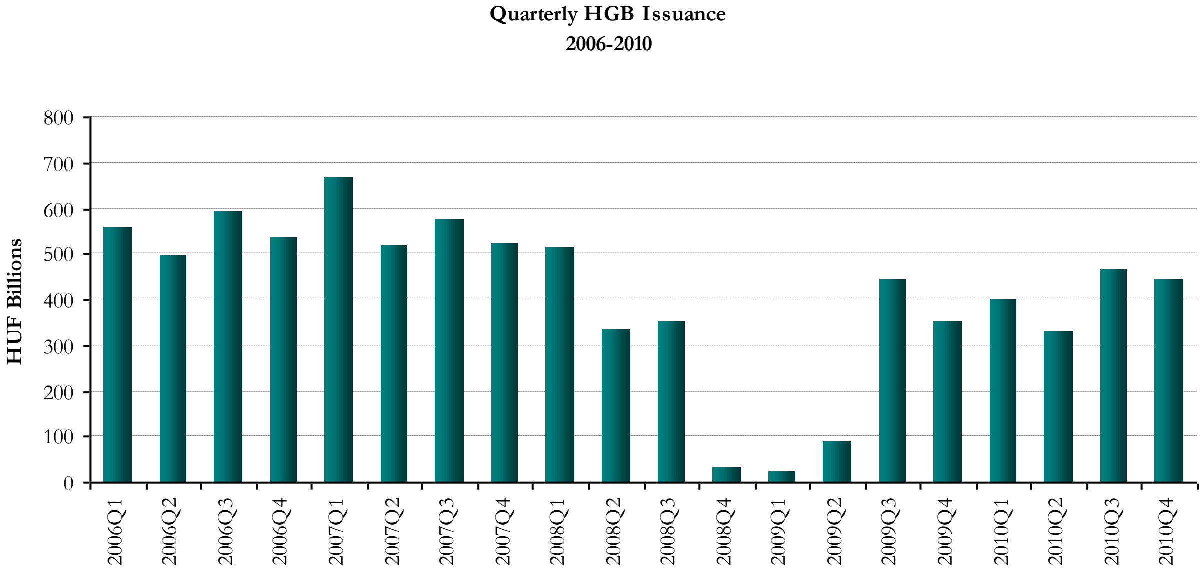
MINISTRY
FOR NATIONAL ECONOMY

Hungary: the consolidation continues

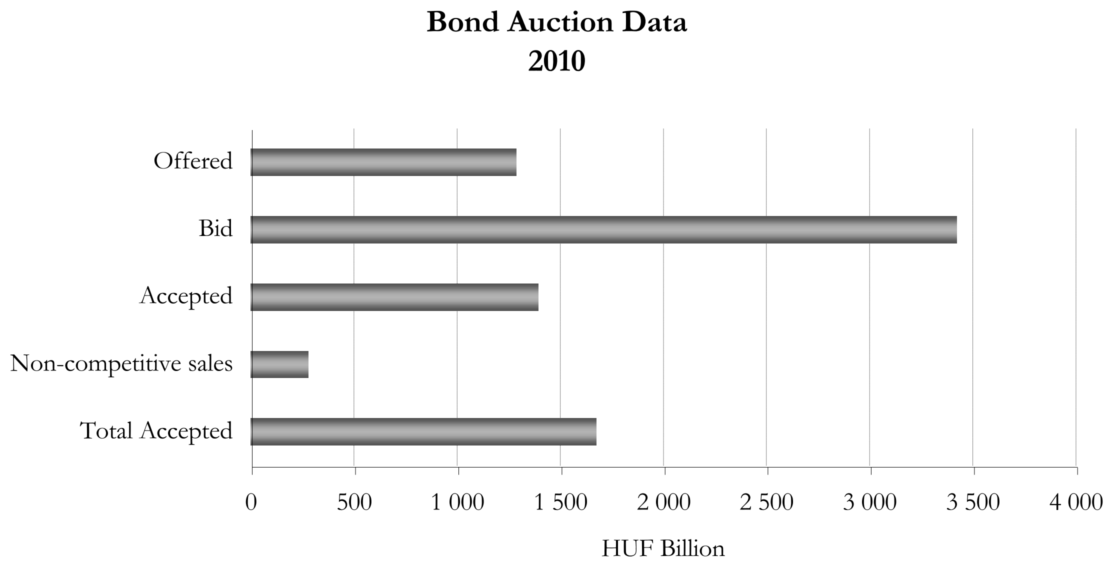
Focus

Despite the ongoing volatility of the international capital markets, mainly caused by renewed concerns about the worsening financial situation in some of the developed countries, the Hungarian government securities market worked well and provided smooth and stable financing for the government throughout 2010.

Background



The average bid-to-cover ratio at the bi-weekly government bond auctions - as a consequence of the strong domestic and international demand for Hungarian government paper - rose to 2.7. This **significant oversubscription** enabled the Government Debt Management Agency Pte. Ltd. (ÁKK) to sell bonds well in excess of the original financing plan.



‘Cornerstones’

The success of the auctions is also a result of the changes in the auction process that had been introduced in 2009. In order to increase flexibility and maximize demand ÁKK introduced a bi-weekly bond auction schedule, where 3 types of medium- and long-term bonds (usually with 3, 5, and 10 year tenor) are being offered on the same day. At regular intervals a 15-year paper replaces the 10-year bond.

