The Public Finance Sector DEBT MANAGEMENT STRATEGY in the years 2004 – 2006

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in the years 2004-2006

I. INTRODUCTION 1

II. IMPLEMENTATION OF THE STRATEGY OBJECTIVES IN 2002 AND IN THE FIRST HALF OF 2003 2
II.1. Evaluation of the objectives implementation 2
II. 2. Conclusions from the objectives implementation 5

III. ASSUMPTIONS OF THE STRATEGY 6
III.1. The macroeconomic situation of Poland and its forecasts 6
III.2. Situation on the international financial market 6
III.3. Changes in public debt in 2002 and in the first half of 2003 8

IV. CAUSES AND CONSEQUENCES OF THE INCREASE IN DEBT-TO-GDP RATIO 10
IV.1. Regulations relating to the public debt in Poland and in the European Union 10
IV.2. Reasons for the increase in debt-to-GDP ratio 12
IV.3. Consequences and threats of increase in the debt-to-GDP ratio 12

V. PUBLIC DEBT RISK ANALYSIS 14
V.1. Risk related to public debt volume 14
V.2. Risk related to debt servicing costs 15
V.3. Risk related to sureties and guarantees granted and other operations of the sector 19

VI. IMPACT OF POLAND'S ACCESSION TO THE EU ON PUBLIC DEBT MANAGEMENT 20
VI.1. Conditions of debt issuance on the domestic market and on the international capital market 20
VI. 2. Financial flows associated with the EU membership 21

VII. DEBT MANAGEMENT STRATEGY OBJECTIVES IN THE YEARS 2004-2006 23

VIII. TASKS OF THE STRATEGY IN A THREE-YEAR HORIZON 26

IX. NEW INSTRUMENTS OF IMPLEMENTING THE STRATEGY OBJECTIVES 29

X. FORECAST OF DEBT VOLUME AND DEBT SERVICING COSTS 31

XI. INFLUENCING THE PUBLIC FINANCE SECTOR DEBT 32
XI.1. Legal regulations 32
XI.2. Analysis of debt of public finance sector units other than the State Treasury 33
XI.3. Proposals of new regulations 35

XII. THREATS TO THE STRATEGY IMPLEMENTATION 36

XIII. EFFECTS OF STRATEGY IMPLEMENTATION 37

Annex 1. G*eneral government* debt and yield of 10-year bonds in EU Member States and in selected acceding countries 38
Annex 2. Main regulations relating to contracting liabilities by local governments in the EU acceding countries 39

I. INTRODUCTION

The Public Finance Sector Debt Management Strategy in the years 2004-2006 covers the strategy of managing the State Treasury debt and the strategy of influencing the public finance sector debt. In accordance with the *Public Finance Act*, the Minister of Finance exercises control over the public debt level. In the case of the State Treasury debt, the Minister of Finance has instruments allowing for direct debt management, while in the case of other debt of the public finance sector, being autonomous in contracting liabilities, the control exerts indirect influence and contributes to reduction of the public debt level in Poland.

The *Strategy* evaluates the implementation of the debt management objectives in 2002 and in the first half of 2003. The strategy objectives for the years 2004-2006 have not changed as compared to those laid down in the previous document. It defines tasks and instruments of the strategy implementation for the years 2004-2006 and presents forecasts concerning the debt level, structure, and servicing costs. Much attention has been given to an analysis of risk associated with the debt level and its structure.

In the time horizon encompassed by this strategy, two developments become of particular significance for the public debt management: These are the rising debt level and European integration.

In 2003, the public debt to-GDP ratio is to exceed 50%, hence it will enter the first band set forth in the *Public Finance Act* thus implying a necessity to use prudential and remedial procedures. In 2004, the debt-to-GDP ratio should be slightly below 55%, and in 2005 below 59.5%. In the following two years, regular cuts in budgetary expenditures and sustained economic growth should result in a reversal of the debt-to-GDP ratio upward trend. The strategy presents causes and consequences of growth in the public debt , as well as threats associated with the growing debt level.

