

**Strategy of State Debt and Liquidity
Management for years 2004 to 2006**

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1. Introduction

The government of the Slovak Republic undertook in its policy statement to carry out reform of public finance consisting of material re-assessment of budgetary incomes, expenditures and reform of public finance management. An important part of this reform is also reform of public and state debt management.

Ratio of gross public debt to GDP was 44.3 % at the end of the year 2002, and it was below the level determined by Maastricht criteria for entry in the Eurozone. Despite these facts, further growth of the debt has its limits.

First of all, expenditures of the state budget for the state debt servicing are at present approximately 12 % to 13 % of total expenditures of the state budget and 36% of GDP. Not only further increase but also current size of those expenditures would significantly restrict options of utilisation of public sources in other areas. And on the other hand, decrease in costs for servicing of the state debt represents an important source of relative decrease in the public budget deficit. For example, decrease in cost interests only for 0.5 % at the present amount of the debt creates space for decreasing expenditures of the state budget by approximately SKK 2 bn.

Secondly, further growth of the debt, as in case of stabilisation or only a moderate increase of its ratio to the GDP, could run against absorbency capacity of the domestic capital market. At the same time, a possible more considerable expansion on foreign markets before entry in the European Monetary Union may increase the exchange rate risk of the state debt.

So the reform of the debt and liquidity management will contribute to macro-economic stabilisation, decrease in pressure in area of public finance and will accelerate fulfilment of conditions for entry in the Eurozone and their subsequent fulfilment by sustainable method. It will also enable to avoid risk, financial losses and unexpected surprises in the future.

In this context, **goal of the reform of the debt and liquidity management is mainly transfer to active management of the state and the public debt, rationalisation of expenditures connected with financing of the state debt, minimisation of risks connected with financial assets, liabilities, as well as open market positions of the state.** Active management of the debt also means better monitoring and taking into consideration situation on the market, starting from short-term analysis of the market development, professionalisation of risk management and support of development of secondary market with government securities. Transition to active debt and liquidity management brings in the system of state finance management the following:

consistency of wider aims and goals of the government and the debt and liquidity management,

limitation and control of future risks and elimination of their influence - savings of future additional expenditures connected with the debt and liquidity management in compliance with the best international practice,

decrease in expenditures connected with services of the state debt and improvement of liquidity management on the "single" account of the state,

arrangement of transparency of the liquidity and state debt management procedure,

flexibility in decision-making, option to flexible respond to fast-changing conditions on financial markets,

acceleration of integration in the EU standards with management of state and public finance and integration in the unified financial market of the EU,

higher independence of the debt management from political influences¹.

The transition to active management of debt and liquidity is also fully in compliance with development tendencies that are asserted in countries with developed market economy, including Eurozone countries.

In order to fulfil goals of the reform, there was established a Debt and Liquidity Management Agency (DLMA) within Act on Treasury. The DLMA originated in February 2003 and its personnel, organisational and information establishment is carried out during the year 2003. At the same time, scope of activities that will remain in competence of the Ministry of Finance of the Slovak Republic (MF SR) and that will be carried out by the Treasury (T), DLMA and the National Bank of Slovakia (NBS) are taken into consideration.

The present Strategy of Debt Management for years 2004 – 2006 (Strategy) is the main and also starting document specifying basic frameworks and direction of the policy of the debt management for the relevant period. Later, regulations governing rules for risk management of the state debt, limits for open positions of the state and checking system will be deduced from this document. At present transition period is not possible clearly and precisely formulate binding indicators and parameters of the state debt. The portfolio of the state debt will be subject to an in-depth financial analysis in the year 2004 in order to precisely identify and quantify parameters of the total state and the public debt. In order to provide connection between the Strategy and the development in the concrete budgetary year and an option to flexibly respond to the market development, **the Strategy will be specified every year and submitted for approval to the government with proposal of state budget for the following year.** Binding quantitative indicators of the state debt for the year 2005 will be proposed on the basis of the analysis.

The Strategy is limited for years 2004 to 2006 for several reasons. First of all, it is the limit of election period. It is fair that the following government have an option to formulate its own strategy in context of its own economic policy and priorities. Secondly, since the year 2007 we can expect considerable changes connected with preparation for acceptance of EUR and entry in the Eurozone. Nowadays it is not possible to forecast those changes in such detail that may enable to use them with all responsibility in the Strategy. And at least thirdly, the mentioned period will be period of construction and tuning of the entire system of the debt and liquidity management. In other words, in addition to determination of goals in area of the debt and liquidity management parameters, also institutional and legislative completion of the debt and liquidity management system will be important.

In context with the present Strategy, it is necessary to stress that the state does not have a direct control over the entire scope of public finance, at present. For instance some state and public institutions (health insurance companies, funds, Social Insurance Company) are independent legal entities and they carry out payments outside the direct control of the MF SR. Although majority of those clients deposit their funds on account in the NBS, those accounts are not consolidated with accounts of the state budget in such way that requirements

¹ Politic influence may be in a form of an effort to decrease expenditures connected with debt service in the current budgetary year on account of higher expenditures and risks in the future.

on short-term liquidity could be minimised. Additionally, some of those clients have accounts in commercial banks. This system obstructs the MF SR, together with other factors, in managing public sources centrally and, in this sense, effectively.

Similarly as the liquidity area, also the possibility of origin of qualified payables and latent debt at the regional level remains outside the direct control, at present. It will be necessary to pay an increased attention to this problem in the context of fiscal decentralisation. In view of the above-mentioned reasons, the Strategy covers only a part of the debt and liquidity that is managed by the Ministry of Finance (by MF SR, T, and DLMA), i.e. the state debt and liquidity of entities managed by the central government.

The present Strategy provides a brief survey on the state of art of the state debt as of the end of the year 2002 and describes the existing problem of the debt and liquidity management. It characterises risks resulting from parameters of the existing debt and shortcomings of the present system of its management. The Strategy itself is based on those evaluations and forms goals in area of the debt restructuring, system of risk management, as well as goals of further development of the debt and liquidity management system in institutional and legislative area.

2. Structure and Basic Parameters of State Debt

As of 31 December 2002, the Slovak Republic recorded the state debt in the amount of SKK 451.6 bn in the ESA 95 methodology. The basic structure of the debt according to type consists of the following:

- payables from issues of government securities	SKK 348 941 mil
- payables from received bank credits and other debt instruments	SKK 37 267 mil
Total without state guarantees	SKK 386 208 mil
- risks from state guarantees	SKK 65 351 mil
Total	SKK 451 559 mil

A detailed structure of the state debt as of 31 December 2002 according to the ESA 95 is given in Annex No. 1.

Payables from Issues of Government Securities²

Issues of government securities represent a standard, tradable form of the debt. As of 31 December 2002, the Slovak Republic issued government securities through the MF SR in the following structure:

- government bonds issued on the domestic market	SKK 234 200 mil
- government bonds issued in foreign countries	SKK 75 295 mil
- treasury bills (TB)	SKK 39 508 mil

Average maturity of government bonds issued on the domestic financial market was 3.48 years in the year 2002 and on foreign markets it was 2.7 years. Under the mentioned parameters, duration of the portfolio of government securities was 2.8 years. TB were issued for continuous covering of the state budget gap³.