Announcement about the actual series offered at the auction comes a week before the actual auction date after consultations with the Primary dealers. (At the beginning of 2010 there were 11 Primary dealers in Hungary. Their number rose to 14 effective July 1, 2010, and to 15 from January 1, 2011. They are mainly subsidiaries or branches of major international financial institutions.) At the auctions ÁKK can increase or decrease the accepted amount in light of the size and quality of the prevailing demand. In 30 per cent of the auctions the accepted amount was increased, and only 9 per cent of the auctions ended with a decrease last year. The total amount of bonds sold at competitive auctions was increased to HUF 1399 billion (approximately EUR 5 billion).

Auctions are supplemented by a newly introduced non-competitive phase (the so-called top-up auction) conducted after the competitive auction. ÁKK offers and primary dealers may buy up to 40 per cent of the amount of their successful (accepted) bids in the competitive phase at the average price of the auction. Non-competitive sales had a result of HUF 258 billion in 2010.

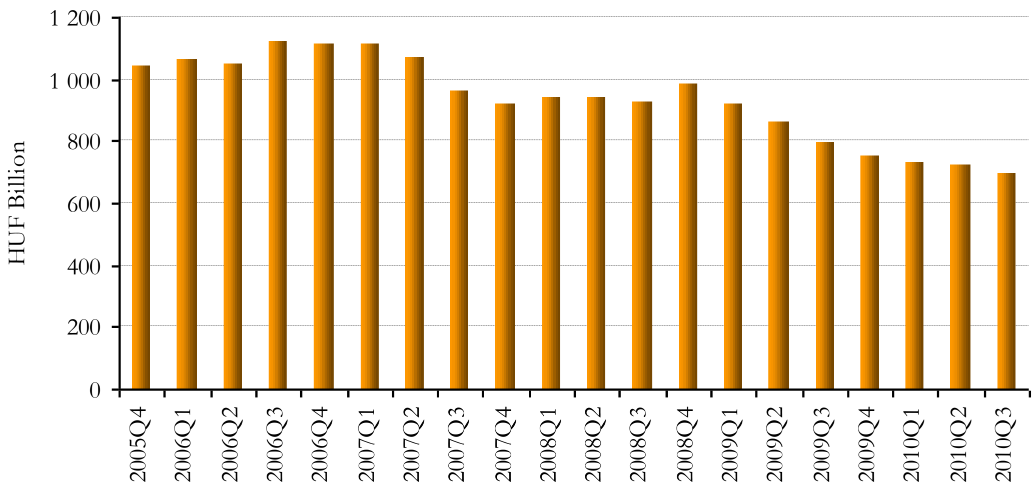
Hungarian government bond issuance is concentrated into a few liquid bond series, the so-called benchmarks. In order to increase their liquidity ÁKK – instead of opening a new benchmark bond series – may reopen a former bond series with a remaining time to maturity of 3 or 5 year, and add to their size through a number of consecutive auctions. So the size of a benchmark bond may reach HUF 600-800 billion (EUR 2.5-3.0 billion), which makes their secondary market trading easier, therefore more attractive.

As market conditions continue improving there is more demand for longer term paper. In order to satisfy this demand ÁKK introduced a so-called switch auction, where bonds with short remaining time to maturity are exchanged for longer term paper in a cash-free transaction. The result is the simultaneous lengthening of the average term to maturity of the government debt portfolio and the decrease of the re-financing risk. The volume of the switch auctions reached HUF 132 billion in 2010.

While demand for government bonds may be more influenced by the changes in global investor behaviour, the Hungarian Treasury bill market, where foreign participation usually is not significant, operates with remarkable stability. Due to their short-term tenor, T-Bills are the ideal means of liquidity management both for ÁKK and the majority of market participants. In 2010 a total of HUF 3730 billion was issued at a bid-to-cover ratio of 2.6. Though based on market demand the issued amount could have been more, a part of the short-term issuance was replaced by the increased sale of medium- and long-term bonds thus improving the maturity profile of the total debt portfolio.

The most important investors of the Hungarian government securities are banks, domestic institutional investors (pension and insurance) and non-residents. At the same time retail investors play a significant role in financing the government. ÁKK is facing fierce competition from the commercial banks for the savings of the population, and the tendency is that their share is declining in the direct financing of the government. At the same time indirect holding of government securities (through mutual funds, voluntary pension assets, insurance schemes) may grow.

Retail Holding of Hungarian Government Securities



Retail investors are served using special channels (the Hungarian Post, or the network of the Hungarian State Treasury) that provide easy and direct access to wholesale (bonds, T-bills), or special retail securities, like the "traditional" Interest-bearing T-Bills and Treasury Saving Bills, or the recently introduced Premium Government Bond. This latter has been a great success: the Hungarian State Treasury sold a total of HUF 104 billion of the four series of these inflation-linked securities issued in 2010. As these bonds have a maturity of 3-5 years, the fact that retail investors switch from of shorter-term securities into these bonds also improves the overall characteristics of the retail debt portfolio.

Conclusion

While international market conditions remained volatile, the consolidation in the Hungarian domestic market continued in 2010. After returning to full-fledged market financing in 2010 the beginning of repayment of the IMF/EC loan is expected in 2011.

Budapest, 7 February 2011.

Ministry for National Economy