The accession of Poland to the European Union in May 2004 will have a strong impact on public debt management conditions. Two most significant aspects in this respect are the consequences of financial flows associated with Poland's membership in the EU and changes to the debt management environment, especially the upgrading of Poland's rating and a gradual integration of the domestic Treasury Securities (TS) market with the European market. Preparations for the subsequent stage of integration, i.e. joining the Economic and Monetary Union are to be continued as well. Necessary adjustments will cover not only the financial policy of the government in order to meet the convergence criteria in the field of, *inter alia*, public debt and budget deficit, but also the public debt management instruments being in use. The methodology, organisation and technical infrastructure of both the public debt management process , and the market for Treasury Securities must meet the EU standards so as to be able to take full advantage of benefits of being a part of the single European market and to meet the competitive pressure posed by other issuers.

II. IMPLEMENTATION OF THE STRATEGY OBJECTIVES IN 2002 AND IN THE FIRST HALF OF 2003

The Public Finance Sector Debt Management Strategy in the years 2003–2005 has seen a change of priorities. The increase in budget expenditures, which since 2001 has been accompanied by a substantial increase in a state budget deficit (PLN 32.4 billion in 2001 and 39.4 billion in 2002), under conditions of declining privatisation proceeds, resulted in a sharp rise in the public debt volume and in a real threat of exceeding the 50% and 55% threshold (provided for in the *Public Finance Act*) by the ratio of the public debt increased by anticipated payments under sureties and guarantees, to GDP, as well as approaching the constitutional limit of 60%. In order to counteract this trend it is required to stop the growth of the debt-to-GDP ratio. It has been reflected in the first objective of the strategy (keeping the public debt at a safe level). Strategy objectives from the previous years have been sorted out and formulated as the second objective: minimisation of debt servicing costs with restrictions concerning particular risks being maintained.

II.1. Evaluation of the objectives implementation

1. Keeping the public debt at a safe level

In 2002 and in the first half of 2003 the necessity of financing high budget deficit (PLN 39.4 in 2002 and PLN 23.8 billion in the first half of 2003) at low privatisation proceeds (PLN 2.0 billion in 2002 and PLN 1.2 billion in the first half of 2003) became apparent. Table 1 presents the levels of the most important public debt categories in absolute terms and relative to GDP[1]:

Table 1.

	XII 2001		XII 2002		VI 2003
	PLN million	% of GDP	PLN million	% of GDP	PLN million
State Treasury debt	283 937.5	**37.8%**	327 909.1	**42.5%**	362 639.2
- domestic	185 028.4	**24.6%**	219 351.9	**28.4%**	243 797.8
- foreign	98 909.1	**13.2%**	108 557.2	**14.1%**	118 841.5
Public debt	302 106.7	**40.2%**	352 615.5	**45.7%**	388 929.8
Public debt increased by anticipated payments under sureties and guarantees	311 602.8	**41.5%**	364 747.9	**47.2%**	399 783.4

The rise in State Treasury debt, especially in 2002, was mostly due to the rise in domestic debt. A substantial increase in the foreign debt level in the first half of 2003 was the consequence of the zloty weakening against foreign currencies and incurring foreign liabilities for repayment of another tranche of bonds acquired by the NBP within the framework of redemption of debt to Brazil. They were denominated and serviced in foreign currencies despite being treated as domestic debt.

2. Minimisation of debt servicing costs within long time horizon

This objective was seen as:

a) minimisation of costs within the horizon specified by the redemption dates of instruments with the longest maturities - through the optimal selection of debt management instruments, their structure, and dates of issue,

[1] Towards the end of 2002, the Central Statistical Office (GUS) changed the GDP calculation methodology, which resulted in its upward reappraisal. The data presented here relate to the size of public debt to GDP calculated in accordance with the new methodology, hence the debt/GDP ratio is not comparable to those presented in the previous strategies.

b) actions taken towards increasing the efficiency of the Treasury Securities market, so that their servicing costs were possibly the lowest at the adopted strategy of issuance.