From the investor's point of view of yields, bonds of the Slovak Republic were issued mainly with fixed yield. Of the total amount of issued government bonds, issues No. 143, 144, 151, 152, and 161 are with floating yield (6M BRIBOR, 12M BRIBOR + 0.32) that were issued (except for issue No. 161) for the purpose of restructuring banks. Of the total

² Further features of the state debt are connected with the debt without considering risks related to state guarantees.

³ Average maturity is the weighted average of maturity of all included background items (e.g. average maturity period of the total debt, or only of a part such as domestic bonds, foreign bonds, securities and like). Duration is weighted average maturity of background items, where present value of future cash flows of background items are used as a weight. Duration expresses sensitivity of included items (of one, group, portfolio or of the entire balance side of the balance sheet) to change in market interest rates and is expressed in years.

amount of government bonds on the market, bonds with fixed yield are 79.46 % portion, while bonds with floating yield are only 20.54% portion.⁴

Government bonds issued in years 1998 to 2000 on foreign financial markets were issued with fixed coupon. In May 2003 the Slovak Republic was successful in the issue with floating interest rate, when it issued two-years government bond with floating interest rate with the following composition: 3M Euribor increased for 5 basic points. This government bond has an interest cost of 2.2 % p.a. at present.

Payables from Received Bank Credits

This type of indebtedness is in the amount of SKK 35 169 mil (9.1 % of the total debt), of that foreign indebtedness is 95% (SKK 33.4 bn, i.e. 8.6 % of the total debt), while credits received by the government are only 28.6 % (SKK 9.65 bn) of the total amount. The remaining part, i.e. SKK 23.77 bn, represents credits received by the MF SR as of 1 January 2002 in connection with take-over of payables of the former State Fund for Road Economy (SFRE). Considered are 18 credits in the total amount of SKK 26 676 mil. (Credits taken over from the SFRE are given in Annex 2/1 and government loans are given in Annex 2/2).

On the basis of business-technical conditions of some received credits we can state that the procedure of accepting government loans was not standard in the past and financial conditions of single credits were not advantageous for the state, they were worse than conditions that could be achieved on the financial market. Market and other risks connected with entry of the state in credit relationship were not taken into consideration during accepting of credits, while the entire procedure was considerable non-transparent. An advantage of the credits was mainly the two facts - longer maturity period than that achievable on the market, and links to providing technical assistance, possibly a grant (mainly in case of credits from international financial institutions for realisation of structural reforms). Average maturity of foreign credits received in single years is shown in the following table:

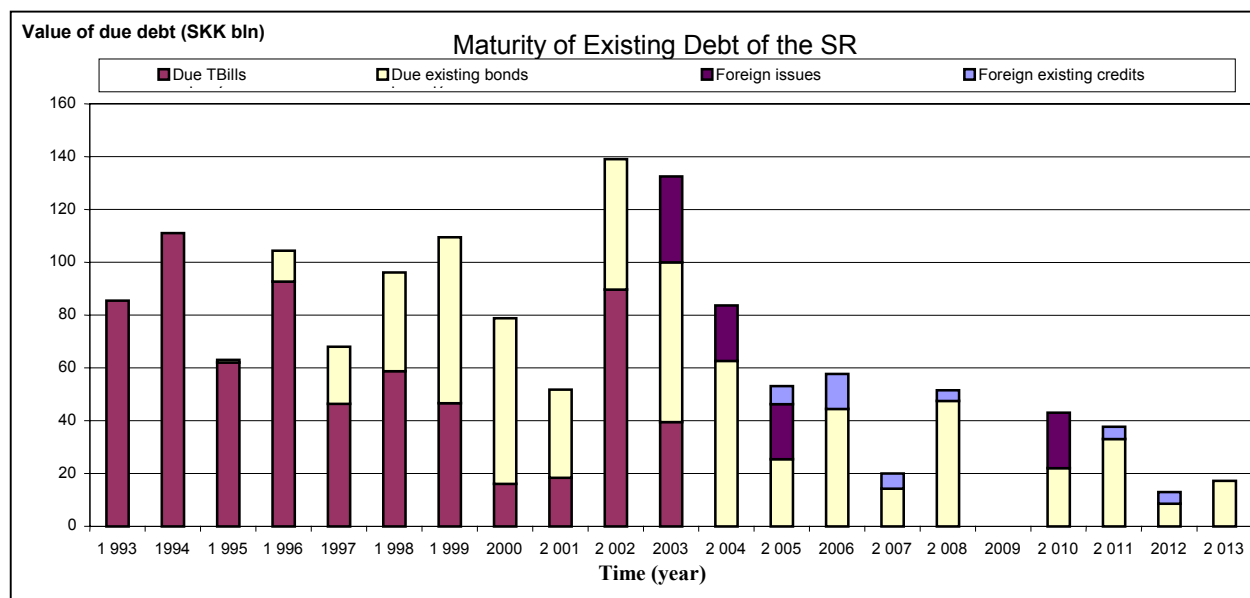
Year	1995	1996	1997	1998	1999	2000	2001	2002
Maturity in years	16.0	9.0	9.6	10.0	31.0	6.4	9.5	14.0

As long as yield for creditors is considered, there is majority of credits with floating interest rate than credits with fixed interest rate in the credit portfolio of the state debt in comparison with government securities (ratio of credits with fixed interest rate on the entire amount of unpaid credits was 36.3 % portion as of 31 December 2002). This results from the fact that the state debt in the form of credits is non-tradable and the floating interest rate is partially an instrument for eliminating of the interest risk.

As long as characteristic of the debt as a whole is considered, its maturity is given in Chart No. 1. As it results from the chart, an important part of government securities is due in the course of following three years.

⁴ For issuer it is advantageous to issue bonds with fixed interest yield, when it is expected that the value of the interest rates will grow in the future period along the entire yields curve, and bonds with floating interest rate are advantageous, when it is expected that the value of the interest rates will sink period along the entire yields curve. High (low) volatility of interest rates along the entire yields curve supports issuing of bonds with fixed (floating) interest yield.

Chart No.1 Maturity of Existing Debt as of 31 December of relevant year.



As long as relation of internal and foreign indebtedness is considered, the internal indebtedness was 71.3 % of the total debt as of 31 December 2002 and it consists of the following payables: (SKK bn)

Issues of government bonds	234.2
Issues of treasury bills	39.5
Domestic credits*	1.7
Total internal debt	275.4

*Domestic credits taken over from the State Fund for Road Economy (credits granted by the VÚB and the SLSP).

Foreign indebtedness was 18.7 % and it consists of the following payables (SKK bn):

Issues of government bonds	75.3
Government loans taken over from the former SFRE	23.8
Other government loans	11.7
Total foreign debt	110.8

Percentage share of single currencies on the total foreign indebtedness as of 31 December 2002 is given in the following table:

Currency	EUR	USD	JPY	other
% share	79	19	1	1

As it results from the table, the key currency of the foreign indebtedness of the Slovak Republic is EUR. Reasons for this are development of universal relationships with the European Union and anticipated integration of Slovakia in European structures. In general, we can state that currency and exchange-rate risk of the Slovak Crown to Euro is lower than to other free convertible currencies. From the Slovak Crown point of view, Euro is the main currency and the Slovak Crown is directly dependent on its development. Risks resulting

from open positions of the state in Euro currency are easier predictable and controllable in this context and due to this fact the portfolio management of the state debt will be focused on denomination of the state debt in this currency on account of other free convertible currencies.

