Annual Report Public Debt in Poland 2003

MINISTRY OF FINANCE

On the cover page Airport in Poznań


Airport in Poznań

Annual Report Public Debt in Poland 2003

MINISTRY OF FINANCE

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Introduction

Świętokrzyski Bridge in Warsaw

This *Annual Report 2003 – Public Debt* contains some basic information on public debt in Poland in 2003, as well as its developments and trends in the last few years. The *Report* covers the following areas:

- the level and structure of the debt and debt service cost,
- debt management, taking into account provisions of the *Public Sector Debt Management Strategy and* the *Budget Act*,
- legislation related to debt creation and its limits.

In addition the *Report* comments on:

- Poland's economic performance in 2003 and its implications for the public debt, and
- secondary trading of Treasury Securities, substantially affecting the debt management.

More attention was also devoted to the methodology of debt calculation according to the European Union's requirements, following Poland's accession to the EU and the need to clarify and resolve the controversial issue of the scope of the public sector, whose debt and deficit are reported to the EU.

The *Report* consists of six chapters and an **Annex** with statistical data, available only in the electronic form. Chapter 1 is devoted to Poland's economic performance in 2003 and the situation of the public finance sector.

Chapter 2 presents the legal grounds of debt incurring by the public finance sector, including the legal constraints limiting an excessive debt growth.

Chapter 3 contains a description of the level, dynamics and structure of the public sector debt during the last few years, with particular focus on the State Treasury debt.

The objectives of the *Debt Management Strategy for 2003* are presented in chapter 4, including the evaluation of the outcome taking into account the macroeconomic and market conditions. It also presents the strategic objectives for the years 2004-2006.

The domestic and foreign financing of the State Budget borrowing requirement, as well as the issue of budget liquidity, are presented in chapter 5.

Chapter 6 includes a presentation of the Treasury Securities secondary market structure and market developments in 2003.

The authors of the *Report* hope that the contents of the *Report* together with other materials on the public debt will satisfy the readers' demand for information in this area. The authors look forward to receive comments, opinions and proposals concerning future editions of the *Report*.

Warsaw Underground

Warsaw Underground

Chapter 1

Economic Developments in Poland in 2003

In 2003 Polish economy entered the path of faster economic growth, after a period of significant slowdown in 2001-2002. Faster growth was driven by the significant rise in exports, which was achieved despite slower than expected GDP growth in the EU countries. Private consumption was growing steadily and positively contributed to GDP growth. Nevertheless, the decreasing output in construction and assembly production and a decreasing trend of gross fixed capital formation expenditures continued. However, with regard to the latter category, a slight increase in the investment activity was observed in the second half of 2003. Moreover, it is worth mentioning that investment in the manufacturing enterprises rose significantly, especially in the high technology sector, which has significant importance for stability of economic growth and improvement of competitiveness of the economy.

As a result of these trends the real GDP growth rate amounted to 3.8% in comparison to 1.4% in 2002. The contribution of domestic demand to GDP growth was about 2.5 percentage points (ppt) and the net exports contribution was roughly 1.3 ppt. The nominal GDP level was PLN 814.7 billion[1)] and it was 4.3% higher than in the previous year.

Developments in public finance[2)]

In 2003 revenues of the State Budget amounted to PLN 152.1 billion and constituted 97.7% of the level planned in the Budget Act, while budget expenditure amounted to PLN 189.2 billion, i.e. 97.3% of the amount planned in the Budget Act. As a consequence the deficit of the State Budget reached the level of PLN 37.0 billion and was 4.4% lower than planned. In comparison with 2002 the budget deficit was lower by 6%. The budget deficit was financed mainly from domestic sources, but in comparison to 2002 the share of foreign financing grew significantly. The privatisation receipts amounted to PLN 2.96 billion, i.e. PLN 4.4 billion less than presumed in the Budget Act. As compared to 2002, the privatisation receipts

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1) Data according to the new GDP calculation methodology, incomparable with data published in previous reports.

2) Elaborated on the basis of the *Report on Operational Execution of the State Budget in January-December 2003*, Warsaw, May 2004. This report is not final and may be slightly amended.

were higher by PLN 0.99 billion. Significant budget deficits and low privatisation receipts during the last years resulted in the growth of public debt (see chapter 3) and deterioration in the public finances. Public debt, increased by the amount of contingent liabilities arising out of state guarantees, exceeded in 2003 the first prudential threshold (50% of GDP) – as defined in the Act on Public Finance. The risk of further rapid increase of public debt was one of the reasons for preparing the Public Finance Reform Program (see chapter 3).


Ring road in Białobrzegi

Monetary and exchange rate policy

In 2003 the monetary policy was conducted within a direct inflation-targeting framework and a floating exchange rate system. The inflation target of the monetary policy – announced by the Monetary Policy Council (MPC) in June 2002 – was the level of inflation at 3% ±1 ppt at the end of 2003. In December 2003 the CPI (Consumer Price Index) was slightly below the lower range of inflation target and amounted to 1.7%.

Due to the falling inflation and low risk of inflationary pressure growth stemming from the increase of domestic demand, the Monetary Policy Council cut the NBP's policy rates six times in the first half of 2003. The main reference rate was reduced by 150 basis points (bps) in total to the level of 5.25%. In the second half of 2003 the MPC did not change the parameters of the monetary policy, especially pointing to the growing uncertainty regarding the fiscal policy stance in 2004 and the following years and strengthening economic recovery, gradually increasing the risk of an inflationary pressure.

The Zloty exchange rate was particularly volatile in 2003 due to domestic political situation and trends on the global foreign exchange market. The above-mentioned factors determined the following exchange rate of the Polish currency:

- average annual PLN/EUR rate amounted to 4.40 and was 14.1% higher than in 2002;
- average annual PLN/USD rate amounted to 3.89 and was 4.7% lower than in 2002;
- the effective depreciation of the Polish zloty (exchange rate weighted by the geographical structure of Polish exports) was noted at: 11.3% in nominal terms, in comparison to 2002, and 13.2% and 10.6% in real terms, deflated by CPI and PPI respectively.

Inflation

In 2003 inflation in Poland reached a very low level. The average annual growth of consumer prices (CPI) amounted to 0.8% and was the lowest since the beginning of Polish economic transition. It was also lower than the average inflation level in EU member states. Low dynamics of prices resulted, above all, from lack of demand pressure (despite visible symptoms of economic recovery) and low food prices.

Labour market

In 2003 the growth of working age population amounted to nearly 1% along with simultaneous decrease in the number of employed persons. As a result, the unemployment rate remained at the unchanged level since the end of 2002, i.e. 20.0%, despite the fall in the number of the unemployed registered in the labour offices. Economic recovery did not result in improvement of the situation on the labour market. As a result the number of employed fell again in 2003, by some 1% as compared to 2002.

Table 1.1. Basic macroeconomic indicators in Poland in 2000-2003

	2000	2001	2002	2003
GDP (nominal, in billion Polish Zlotys)	723.9	760.6	781.1	814.7
GDP (real growth rate in %)	4.0	1.0	1.4	3.8
individual consumption	2.8	2.1	3.3	3.1
gross fixed capital formation	2.7	-8.8	-5.8	-0.9
exports	23.2	3.1	4.8	14.7
imports	15.6	-5.3	2.6	9.3
Production[1)] (real growth rate in %)				
industry	6.7	0.6	1.1	8.7
construction	1.4	-11.7	-4.1	-5.9
Unemployment rate (end of period) in %	–	19.4	20.0	20.0
Consumer prices in %				
Dec/Dec	8.5	3.6	0.8	1.7
period average	10.1	5.5	1.9	0.8
Current account balance[2)]				
EUR billion	-10.8	-6.0	-5.4	-3.7
as % of GDP	-6.0	-2.9	-2.6	-2.0
Official reserve assets (end of the period, in USD billion)	27.5	26.6	29.8	34.0
Exchange rate (period average)				
PLN/USD	4.35	4.09	4.08	3.89
PLN/EUR	4.01	3.67	3.86	4.40
USD/EUR	0.92	0.90	0.95	1.13
Refinancing rate on NBP's open-market operations				
end of the period	19.0	11.5	6.75	5.25
period average	17.9	15.9	8.8	5.7

1) In the years 2000-2002 the data include a complete collection of entities, while in 2003 it covers only entities employing more than 9 persons.

2) Balance of payments data on transactions basis.

Industrial and construction sector

The industrial production growth was much faster than in the previous year and amounted to 8.7%. Good performance of industrial sector, in particular in manufacturing, was backed by restructuring effects, costs reduction and favourable trends in exchange rates which stimulated export growth.
In the case of construction and assembly production performed by construction companies domestically, once again the output fell by 5.9%. Very weak performance of the construction sector was mainly caused by low investment activity of enterprises. Moreover, financing constraints negatively influenced demand for construction works coming from the public sector and households.

Foreign trade and foreign investment

Gradual recovery abroad and favourable exchange rate conditions prompted the producers to look for foreign buyers of goods. In 2003 exports in terms of national accounts increased by 14.7% in real terms against 4.8% in 2002. At the same time growing demand on the domestic market (in 2003 domestic demand increased by 2.4% in real terms compared to 0.8% in 2003) contributed to faster growth of imports. In 2003 imports, as recorded in the national accounts, increased by 9.3% in real terms against 2.6% in 2002. Significant acceleration of exports growth and moderate increase in imports resulted in considerable increase of net exports contribution to GDP growth, from around 0.5 ppt in 2002 to some 1.3 ppt in 2003.
The rising trend of exports exceeding the rise in imports contributed to a significant reduction of the foreign trade deficit. According to balance of payments statistics (on transaction basis) the negative trade balance in 2003 amounted to EUR 5.077 billion against EUR 7.701 billion in 2002. It contributed to a reduction of the current account deficit to EUR 3.660 billion from EUR 5.404 billion in 2002. In relation to GDP the current account deficit narrowed to 2.0% against 2.6% in 2002.
With regard to the capital account of the balance of payments a decrease in foreign direct investment (FDI) inflow was observed. In 2003 the FDI inflow amounted to EUR 3.756 billion against EUR 4.371 billion in 2002 and EUR 10.334 billion, which was the all-time-high amount, in 2000. This adverse trend resulted mainly from a slowdown of the privatisation process in recent years.

Chapter 2


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Legal Basis and Definition of the Public Debt


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Definition of the public debt, formulated in Polish legislation, indicates some methodological differences in relation to the EU regulations. Both definitions are provided below with a review of differences. In addition the rules of debt contracting in Poland and restrictions thereof are presented.

2.1. Legal basis of the public debt

Rules governing public debt are set out in several legal acts, which have various levels of importance:

1) The Constitution of the Republic of Poland, Chapter X – Public Finance. The Constitution introduced the principle banning the contracting of loans or extending state guarantees or financial sureties resulting in the public debt exceeding 3/5 of the gross domestic product. The Council of Ministers is granted the exclusive right to take legislative initiative with regard to the Budget Act, the Provisional Budget Act, any amendments to the Budget Act, the Public Debt Incurrence Act and the Act on Extending Sureties and Financial Guarantees by the State Treasury. Furthermore the Constitution introduced a ban on financing State Budget deficit in the central bank;

2) The Public Finance Act of 26 November 1998[3]. It is the fundamental law comprehensively regulating the public debt issues. This Act introduced some necessary definitions, specified general rules on debt incurring, issuance of securities and management of the State Treasury debt, as well as prudential and remedial procedures;

3) Supplementary Acts (ordinances) to the Public Finance Act regulating in detail some issues including: specification of debt instruments included in public debt, the rules of calculating the nominal value of public debt etc.

2.2. Definition of the public debt

Public debt includes the nominal debt of public finance sector entities, after netting out the internal flows elimination of financial flows between sector

[3] Journal of Laws 2003, No. 15, item 148 and No. 45, item 391, as amended.

entities (consolidated gross debt), incurred under titles specified in item 2.3 below.
The public debt is calculated at nominal value.
The value of securities issued is taken as their nominal value, calculated as:

– the principal amount associated with the securities issued, due on the redemption date,

– in case of securities providing for the indexation or capitalization of the principal amount, the principal amount is recorded taking into account the increase resulting from the indexation or capitalization, accrued at the end of the reporting period.

The amount of credits and loans drawn is calculated at the nominal value, i.e. as the principal amount resulting from the use of a given credit or loan due at maturity.
The amount of deposits taken is calculated as the deposited amount which, according to a contract concluded, debtors are required to pay to creditors on the day when the deposit matures; it is the amount subject to calculation of interest.
The amount of due and payable liabilities, excluding contingent liabilities arising out of state guarantees and sureties, includes the amount of liabilities, excluding overdue interest, which are neither written off nor cancelled.
The nominal value of the indexed or capitalized liabilities (e.g. bonds or loans with capitalised interest) corresponds to the principal amount increased in line with the indexation or capitalization mechanism, calculated at the end of a reporting period.
Debt denominated in foreign currencies is converted into the domestic currency at the average exchange rate of such currencies announced by the National Bank of Poland, in effect on the last working day of a given reporting period.

2.3. Subject scope of the public debt

Public debt includes liabilities of the public finance sector entities under the following debt titles:

1) securities with monetary-type liability (excluding equity),

2) loans (including securities with limited transferability),

3) credits,

4) deposits accepted,

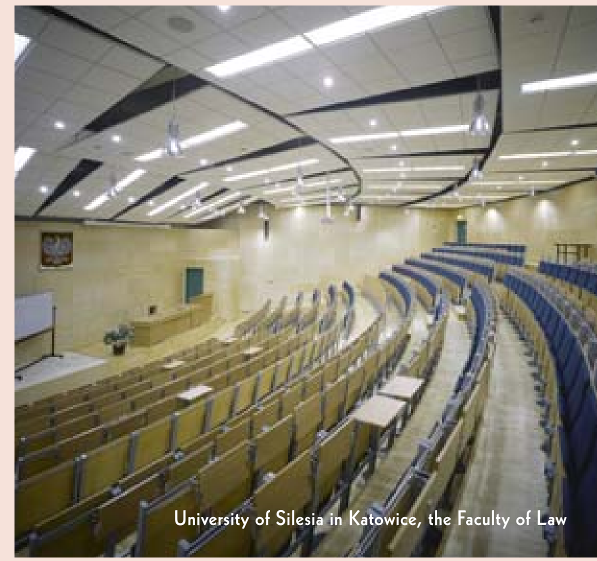
5) matured liabilities (i.e. liabilities due, which date of maturity has passed, but they are neither written off nor cancelled).