Minimisation of debt servicing costs in the first meaning of that objective involved adjustment of the structure of TS issuance to the domestic financial market conditions in 2002 and in the first half of 2003. The sales were so structured that excessive supply in respective segments of the yield curve would not lead to acceptance of excessively high debt servicing costs. This occurred under conditions of a substantial decline in the yield of short-term securities (yield of 13-week bills fell from 10.1% to 5.1%), with a slightly less pronounced decline in the yield of long-term securities (from 8.2% to 5.2% for 10-year bonds). Hence the shape of the yield curve changed from an downward sloping one to an almost flat one.

A revision of the calendar of issuance of the Treasury bonds offered at auctions as of September 2002 also served to the purpose of costs minimisation . The main assumption was to issue medium- and long-term bonds of one series as long as they reach the value of at least €5 billion. This allows to reduce bonds servicing costs by the margin demanded by investors in case of small issues ofi limited-liquidity. The same purpose was the case for reducing the number of auctions held in a year, coupled with increasing the value of bonds offered at a single auction. Faster achievement of liquidity by new issues was also accompanied by introduction of supplementary non-competitive auctions. At the same time, it was assumed that the refinancing and liquidity risks arising from cumulation of redemptions of large issues, would be reduced by continued operations of bond switches and even distribution of payments deriving from servicing of new issues in particular months.

The main actions taken up towards debt servicing costs minimisation in the second meaning of that objective included:

- the launch of the Electronic Market of Treasury Securities (ETSM) in April 2002,
- implementation of the System of Treasury Securities Dealers (Primary Dealers) in early 2003,
- introduction of intraday credit in the NBP collateralised by Treasury Securities.

Minimisation of debt servicing costs was taking place with the adopted restrictions as to the level of:

1) domestic currency refinancing risk

The value of the basic measure of risk refinancing, i.e. the average maturity of marketable debt expressed in years[2], went up from 2.51 at the end of 2001 to 2.73 at the end of 2002 and 2.82 at the end of June 2003. The increase in this indicator was mostly due to the following factors:

- changes in the calendar of wholesale bonds' issuance – maturities of newly-issued 5- and 10-year bonds became extended at early auctions so that five and ten years referred to average maturity in the period of offering a given series, and not at the first auction, as was the case in the previous period.
- Carrying out switching auctions and bonds buy-backs - in 2002 and in the first half of 2003 PLN 13.2 billion nominal worth of bonds were early redeemed, and 13.4 billion nominal worth of bonds were issued with a significantly longer maturity.
- 20-year bond issue – PLN 1.4 billion of total worth of bonds were sold in 2002. Additionally, PLN 0.15 billion worth of these bonds were sold at switching auctions in 2003.

Refinancing risk reduction was contributed to by such a choice of months of redemption of newly-issued wholesale bonds, which ensured for debt servicing payments to be evenly distributed over the year.

The share of TS maturing up to 12 months went up from 37.8% at the end of 2001 to 38.0% at the end of 2002, and declined to 34.1% in the middle of 2003. An obstacle to implementation of the refinancing risk reduction objective was posed by growing debt in Treasury bills, whose share in domestic debt of the State Treasury remained at a stable, high level (19.0% at the end of 2001, 19,2% at the end of 2002, and 18.5% at the end of the first half of 2003). This trend resulted from the necessity to finance high budget deficit at low privatisation proceeds and limited capacity of the bond market.

[2] The higher the measure's value, the lower the risk (see chapter V.2).

2) exchange rate risk and foreign currency refinancing risk

The share of foreign debt in the State Treasury debt according to the place of issue criterion declined insignificantly from 34.8% at the end of 2001 to 33.1% as at the end of 2002, to subsequently rise to 34.0 % in the middle of 2003. This was due to two reasons:

- weakening of the zloty against foreign currencies in which foreign debt is denominated,
- principal repayments of bonds acquired by the NBP within the framework of early redemption of debt to Brazil ($1.1 billion in 2002 and $0.5 billion in the first half of 2003).