Influence of State Guarantees on State Debt

The Slovak Republic has an obligation towards the EU to record deficit and debt of the public budget in the ESA 95 methodology. According to this methodology, parts of the state debt are also risks resulting from granted state guarantees.

Granting of state guarantees used to be instruments for making the condition of public finance appear better. The government granted state guarantees for the loans of which it was obvious that the debtor would not settle them. In this way the government improved the debtor's position in the short-term. Despite granting of the state guarantee, interest costs on credits were always higher than costs for which the state could borrow, which emphasises necessity to centralise the debt management by the state. State guarantees in the total amount of SKK 40.3 bn were realised by the end of the year 2002, of that SKK 17.8 bn was from the state budget and SKK 22.5 bn was from the National Property Fund of the Slovak Republic (years 2000 to 2002). The highest amount of state guarantees was realised in the years 2001 (SKK 8 bn from the state budget and SKK 14.6 bn from the National Property Fund).

Survey of development of granted state guarantees is given in Annex No. 3. Data on total amount of principal of all credits with state guarantee as of the end of years 1996-2002 and amount of principal of credits that could be considered as risky are given in the Annex. Risk of credits was determined individually on the basis of the debtor's financial situation analysis. SKK 65.3 bn (i.e. 63.6 %) of the total amount of principal of state guarantees (SKK 102.6 bn) may be considered as risky. Risk of realisation of credits with the state guarantee of Railways of the Slovak Republic in the amount of SKK 37.3 bn was classified as the highest risk. The amount of SKK 65 bn of risky state guarantees is divided to years 2003 to 2021 in respect of maturity with maximum of instalments in the years 2005, 2006 and 2007 due to bullet maturity of credits with state guarantee for the Slovenské elektrárne, a.s., Bratislava and Railways of the Slovak Republic.

In connection with change in approach of the Slovak government to granting state guarantees and the changeover in the strategy of public and state finance management, in the following period the increase in risky state guarantees is not expected. State guarantees may be generally considered as the most expensive method of indebtedness of the state, since credit providers take into consideration also credit risk of the credit beneficiary in addition to the state risk in the price for the credit granted.

3. Risks Connected with Debt Structure

Despite the fact that there is no integral system of the debt management so far, and the existing portfolio has not been analysed in-depth, the structure and parameters of the debt already signalise several types of risks.

Refinancing Risk

The refinancing risk, i.e. risk that state could not be able to raise funds to cover maturing debt or will be able to cover maturing debt but only for the price of higher yields can be considered as the most important risk. We can state that substantial part of state debt covered by state securities is due in the next three years (SKK 146 bn due in the year 2004, SKK 114 bn due in the year 2005 and SKK 114 bn due in the year 2006). From this point of view, we classify the refinancing risk of the SR state debt to be relatively high considering size and opportunities of the Slovak financial market and common standards of EU countries. The market may calculate with this fact and it may develop pressure on the state to refinance its payables for higher interest rates similarly as in the second quarter 2003. Over-elaborated issue politic comparable with international standards and access to foreign financial markets can this risk considerably decrease. Refinancing risk of state from year 1998 is continually decreasing and along with it average value of maturity of state debt portfolio is greater as well as value of duration. Both indicators achieve in year 2003 best values from origin of state debt in year 1993. Target values of those indicators which are part of present strategy should SR meet in year 2006. Capacity of domestic market of bonds with longer maturity is limited and therefore it should be necessary to keep direct contact (gaining of information about possibilities to issue state bonds on foreign markets) with international financial market.

Interest Rate Risk

The interest rate risk is closely connected with the refinancing risk. The interest risk is a risk resulting from impact of changes of market interest rates on the debt portfolio of the Slovak Republic. This risk results from need of refinancing the debt that will be due in the future at unknown or estimated interest rates and from volatility of payments of coupons with floating interest rates of government bonds. The portfolio of government loans including debt payables with short-term maturity and debt payables connected on floating interest rate faces the risk of increase in interest rates. At present the percentage of the fixed interest rate of the total state debt is in the amount of 65 % and the floating interest rate is 35 %. Average maturity of the total unpaid debt is 3.6 years and it express a speed with which the existing debt becomes short-term⁵.

Key indicator used during monitoring and management of the interest risk is duration of the portfolio⁶. Average present duration of the SR government bonds portfolio is 3.2 years.

⁵ Average maturity of debt in majority of EU states is in interval 5 - 6 years. An exception is Great Britain, where the average maturity is app. 11 years. The average maturity of domestic state securities in Hungary is over 3 years, and in the Czech Republic it is approximately at the same level.

⁶ The higher value of this indicator is, the less sensitive to change of interest rates is the portfolio, and so also the risk of negative impact of change in interest rates is more eliminated. On the other side, the portfolio with short duration may bring savings in budgetary sources under the expected decrease in interest rates.

It is probable that this indicator is even lower in case of the entire state debt (amount of the duration of the entire SR state debt portfolio ranges probably in interval from 2.5 to 2.8 years), as long as most of government loans are linked to floating interest rate. With this value of duration and with high historic volatility of interest rates on the Slovak financial market, the state debt portfolio faces a high interest risk that is at present eliminated only by estimated expectations of decrease in interest rates in connection with the SR integration. In this context, low duration of the portfolio may bring savings of budgetary sources, mainly in the years 2005 and 2006. It will be necessary to actively manage the interest risk in the future. The basic assumption of decrease in the interest risk of the portfolio is change of its structure in respect to profile of maturities. Subsequently, it will be necessary to partially eliminate influence of the interest risk via use of financial instruments including derivatives.

Liquidity Risk

Liquidity risk express degree of probability that state would not have enough liquidity to cover its payables. Taking into consideration the fact that background materials and information for liquidity management of the state budget and of the entire area of public finance are not sufficient and exact, it is not possible to competently assess importance of the liquidity risk at present. Predictions of cash flows from incomes and expenditures of single spending units are missing, except for cash flows related to treasury bills, government bonds and credits, i.e. cash flows directly managed by the MF SR. Information on realised payments of state budgetary organisations are missing particularly information on expected and received payments in real time. At present, there is no financial planning monitored at a central level in the entire area of public finance. Fulfilment of Act on Treasury will bring change in this area. Under the Act, state budgetary organisations are obliged to plan its incomes and expenditures.

Since there is no financial planning of the entire area of state and public finance, there is a considerable time discord of incomes and expenditures, which considerably increases costs on liquidity management of the state. We can state that the liquidity risk is quite high at present. Because costs of liquidity cannot be planned at present and the liquidity is managed passively, the state must keep high surpluses of funds in order to arrange liquidity. These funds would not exist necessarily in case of active management of the liquidity or they could be invested on the financial market under market interest conditions.

