.)

C. RETAIL SALES

The central government budget is financed – in accordance with international practice – mainly through wholesale distribution of government securities to institutional investors. At the same time it has always been an important target to meet part of the borrowing requirement through direct sales to households in order to increase the security of financing (diversification).

SHARE OF RETAIL GOVERNMENT SECURITIES IN GOVERNMENT DEBT



IV. THE DEVELOPMENT OF DEBT IN 2002

As of January 2002 there is an important change in the type of retail sales of government securities:

- Treasury Saving Bills (sold to households through post offices with one and two year maturity) are the only government securities series which are still not in dematerialised form. These types of securities have become registered securities as a result of the legislation on the prevention of money laundering as part of the measures against international terrorism.[3]

D. INTRODUCTION OF EURO CONVENTIONS

In the debt management strategy harmonisation of existing Hungarian bond market practice with best European Union practice clearly is of outstanding importance. In following through this strategy two new conventions have been introduced on the government paper market.

Firstly, fixed rate Hungarian Government Bonds will in future pay interest annually, not semi-annually.

Secondly, yield/price and accrued interest calculations will be made on the basis of the Actual/Actual method used on the bond markets of EMU member countries. In the case of bonds issued earlier which are still in circulation – with unchanged frequency of interest payments – the new method will be used in the calculation of accrued interest from the day of the first interest payment following March 1, 2002.

The ÁKK hopes that the adoption of these conventions will accelerate the move by the market to quote Hungarian Government Bonds on the basis of price, as is the international standard, rather than yield, which is the current practice.

[3] The transformation of these instruments into registered securities was made necessary by the Act No. LXXXIII 2001 on the fight against terrorism, on tightening up the prevention of money laundering, according to which "Securities issues in series in public form are allowed only in registered form". This addendum was entered into the Act on the Capital Markets No. CXX 2001; as a result government securities issued after January 1, 2002 are all registered.

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

The financing programme for the financial year 2002, as approved by Parliament, was prepared on the basis of the situation as at December 2001. It may happen therefore that the structure of issuance will change slightly during the year. In the list below we have tried to summarize the most important events which might influence the realization of the financing plan. It is an important part of the ÁKK's commitment to transparency to make information on current developments and the likelihood of consequent changes to the financing plan readily available to all participants on the government securities market and to a significant extent to the public generally:

- changes in the financing requirement of the central government, the social security and extra-budgetary funds, in the forex reserves of the NBH, and unexpected seasonal fluctuations in the financing requirement throughout the year;
- the ratio of the foreign currency debt to HUF debt may be affected by the amount and direction of capital flows;
- the issuer might need to be able to respond flexibly to changes in demand (by minor changes in the auctioned volumes of government securities of different maturities, but not so as to change the preannounced issuing calendar).

For further information visit our website www.allampapir.hu.

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