The policy of gradual increasing of the euro share in foreign debt (from 43.0% to 46.7% of total foreign debt in 2002 and to 55.2% in the first half of 2003) was continued as well. The share of foreign debt according to the resident criterion increased slightly (from 41.1% in 2001 to 42.0% in 2002 and to 42.0% in the first half of 2003), mostly as a result of growing debt to foreign investors for their purchase of Treasury Securities issued on the domestic market. The foreign debt refinancing risk remained relatively small compared to domestic debt refinancing risk, in respect to both level of repayments in particular years and to average maturity. Although the latter declined from 6.4 years at the end of 2001 to 5.9 years at the end of 2002 and 6.0 years in the middle of 2003, its level is close to European standards.

The peak of foreign payments falling due in the years 2004-2009 has been taken into account in new issues on foreign markets.

3) interest rate risk

Average *duration* of domestic marketable debt, being a measure of debt servicing costs sensitivity to interest rates' fluctuations[3], rose in 2002 from 1.75 years to 2.16 years, reaching 2.32 in the middle of 2003. This growth resulted from the following factors:

- considerable cuts in the level of interest rates,
- reduction of the share of floating-rate market instruments (from 16.4% to 10.3% and 7.8%, respectively),
- increase in average debt maturity (from 2.51 to 2.73 and 2.82 years, respectively).

Over 2002 the share of liabilities implying interest rate risk in the entire foreign debt portfolio[4] fell from 57.2% to 45.9% (of which floating-rate debt from 54.7% to 42.3%). In the middle of 2003 this share was 43.1% (of which floating-rate debt 40,2%). The average debt maturity, indicating the average period, in which maturing liabilities are replaced with new ones, was about 6 years.

It should be noted that reduced floating interest rates are applicable to a major share of liabilities (32.6%, 30.2% and 29.1% at the end of 2001, 2002 and the first half of 2003, respectively). In view of reaching by market interest rates historically low levels, conventional reduced rates reached their minimum, at which they would remain even in case of market rates going up within certain limits.

The risk of growing debt servicing costs in case of a rise in market rates had been gradually reduced through contracting new debt almost exclusively at a fixed rate.

4) State budget liquidity risk

Depositing funds with the NBP was the basic instrument of state budget liquidity management. During the analysed period there was no need to issue short-term bills, redeemable up to 13 weeks. Switching and buy-back auctions also contributed to liquidity risk and refinancing risk reduction. The buy-back involved mostly bonds maturing within a year of a switching auction, which to a major extent allowed to ease redemption pile-ups, being particularly strong in the first half of 2002

Towards the end of 2002, the state budget's currency liquidity management system was launched, consisting of a currency account with the NBP and of a special instrument, providing for a possibility of short-term bridge financing in foreign currencies, until inflow of foreign

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[3] The longer the *duration*, the lower the sensitivity (see chapter V.2).

[4] The share of floating rate liabilities and debt maturing within a year.

currency funds from debt issuance on foreign markets or from privatisation. The currency account is used for temporary depositing of surplus currency funds.

5) Other risks, especially credit and operational risks

During the analysed period no transactions generating credit risk were concluded, as free assets, which can be used for liquidity management, were deposited only in the NBP.

6) Distribution of debt servicing costs in time

In 2002 service costs of the State Treasury debt accounted for 3.1% of GDP (compared to 2.8% in 2001). The rise in costs, despite a significant cut in interest rates, resulted mostly from the increase in the public debt size and from inertia accompanying adjustment of debt servicing costs to new interest rates' levels.

Equal distribution of payments for service of TS was taken into consideration at new issuance. In particular, the level of interest on new issues of wholesale bonds was close to their yield so that to limit cumulation of service costs associated with discount at their redemption.

II. 2. Conclusions from the objectives implementation

The public debt to-GDP ratio, which in 2002 amounted to 47.2%, is not dangerous from the point of view of feasibility of its servicing, the law applicable in Poland, and international commitments. Nevertheless, the upward trend, which was the cause of reformulation of objectives of the previous strategy, gives rise to concern. The process of reducing the structural deficit of the state budget, as well as of the public finance sector deficit to a level not contributing to a further increase of this ratio will take at least several years.