Exchange Rate Risk

The basic indicator of the exchange rate risk is ratio of the debt in foreign currency to the total debt. At present, this ratio is in value 28.6%⁷ (of that 79% in EUR, 19% in USD and 2% in other currencies).

The duration in the second half of 90-ties was lower than 2 years, which caused considerably increased costs at the end of this period - expenditures of the state budget on the debt service increased for several billions SKK in the years 1999 and 2000.

⁷ This ratio is under 5 % in majority of the EU states. However, this is connected with uniform currency Euro in Member States of the monetary union. Ratio of foreign debt on the total debt in the EU states that did not accept common currency is different. In Sweden it is 33 % (of that more than a half is in EUR), in Denmark 8 % and in the Great Britain 2 %. In the Czech Republic as a one of candidate countries, the ratio of the foreign debt on the total debt is less than 10%.

The exchange rate risk is monitored at present, but it is not managed actively. The state has an account in the NBS only in Slovak Crowns and the portfolio of the foreign state debt consists mainly of credits connected on the floating interest rate. The state debt portfolio faces the risk of change in the exchange rate of the Slovak Crown to the relevant foreign currency and so to the change of the debt portfolio value (change in exchange rate of the currency will cause increase or decrease in the debt value and the present value of the debt portfolio will change); however, mainly values of the cash flow (instalments of coupons from bonds, interests from received credits and principals will increase or decrease due to change in the exchange rate, what directly influences the budget).

The exchange rate risk of the state debt can be considered to be important, on the other side we can state that generally expected strengthening of the Slovak Crown in the years 2005 and 2006 would probably bring savings of budgetary sources. Opened exchange rate positions of the state debt are under EUR/SKK exchange rate in the amount of 43.0 and higher, what means that less Slovak Crowns will be needed for repayment of payables from credits and securities. Influence of the NBS position in conversions of the state debt was not taken into consideration in this contemplation.

Counter-party Risk

Another risk the state has to face is the risk that the counter-party will be not able to fulfil its payables resulting from financial transactions. Although the counter-party risk relates at present only to granting of state guarantees for credits, it is not monitored actively.

4. State-of-Art of Debt and Liquidity Management and Risks Related

Legislative framework for area of the state debt management is determined by the following acts:

Act No. 291/2002 Z.z. on Treasury and on change and amendment of some acts,
Act No. 386/2002 Z.z. on State Debt and State Guarantees,
Act No. 566/2001 Z.z. on Securities and Investment Services,
Act No. 510/2002 Z.z. on Payment Transaction and on change and amendment of some acts,
Act No. 566/1992 Zb. on National Bank of Slovakia as amended,
Act on State Budget for the relevant year,
Act No. 303/1995 Z.z. on Budgetary Principles as amended,
Act No. 530/1990 Zb. on Bonds as amended.

On the basis of the above-mentioned legislative, the MF SR is responsible for strategic part of the debt and liquidity management, as well as for its realisation - operative management. The NBS operates as an agent of the Ministry of Finance and arranged technical performance of issue and repayment of government bonds, inclusive yields. The co-operation of these two institutions is more at operative and realisation level than at management and strategy levels.

During liquidity management, the Ministry of Finance mainly elaborates operation plan of sources and needs of financing of current deficit of the state budget and the due state debt in a time horizon of one month on a daily basis and it manages balance on the summary account of the state. Temporarily and mainly in a short-term, it allocates free funds on term deposits in the NBS exclusively, and so it increases yields from financial assets and incomes of the state budget.

During state debt management, the Ministry of Finance issues government securities on the domestic and foreign financial market in compliance with approved plans of government securities issue in co-operation with the NBS as its agent on the domestic market. In the course of developing the issue policy, it uses conclusions of the Auction Committee as a consultative body of the Minister in order to improve the issue plan of securities and co-ordinate the debt policy with the currency, fiscal and budgetary policy.

In order to conclude quality credit contracts in the name of the Slovak Republic, the MF SR processed procedures for receiving government loans and state guarantees in July 2003, which ended in normative acts - Guideline of the MF SR for receiving, drawing and repayment of government loans from foreign countries, which unanimously determined position of beneficiary of the government loan (relevant department), the MF SR and other institutions interested in the relevant procedure. At the same, there was established an expert committee "Credit and Guarantee Committee for Government Loans and State Guarantees" as the Minister's consultative body for financing in the area of government loans and state guarantees.

At present, the NBS as the MF SR agent prepares conditions for auctions of government securities (GS), pays yields and principals GS, keeps central register of T-Bills, prepares background materials for quoting of GB issues on the Bratislava Stock Exchange, evaluates information on trading on the secondary market and collects information on the primary market (monitors the financial market, publishes results of auctions and the like).

Risks of State-of-Art Management System

The present state of art of the debt and liquidity management, the origin of which dates from the year 1993, does not correspond in terms of the requirements placed on modern system of the debt and liquidity management in an advanced market economy. This condition of the system evolved from undervaluing importance of these problems in the past and from insufficient personnel, material and technical arrangement. Risks are connected mainly with the following facts.

First of all, determination of strategic goals in a mid-term and long-term horizon is missing. The management adapts to topical status of the state budget via transfer of risks to the future. The management is decentralised, decisions on single items of the debt are taken outside the context of the total debt and they only respond to operatively changing needs of financing without taking into consideration wider connectivity. Decision-making is not supported with financial analyses and future development forecast. Information facilities and personnel conditions for carrying out of financial analyses were not created.

Secondly, there is no integrated information system, nor records or recording of the debt is unambiguous, transparent and exact. The debt service is considerably performed via manual inputs without preparation and control phase.

Thirdly, risk management system absents and this in the entire scope - from methodology of risk analysis, through monitoring and evaluation system, which leads to the fact that limits are not determined for single risks and there is no control system of their observance.

Fourthly, the National Bank of Slovakia monitors the financial market for the MF SR. The MF SR cannot flexibly respond to the market development. However, approach to most recent information from this market is a pre-requisite for effective management of the state debt and liquidity and realisation of operations and transactions on the financial inter-bank market.

Fifthly, active communication with domestic and foreign financial markets is missing. The goal of such communication is increase in the liquidity of the market with government securities in countries with less developed capital market. Apart from that, secondary market development conception with goal of extension of a potential investors' circle and to achieve decrease in expenditures connected with issuing of GS via increased liquidity of GS is missing. The Ministry of Finance does not have any strategy for this area.

Present debt and liquidity management system generates an important operation risk - risk of potential losses resulting from failure to deal with the process management of the state debt service. Missing central management and database recording of credit portfolio of the state debt may be considered to be its most important shortcoming.

5. Reform of Debt and Liquidity Management – State-of-Art and Further Procedure

The Ministry of Finance is aware of shortcomings in the debt and liquidity management system and risks ensuing from it. **In the context of international experience and the best international practice, the Ministry has chosen the concept of separating the strategic-conception management from operative debt and liquidity management.** While the strategic-conception management will remain in the competence of the Ministry of Finance, the operative management is transferred to the newly established Debt and Liquidity Management Agency. Reform in this field of public finance management started in the year 2002 after approval of Act No. 386/2002 Z.z. on State Debt and State Guarantees that determined basic institutional and political frameworks for this field and after approval of Act No. 291/2002 Z.z. on Treasury. Just the Act on Treasury enabled establishment of the Debt and Liquidity Management Agency.