2.4. Entity scope of the public debt

The Public Finance Act provides a limited list of entities included in the public finance sector.
The public finance sector includes:

1) public authorities and their bodies, government administration, state audit, law enforcement, courts and tribunals, as well as local government units and their unions,

2) budgetary units and their auxiliary estates as well as budgetary establishments,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3) earmarked funds,

4) state universities and higher education institutions,

5) research and development units,

6) independent public health care units,

7) state or local government cultural institutions,

8) ZUS (the Social Insurance Institution), KRUS (the Farmers Social Insurance Fund) and their managed funds,

9) the National Healthcare Fund,

10) the Polish Academy of Science and its established organizational units,

11) state or local government legal entities established under separate acts for public tasks execution, excluding enterprises, banks and commercial companies.

Currently, the Polish legislation does not specify division of the public finance sector into sub-sectors. For the purposes of this *Report* the public finance sector may be divided into the following sub-sectors:

a) *government*, which includes the public authorities and their bodies, government administration, state audit and law enforcement, courts and tribunals, the Polish Academy of Science and its established organizational units, the Social Insurance Institution and the Farmers Social Insurance Fund and funds managed by them, the National Healthcare Fund and the entities listed in items 2-7 and 11, for which the founding or regulatory authority is a government administration body or other entities in the government sector,

b) *local government*, which includes local government units and their bodies, their unions and the units listed in items 2, 3, 6, 7 and 11, for which the founding or regulatory authority is a local government unit.

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2.5. Influence on the public finance sector debt

The concepts of the State Treasury debt management strategy and influence on the public finance sector debt have been introduced in the Public Finance Act. The Minister of Finance has been entrusted with elaboration and submission of the strategy to the Council of Ministers, which after approving it presents it to the lower chamber of Parliament (Sejm) together with the explanatory part of the draft Budget Act. Distinction between „debt management" and „influence on debt" results from the fact that the Minister of Finance has the management powers with regard to the State Treasury debt. With regard to other units of the public finance sector, whose debt is included in the public debt, but not in the State Treasury debt, i.e. mainly debt of local government units, we can only speak of indirect influence.

The Public Finance Act introduced the following restrictions on incurring financial liabilities by local government units and other entities of the public finance sector, which have an impact on the debt amount and its shape:

- local government units (LGUs) may only borrow and issue securities for specific purposes indicated in the Act,

- when borrowed funds, or receipts from securities issued, are used to finance current deficit, they must be repaid or redeemed in the same year,

- LGUs may borrow and issue securities within the repayment period or maturity exceeding one year, provided that receipts may be used only and exclusively to finance expenditure that can't be covered by the LGU's budgeted revenue,

- long-term debt servicing payments must be made at least once a year,

- the discount on securities issued by LGUs cannot exceed 5% of the nominal value,

- in the case of issuing securities or borrowing with a maturity exceeding one year, interest cannot be capitalized,

- LGUs and other entities of the public finance sector, excluding the State Treasury, may only incur those financial obligations, which nominal value expressed in PLN is determined on the transaction date,

- if an LGU applies for a credit or a loan or intends to issue securities, it must obtain an opinion of the regional clearing chamber on its ability to repay the credit or the loan or to redeem securities,

- regional clearing chambers issue opinions on the ability to finance the deficit proposed by LGUs and on the accuracy of the LGU's debt forecast included in the budget. Such an opinion is announced to the general public. If the opinion of the regional clearing chamber is negative, the LGU's founding body is required to adopt an appropriate resolution,

- the total amount of credit and loan payments, as well as contingency payments related to the guarantees granted by the LGU, falling due in a given budget year, together with interest on such credits and interest on the discount payable in that year, as well as the LGU's issued securities redeemable in a given budget year, cannot exceed 15% of the LGU's income planned for that budget year,

- if the total amount of public debt plus the amount of contingent liabilities arising out of state guarantees and sureties exceeds 55% of GDP, the amount payable under the total debt servicing in a given year cannot exceed 12% of the specific LGU's planned income, unless the financial burden in question results entirely from obligations incurred prior to the date of announcing breaching the above debt limit,

- the total debt of a LGU at the end of a budget year cannot exceed 60% of its income in that budget year.

The enforcement of the public finance sector's compliance with the constitutional rule banning the borrowing and granting of guarantees and sureties resulting in the public debt exceeding 3/5 of the gross domestic product is exercised by the Minister of Finance on the basis of the Public Finance Act.

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The Public Finance Act introduces the prudential and remedial procedures aiming at preventing exceeding the constitutional limit. Prudential and remedial procedures concerning the ratios of public debt enlarged by contingent liabilities arising out of state guarantees and sureties are the following:

1) debt to GDP ratio in year n is greater than 50% but not more than 55%:

a) a limit on the ratio of the State Budget deficit to its revenue is introduced; this ratio, set in the draft Budget adopted by the Council of Ministers for the following (n+2) year, cannot be higher than in the given (n+1) budget year,

b) the ratio of deficit to revenue, adopted in the State Budget for the following budget year, is the upper limit applicable to each local government unit (LGU) and its deficit to revenue ratio adopted in the budget of such LGU;

2) debt to GDP ratio in year n is greater than 55% but not more than 60%:

a) the draft Budget for the year n+2, submitted by the Council of Ministers, has to ensure a decreasing ratio of the State Treasury debt (including contingent liabilities arising out of state guarantees and sureties) to GDP in the budget year n+2 in comparison with the ratio announced for the year n,

b) the deficits of the respective local governments' budgets are also subject to limitations,

c) the Council of Ministers presents a recovery programme supposed to ensure a declining ratio of the public debt-to-GDP (debt including the contingent liabilities arising out of state guarantees and sureties and);

3) debt to GDP ratio in year n is equal to or greater than 60%:

a) the draft Budget for the following budget year (n+2) does not allow for a deficit, and the budgets of LGUs are adopted without any deficit,

b) a ban on granting new sureties and guarantees by the public finance sector is introduced,

c) the Council of Ministers presents a recovery program to the Parliament. Its basic objective is to undertake measures aimed at reducing the public debt-to-GDP ratio below 60% of the GDP.

2.6. Legal basis of the public debt in the European Union and differences between the *general government* sector debt and the public debt

The following legal acts constitute the legal basis of the public debt in the European Union:

1) Maastricht Treaty (Article 121) – the public debt level, besides restrictions concerning a deficit, is a criterion, on the basis of which the Commission examines compliance with budgetary discipline by the Member States. The Commission evaluates whether the ratio of the public debt to GDP does not exceed the reference value unless the ratio is

sufficiently diminishing and approaching the reference value at a satisfactory pace.

2) Protocol on the excessive deficit procedure, annexed to the Maastricht Treaty – specifies:
   a) reference value of the public debt to GDP ratio at 60%;
   b) general definition of the debt.

3) Regulation concerning application of the Protocol on the excessive deficit procedure annexed to the Maastricht Treaty:
   a) introduces precise definition of the *general government* sector debt as consolidated gross debt of that sector, calculated at the nominal value;
   b) specifies categories of financial liabilities composing the *general government* sector debt such as:
      - cash and deposits,
      - securities other than shares, excluding financial derivatives,
      - loans;
   c) contains a definition of the nominal value.

4) The European system of national and regional accounts (ESA 1995) adopted in the form of the Council Regulation (EC) of 25 June 1996; introduces, *inter alia*, division of the *general government* sector into three sub-sectors and criteria of inclusion into the relevant sub-sectors.

Differences between the *general government* sector debt and public debt result from:

a) different scope of public finance sector and *general government*:
   - open pension funds are not included to the public finance sector (according to the Public Finance Act), and in the opinion of Polish authorities they should be included in the *general government* sector (which is currently discussed with the EU),
   - Agricultural Market Agency is an entity of the public finance sector, but it is not included in the *general government* sector,
   - research and development units are included in the public finance sector, but they are not entities of the *general government* sector;

b) different subject scope of the debt; the debt calculated according to EU regulations, in contrast to the Polish regulations, does not include all liabilities due (according to the EU rules they are treated as expenditure on the accrual basis).

Restrictions on the debt limit in Poland refer to the public debt increased by the amount of contingent liabilities arising out of state guarantees. EU regulations do not take into consideration the potential debt amount.

Due to the above differences, at present the level of Polish debt, calculated according to EU rules (*general government* sector debt), is lower than calculated on the basis of Polish legal regulations.

2.7. General principles and procedure of issuing securities and borrowing by the State Treasury

General principles and procedure of issuing securities and borrowing by the State Treasury are set out in Chapter II of the Public Finance Act – Public Debt.

The Minister of Finance has the exclusive right to issue Treasury securities and to borrow (take loans and credits) on behalf of the State Treasury.

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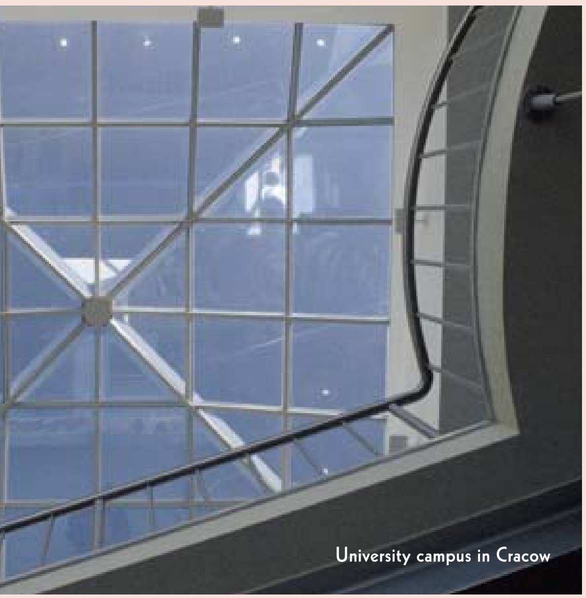

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The exception is loans or credits incurred on the basis of an international agreement, when the government is required to be the borrower. In such cases the Council of Ministers authorises the Minister of Finance to sign the agreement and determines terms of its implementation.

The amounts of loans and credits taken and of the securities issued are subject to limits defined in the annual Budget Acts.

The Public Finance Act provides for the following types of treasury securities which may be issued by the Minister of Finance on behalf of the State Treasury:

1) Treasury bonds defined as securities offered for sale on domestic and foreign markets, bearing interest in the form of a interest or discount coupon.

2) Treasury bills defined as short-term securities offered for sale on the domestic primary market at a discount and redeemed at the nominal value at maturity.

3) Treasury savings bonds defined as Treasury securities offered for sale exclusively to resident natural persons and, upon accession to the European Union, also to non-resident natural persons.

The general terms of issuing Treasury Securities are defined in the relevant ordinances, and the detailed conditions are announced in the offering letters published by the Minister of Finance. Public release of the offering letter a condition for the issue to be effective. To this end the offering letters are published in the nationwide press and on the Ministry of Finance's website.

Based on the mandate stipulated in Article 55 of the Public Finance Act, in 1999 the Minister of Finance issued five ordinances regulating the general issuance terms for specified groups of Treasury Securities[4)].

The ordinances set out the general conditions of structuring the instruments, sale procedures, investor groups to whom the Treasury Securities are offered, the rules of securities-related-debt servicing and redemption (including repurchase and early redemption).

[4)] 1) Ordinance of the Minister of Finance of April 26, 1999 on the general terms of issuing Treasury bonds offered at auctions (Journal of Laws No 38, Item 368, as amended).
2) Ordinance of the Minister of Finance of April 26, 1999 on the general terms of issuing Treasury bonds offered for the retail sale (Journal of Laws No 38, Item 369, as amended).
3) Ordinance of the Minister of Finance of August 26, 1999 on the terms of issuing Treasury bills (Journal of Laws No 74, Item 831, as amended).
4) Ordinance of the Minister of Finance of September 7, 1999 on the terms of issuing Treasury bonds on foreign markets (Journal of Laws No 75, Item 845, as amended).
5) Ordinance of the Minister of Finance of September 8, 1999 on the terms of issuing Treasury bonds for conversion of State Treasury liabilities (Journal of Laws No 74, Item 834, as amended).

Chapter 3


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Level, Dynamics and Structure of the Public Finance Sector Debt


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The public debt to Gross Domestic Product (GDP) ratio is one of the basic macroeconomic indicators used to evaluate the condition of the economy and the stability of country's public finance. An increasing debt causes debt servicing to become a more and more important item among the State Budget's rigid expenditures.

3.1. Factors affecting the public debt in 2003

In order to analyse factors shaping the level of public debt it is appropriate to separate debt of the State Treasury (ST) and the debt of other entities of the public finance sector.

In case of the State Treasury, the most important factors shaping the debt level in 2003 were:
– the necessity to finance high level of budget deficit amounting to PLN 37 043 million, with low level of receipts from privatisation (PLN 2 963 million against PLN 7 400 million planned);
– early redemption of some foreign debt components;
– continuation of the programme, initiated in 2000, of compensation payments for absence of remuneration raises in the budgetary sphere[5)] (debt was reduced by PLN 2 989.5 million);
– the November 2003 launch of the conversion of ZUS liabilities into marketable bonds under outstanding contributions towards Open Pension Funds (OPF), which were taken over by the State Treasury (an increase of debt in Treasury Securities (T-S) amounted to PLN 387.7 million);
– exchange rate transaction valuation adjustments (an increase of debt by PLN 11 660 million);
– capitalization of interest (an increase of debt by PLN 100.9 million).