During the analysed period, the additional strategy objective, covering debt servicing costs and restrictions concerning the risk level was achieved to a larger or smaller extent. A particularly big progress was achieved in activities aimed at reduction of debt servicing costs – through creation of an institutional environment contributing to improvement of the TS market efficiency and adoption of a new issue calendar, adjusted to investors' requirements and, in a longer perspective, integration with the single European financial market. Interest rate risk was significantly reduced, and to a slightly smaller extent the same was the case with refinancing in the domestic currency risk, exchange rate risk and refinancing risk in foreign currencies. The bonds switching auctions introduced at the end of 2001 played a positive role in reducing the refinancing risk and the state budget liquidity risk. Even distribution of debt servicing costs over time was properly taken into account in the issuance policy. During the analysed period there was no need for credit risk management.

III. ASSUMPTIONS OF THE STRATEGY

III.1. The macroeconomic situation of Poland and its forecasts

The Table below presents macroeconomic assumptions on which the strategy is based. Unlike the previous strategy, this document presents one scenario of main macroeconomic and budgetary indicators. An unfavourable deviation of these indicators from the adopted assumptions will result in the public debt-to-GDP ratio exceeding 55% threshold in 2004 which, in accordance with the *Public Finance Act*, will involve a necessity of at least balancing the budget for 2006. Such a radical change will have a major impact on the level of macroeconomic and budgetary indicators.

Table 2.

	2003	2004	2005	2006
Real GDP growth	3.5%	5.0%	5.0%	5.6%
GDP at current prices (PLN billion)	805.1	861.5	926.1	1002.8
State budget deficit (% of GDP)	4.8	5.3	4.2	3.3
State budget deficit (PLN billion)	38.7	45.5	38.8	33.0
Deficit of local government units (% of GDP)	0.4	0.3	0.3	0.3
Privatisation proceeds (PLN billion)	4.5	7.0	7.0	7.0
Average annual CPI	0.8	2.2	2.8	2.9
Rate of open market operations				
- Period average	5.6%	3.7%	3.8%	4.0%
- end of period	4.8%	3.5%	4.0%	4.0%
PLN/USD				
- period average	3.84	3.78	4.00	4.20
- end of period	3.74	3.82	4.00	4.20
PLN/EUR				
- period average	4.32	4.25	4.20	4.20
- end of period	4.30	4.20	4.20	4.20

III.2. Situation on the international financial market

Economic situation and the degree of uncertainty which accompanies decisions taken by economic entities are the main factors influencing situation on the international financial market, in this number also the possibilities of financing development needs of the emerging economies on that market.

The latest analyses contain more and more indications pointing to prospects for a gradual improvement of the situation on the international financial market. The impact of such factors weakening and destabilising the financial market, as a threat of returning recession and deflation, economic and financial crises, as well as political tensions in certain emerging economies (e.g. Brazil, Argentina, Turkey, Venezuela) weakens. In the global scale, the geopolitical risk has diminished in connection with the end to hostilities in Iraq. As a result, the balance of advantages and threats to developments on the international financial market has been shifting to the advantage of the former.

In the second half of 2003 the world economy should experience a gradual recovery.

The US economy gathered momentum in the middle of 2003. Analysts of both the IMF and 18 leading investment banks forecast the growth rate of GDP of the United States in 2003 and 2004 at a similar level of 2.25-2.3% and 3.4-3.5%, respectively. It is not certain, however, whether the return of the US economy to the balanced growth path will be permanent or not. High current account and budget deficits (almost 5% of GDP and above 4% of GDP, respectively) pose a threat to sustained growth.

In the first half of 2003, investors reckoning with subsequent cuts in interest rates, continued purchases of US Treasury bonds, this way affecting their yield. The demand for bonds was also strengthened by the long-term decline in share prices and uncertainty involved with the war in Iraq. Extra demand came from Asian central banks, which counteracted appreciation of their

currencies against the US dollar by buying US Treasury Securities. In June, there was a shift in demand for bonds caused by more optimistic economic growth forecasts and a strong reduction of deflation risk. Anticipating inflationary trends and a rise in interest rates investors reduced their demand for bonds, which resulted in increase of their yield.