Origin of the DLMA is a part of changes focused on creating of a modern regime of the debt and liquidity management on the basis of the best international practice.

International Experience

Reforms in area of the debt management are topical in many developed countries, and they are result of growing importance of a professional debt management in order to decrease loading of the debt service for public finance. Although there is no single universal model of the debt management, each country adapts general theoretical knowledge to its practical needs, options, as well as factors that are given. There have been formed principles of the best international practice in area of the debt management. According to the mentioned principles, a modern debt management system should start from clearly determined political goals, it should create assumptions for minimization of long-term costs on the debt service under acceptable rate of risks, it should strengthen transparency during the debt management and so minimize danger of hidden, uncontrolled indebtedness of the state. An assumption of the modern debt management system is development of liquidity and functional secondary market with state securities.

A good example of a successful reform is a good operating debt service in Portugal that gone through interesting development during last 5 years. In co-operation with other state institutions, it restructured its state debt and prepared the state debt management system for entry in the European Monetary Union. The debt service used and applied knowledge and experience of more developed countries of the EU, mainly of Belgium, where the agency has operated for app. 10 years. Operation and results of this agency may serve as a good example for Slovakia, since starting position of Slovakia is very similar to that of Portugal five years ago - inadequate legislative framework for debt management, non-liquidity market of state securities, passive approach to the state debt management and likes. Slovakia has the chance to win an important position in this area within Central European region in a short-term, since only Hungary has a standard operating agency for the debt and liquidity management among acceding countries. In the Czech Lands the possibility of setting up an agency for the debt and liquidity management is considered within the prepared reform of public finance and discussion to this topic is not concluded. Management of the state debt in Poland is an integral part of the Ministry of Finance of the Republic of Poland with all disadvantages brought by this status.

On international level, there exists formal, as well as informal co-operation of agencies of single countries in the area of debt management. They organize common seminars, as well as informal meetings in order to exchange experience of the applied theory and know-how. Countries such as Ireland, Belgium, Finland, Italy and Portugal, and many others achieved the most important success in the debt and state finance. Slovakia already took part in international co-operation and has a contact with several agencies through the DLMA. In the year 2004, the DLMA will have assumptions created for acquiring and application of a modern know-how of the EU states and participation in international co-operation. On the basis of comparison analysis of starting points of the debt management, we assume to use combination of Belgian, Irish and Portugal model of the state debt management. From regional and integration point of view, the Slovak Republic may utilize experience from establishment of the agency in Hungary.

The following will be main tasks of the DLMA:

to arrange professional debt and liquidity management, within which it will optimise structure of the debt and costs connected with it on the basis of the market analysis, debt portfolio analysis and worked out risk management system,

to enable separation of operative debt and liquidity management from the formulation of policy and control of observing frameworks and regulations,

to considerably improve communication with the market and with investors - and it will try to increase of liquidity of GS market in co-operation with the MF SR and with other institutions,

to arrange flexibility of the operative debt management,

at international level, to co-participate in integration of the financial market and financial management of the scope of public finance with EU countries.

Taking into consideration the DLMA establishment, there arose a need to newly define division of activities and competencies between the MF SR, DLMA, T and NBS. Due to the mentioned fact a document "Proposal of Re-Division of Activities and Competencies between the Debt and Liquidity Management Agency, Treasury, Ministry of Finance of the SR and National Bank of Slovakia" was approved at the Management Board of the MF SR. This document specifies basic activities and competencies of single entities in the debt and liquidity management procedure. The proposed division respects Act No. 575/2001 Z.z. on Government Activity Organisation and Central State Administration Organisation.

The Ministry of Finance will continue in providing for administration of the state debt in compliance with Act No. 386/2002 on State Debt and Guarantees. In the future, the Ministry of Finance will be responsible for the entire strategy of the debt, it will create and approve operation framework for the debt management and control its observance.

In compliance with the above-mentioned document, the DLMA will be responsible for performance of the state debt management and it will mainly:

arrange issuing of government securities, inclusive auctions, for the Ministry of Finance,

participate in developing the debt management strategy,

in co-operation with the Treasury, it is responsible for arrangement of daily payment ability of the state,

carry out financial operations on the financial market related to cover market risks in connection to managing debt and liquidity,

in co-operation with T to manage and optimise the balance on a single account of the state,

provide NBS with background materials for the settlement of GS issues,

elaborate operative plan of sources and needs of financing of continuous state budget gap and due state debt in the perspective of one month on a daily basis,

co-operate during recording, reporting and analysis of the state debt and liquidity according to the Ministry's requirements and it will arrange other activities in compliance with valid standards.

Likewise, the National Bank's of Slovakia position is changing, it will mainly:

- as the state agent settle results of primary issues of GB, TB and redeem TB at their maturity, realise payment of coupons and securities of GB at their maturity,
- participate in activities for development of the government securities market and support standardisation of GS settlement in compliance with usual practise of the EU,

- prepare background materials for strategy development of debt, liquidity and risks management in connection with the currency policy and co-operate in developing strategy of the state debt management on an expert level.

The new system of the debt and liquidity management becomes effective since 1 January 2004, when the DLMA will take over full responsibility for operative debt management. However, there is no doubt that effective state debt management will necessitate, even in the future, to further specifying re-division of activities and competencies between the DLMA, T, MF SR and NBS. After mastering the operative debt management by the agency, the reform in area of the debt will focus on improvement of decision-making procedure, determination of regulative measures, limits and standards for the debt management.

6. Strategy of Debt and Liquidity Management for years 2004 to 2006

Starting from existing risks related to structure and parameters of the state debt and present debt and liquidity management system, and when taking into consideration the market and other external environment, the aim of the strategy is to formulate basic political goals in area of the debt and liquidity management, to transform them to operative goals and to identify methods of their achievement.

Starting Points

In respect of the state-of-art of the debt portfolio, the strategy starts mainly from need to respond to re-financing and interest risk.

In area of the debt and liquidity management, the strategy responds mainly to four key problems:

- missing integrated information system as a basis for monitoring of the debt and liquidity management quality,
- absent risk management system and absent active liquidity management,
- absent regular market analysis,
- absent professional communication with the market.

As far as the development of market and other external environment is concerned, the strategy starts from the Pre-admission Economic Programme that assumes favourable development in respect to strategy goals fulfilment, mainly:

- Decreasing pressure of development of public finance on state budget through debt service
- Relative stable exchange rate development with option of its further appraisal,
- Gradual rapprochement of interest rates in the Slovak Republic and abroad,
- Decrease in interest costs ratio for serving of the state debt on the GDP.

Successfully mastered procedures within the framework of public finance could participate in gap decrease on 3% of the GDP in the year 2006 from 3.9 % in the year 2004. There is expected that a large participation on this fact would also have a relative high economic growth of the SR that should achieve over 4 % during years 2004 to 2006. The positive prediction of the SR economy development creates assumptions for relative stable development of Crown, not excluding also an option of its further nominal and real revaluation.