In case of other public finance sector entities the following factors were of primary importance:
– the necessity to finance deficits (in case of LGUs the total deficit amounted to PLN 1 813.9 million);
– operations conducted on existing debt, for instance redemption by the ST of a PLN 6 000 mil-

[5)] These are the compensations for the lack of remuneration increases in the budgetary sphere resulting from non adjustment of regulations on formation of fund for remuneration and salaries in that sphere in the period from 1 July, 1991 to 28 June, 1992 and for loss of certain increases and allowances applicable to pensions and handicap pensions granted for employment in certain conditions or of the certain character.

Table 3.1. The public debt in 1999-2003 at nominal value (PLN m) and its ratio to GDP*), year- end

Item	1999	2000	2001	2002	2003
Public debt (PD)	273 357.6	280 321.8	302 107.4	352 610.6	408 637.7
Public debt to GDP (%)	41.9	38.7	39.7	45.1	50.2
Public debt plus risk-weighted contingent liabilities arising out of state guarantees	281 650.9	289 812.0	311 603.5	364 734.5	420 047.1
Public debt plus risk-weighted contingent liabilities arising out of state guarantees to GDP (%)	43.2	40.0	41.0	46.7	51.6
GDP (PLN m)	652 517.1	723 886.3	760 595.3	781 112.4	814 698.1

*) In 2002 the Central Statistical Office changed the GDP calculation methodology. The GDP values here are according to the new methodology.

lion loan granted to the Social Security Fund and the taking over of the ZUS liabilities towards OPF started by the Sate Treasury (in 2003 PLN 386.7 million were taken over);

– current expenditure arrears, shown as the increase of due liabilities by PLN 1 172.8 million in 2003 (before consolidation within public finance sector).

3.2. Level and dynamics of the public finance sector debt

Analysis of the level and dynamics of the public finance sector debt during the last few years leads to the following fundamental conclusions:

1) in 2001 the reversal of the debt to GDP ratio trend took place – from decreasing into increasing;
2) in 2002-2003 there was a significant increase in debt, both in absolute numbers and as a share of GDP (compare with data in table 3.1).

Table 3.2. The public debt according to the place of issue criterion, year- end (PLN m, at nominal value)

Item	2002	Structure	2003	Structure	Change in 2003	
	PLN m	%	PLN m	%	PLN m	%
Public debt	**352 610.6**	**100.0**	**408 637.7**	**100.0**	**56 027.1**	**15.9**
1. Domestic debt	**243 528.0**	**69.1**	**280 080.3**	**68.5**	**36 552.2**	**15.0**
1.1. Treasury Securities	213 562.1	60.6	248 271.6	60.8	34 709.6	16.3
1.2. Loans and credits	14 855.2	4.2	19 548.4	4.8	4 693.3	31.6
1.3. Other domestic debt	15 110.8	4.3	12 260.2	3.0	-2 850.6	-18.9
2. Foreign debt	**109 082.6**	**30.9**	**128 557.4**	**31.5**	**19 474.9**	**17.9**
2.1. Treasury Securities	29 330.7	8.3	44 430.8	10.9	15 100.1	51.5
2.2. Loans and credits	79 725.1	22.6	84 094.8	20.6	4 369.7	5.5
2.3. Other foreign debt	26.8	0.0	31.8	0.0	5.1	18.9

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The debt to GDP ratio at the end of December 2003 was 50.2% and rose by 5 percentage points since the end of 2002; the ratio of debt, enlarged by risk-weighted contingent liabilities arising out of state guarantees and sureties, to GDP increased from 46.7% at the end of 2002 to 51.6% at the end of 2003. This means that the first prudential threshold specified in the Public Finance Act was breached.

Data on the public finance sector debt can be broken down into domestic and foreign debt in two ways: according to the place of issue criterion and the residency criterion.

Debt according to the place of issue criterion takes into consideration place where the debt was incurred (domestic or foreign financial market), while **debt according to the residency criterion** takes into consideration the subject (resident or non-resident[6)]), towards whom the debtor has liabilities. The level of debt of the public finance sector according to the place of issue and residency is presented in tables 3.2 and 3.3.

The increase of the public finance sector debt in 2003 resulted mainly from the increase of the government sector debt. Among the entities in that sector the highest debt increase has been observed in the case of the State Treasury, ZUS and independent public health care institutions (SPZOZ). An increase of local government sector debt was also significant, mainly due to debt of local government units and SPZOZ.

At the end of 2003 the debt of ZUS and funds managed by it constituted approximately 2,7% of the sector's debt before consolidation.

Table 3.3. The public debt according to the residency criterion, year- end (PLN m, at nominal value)

Item	2002 PLN m	Structure %	2003 PLN m	Structure %	Change in 2003 PLN m	Change in 2003 %
Public debt	**352 610.6**	**100.0**	**408 637.7**	**100.0**	**56 027.1**	**15.9**
1. Domestic debt	**214 509.2**	**60.8**	**242 913.8**	**59.4**	**28 404.6**	**13.2**
1.1. Treasury Securities	184 573.9	52.3	211 232.4	51.7	26 658.6	14.4
1.2. Loans and credits	14 855.2	4.2	19 548.4	4.8	4 693.3	31.6
1.3. Other domestic debt	15 080.2	4.3	12 133.0	3.0	-2 947.2	-19.5
2. Foreign debt	**138 101.4**	**39.2**	**165 723.9**	**40.6**	**27 622.5**	**20.0**
2.1. Treasury Securities	58 318.9	16.5	81 470.1	19.9	23 151.2	39.7
2.2. Loans and credits	79 725.1	22.6	84 094.8	20.6	4 369.7	5.5
2.3. Other foreign debt	57.4	0.0	159.0	0.0	101.6	177.0

6) Terms "resident" and "non-resident" are defined in the Foreign Exchange Law of July 27, 2002 (Journal of Laws 2002, No 141, Item 1178, as amended).

The main reason for the increase in the level of liabilities due of these entities are the delays in transferring the share of the pension contributions to the Open Pension Funds.

Due to the continuous growth of the ZUS's debt towards OPFs a decision was undertaken, in the form of the Act of July 23, 2003[7] on taking over liabilities (with interest accrued) incurred in the period 1999-2002, by the State Treasury. Liabilities taken over by the State Treasury are converted into Treasury bonds. Therefore, by the end of 2003, a total of PLN 387.7 million of face value bonds were issued.

Among other entities of the government sector, **the debt of other State legal persons, including governmental agencies** is at a significant level. Their debt is growing at an increasing rate. The Agricultural Market Agency (AMA) reported the highest debt in this group – amounting to PLN 1 201.0 million. The increasing debt of this Agency is mainly the consequence of borrowing funds for intervention purchases of grains.

As for the local government sector, attention should be drawn to the systematic increase of **local government units'** debt, with a relatively stable structure thereof (credits and loans are a dominant element).

The LGUs incur liabilities mainly on the domestic market (95.7% of total debt). Domestic character of this debt results mainly from restrictions imposed by the Public Finance Act. Until Poland's accession to the EU, local government units were permitted to finance their deficits by taking loans only from domestic banks, besides issuing securities.

Among other entities of the public finance sector, particular attention should be paid to the level and dynamics of the independent public health care institutions' (SPZOZ) debt.

Table 3.4. The debt of ZUS and funds managed by it in 2002-2003, year-end (PLN m, at nominal value)

Item	2002	2003
Debt of ZUS and funds managed by it, of which:	**15 014.6**	**11 225.4**
– loans from commercial banks	2 388.8	4 756.0
– loan from the State Budget	6 000.0	0.0
– total liabilities due, of which:	6 625.8	6 469.5
liabilities towards Open Pensions Funds (OPFs)	6 586.8	6 451.0

Table 3.5. The debt of local government units in 2002-2003, year- end (PLN m, at nominal value)

Item	2002	Structure	2003	Structure	Change in 2003	
	PLN m	%	PLN m	%	PLN m	%
LGUs total debt	**15 358.4**	**100.0**	**17 276.8**	**100.0**	**1 918.5**	**12.5**
Credits and loans	12 237.5	79.7	13 785.7	79.8	1 548.3	12.7
Securities	2 381.0	15.5	2 817.8	16.3	436.8	18.3
Other debt, of which:	740.0	4.8	673.3	3.9	-66.6	-9.0
liabilities due	712.4	4.6	648.4	2.6	-64.0	-9.0

[7] Journal of Laws No 149, Item 1450.

Table 3.6. The debt of independent public health care institutions in 2002-2003, year- end (PLN m, at nominal value)

Item	2002	Structure	2003	Structure	Change in 2003	
	PLN m	%	PLN m	%	PLN m	%
SPZOZ total debt, of which:	**3 545.8**	**100.0**	**5 132.9**	**100.0**	**1 587.1**	**44.8**
liabilities due	**3 248.0**	**100.0**	**4 729.8**	**100.0**	**1 481.8**	**45.6**
SPZOZ debt – government sector, of which:	542.9	15.3	721.1	14.0	178.2	32.8
liabilities due	531.1	16.4	708.6	15.0	177.5	33.4
SPZOZ debt – local government sector, of which:	3 002.9	84.7	4 411.8	86.0	1 408.9	46.9
liabilities due	2 716.9	83.6	4 021.2	85.0	1 304.3	48.0


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The debt of the independent public health care institutions is mainly the result of arrears in financing current liabilities. A high level of this debt may pose a risk for financial stability of their supervising units, which are obliged to take over the SPZOZs' liabilities in case of their liquidation.

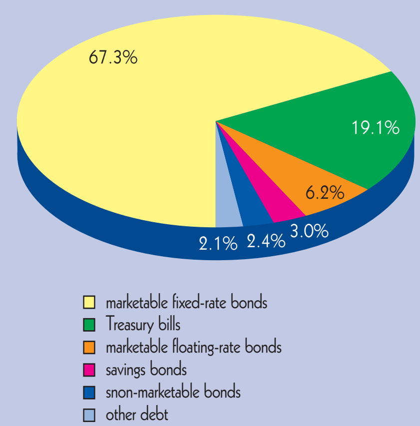
3.3. State Treasury debt in 2003

The State Treasury debt is the dominant element in the public finance sector debt. It constitutes nearly 93% of it. At the end of 2003 it amounted to PLN 378 943.8 million (i.e. some USD 101.3 billion or some EUR 80.3 billion – at the exchange rates on 31.12.2003 – 1 USD = 3.7405 PLN, 1 EUR = 4.7170 PLN).
The State Treasury debt, similarly to the public debt, can be presented according to the place of issue criterion and the residency criterion. Components of the ST debt according to the place of issue criterion are presented in the table 3.7.
At the end of 2003 the State Treasury debt according to the place of issue amounted to PLN 251 165.9 million and increased since the end of 2002 by PLN 31 818.9 million.

This change resulted from:

1) **an increase of debt in marketable fixed-rate bonds** by PLN 35 187.3 million i.e. by 26.3%;

Chart 3.1. Structure of domestic ST debt according to the place of issue criterion, end-2003



2) **an increase of debt in Treasury bills** by PLN 6 036.6 million, i.e. by 14.4%;

3) **a decline of debt in non-marketable bonds** by PLN 2 800.3 million, i.e. by 31.9%;

4) **a decline of debt in marketable floating-rate bonds** by PLN 4 547.0 million, i.e. by 22.6%;

5) **a decline of other domestic ST debt** by PLN 1 789.2 million, i.e. by 25.6%. The change resulted mainly from:
- a decline in debt due to the lack of wage increase in the budgetary sphere by PLN 2 989.5 million, i.e. by 62.8%;
- a decline of the liabilities due level by PLN 94.8 million, i.e. by 23.3%;
- an increase of the Labour Fund's debt by PLN 1 300 million, i.e. by 72.2%;

6) **a decline of debt in savings bonds** by PLN 268.5 million, i.e. by 3.5%.

Chart 3.2. Structure of ST domestic debt by holder, end-2003

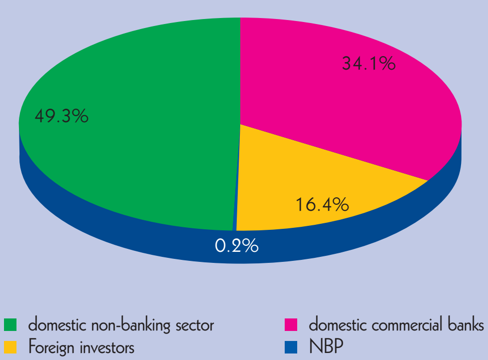


Table 3.7. State Treasury debt according the place of issue criterion in the years 2002-2003, year- end (PLN m, at nominal value)

Item	2002 PLN m	Structure %	2003 PLN m	Structure %	Change in 2003 PLN m	%
State Treasury debt	**327 904.2**	**100.0**	**378 943.8**	**100.0**	**51 039.7**	**15.6**
I. Domestic State Treasury debt	**219 347.0**	**66.9**	**251 165.9**	**66.3**	**31 818.9**	**14.5**
1. Treasury Securities (TS)	212 371.3	64.8	245 979.3	64.9	33 608.1	15.8
1.1. Marketable TS	195 887.5	59.7	232 564.4	61.4	36 676.9	18.7
– Treasury bills	42 030.8	12.8	48 067.4	12.7	6 036.6	14.4
– Treasury Securities issued for the domestic market	153 856.7	46.9	184 496.9	48.7	30 640.3	19.9
1.2. Savings bonds	7 718.1	2.4	7 449.6	2.0	-268.5	-3.5
1.3. Non-marketable TS	8 765.7	2.7	5 965.4	1.6	-2 800.3	-31.9
2. Other debt	6 975.8	2.1	5 186.6	1.4	-1 789.2	-25.6
II. Foreign State Treasury debt	**108 557.2**	**33.1**	**127 777.9**	**33.7**	**19 220.8**	**17.7**
1. Treasury securities (TS)	29 187.7	8.9	44 267.4	11.7	15 079.7	51.7
– Brady bonds	10 358.3	3.2	4 463.3	1.2	-5 895.0	-56.9
– Other foreign bonds	18 829.4	5.7	39 804.1	10.5	20 974.7	111.4
2. Loans	79 369.4	24.2	83 510.6	22.0	4 141.1	5.2
– Paris Club	65 960.5	20.1	67 121.5	17.7	1 161.0	1.8
– IFIs*)	11 538.2	3.5	15 279.1	4.0	3 740.9	32.4
of which: The World Bank	7 215.3	2.2	7 476.8	2.0	261.5	3.6
– Other debt	1 870.7	0.6	1 109.9	0.3	-760.8	-40.7