In the year 2004, we can expect moderate increase in interest rates in foreign countries mainly by 0.5 – 0.6 percentage point. In other years by the year 2008, it is realistic to expect further gradual growth of interest rates. This means that interest rates (as well as inflation rate) in the SR, as well as in foreign countries, will gradually get closer. Decision-making on domestic or foreign loans will be able to reflect needs of stabilisation policy of the Slovak Republic to a greater extent.

Taking into consideration high growth of the GDP, decrease in domestic interest rates, other due bonds with high coupon and advantageous conditions on foreign markets, we can assume that interest costs for service of the state debt will decrease by the year 2006 to 2.3 % of the GDP from the level 3.7% in the year 2002.

In other words, we can state that restrictive fiscal policy, structural reforms and expansive monetary policy should lay foundations for stabilisation of the debt ratio on the GDP in following three years.

Goals

General, political goal in area of the debt and liquidity management can be formulated as follows: **"arrangement of liquidity and access to market for financing the needs of the state by a transparent, prudent and cost saving method, on condition the risks included in the debt are maintained at an acceptable level."** Starting from the mentioned goal, it is possible to identify some general principles.

***First principle:** any increase of the debt must be transparent and must have clear rules. It is necessary to eliminate not controlled and uncontrollable growth of the debt.*

***Second principle:** mid-term and long-term goals should be preferred to short-term savings during active debt management. Short-term "savings" may not be at the expense of higher costs or higher risk of costs in the future.*

***Third principle:** the debt management should start from principle of optimum risk. This means that active debt management should start from quantification of difference between potential loss from non-managed risk and costs connected with its elimination.*

Specification of Goals and Principles

First Principle

As far as the first principle is considered, it relates mainly to area of credits, state guarantees, but also other items of public finance, such as public funds, municipalities and self-governing territorial units and public institutions. **Proposal of Strategy of Debt Management starts from an assumption that the most effective form of indebtedness of the state is form of issues of government bonds on the domestic and foreign markets.**

Indebtedness of the state in the form of credits for specific projects is an alternative source of financing the direct financial costs of which are usually higher, if compared with bonds, because it is an non-tradable debt that may not be sold on the market by the credit provider. This fact together with the counter-party risk (settlement risk) is directly considered in the price of the credit.

Accepting credits brings also indirect costs that are, in general, difficult to quantify, because they ensue from concrete provisions of credit contracts. However, an advantage of credits in comparison with bonds is an option to diversify in this way an investor basis of the state debt of the Slovak Republic and an option to acquire sources for a period longer than 15 years.

An absolutely unsatisfactory form of indebtedness of the state may be granting of state guarantees, in general, for commercial credits of state organisations, since their realisation most likely brings an increase of the state debt in the way that is hard to control and non-transparent.

This method of dealing with financial needs of the state and state organisations is considered to be least effective, also according to international practice. Apart from a traditional weak possibility of financial control of the economy of the state (or commercial) organisation (in case of non-repayment of the credit, the state guarantee becomes a state payable increase for penalty), this method of financing brings increased costs in the form of credit surcharge for the beneficent. In case of direct financing of the state via government bonds, costs in a comparable bond are lower for 1 % p.a. on average.

Basic principles for granting state guarantees are given in Act No. 386/2002 Z.z. on State Debt and State Guarantees. Apart from that, the government undertook to make a material change in granting of state guarantees in the Policy Statement as of November 2002. The Policy Statement reads: "A part of the public finance reform will be also a fundamental tightening in providing state guarantees. The government will use state guarantees only in necessary cases for re-financing of due credits with state guarantees, if the Act on State Support enables it and if there is danger of utilisation of guarantees from sources of public finance. If it is necessary, the government will enable takeover of state guarantees for financing of projects, if it also enables utilisation of foreign grants from pre-admission and structural funds of the European Union, at the same time. The government will also arrange that credits and bonds with state guarantees will not replace direct expenditures of the state budget. This material change in granting of state guarantees will result in gradual decrease in the amount of risks ensuing from state guarantees."

In order to realise goals of the Policy Statement in area of evaluation of state guarantees, the government established Credit and Guarantee Committee. The Credit and Guarantee Committee of the government of the Slovak Republic was established by Government Resolution No. 131/1999 as of 10 February 1999 in compliance with §2a of Act of the National Council of the Slovak Republic No. 74/1995 Z. z. as of 6 April 1995 that changes and amends Act of the National Council of the Slovak Republic No. 347/1990 Zb. on Organisation of Ministries and of other Central State Administration Authorities of the Slovak Republic as amended. Apart from the above-mentioned committee, there was founded an Expert Committee that is a consultative and co-ordination body of the Ministry of Finance of the SR for financing of economic refundable projects classified in development programmes declared by the government of the SR in area of takeover of state guarantees and in area of financing of government loans. Members of the Expert Committee are designated representatives of expert departments of the Ministry of Finance of the SR, representative of the Debt and Liquidity Management Agency and representative of the National Bank of Slovakia.

In area of government loans and state guarantees, the Strategy assumes observance of agreed principles, while if the following is considered:

government loans, there is assumed individual assessment at the level of Credit and Guarantee Committee and decision-making at the level of the government on trade-off between commercial-financial conditions and other advantage of the credit (technical assistance, grant, co-financing and the like). Commercial-financial conditions, as well as adequacy of the credit in respect of the structure of the entire debt portfolio will be assessed by the DLMA,

state guarantees, there is also assumed individual assessment at the level of the Credit and Guarantee Committee and the Committee will use rating evaluation of debtors. The state guarantee could be granted only in cases, when solvency of the beneficiary guarantee return (rate of risk of the state guarantee is approaching zero), it is impossible to acquire sources without the state guarantee and purpose of use of sources is in compliance with the government priorities, while the state guarantee is in compliance with principles on the state support.

As far as the option of uncontrollable indebtedness is considered, an important transition to elimination of this option will be start of the Treasury system that will not enable entry of a client (budgetary or contributory organisation) in a non-covered commercial obligation relationship. Because the Treasury system will not include all budgetary and contributory organisations in the area of public finance, risk of origin of uncontrollable debt still remains. An option of uncontrollable indebtedness mainly at a regional level, as well as indebtedness of public institutions remains unsolved.

The target state of the reform are as follows: to achieve that main parameters specifying sustainability of the state budget – deficit indicator (net loans in ESA 95 methodology) and public debt indicator are fully under control of the National Council of the Slovak Republic so that there is a uniform usage of transparency principles and sustainable development of public finance for all units of the public administration.

Second Principle

Observing of the second principle requires mainly restructuring of the existing debt and issuing of a new debt so that there will be created assumptions for a mid-term optimisation of costs for financing needs of the state and, at the same time, there will be created assumptions for observing of the third principle. ***In other words, the target structure of the debt portfolio should be such that the need for using hedging instruments may be as small as possible.***

Restructuring from the point of view of interest risk elimination

Optimisation of costs on debt service means issuing of government bonds with such maturities that the risk of increased costs in mid-term and long-term perspective will be minimised.