*) International Financial Institutions (The World Bank, European Investment Bank, European Bank for Reconstruction and Development, Council of Europe Development Bank)

The marketable fixed-rate bonds dominate the domestic State Treasury debt. The share of these bonds in total debt significantly influences the reduction of risk connected with variability of its servicing costs and the increase of the degree of certainty of these costs. A decrease in the share of the total non-marketable debt in the total domestic debt – from 7.2% at the end of 2002 to 4.4% in December 2003 – is also worth mentioning. Such a decrease is directly con-

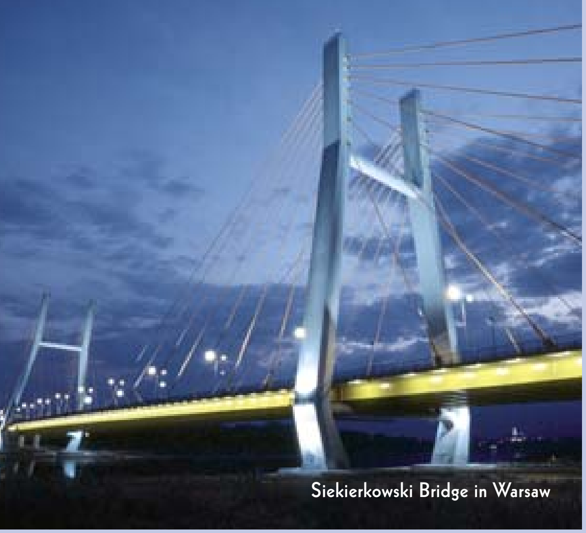


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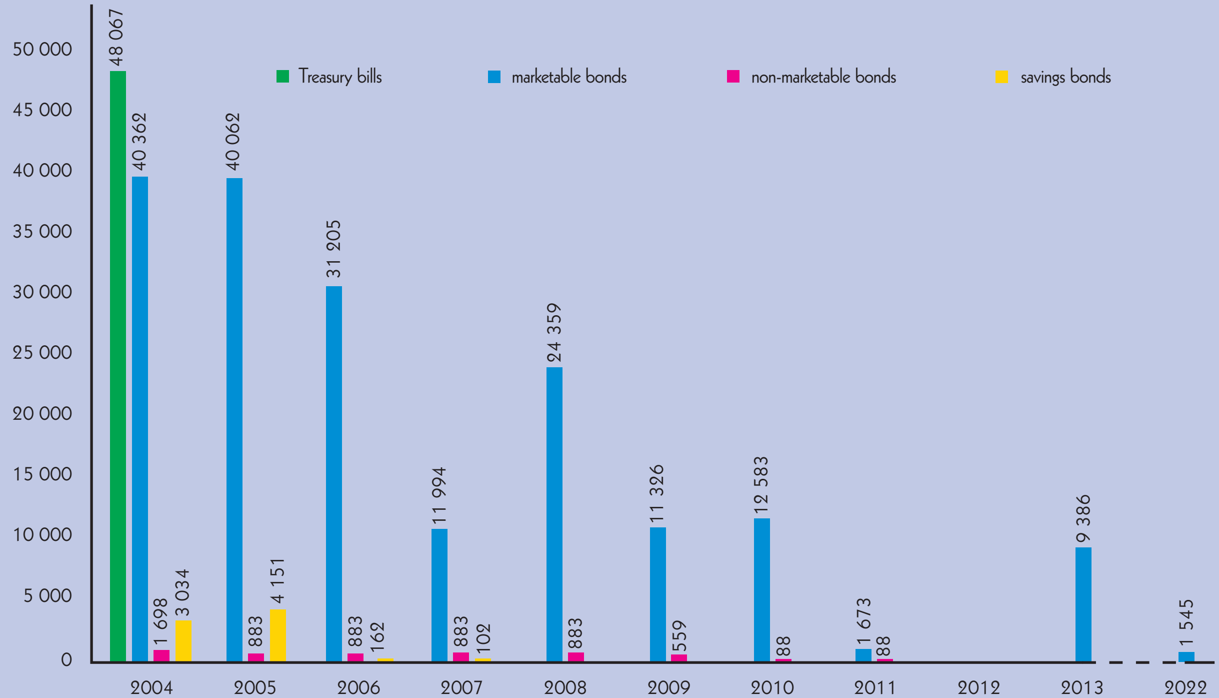
Chart 3.3. Maturity profile of TS issued on the domestic market, end-2003 (PLN m)



nected with the goal of achieving a more flexible debt structure by replacing the non-marketable debt with the marketable one (enabling smooth trading on the secondary market).

The following changes in the holder structure of the ST debt (allowing the identification of major groups of State Treasury creditors) in 2003 could be observed:

1) **considerable decline in debt towards the National Bank of Poland** by PLN 6 138.5 million, i.e. by 94.1%;
2) **increase in debt towards commercial banks** by PLN 13 677.8 million, i.e. by 19.0%;
3) **increase in debt towards the domestic non-banking sector** by PLN 14 556.3 million, i.e. by 13.3%;
4) **increase in outstanding Treasury securities issued on the domestic market held by foreign investors** by PLN 9 723.3 million, i.e. by 31.0%.

The average maturity and duration are among the important parameters for every debt manager. At the end of December 2003, **the average maturity**[8)] of marketable TS issued on the domestic market was 2.66 years (decline from 2.73 at

[8)] Average maturity indicator is an important measure in estimation of the refinancing risk, in most of the EU Member States this indicator ranges from 5 to 6 years.

the end of December 2002). With regard to particular types of marketable securities the average maturity amounted to (in years):
1) marketable bonds – 3.22 (3.36 in December 2002);
2) Treasury bills – 0.52 (0.47 in December 2002).

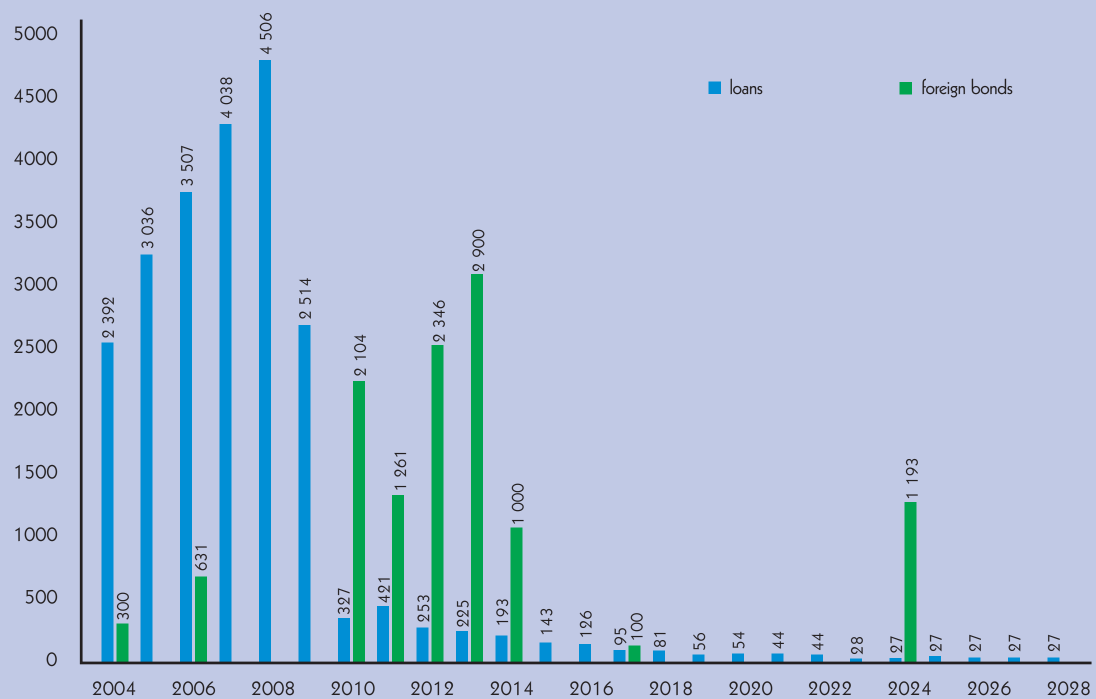
In the same period, the **duration**[9)] of marketable TS declined from 2.16 to 2.12 years and was:
1) marketable bonds – 2.53 years (2.61 in December 2002);
2) Treasury bills – 0.52 years (0.47 in December 2002).

In 2003 the State Treasury's foreign debt (according to the place of issue criterion) increased by PLN 19 220.9 million (17.7%) in comparison with the end of 2002 and amounted to PLN 127 777.9 million (USD 34 160.7 million). The change in debt resulted from: partial repayment of some foreign liabilities, incurring of new liabilities and changes in the PLN exchange rate in relation to other currencies in which some of the foreign ST debt is denominated. The State Treasury's foreign debt in 2003 comprised of two major items:
1) outstanding Treasury securities – PLN 44 267.4 million (USD 11 834.6 million);
2) outstanding foreign loans – PLN 83 510.6 million (USD 22 326.0 million).

The outstanding Treasury securities consist of the Brady bonds (issued in 1994 in line with the agreement on reduction and restructuring of Polish debt to commercial banks – the so called London Club) and other bonds issued on international capital markets.

Changes in the level of foreign debt related to outstanding Treasury securities resulted from:
1) fall in the amount of Brady Bonds outstanding – by USD 1 505.1 million (55.8%) to the level of USD 1 193.2 million, mainly due to the early redemption (in April) of the PDI Brady bonds valued at USD 1 089.2 million and the DCB Brady bonds valued at USD 393.0 million (in October);
2) increase in debt due to bond issuance on international capital markets – by USD 5 736.4 million (116.9%) to USD 10 641.4 million.

Chart 3.4. Maturity profile of foreign loans and bonds issued on international markets, end-2003 (USD m)



9) Duration – is the average period for adjustment of debt servicing costs to the new level of interest rates. It is a measure of sensitivity of debt servicing costs to changes of interest rates. The higher the level of interest rates and greater share of short-term floating-rate instruments, the higher interest rate risk and the lower duration. In most developed countries this measure ranges from 3 to 5 years.


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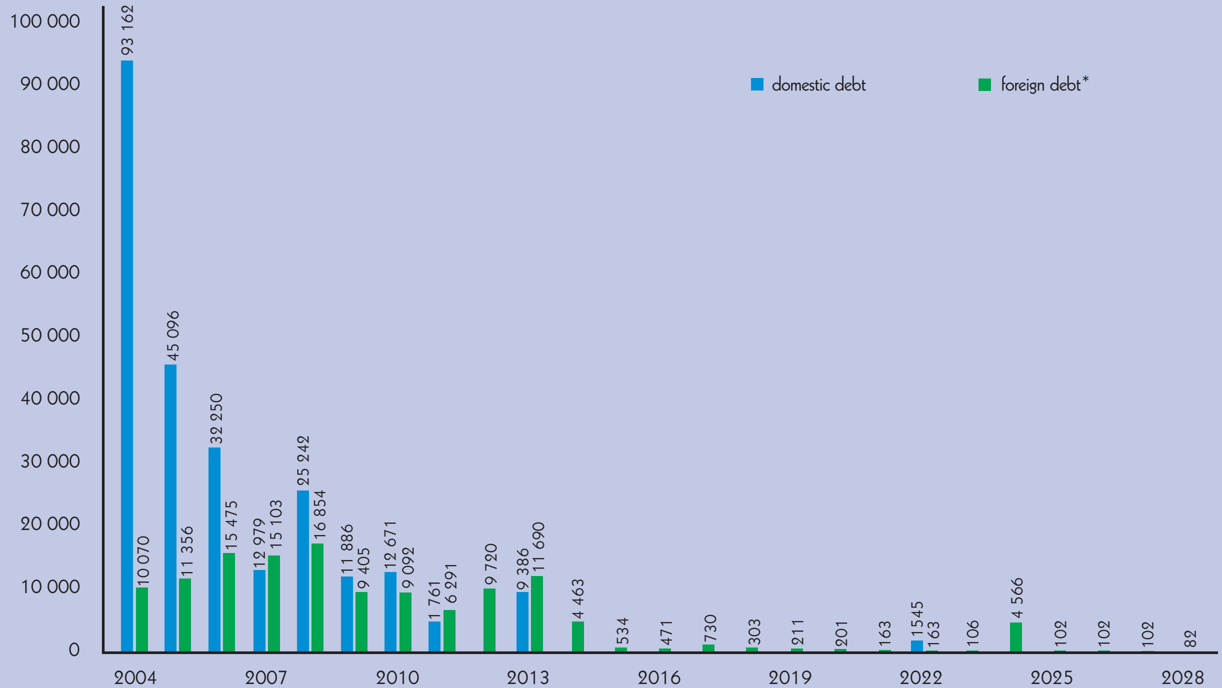
Chart 3.5. Maturity profile of the total State Treasury debt, end-2003 (PLN m)



*) Based on the exchange rates as of 31 Dec, 2003.

At the end of 2003 only two types of Brady bonds were outstanding: Par – USD 744.7 million and RSTA – USD 448.6 million.

The outstanding bonds issued on the international capital markets at the end of 2003 comprised of the instruments issued between 1997 and 2003. As of the end of 2003, 61% of all bonds issued are denominated in EUR, 30% – in USD, 7% – in GBP and 2% in JPY.

The change in the level of outstanding international bonds resulted from:

- the February 2003 issue of 10-year bonds valued at EUR 1 500 million; the issue was increased in May 2003 by further EUR 800 million;
- the July 2003 issue of bonds on the Japanese market – JPY 25 billion;
- the September 2003 issue of 3-year floating rate bonds – EUR 500 million;
- the October 2003 issue of bonds maturing in 2014 – USD 1 000 million;
- the December 2003 issue of 7-year floating rate bonds – USD 400 million.

At the end of 2003 the average maturity for all Treasury bonds issued on international markets was 9 years and 2 months.

In 2003 changes in the amount of outstanding foreign loans resulted from:

- new loans taken – total amount of USD 2 003.1 million;

- repayment of loans – USD 3 261.9 million;
- depreciation of USD towards other currencies in which part of the foreign ST debt is denominated.

The largest portion of debt resulting from foreign loans is the debt towards creditors affiliated in the Paris Club. At the end of 2003 it represented 80.4% of all foreign loans of the State Treasury.

State Treasury debt according to the residency criterion

The data on the State Treasury debt according to the residency criterion is broken down into domestic debt (residents) and foreign debt (non-residents).

At the end of December 2003 domestic ST debt (towards residents) amounted to PLN 213 999.4 million while foreign debt (towards non-residents) amounted to PLN 164 944.4 million.

Marketable Treasury securities issued on the domestic market dominated (89.5%) the domestic State Treasury debt. Treasury bonds issued on foreign markets and Brady bonds held by residents (domestic commercial banks) accounted only for 1.9% of the total domestic debt.

The foreign debt according to the residency criterion takes into consideration all securities in the foreign investors' portfolios, regardless of the place of issue of

Table 3.8. State Treasury debt according to the residency criterion in 2002-2003, year- end (PLN m, at nominal value)

Item	2002 PLN m	Structure %	2003 PLN m	Structure %	Change in 2003 PLN m	Change in 2003 %
State Treasury debt	**327 904.2**	**100.0**	**378 943.8**	**100.0**	**51 039.7**	**15.6**
I. Domestic State Treasury debt (towards residents)	**190 328.2**	**58.0**	**213 999.4**	**56.5**	**23 671.3**	**12.4**
1. Treasury securities	183 383.1	55.9	208 940.1	55.1	25 557.0	13.9
1.1. Marketable Treasury securities	166 899.4	50.9	195 525.2	51.6	28 625.8	17.2
– Treasury bills	40 975.3	12.5	47 265.1	12.5	6 289.8	15.4
– Treasury bonds issued on the domestic market	123 519.0	37.7	144 182.9	38.0	20 663.8	16.7
– Brady bonds and bonds issued on the foreign market	2 405.0	0.7	4 077.3	1.1	1 672.3	69.5
1.2. Savings bonds	7 718.0	2.4	7 449.5	2.0	-268.5	-3.5
1.3. Non-marketable bonds	8 765.7	2.7	5 965.4	1.6	-2 800.3	-31.9
2. Other State Treasury debt	6 945.1	2.1	5 059.3	1.3	-1 885.8	-27.2
II. Foreign State Treasury debt (towards non-residents)	**137 576.0**	**42.0**	**164 944.4**	**43.5**	**27 368.4**	**19.9**
1. Treasury securities	58 175.9	17.7	81 306.6	21.5	23 130.7	39.8
1.1. Marketable Treasury securities	58 175.8	17.7	81 306.6	21.5	23 130.7	39.8
– Treasury bills	1 055.5	0.3	802.4	0.2	-253.1	-24.0
– Treasury bonds issued on the domestic market	30 337.6	9.3	40 314.1	10.6	9 976.5	32.9
– Brady Bonds and bonds issued on the foreign market	26 782.8	8.2	40 190.1	10.6	13 407.4	50.1
1.2. Savings bonds	0.1	0.0	0.0	0.0	-0.1	-52.9
2. Loans	79 369.4	24.2	83 510.6	22.0	4 141.1	5.2
3. Other State Treasury debt	30.7	0.0	127.2	0.0	96.6	314.9

Table 3.9. State Treasury debt in 1999-2003 at nominal value (in PLN m) and as a ratio of GDP; year- end

Item	1999	2000	2001	2002	2003
State Treasury debt	264 370.3	266 816.8	283 938.2	327 904.2	378 943.8
Ratio of GDP (%)	40.5	36.9	37.3	42.0	46.5
ST debt enlarged by risk-weighted contingent liabilities arising out of state guarantees	272 532.1	276 202.6	293 274.8	339 960.0	390 281.0
Ratio of GDP (%)	41.8	38.2	38.6	43.5	47.9
GDP (PLN m)	652 517.1	723 886.3	760 595.3	781 112.4	814 698.1

these instruments. The share of foreign debt in ST total debt was 43.5% against 42.0% at the end of 2002. This growth resulted mainly from the increase of holdings of Treasury bonds issued on the domestic market and bonds issued on foreign markets by non-residents. The share of these instruments in total foreign debt was 49.3% (42.3% at the end of 2002).

State Treasury debt to GDP ratio

The ratio of the State Treasury debt to GDP rose to 46.5% at the end of December 2003 against 42.0% at the end of 2002. At the same time, the ratio of State Treasury debt enlarged by risk-weighted contingent liabilities arising out of state guarantees and sureties to GDP increased from 43.5% at the end of 2002 to 47.9% at the end of 2003.

3.4. Public debt calculated according to the European Union's methodology

Even before the EU membership, Poland was obliged to submit a questionnaire on deficit and debt of the central and local government institutions sector (*general government*) in order to evaluate meeting the convergence criteria of the Maastricht Treaty in

Table 3.10. The *general government* debt in 2001-2003 at nominal value (PLN m) and as a ratio of GDP, year- end

Item	2001	2002	2003
General government sector debt	279 145.5	321 335.2	369 694.8
Ratio of GDP (%)	36.7	41.1	45.4

Table 3.11. The *general government* debt as a ratio of GDP (in %) in the Euro zone and in EU member states in 2001-2003, year- end

Item	2001	2002	2003*)
Euro zone (average)	69.4	69.2	70.4
EU member states (average)	63.2	62.5	64.0

*) Estimates

a given year. This questionnaire is updated by the Ministry of Finance twice a year and then submitted to the European Commission and to the Eurostat. Due to the methodological differences specified in Chapter 2 of this report the level of debt according to the EU methodology is lower than public debt calculated according to Polish methodology.
Tables 3.10 and 3.11 present data on the general government debt in Poland and in the EU member states in 2001-2003[10).

3.5. State Treasury debt servicing in 2003

The growth of the State Treasury debt in the recent years resulted in the increase of the cost of its servicing – in particular in 2001 and 2002. This is a reason why the State Treasury debt servicing costs were becoming a more and more important item in State Budget expenditures, which also had a substantial influence on the increase of budgetary deficits.
In 2003, similarly to the preceding years, there was no primary surplus of the State Budget, which meant that the budget expenditures, after subtracting the debt servicing cost, were lower than the budget revenues.
Expenditure on public debt servicing is a significant item in the budget and its level depends on the financial markets situation, and in particular on:

- level of market interest rates – current and historical ones;
- exchange rates – which influences all liabilities in foreign currencies.

Taking this into consideration some costs are not known at the time of drafting the budget and they have to be estimated. For the sake of prudence, as well as for active debt management purposes, the debt manager has to establish a provision for an unforeseeable increase in the exchange rates and interest rates. Such a provision is also needed in view of possible debt transactions, such as swaps and early redemption.

Chart 3.6. Servicing costs of domestic and foreign debt (place of issue criterion, PLN m)

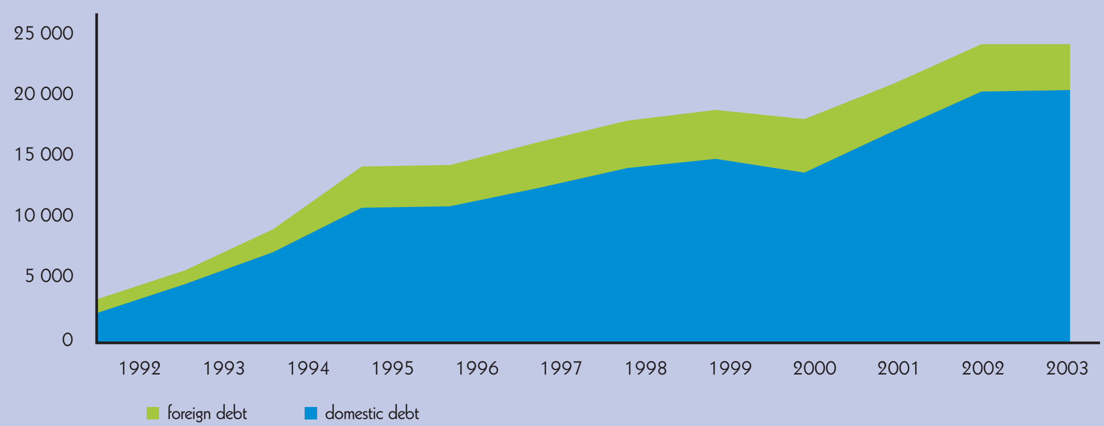


Table 3.12. State Treasury debt servicing costs in 1995-2003 (PLN m)

	1995	1996	1997	1998	1999	2000	2001	2002	2003
ST debt servicing costs	**14 202.1**	**14 390.7**	**16 271.1**	**17 910.6**	**18 777.5**	**18 023.1**	**20 898.5**	**24 048.3**	**24 137.4**
domestic debt	10 939.6	11 021.2	12 587.9	14 140.7	14 893.5	13 726.5	17 104.7	20 323.9	20 378.3
foreign debt	3 262.5	3 369.5	3 683.2	3 769.9	3 884.0	4 296.6	3 793.8	3 724.4	3 759.1

10) More information available on the Eurostat web page: http://europa.eu.int/comm/eurostat/

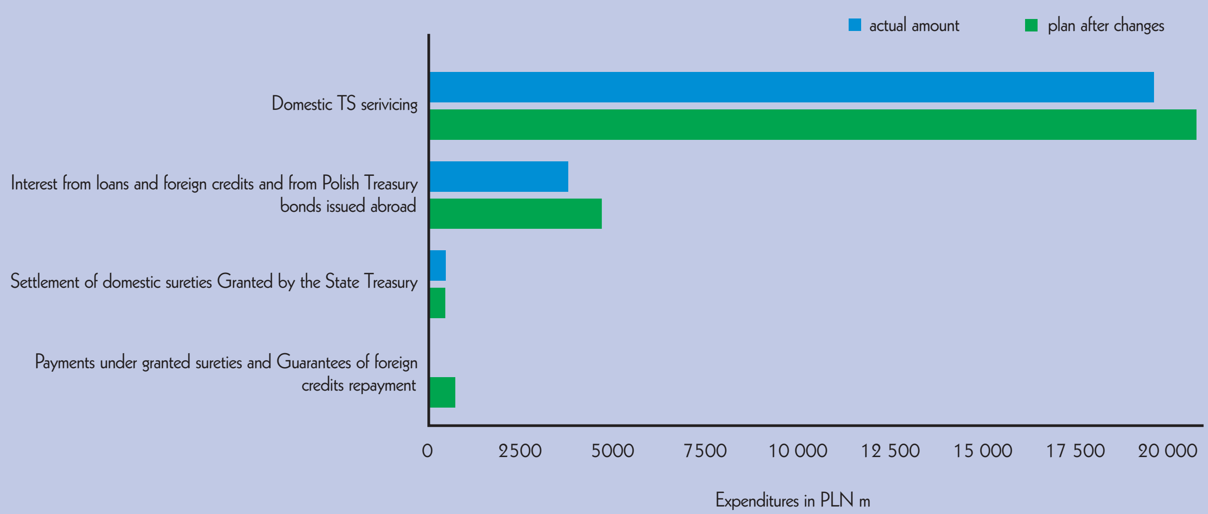

Siekierkowski Bridge in Warsaw

The 2003 Budget[11)] provided for debt servicing expenditures at the level of PLN 27 156.6 million (nearly 13.4% more than the executed expenditures in 2002), of which PLN 21 777.1 million (i.e. 80.2%) accounted for the domestic debt portion and PLN 5 379.5 million – for the foreign debt portion. The actual debt servicing expenditures in 2003 were lower by PLN 3 019.2 million and amounted to PLN 24 137.4 million (see Chart 3.7.).

Lower than planned expenditures in 2003 resulted mainly from:

- more favourable PLN/USD and PLN/EUR exchange rates applied to the payments made;
- lower than assumed interest rates on the domestic and the foreign markets;
- less drawings from the loans extended by the international financial institutions;
- much lower than planned payments under guarantees for the repayment of foreign loans;
- less Treasury bills and bonds sold, generating costs in 2003;
- early redemption of the 2001 bond denominated in USD;
- lower issuance costs of Treasury bonds.

Chart 3.7. 2003 Budget – planned and actual debt servicing expenditures



[11)] The Minister of Finance has changed the planned level of debt servicing costs twice.

Chapter 4

Debt Management Strategy

Śląski Stadium in Chorzów

Debt management, given the distant maturity of the prevailing part of debt components, should be considered at least in the medium-term horizon. Efficient management requires the adoption of a strategy, setting out the objectives and tasks, as well as instruments for their implementation.

4.1. Objectives and tasks of the debt management strategy in 2003

Considerable increase in the State budget deficit since 2001, with trend decreasing of privatisation receipts, led to substantial growth of public debt level. As a result restraining growth of public debt became the basic objective of the *Public Finance Sector Debt Management Strategy in the years 2003-05*, along with minimizing the debt servicing costs.
Objectives of the *Public Finance Sector Debt Management Strategy in the years 2003-2005* were set out as follows:

1. Maintaining the public debt at a safe level.

2. Minimizing the debt servicing costs in the long-term horizon, given the adopted limitations of the level of:

   a) domestic currency refinancing risk,
   b) exchange rate risk and foreign currency refinancing risk,
   c) interest rate risk,
   d) State Budget liquidity risk,
   e) other risks, in particular credit and operating risk,
   f) distribution of debt servicing costs over time.