As far as the interest curve has a normal form (i.e. interest rate of investments with short-term maturities is lower than interest rate of investments with longer maturities), there is a tendency to finance needs with debt instruments with shorter maturity period and thus cheaper. However, via the mentioned financing method, there arose a relative high risk of increased costs in the future caused by shifting of the entire interest curve to higher values. This risk may be removed via issuing of bonds with longer maturity period with fixed interest

rate. Background material for determination of the maturity period of issued bonds is always analysis of interest risk and determination of acceptable value of this risk.

The present Slovak interest curve has an inverse form, which supports issuing of bonds with longer maturity periods and "depositing of money for short periods". There is a justified assumption that the form of the interest curve will get to normal in the following years and because of that **it is necessary to use year 2004 - 2006 for issuing of bonds with longer maturity**. Task of the DLMA in the years 2004, 2005 and 2006 will be a gradual division of repayment of the existing state debt, which is due by the year 2006, from 3 up to 15 years depending on development on the domestic and foreign markets with bonds and prolongation of average maturity period in interval of 4 up to 4.5 years. In respect of the absorbance ability of the domestic financial market for securities with maturity longer than 3 years, it will be necessary to consider "benchmark" issues on foreign capital markets.

As long as new issues are considered, in the future it will be necessary to observe profile of maturity on the basis of acceptable size of the risk of increased costs, i.e. 20 % maturity over 10 years, 30 % maturity from 5 up to 10 years and 50 % maturity up to 5 years of the total value of the government debt securities portfolio. As it was already mentioned, the present interest curve in Slovakia is inverse (i.e. short-term interest rates are higher than mid-term and long-term interest rates), its profile supports issuing of bonds with longer maturity. However, also needs of arrangement of the debt re-financing and needs and expectations of the financial market must be taken into consideration in case of issues.

Restructuring from the point of view of re-financing risk elimination

Improvement of liquidity of the secondary market with GS is important for re-financing, which can be achieved via reduction in number of issues of bonds and increase of the size of issues at the same time. The MF SR will issue through the DLMA open (Tap) issues in nominal value of app. SKK 40 bn (more auctions per one issue) in the following years. The DLMA will try to concentrate small issues from previous years with the aim to purchase older small issues or to change older small issues for an equivalent part of a new large issue⁸. Increase in the amount of single issues will contribute to increase of the secondary market liquidity that will bring lower costs for issuer.

However, assumptions are legislative changes leading to standardisation of the market with government securities from the point of view of investor, mainly standardisation of settlement of securities in compliance with the EU practice, as well as improved communication of issuer with the market. An important step to increase the transparency from the investor's point of view is government proposal of tax reform. Unification of taxation of all securities (flat tax 19%) will help to transparency of trades with state securities because subject of trade will be comparable yield to maturity and not tax avoiding speculation. Replacing of withholding tax with income tax in the region of securities tax reform gradually restrict tax avoiding by coupon payments and thus eliminate important deformity of Slovak capital market. Remove of withholding tax bring increase of tax income to state budget. On the other side elimination of tax avoiding in the debt securities market can

⁸ In this connection, it is necessary to add that majority of government bonds is owned by banks that classified most of bonds in the "held to maturity" portfolio and so they cannot sell the mentioned bonds without auditor's opinion.

have negative impact on the absorbance capacity of domestic market of state securities because investors partially loose motivation to buy debt securities.

New system of taxation of securities will become understandable also for foreign investors, which will bring increased interest of foreign investors in Slovak debt securities. Engagement of foreign investors to the state securities market decrease refinancing risk of state debt of SR and create better competition environment from the point of view of diversification of investors base. Requirement of reliable re-financing of the state is connected with maturity profile of the state debt (liquidity gaps). **It is necessary to achieve equidistant maturity profile of government debt securities via issues of bonds in the year 2004 to 2006.** In order to decrease the re-financing risk, it is necessary to achieve the equidistant maturity profile of the entire existing portfolio of bonds until the year 2006 with maximum deviation less than 30 % of average due amount per one year, as well as the following maturity criteria:

- a) maximum amount of debt due up to one year - less than 25 % of the total value of government debt securities portfolio,
- b) maximum amount of debt due up to two years - less than 40 % of the total value of government debt securities portfolio,
- c) maximum amount of debt due up to three years - less than 65% of the total value of government debt securities portfolio.

The above-mentioned criteria are determined empirically according to experience with state debt management in EU countries that can be compared with Slovakia in terms of the profile. These parameters will be further quantified, mainly in connection to take-over of documents of the state debt by the DLMA from the Ministry of Finance and their including in the information system, analysis via standard analytical instruments, but mainly in connection to analysis of market risks.

Despite the fact that saturation of the domestic market with government securities is currently important, moreover, for banks, a strong competition to state securities in terms of yield and risk is sterilisation of the liquidity by the NBS via own treasury bills. Consequently, the re-financing of the state debt on the domestic market exclusively will be limited by the market's absorbance ability in a time horizon of following three years. Problems will most probably appear in the course of issuing securities with maturity over 3 years. Due to this fact (together with other factors and reasons), it will be necessary to maintain permanent contact with foreign financial markets and to consider each year with one foreign issue of government bonds. According to recommendations of countries that entered the EMU, **it will be necessary to "open" the government bonds portfolio of the SR for foreign investors and to gradually diversify the investors' basis** before entry in the EMU. Depending on conditions on financial markets it will be necessary to **diversify share of sources for covering the state debt via government bonds acquired on the primary market from domestic and foreign investors (82 % to 18 %, at present) in order to provide higher share of foreign investors.**

Restructuring from the point of view of exchange rate risk

In respect of the structure of the domestic and foreign debt, covering of the state debt in foreign countries brings comparable advantages, as well as disadvantages. It generates the exchange rate risk for the state and increases the amount of funds on the market that the NBS

must sterilise, which is connected with interest costs. Acquired foreign currency funds become a part of foreign reserves in the NBS and they are being appraised by minimum risk-free yield. On the other hand, covering of the state debt by the foreign issue of bonds brings nominally lower interest rates (the difference is at present 3 % p.a.) and the state acquires investors from foreign countries, that way it divides the local market risk and diversifies its investor basis. In case of a successful foreign issue and positive development of the country, there is an assumption of higher interest of investors in the country and probability of acquiring new foreign direct investments for a real economy is getting higher. **In other words, it will be possible to use foreign issues under decreasing exchange rate risk for treatment of other risks, mainly of the re-financing and interest risk.**

Parameters of the debt portfolio expressing optimum costs for the debt service in a mid-term and long-term perspective under an acceptable rate of risk are - the average residual maturity of the portfolio (it is goal-directed from 4 to 6 years in European countries) and the portfolio duration (that should minimally achieve the level of 4 years).

In respect of optimisation of costs for financing needs of the state, the following values can be considered to be target values of key parameters of the debt for the period up to the year 2006:

- **in compliance with recommendations of EU experts, it is necessary to achieve and maintain an average residual maturity of government debt securities portfolio ranging from 4 up to 6 years,**
- **in compliance with the assumed development of interest rates, it is necessary to achieve value of duration of the state debt portfolio at the level of app. 4 years.**

At the same time, the average maturity is: 4 years in case of domestic bonds, 3.1 years in case of bonds in other currencies and less than 0.2 years in case of T-Bills; the total average maturity of government debt securities is 3.6 years and the portfolio duration is 3.2 years.

In connection with the portfolio duration, we have to **moderately decrease ratio of securities with fixed yield to securities with floating yield** (81 % to 19 %, at present) with respect to optimisation of costs for the debt service, as well as requirements of investors. According to experience of countries with a similar structure of the state debt than the Slovakia, ratio 75 % to 25 % can be preliminary considered to be optimal with respect to the expected development of the market environment. *However, realisation of the mentioned goal will be conditioned by analysis of the interest risk of the entire securities portfolio and subsequently the optimum ratio will be specified.* Subsequently, the DLMA will carry out issues of securities in order to approach the optimum ratio of securities with fixed yield and securities with floating yield to the total debt.

The required value of the duration can be achieved faster via use of derivative financial transactions on the interbank market - namely by means of the interest swap. In case of such transaction, the debtor (state) pays fixed interest and becomes floating interest, while the state will fix costs against changing incomes. This method was successfully used by Italy and the Czech Republic, and by some other countries.

Risks connected with credit portfolio

Risks resulting from the present credit portfolio of the state for the future - possible increased expenditures connected mainly with exchange rate and interest risk. In the year 2004 the task of the DLMA will be to analyse these risks and to eliminate them via use of financial instruments. **It will be necessary to restructure the government loans portfolio in the years 2004 and 2005, i.e. to eliminate influence of disadvantage credits as much as possible and after analysis to replace them with credits or government bonds with standard business and technical conditions.**

Third Principle

Minimising of risk must be based on permanent monitoring and analysis of risks. Risk management relates not only to each single financial instrument and related operations (bonds, credits, deposits, currency conversions and likes), but also to the debt portfolio as a whole. Risks ensuing from the structure of the state debt must be regularly monitored and assessed. The goal of the DLMA is proposal, monitoring and management of optimum ratio between the market risk, cost on limitation of risk and possibilities of hedging arrangement available on the market. Since the MF SR does not carry out any monitoring at present and there does not exist methodology and limits for risk management, the main goal will be preparation of methodology of monitoring, evaluation and management of risks, as well as determination and control of limits of single risks. On the basis of regulations of the MF SR and consultation with the NBS, the DLMA will use financial instruments – derivatives for elimination of single types of market risks.

Mainly centralisation of the entire agenda of the debt and liquidity management will contribute to decrease of risks via implementing of a standardised and centralised information system that will enable to keep reliable records of transactions and control of limits in real time. In area of risks management, the system offers outputs on values of individual parameters of the debt portfolio (duration, average maturity, et cetera), value of the credit risk towards individual counter-parties, options for simulation of different market conditions. A direct access to most recent market financial data and information will be provided by systems Reuters, Telerate and Bloomberg.

Specification of Goals of State Debt Strategy in the year 2004

The Debt and Liquidity Management Agency will manage the state debt since the year 2004.

The strategic goal of the DLMA in the year 2004 will be transition to active method of debt and liquidity management. In order to fulfil the strategic goal, it will be necessary to arrange the following in the year 2004:

- gradual restructuring of the state debt portfolio in order to eliminate the refinancing and interest risk,
- implementing regular analyses of the debt portfolio and of market risks related,

- elaborating of internal regulations and working procedures for the system of the state debt and market risks management, inclusive use of derivative instruments within the competence of the MF SR,
- modernisation of the system of auction sale and transition to electronic method of participation of investors at primary auctions,
- try to improve liquidity of government securities in co-operation with other institutions operating on the capital market and to acquire higher participation of foreign investors in the debt of the SR,
- gradual standardisation and simplification of settlement of government securities via legislative and institutional changes,
- re-assessment of concept of implementing the primary dealers system in co-operation with domestic and foreign investors,
- considerable improvement of communication with domestic and foreign financial market, mainly with banks; regular presentation of results of the debt management and informing on strategic aims of the debt management in general and in advance.

In respect to parameters of the state debt, the DLMA will emphasise in the year 2004 the prolongation of the duration and average maturity of government securities portfolio and smoothed profile of debt due to a longer period of time. The goal of the year 2004 will be achievement of duration of portfolio of state securities in interval from 3.5 to 3.8 years and of average maturity over 4 years. An assumption for elimination of mainly the refinancing risk will be promotion of the country on foreign financial markets with aim of diversification of investors' portfolio in the state debt of the SR.

An important task of the DLMA will be also support of the capital market development in area of government securities. History (privatisation, collective investment, legislation, complicated tax laws, incompetent intervention of state to capital market, size of market et cetera) is reason that secondary market of state securities is least developed in V4 region and one of weakest in Europe at all. Organisation and improvement of function of capital market and secondary market of state securities is out of scope of ARDAL. Despite of this fact ARDAL will try together with other participants of secondary market (MF SR, Bratislava stock exchange, Central depository and institutions like Bank associations, Security traders associations and like) to improve liquidity of state securities. Development of capital market and especially its liquidity is one of limiting factors of decreasing of interest costs of state on refinancing. Further step towards the standard capital market will be probably implementing of system of primary dealers to the auctions of state securities.

Pursuing foreign experiences ARDAL will initiate formation of system of primary dealers for primary auctions of state debt securities. System should ensure primary sale of state debt securities at ahead-defined conditions for recognized selected crucial investors that should indemnify further distribution of those bonds to other smaller investors a that should guarantee at least minimal liquidity of individual issues. That form of system is successful in almost all countries of EU and substantially contributes to development of state securities market in those countries.

To enable transition to the modern electronic method of government securities auctions, the DLMA will implement an electronic auction system (for example BAS) for receiving and evaluation of orders for the primary market with government securities what will increase transparency of the primary market of government securities and compatibility with financial markets of the EU⁹.

Standardisation of the capital market with developed capital market means also offering of long-term investment instruments to investors - benchmark issues of the SR. Investments of Pension funds in long-term investment financial instruments will indirectly support Pension and Social reform, at the same time.

At present critical condition of development of market of state debt securities particularly from point of view of foreign investors is improvement, modernisation and simplification of settlement of commitments from security trades. Support of transformation of Centre of securities to Central depository can cause achievement standard conditions of settlements of trades (delivery versus payment - DVP) such as e.g. in Clearstream or Euroclear. In this region will be necessary coordination and cooperation with NBS namely in area of short-term state securities.

In respect to marketing, communication with media will be very important. Maintaining of contact with investors and flexible response to requirements of the domestic or foreign market is not of a lesser importance. In order to achieve the mentioned goal, the DLMA will organise activity of informal "group for development of government securities market" with important participation of representatives of the market. Publicity of reforms of state debt management abroad mainly in EU countries enforces interest in investment to state debt from side of foreign investors. According to foreign experiences it can indirectly help to gain direct foreign investments and deepening of interest of country. Year 2004 should be first important milestone by the preparation of system of state debt management to the entry to EMU.

At the same time, setting up of "consultative group for the state debt" consisting of representatives of the MF SR, T, NBS and DLMA will provide information and co-ordination of the MF SR and the NBS by management of the currency and budgetary policy together with recommendation for the DLMA for the debt management.

⁹ Majority of institutions involved in issuing of government securities in European countries use the Bloomberg Auction System.