A safe level of public debt is thought to be a debt level which does not have any significant negative impact on the macroeconomic situation of the country, does not cause difficulties in preparation of the State Budget and does not exceed limits stated in the national and EU legislation (see Chapter 2). This objective was to be implemented through:

- reduction in budget deficit levels in subsequent years,
- reduction in new sureties and guarantees in order to limit them only to those granted to support projects contributing to acceleration of the economic growth,
- restraining the growth of debt in the public finance sector other than the State Treasury and local government units,

- implementation of prudential measures resulting from the Public Finance Act, after debt to GDP ratio exceeds the 50% threshold.

Implementation of the second objective (minimizing the debt servicing costs) was to be executed on two levels:

- through the optimal composition of debt instruments and their issue dates, within a time horizon specified by the maturity of the longest-life-instruments with substantial share in debt;
- through permanent efforts to improve efficiency and liquidity of Treasury Securities market.

The specific tasks resulting from the above objectives focused on:

1) improving liquidity, efficiency and transparency of the Treasury Securities market,
2) launching a programme for refinancing foreign debt payments due in 2004-09 in the best manner from the point of view of costs and risks incurred,
3) improving of the Treasury Securities Primary Dealers System,
4) developing a system for State budget liquidity management,
5) developing a system for selling the retail instruments,
6) continuing the conversion of non-marketable debt into marketable instruments.

In 2003, the *Public Finance Sector Debt Management Strategy in 2004-06* was developed. The adopted objectives remained unchanged in principle. However, given the growth of debt in 2003 and forecasts concerning the debt to GDP ratio in the period covered by the strategy (possibility of this ratio to be close to 55% in 2004), the implementation of the first objective, i.e. maintenance of the public debt at a safe level, becomes more and more important. It is not possible without a fundamental reform of the public finance.

Taking into account the time horizon covered by the strategy, two phenomena have become particularly important for the public debt management: growing debt level and Poland's accession to the EU. As a consequence, the strategy developed in 2003 pointed out risks resulting from growing debt level, as well as issues concerning financial flows connected with the EU membership and changes in the environment of debt management.

4.2. Assessment of implementation of the strategy in 2003

Implementation of the strategy in 2003 was influenced by budgetary and macroeconomic developments, as well as by situation on financial markets and their outlook.

1. Maintenance of the public debt at a safe level

Higher borrowing needs than in previous years, low privatisation receipts and weakening of the Polish zloty were the main reasons for the growth of debt in 2003. In consequence, the public debt, increased by risk-weighted contingent liabilities arising out of guarantees, exceeded 50% of the GDP. The risk of exceeding the 55% threshold in 2004 and 60% in the near future also increased.

2. Minimization of debt servicing costs in the long-term horizon

The objective of minimization of debt servicing costs was implemented through an appropriate issuance policy. It had to take into account the situation on the financial market, in particular the investors' reaction on the risk resulting from the budgetary and political situation. One of the consequences of this situation was no improvement in risk parameters, i.e. small growth of foreign debt share and a slight reduction of average maturity and duration.

The TS issuance structure in 2003 was adjusted to the conditions on the domestic financial market. In particular, effort was made not to allow for the excessive supply in the given yield curve segments affect higher debt servicing costs. In the first half of the year it was accomplished in the environment of decreasing rates throughout the yield curve. An increase in interest rates throughout the yield curve (particularly in the segment of medium and long-term instruments) and weakening demand for medium and long-term instruments in the second half of the year caused that, from the debt servicing costs point of view, financing borrowing needs with shorter maturity instruments was more rational. On the other hand, the goal of reducing the refinancing risk was a restriction for this policy.

Minimization of foreign debt servicing costs was implemented by an appropriate, from the point of view of debt servicing costs, policy of new issues, taking into account the risk level, and replacing instruments with high servicing costs with cheaper ones. This objective was implemented, inter alia, through early redemption of PDI and DCB Brady bonds.

The most important measures for lowering debt servicing costs through improving efficiency of the Treasury Securities market were the following:

- reduction in the number of bond issues and higher nominal value of each series,
- implementation, beginning from 2003, of the Treasury Securities Primary Dealer System,
- implementation of technical credit (intra-day) extended by the NBP collateralised by Treasury bonds.

Minimization of debt servicing costs was implemented under the existing limits as to the level of risk.

Domestic currency refinancing risk

The average marketable debt maturity (expressed in years), decreased from 2.74 at the end of 2002 to 2.66 at the end of 2003. It was mainly the result of:

- reduction in sale of medium and long-term bonds (i.e. above 5-years) in the second half of the year, due to decrease in demand resulting mainly from the market participants' reaction to the condition of public finance,
- increase in outstanding Treasury bills due to the need for financing the budget deficit in the context of low privatisation receipts and limited market absorption of bonds (at the end of 2003 its share in the domestic State Treasury debt remained unchanged at some 19%),
- bond switching auctions, which restrained a decrease in the average debt maturity and contributed to the even distribution of debt service and redemption payments (bonds of the face value of PLN 6.8 billion were sold in that way).

Exchange rate risk and foreign currency refinancing risk

In 2003, the share of foreign debt in State Treasury total debt according to the place of issue criterion increased slightly (from 33.1% to 33.7%), mainly as a result of significant weakening of PLN – in particular towards EUR. The share of debt denominated in PLN in the State Treasury debt increased from 64.9% to 66.1% as a consequence of repayment of USD bonds issued on the domestic market.

The share of debt denominated in EUR in the foreign State Treasury debt increased from 46.7% to 58.4%; at the same time its share in total debt increased from 15.5% to 19.1%. It is a positive trend in the context of Poland's future entry into the euro zone, as it will eliminate the exchange rate risk for this part of debt.
The refinancing risk remained relatively low. The average foreign debt maturity slightly decreased from 5.9 years in 2002 to 5.7 years at the end of 2003, remaining at a safe level.
New issues on the international markets took into account the increased foreign debt servicing payments due in 2004-09.

Interest rate risk

In 2003, the duration of the domestic marketable debt decreased slightly from 2.15 to 2.12 years. The change in duration was influenced by the following factors:

- decline in the average debt maturity (from 2.74 to 2.66 years),
- change (in the middle of 2003) of the interest rate trend from decreasing to increasing,
- decrease in the share of floating-rate marketable instruments in debt (from 8.4% to 6.78%), contributing to the reduction in the risk exposure resulting from the interest rate increase.

The share of floating-rate liabilities in foreign debt decreased from 42.3% to 39.8%. A great part of floating-rate liabilities accounts for the Paris Club loans, subject to a floating reduced interest rate. Reduction in the interest rate risk was implemented by incurring new liabilities – mainly fixed-rate.

State Budget liquidity risk

Maintaining a safe level of the State budget liquidity was implemented mainly through deposits in PLN and in foreign currencies held with the NBP. Both the reduction in the liquidity risk and the related refinancing risk were also the positive result of bond switching auctions.

Other risks, in particular credit and operating risk

In the period covered by the Report there were no transactions that could be a potential source of credit risk. Reduction in the operating risk was the result of the implementation of the IT system of the State Treasury debt management including an integrated debt database.

Distribution of debt servicing costs over time

In 2003, the level of debt servicing costs did not change significantly in comparison with the previous year; it was a result of two developments: an increase in debt and a fall in interest rates from the end of 2000 till the middle of 2003.
While issuing new securities the goal was to have an even distribution of debt service payments. In particular, the coupons of newly issued wholesale bonds were close to their yields in order to reduce accumulation of discount payments at the time of their redemption.

Implementation of the tasks of the strategy in 2003 could be characterized briefly as follows:

Improving liquidity, efficiency and transparency of Treasury Securities market

In 2003 the improvement in liquidity of medium and long-term bonds was continued through reduction in the number of issues together with an increase in a face value of each issue.
The implementation of this task was supported by the development of an electronic trading platform

Sports and Exhibition Hall in Bydgoszcz

for Treasury securities. In May 2003 this electronic platform was expanded by allowing conditional repo and sell/buy back transactions involving Treasury bonds and bills.

According to the letter of intent signed by Centralna Tabela Ofert S.A. (running the electronic trading platform for TS) and the MTS company, in future the existing trading system for the State Treasury debt instruments will be replaced by the MTS platform.

Launching a programme for refinancing of foreign debt redemption due in 2004-09

Refinancing of increasing principal repayments, mainly for the Paris Club debt due in 2004-2009, is implemented through the issue of foreign bonds with long-term maturity. In 2003 the basic part of new issues constituted 10-year fixed-rate bonds (EUR 2.3 billion and USD 1 billion). While making decisions on new issues the goals of diversification of investor base and reduction in debt servicing costs were taken into account. It applied to the issue denominated in JPY, the 3-year floating-rate EUR bond and the first issue of the 'private placement' type.

Improving the Primary Dealer System

Since the beginning of 2003, the system of primary dealers began its operation. In December 2002, agreements were signed with 12 most active banks, which obtained a status of the Primary Dealer for the year 2003. In consequence, since the beginning of 2003, only banks having the status of the Primary Dealer and the state owned BGK bank can participate in the Treasury Securities auctions. At the same time, on 1 January 2003 a competition was launched to choose Primary Dealers for 2004. On the basis of this competition, in December 2003 the Minister of Finance granted the status of the Primary Dealer for 2004 again to twelve banks, and signed the appropriate agreements.

According to the issuer's intention, the Primary Dealer System should serve to minimize debt servicing costs, improve transparency and liquidity of Treasury Securities market as well as improve cooperation with banks as regards issuance policy and capital market needs. To this effect, in February 2003, the Board of Market Participants was appointed, an opinion making and advisory body for the Minister of Finance. This Board is composed of the Primary Dealers' representatives. The Board meetings are also attended by the representatives of the Ministry of Finance, the NBP, and the National Depository for Securities (KDPW) and companies running the electronic trading platform for TS. A representative of the Ministry of Finance chairs those meetings taking place at least once every three months.

In the context of further improving the Primary Dealer System, at the end of 2003, the work began to allow foreign banks to participate in the competition, which is planned for the end of 2004.

Development of a system for State budget liquidity management

Work was started on further changes in the system for liquidity management in order to improve its efficiency and flexibility.

Development of the system of retail instruments sale

Starting in August 2003 the CDM Pekao S.A. was replaced by the PKO BP S.A. bank as the sales agent. The network of retail points of sales for bonds was enlarged – in December 2003 it was possible to buy bonds in 887 branches of the PKO BP S.A.

bank and in 35 Customer Service Centers of the BDM PKO BP S.A. against nearly 460 Customer Service Centers run by the CDM PKO S.A. in the middle of 2003. Since August 2003 it is possible to buy bonds via Internet and over the phone. The sale is made „on-line" with simultaneous financial settlement of the transactions. Financial settlement, recording the transaction and registering of issue and servicing operations are conducted in real time. The system for Treasury bonds sale ensures liquidity of the instruments' offering and allows customers to place their orders in any point of sale within Poland.

Continued conversion of non-marketable debt into marketable instruments

In 2003 the share of non-marketable debt in the State Treasury debt decreased from 7.2% to 4.4%, of which non-marketable TS fell from 4.0% to 2.4%. Reduction in outstanding non-marketable TS resulted from: scheduled redemption of non-marketable bonds and early redemption of the A-Series of the restructuring bond. Reduction in other State Treasury debt was influenced mainly by repayment of compensation for non-indexation of wages in the budgetary sphere. The increase in debt of the Labour Fund had the opposite effect (see Chapter 4). In November 2003, the State Treasury began the process of taking over the ZUS's verified liabilities towards the Open Pension Funds (OPF) and their conversion into Treasury bonds. By the end of 2003 liabilities of the value of PLN 387 million were taken over and bonds of the value of PLN 388 million were issued to the OPF.

Swimming Pool in the 3-rd High School in Warsaw

Chapter 5


Concert hall in Łódź


Concert hall in Łódź

Financing of the State Budget's Borrowing Requirement

The State budget deficit in 2003 amounted to PLN 37 043 million against PLN 38 734 million set in the Budget Act (95.6% of the plan). The deficit resulted from revenue at the level of PLN 152 111 million against PLN 155 698 million assumed in the Budget Act (97.7%) and expenditures at the level of PLN 189 154 million against PLN 194 432 million (97.3%).
The deficit and other borrowing requirements were financed both on the domestic market (PLN 31 081 million, i.e. 84% share of total financing) and on the foreign market (PLN 5 962 million, 16%). The actual amount of funds obtained from foreign sources was PLN 6 576 million. The positive difference between these numbers meant an increase in the share of foreign exchange resources in the foreign financing at the end of 2003 compared to 2002.

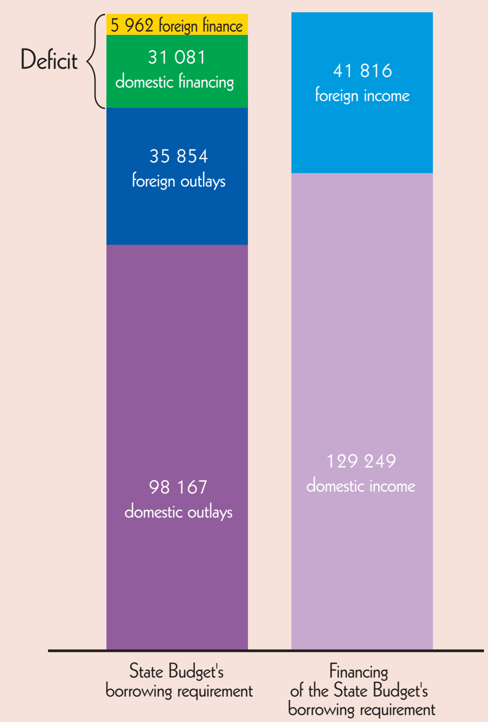
5.1. Domestic financing

Gross domestic borrowing requirement amounted to PLN 129 249 million and its main component was redemption of Treasury Securities (PLN 84 624 million). The most important source of financing of this requirement was sale of Treasury Securities. The funds thus obtained amounted to PLN 118 963 million, which meant a positive financing balance of PLN 34 339 million. An important role was also played by liquid funds carried over from 2002 (PLN 7 174 million). Funds from domestic financing in 2003 carried over to 2004 amounted to PLN 10 393 million. Sources of domestic financing are presented in aggregate form on Chart 5.2.
Developments affecting domestic financing:
– faster growth of deficit in the first half of the year (according to the trend observed also in previous years). In the first six months of 2003 the deficit amounted to PLN 23 818 million, while in the second half of 2003 – PLN 13 225 million,
– low privatisation receipts (40% of the planned amount),
– positive foreign financing balance (in most months),
– volatility on Treasury Securities market and foreign exchange market.

5.1.1. Revenues from Treasury Securities

Revenue from the sale of Treasury Securities was the main source of domestic financing. Sale of TS took place in the period of changing market and budgetary conditions (see point 5.3 below).
In the first half of the year the TS market was strengthening systematically and subsequently record low yields were observed (see chart 6.1 in Chapter 6).

Chart 5.1. State Budget's borrowing requirement, including the budget balance in 2003 (in PLN million)



On the secondary market, the 2-year bond yields dropped by nearly 80 bps, 5-year bonds – 70 bps, 10-year bonds – 60 bps and 20-year bonds – 50 bps, and 1-year T-bills (on the primary market) by nearly 120 bps. It was mainly the result of:

– interest rate cuts by the Monetary Policy Council (policy rate of the central bank was cut by 150 bps to 5.25%),
– the process of nominal convergence of Polish and European interest rates (yields on the main world markets were also decreasing in that period).

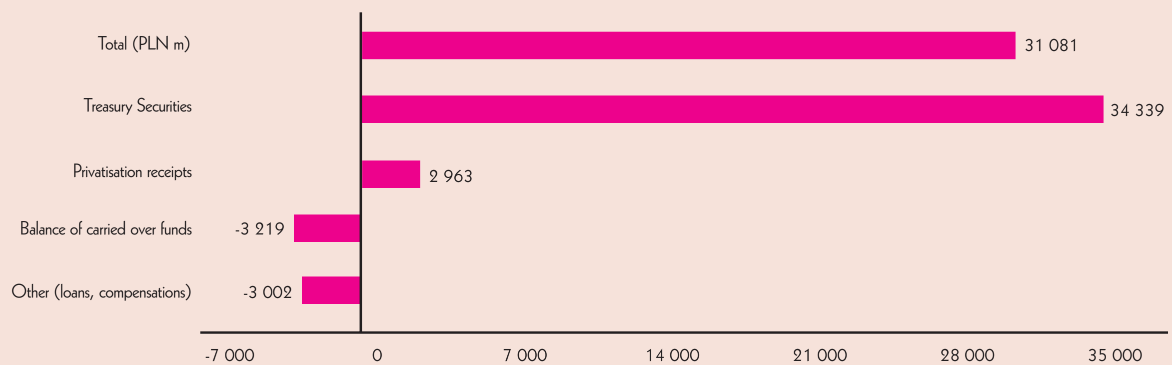
Financing terms on the domestic market worsened significantly in the second half of the year due to:

– increasing yields on main world markets (yield curve raised by nearly 100 bps),
– planned and finally adopted significant increasing of budget borrowing requirement in 2004,
– uncertainty as to the public finance developments (increase of borrowing requirement, increase of public debt and approaching the prudential thresholds set in the Public Finance Act) and then – uncertainty associated with a shape of prepared reform of the public finance (Mr. Hausner's Plan) and expectations of an increase of main interest rates.

Thus the Treasury Securities yields increased temporarily from 150 to 300 bps in comparison to the lowest levels recorded in the first half of the year. The demand for medium and long-term bonds dropped significantly. Only in December 2003 the financial market calmed down to some extent as a result of announcing of the financing plan for the first quarter of 2004 by the Ministry of Finance. Finally, at the end of 2003, the yields of 2-, 5- and 10-year bonds reached the level of, respectively, 60, 110 and 90 bps more than 12 months earlier. It should be pointed out, that weakening demand for Treasury Securities resulted mainly from lack of interest from domestic investors. In the fourth quarter, foreign investors increased the value of bonds in their portfolios by PLN 7.2 billion according to the nominal value while in the whole year this increment amounted to PLN 10.0 billion.

Aggregate data on financing using the Treasury Securities is presented in table 5.1. The most important sources of net financing were wholesale bonds and Treasury bills, while the balance of retail bonds was negative. Moreover, redemption of non-marketable bonds was continued (PLN 2 957 million including early redemption of one of the restructuring

Chart 5.2. Domestic financing



bonds). Servicing of a bond issued in connection with debt redemption towards Brazil was completed (PLN 4 179 million, of which PLN 2 117 million was early redemption of debt).

Among wholesale bonds, offered at sale auctions (regular and complementary ones) and switching auctions, the largest share was represented by 2-year and 5-year instruments. Their sale in nominal terms generated PLN 34 013 million and PLN 20 592 million, respectively, i.e. 54% and 33% of the total sale of wholesale bonds at auctions. The sales structure resulted from implementation of the debt management objective, regarding minimization of debt servicing costs with adopted constraints regarding the interest rate risk and refinancing (extension of duration and average maturity of TS) and the prevailing market situation. The level of sale at auctions was characterised by substantial differentiation in time (64% of the offers were placed in the first half of the year). It was a result of the fixed schedule of auctions (more auctions in the first six months) and drop of investors' interest in medium and long-term TS in the second half of the year.

Another basic group of instruments for financing of borrowing requirement were Treasury bills. The revenues from sale of these instruments reached PLN 56 967 million according to nominal value (PLN 54 352 million according to cash value). It meant the positive balance of financing amounting to PLN 6 774 million, i.e. PLN 4 888 million more than planned in the Budget Act. This was mainly the result of lower than anticipated privatisation receipts and gradually worsening, beginning in August 2003, developments on the Treasury bonds market.

As far as retail bonds are concerned (marketable and savings bonds) the total balance of sale and redemption was negative of PLN 868 million. The sale reached the level of PLN 5 260 million against PLN 5 915 million a year earlier. It constituted 8% of all the bonds sold in 2003 (9% in 2002). Similarly as it was in case of wholesale bonds, the sales of retail bonds were not evenly distributed through the year. Vast majority of realized revenues came from the sales in the second half of the year (68%) including record-high monthly revenues at PLN 1 280 million in December. In 2003, several structural changes were introduced in the retail market segment. They included, inter alia, a change of the issue agent which led to an expansion of the sales network and modifications to the 3-year bond (interest period was extended to six months and the 6M Wibor rate was adopted as the basis for the interest

Table 5.1. Treasury Securities on the domestic market used to finance State budget borrowing requirement (in PLN m)

	Item	Revenues	Outlays	Balance
	Treasury securities	**118 963**	**84 624**	**34 339**
	1. Treasury bills	**54 352**	**47 577**	**6 774**
Wholesale bonds	**2. Marketable bonds**	**60 682**	**29 809**	**30 873**
	– 2-year zero-coupon bonds (OK)	30 763	15 708	15 055
	– 5-year fixed-rate bonds (PS, OS)	20 476	8 156	12 320
	– 10-year fixed-rate bonds (DS)	8 048	–	8 048
	– 20-year floating-rate bonds (WS)	145	–	145
	– denominated in USD (2001)	–	4 179	-4 179
Retail bonds	– 3-year floating-rate bonds (TZ)	930	1 766	-836
	– 5-year fixed-rate bonds (SP)	319	–	319
	3. Savings bonds	**3 929**	**4 280**	**-351**
	– 2-year fixed-rate bonds (DOS)	3 821	4 237	-416
	– 4-year indexed bonds (COI)	109	44	65
	4. Non-marketable bonds	**–**	**2 957**	**-2 957**
	– denominated in USD (1991)	–	1 755	-1 755
	– restructuring	–	1 116	-1 116
	– bonds for the increase in BGZ S.A. bank's own funds	–	86	-86

calculation) and 4-year bonds (annual payment of coupons was introduced instead of their capitalization).

5.1.2. Privatisation receipts

Concert hall in Lublin

Similarly to the last year, the whole planned amount of privatisation receipts was not achieved. Total privatisation proceeds amounted to PLN 2 963 million (PLN 1 972 million in 2002), half of which was received in the last quarter of 2003. Moreover, a large part of the proceeds in 2003 was in foreign currencies (PLN 1 805 million). Lower privatisation receipts meant the necessity of expanding the issuance of Treasury Securities and hence increase of debt and costs of its servicing in the following years.

5.1.3. Carried over funds

Balance of carried over funds from 2002 and funds held at the end of 2003 in the domestic part was negative and amounted to PLN 3 219 million. It was a result of utilizing funds carried over from 2002 in the amount of PLN 7 174 million (PLN 7 173 million – in Polish zlotys and PLN 1 million – in foreign exchange from privatisation) and holding funds at the end of 2003 in the amount of PLN 10 393 million (funds in zlotys – PLN 9 608 million, in foreign exchange from privatisation – PLN 785 million). The borrowing requirement of the budget was also covered using the foreign exchange funds from the issue of bonds on foreign markets. At the beginning of the year the balance of these funds accounted for PLN 159 million and at the end of the year – PLN 808 million. Total funds held at the end of 2003 were utilized to finance borrowing requirement of the State budget during the first months of 2004.

5.1.4. Other items in the domestic financing

Revenues

Other revenues achieved in 2003 include repayment of the budget loan taken by the Orbis S.A. company (PLN 6 million) and repayment of the liabilities by the State Treasury Agricultural Property Agency (PLN 143 million).

Outlays

In 2003 payment of benefits under the periodical absence of remuneration rises in the budgetary sphere and loss of certain pension increases and allowances (repayment of compensations) continued. Those outlays amounted to PLN 3 134 million. Budget funds were also used to extend a loan to the Export Credit Insurance Corporation (PLN 16 million).

5.2. Foreign financing

The balance of foreign financing was PLN 5 961.6 million (in 2002 it amounted to PLN 3 448 million). It was a result of realized revenues of PLN 41 815.9 million and outlays of PLN 35 854.3 million. The above-mentioned revenues and outlays do not show precisely the amount of foreign financing. They are overvalued by the operations on the foreign exchange account of the Ministry of Finance, arising from budgetary accounting requirements. The operations involved recording receipts on the foreign exchange account (from sources other than privatisation) as outlays and then recording utilisation of these funds for servicing the foreign debt on the revenue side. If these operations were excluded, the foreign financing balance would be at PLN 6 576.3 million with revenues at PLN 25 335.3 million and outlays at PLN 18 759.0 million. The balance of operations on the foreign exchange account amounted to PLN -615 million (negative).

In 2003, early redemption of Brady bonds issued in 1994 in connection with reduction and restructuring of debt towards the London Club was performed. In April 2003 all the remaining PDI bonds were redeemed, invoking the right for early redemption at the nominal price. The amount of early redemption was at USD 1 089.2 million. In October 2003 all DCB bonds were redeemed early, at the nominal value – USD 393.0 million. Total Brady bonds redemption amounted to PLN 5 794.5 million. It's worth mentioning that early redemption of these bonds was conducted seven times so far, beginning in 1997.

In 2003, six sovereign bond issues took place (including one reopening). In February 2003, 10-year bonds with the nominal value of EUR 1 500 million were issued. In May 2003, the issue was reopened at the amount of EUR 800 million. In July 2003, bonds were issued on the Japanese market with the nominal value of JPY 25 billion. In September 2003, the 3-year issue of floating-rate foreign bonds of the nominal value of EUR 500 million took place. In October 2003, the issue of USD bonds with the nominal value of USD 1 000 million and maturity in 2014 took place. In December 2003, 7-year floating-rate bonds with the nominal value of USD 400 million were issued. Revenues thereto totalled PLN 18 159.2 million.

In April 2003, a drawing of EUR 950 million (PLN 4 145.0 million) was made on the revolving credit. The funds obtained were used as a bridge loan to finance the early redemption of PDI bonds. The credit was repaid in June, after obtaining funds from a reopened issue of EUR bonds with maturity in 2013. Outlays under the revolving credit amounted to PLN 5 289.0 million (additionally, in February 2003, USD 275 million of credit taken in 2002 was repaid).

In addition to the operations specified above a planned repayment of PLN 832.6 million of maturing debt towards creditors associated in the Paris Club and other creditors (including World Bank, European Investment Bank, European Bank for Reconstruction and Development) took place in 2003. In 2003, borrowing from international financial institutions amounted to PLN 2 971.8 million and receipts from the World Bank credit line available for domestic entities amounted to PLN 35 million.

Table 5.2. Foreign financing in 2003 (PLN m)

Item	Revenues	Outlays	Balance
Foreign financing	**41 816**	**35 854**	**5 962**
Bonds	**18 159**	**89**	**18 070**
– foreign bonds	18 159	–	18 159
– Brady bonds	–	89	-89
Early repayment of liabilities	–	**6 111**	**-6 111**
– redemption of Brady bonds	–	5 795	-5 795
Foreign loans received	**2 972**	**6 920**	**-3 948**
– Paris Club	–	5 925	-5 925
– World Bank	221	792	-570
– European Investment Bank	2 634	113	2 521
– European Bank for Reconstruction and Development	–	18	-18
– Council of Europe Development Bank	116	–	116
– other	–	72	-72
Liquidity instruments (revolving credit)	**4 145**	**5 289**	**-1 144**
Turnover on the foreign exchange account	**16 481**	**17 095**	**-615**
Other items of foreign financing	**59**	**350**	**-291**
– loans granted	24	140	-116
– Ecofund	–	167	-167

In 2003, the Government of the Republic of Poland granted loans to Vietnam, China, Serbia and Montenegro to finance exports of goods and services in the amount of PLN 139.9 million (USD 36 million). In the same period, repayment of loans by Algeria, Yemen and Vietnam reached PLN 23.6 million (USD 6.3 million).

In 2003, payments under the ecoconversion/Ecofund amounted to PLN 167.4 million (USD 37 million and EUR 4.1 million) and payments related to Poland's shares and quotas in the international financial institutions reached PLN 35 million.

5.3. State Budget liquidity situation

During almost the whole year, the budget liquidity situation was favourable ensuring safe financing of borrowing requirement (chart 5.3). A low level of liquidity reserves at the turn of September and October was temporary and was rapidly increased as a result of sale of short-term Treasury bills of the nominal value of PLN 3.5 million. Budget liquidity was ensured through maintaining constant reserve both in PLN and in foreign exchange.

The level of liquid assets in PLN was subject to:

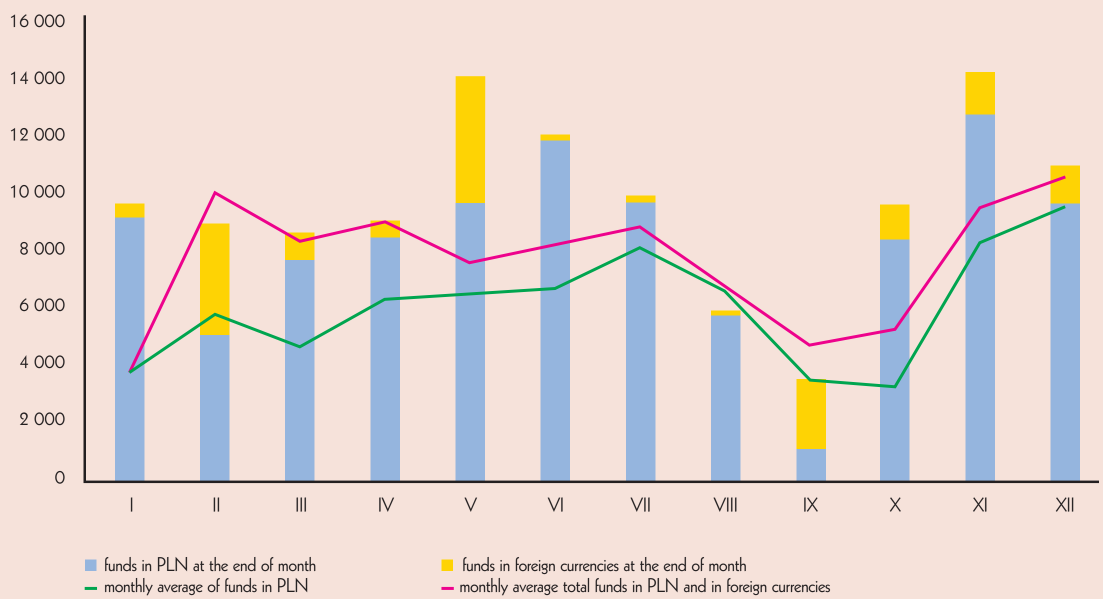
– the need to maintain reserves for the event of non-favourable market situation – restricting or precluding sale of TS at an acceptable cost,
– the use of bond switching auctions; they helped ease the peaks of TS redemptions,
– the pursuit of stable (uniform) supply volume of TS during the year, taking into account seasonal factors in the demand for TS,
– the size of borrowing requirement in subsequent months of 2003 and 2004, and also the uneven distribution of this requirement in time,
– the level of foreign financing, including use of funds from the foreign exchange account,
– the uncertainty as to the planned privatisation receipts (40% of the planned amount was realized).

The prevailing form of liquid assets was term deposits in the National Bank of Poland. The budget earned almost PLN 0.3 billion in interest on these deposits.

In order to secure payments in foreign exchange also foreign exchange resources were accumulated. They came mainly from sale of bonds on foreign markets and from foreign exchange proceeds from privatisation. From time to time, the debt servicing payments were also conducted as a result of purchase of foreign exchange in the central bank.

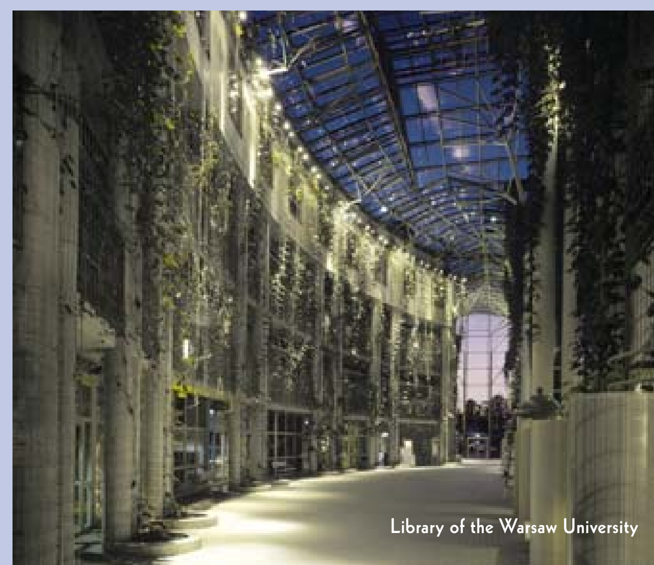
The level of foreign exchange funds varied throughout the year. At the end of 2003 the funds amounting to almost USD 426 million were left on the foreign exchange account against USD 42 million in December 2002.

Chart 5.3. Liquid funds (Polish Zloty and foreign exchange) in 2003, in PLN m (as of the end of a month and monthly averages)



Secondary Market of Treasury Securities

Chapter 6

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Efficiency and liquidity of the secondary market are of great importance for public debt issuance and management. The current developments on this market and its outlook are among the key factors influencing the decision making by the issuer.

6.1. Domestic market

Secondary market of Treasury Securities (TS) is the place, where purchase or sale transactions of securities issued previously by the State Treasury on primary market are performed. Essential functions of the efficient secondary market include:

– possibility to buy Treasury Securities by entities other than banks, having the status of Primary Dealer, influences the level of prices on the primary market and hence debt servicing costs,
– providing information on an offer, volume of turnover and quotations of Treasury Securities for all market participants,
– providing liquidity through possibility of conditional transactions,
– ensuring continuous price quotations of Treasury Securities.

Secondary market of Treasury Securities could be divided into two main segments – the Treasury bills market and the Treasury bonds market. Transactions concluded on bills are settled through Securities Register (SR) run by the central bank. The National Depository for Securities (KDPW) is responsible for settlement of transactions on bonds. However, it is possible to exclude the KDPW's participation from cash settlement – in such a case a cash flow risk is assumed by parties of transactions and the KDPW's role is limited to ensuring bonds transfer (registering changes on deposit accounts). The secondary turnover of bills is performed on the over the counter market (OTC) and on the Treasury Securities Electronic Market conducted by the CeTO company. In the case of bonds, investors may also use the Warsaw Stock Exchange and the regulated CeTO market (since December 2003) for trading.

In 2003 the total value of transactions on secondary market of Treasury Securities was PLN 3.8 trillion and it was PLN 1.5 trillion higher than in 2002. The share of Treasury bills and bonds trading on the TS secondary market was similar. Nevertheless, in 2003 the Treasury bonds segment prevailed (52.5% share in total market). An increase in trading (value of transactions) of Treasury bills and bonds resulted

Table 6.1. Value of transactions on the securities secondary market

Instrument	2002 transactions value	2002 share	2003 transactions value	2003 share	Annual change	
	PLN m	%	PLN m	%	PLN m	%
Treasury bills	1 081 078.7	48.6	1 782 067.4	47.5	700 988.8	64.8
Treasury bonds	1 141 349.9	51.4	1 970 358.6	52.5	829 008.8	72.6
Total	2 222 428.5	100	3 752 426.1	100	1 529 997.5	68.8

mainly from a significant rise in the amount of outstanding T-bills and T-bonds and also due to the implementation of the Primary Dealer System. As far as bonds are concerned, an important factor was also the increase in the issuance of *benchmark* bonds.

The trading (value of transactions) of the Treasury bills market amounted to PLN 1.8 trillion, which was 65% more than in the previous year. This increase in trading was mainly a result of *sell-buy back* transactions, the share of which increased from 83.0% in 2002 to 91.7% in 2003. Conditional transactions (sell-buy back and repo), continued to have the prevailing share in the secondary market, while the share of outright sell/buy transactions was relatively low and decreasing (fell from 10.2% to 5.8%). Such a structure of the market resulted from the fact, that Treasury bills are instruments of current liquidity management and the secondary market of bills plays the role of short-term loans for the banks and their largest customers.

In 2003 the trading of the T-bonds on the secondary market rose again considerably. In comparison with the previous year the value of transactions increased by PLN 829.0 billion and reached the level of PLN 1.97 trillion. The OTC market kept its dominant position with 95.1% share in total trading. The share of CeTO electronic market increased slightly from 4.2% to 4.7%.

The activity of investors on the OTC market was focused on 5-year fixed-rate bonds (PS), but in 2003 the share of these bonds in the total market decreased from 57.9% to 52.7%, while the share of trading of 2-year zero-coupon bonds and 10-year

Table 6.2. Value of transactions on the Treasury bills secondary market according to types of transactions in 2002 and 2003

Year	Total value of transaction	Sell-buy-back transactions		Repo transactions		Outright transactions	
	PLN m	PLN m	share	PLN m	share	PLN m	share
2002	1 081 078.7	897 207.1	83.0%	73 077.4	6.8%	110 794.1	10.2%
2003	1 782 067.4	1 634 511.7	91.7%	43 336.3	2.4%	104 219.4	5.8%

Table 6.3. Value of transactions on the bonds secondary market in 2002 and 2003

Instrument	2002 transactions value	2002 share	2003 transactions value	2003 share	Annual change	
	PLN m	%	PLN m	%	PLN m	%
Secondary market	**1 141 349.9**	**100.0**	**1 970 358.6**	**100**	**829 008.8**	**72.6**
OTC market	1 091 402.1	95.6	1 874 101.1	95.1	782 699.0	71.7
CeTO	47 990.0	4.2	92 485.0	4.7	44 495.0	92.7
WSE	1 957.8	0.2	3 772.5	0.2	1 814.8	92.7

fixed-rate bonds increased significantly (from 18.2% to 27.3% and from 10.0% to 14.7% respectively). The biggest trading was recorded for the *benchmark* bonds and for securities having this status previously. The trading of the eight bond series (see table 6.4) amounted to PLN 1.4 trillion constituting 70.7% of the trading on the secondary market.

The introduction of the Primary Dealer System led to strengthening of the dominant position of banks in the market. The trading on the OTC market, in which at least one party was represented by a bank, accounted for 89.8% of the value of all the transactions (against 79.5% in 2002). The fastest rate of growth regards

Table 6.4. Value of transactions on the most liquid securities on the bonds secondary market in 2003

Bonds	Transactions value PLN m	Market
OK1204	112 936.3	5.7%
OK0405	95 932.1	4.9%
OK0805	47 622.3	2.4%
PS1106	89 126.6	4.5%
PS0507	193 548.3	9.8%
PS0608	610 747.6	31.0%
DS1110	81 186.4	4.1%
DS1013	161 721.0	8.2%

Table 6.5. Entity structure of OTC Treasury bonds market 2002 and 2003

Parties of transactions	2002		2003	
	transactions value	share	transactions value	share
	PLN m	%	PLN m	%
bank – bank	306 086.6	28.0	585 182.5	31.2
bank – non-banking sector	238 102.0	21.8	675 495.5	36.0
bank – non-resident	323 084.8	29.6	422 366.8	22.5
non-banking sector – non-banking sector	2 997.9	0.3	5 418.7	0.3
non-banking sector – non-resident	25 175.9	2.3	28 869.5	1.5
non-resident – non-resident	195 954.8	18.0	156 768.1	8.4

Table 6.6. Liquidity of Treasury bonds secondary market in 2002 and 2003

Year	OK*			PS*			DS*			Total		
	debt outstanding (average)	transactions value (average)	liquidity	debt outstanding (average)	transactions value (average)	liquidity	debt outstanding (average)	transactions value (average)	liquidity	debt outstanding (average)	transactions value (average)	liquidity
	PLN m		%	PLN m		%	PLN m		%	PLN m		%
2002	7 955.0	28 128.4	403.5	5 223.2	8 383.4	186.9	8 537.4	7 235.8	83.7	136 054.7	95 385.3	69.2
2003	16 929.4	50 895.6	348.4	7 837.7	10 503.3	137.0	8 036.2	13 256.7	169.7	175 044.1	164 144.2	94.0

*) currently sold series

the share of transactions concluded by banks and domestic non-banking sector, which reached 36.0% of all transactions concluded (21.8% in 2002).

In 2003 the ratio of trading on the secondary market to the debt level rose significantly. In comparison with 2002, the ratio increased (monthly average) from 69.2% to 94.0%. This ratio fell significantly for 2-year and 5-year securities currently sold on the primary market, which was mainly a result of an increase in the value of new issues of these bonds. In the case of benchmark bonds, the improvement was only noted for 10-year securities, resulting mainly from rather low liquidity of these bonds in previous years.

An increase of the above mentioned ratio is not equal with actual increase of liquidity of the secondary market for bonds. The decrease in prices of bonds, observed from the middle of the year 2003 and the related losses to the dealers caused a substantial decrease in the activity of the biggest banks operating so far as the market-makers. It led to a significant decrease of market liquidity understood as the ability to sell large packages of bonds without the necessity to accept lower prices and to a significant increase of bid-offer spreads.

6.2. Foreign market

The majority of foreign bonds issued by the State Treasury in 1995-2003 (including the Brady bonds) are registered on foreign Stock Exchanges. However, they are traded mostly on the OTC inter-bank markets, featuring a significant degree of decentralization and a large number of institutions participating in transactions. These features of inter-bank markets make the monitoring of trading of specific issues more difficult.

A new electronic platform for trading bonds denominated in EUR issued by the EU accession countries was launched at the end of 2003 (NewEuroMTS). The participating dealers are obliged to provide continuous quotations with small bid-offer spreads. Since launching of the platform, a large part of the secondary trading takes place on this platform. At the end of 2003 two Polish most liquid foreign bonds (maturing in 2011 and 2013) were quoted on this platform.

Foreign bond transactions are settled through two systems: in the case of American investors a specialised financial institution – the Depository Trust Company- is responsible for the settlement, in the case of investors outside of the USA – settlement is made by two European clearing institutions – Euroclear and Clearstream.

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Buildings and other objects presented in the pictures were financed from public sources

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