According to Eurostat data, zero-growth was achieved in the euro area in the second quarter of 2003. The European Commission expects symptoms of recovery to appear only in the fourth quarter, and economic growth in the whole of 2003 to close at 0.5-0.6%. Forecasts for 2004 provide for a slow recovery of the euro area economies, with the growth rate estimated at 1.7% (according to leading investment banks) or 1.1-2.1% (according to ECB).

There is variation in forecasts concerning changes to monetary policy in the euro area in the coming months. In view of slightly more optimistic growth forecasts according to ECB, and the Bank's indication that the current interest rates (2%) are record low, financial markets anticipate a rise in interest rates by 0.5% in the first half of the coming year. On the other hand, economists predict that slow growth and low inflation would incline the ECB to a further cut in interest rate towards the end of this year.

Japan still remains troubled by sluggish domestic demand and deflation as well as the banking system reform. Market analysts project only insignificant GDP growth in Japan in 2003 and 2004 (0.9%).

Despite showing considerable variations, the situation in the emerging economies has been generally improving. In 2002 and 2003 fast growth continues in the Asian economies, especially China (some 7%), India (5-6%) and ASEAN group economies (e.g. in Indonesia the government targets for 2004 provide for a 5% GDP growth). Among the transition economies attention should be paid to performance of the Russian economy (GDP growth by 4 to 5% in 2001-2003, falling inflation, budget surplus), where in the first half of this year foreign investment (excluding repatriated capital) reached the value of $12.6 billion, i.e. by 51% higher than in the same period of 2002.

Over the last dozen or so months stabilisation of situation in the countries which until recently had been troubled by sharp crises, fast growth of other emerging economies and low return on investment in industrialised countries' markets contributed to a gradual restoration of demand for investment in the emerging economies and to rise in the capital inflow from the international financial market to those economies. This contributed to a reduction of the cost of acquisition of funds by the emerging economies on the international financial market.

It is difficult to predict whether emerging markets trends, being favourable for issuers of bonds, should continue in the future. On the one hand, prospects for recovery in the industrialised countries would encourage capital inflow to those countries making investment in emerging markets relatively unattractive (especially if a rise in interest rates in advanced economies was the case). On the other hand, as much as the recovery is involved with a decline in global uncertainty and with confidence growth, demand for bonds issued by emerging markets will grow. In this situation much will depend on improvement of fundamental factors in the emerging economies. This is a step-by-step process and it cannot be ruled out that it was outpaced by the so-far apparent fall in yield margins, this way limiting the room for further cuts in margins in the future.

III.3. Changes in public debt in 2002 and in the first half of 2003

In 2002, the public finance sector debt (after consolidation) increased by PLN 50.4 billion (i.e. by 16.7%) and in the first half of 2003 by PLN 36.5 billion (10,3%) to reach PLN 388.9 billion at the end of that period.

Table 3. Domestic and foreign public debt (PLN million)

Specification	Dec. 2001	Dec. 2002	June 2003	Change Dec. '02 – Dec. 01		Change June '03 – Dec. 02	
				PLN million	%	PLN million	%
Public debt	**302,106.7**	**352,615.5**	**388,929.8**	**50,508.8**	**16.7%**	**36,314.3**	**10.3%**
Domestic debt							
Place of issue criterion	202,869.7	243,533.0	269,467.8	40,663.3	20.0%	25,934.8	10.6%
Resident criterion	184,966.0	214,514.1	234,648.6	29,548.1	16.0%	20,134.5	9.4%
Foreign debt							
Place of issue criterion	99,237.0	109,082.6	119,462.0	9.845.5	9.9%	10,379.5	9.5%
Resident criterion	117,140.8	138,101.4	154,281.2	20.960.7	17.9%	16,179.7	11.7%
PLN/USD exchange rate	*3.9863*	*3.8388*	*3.8966*				
PLN/EUR exchange rate	*3.5219*	*4.0202*	*4.4570*				

The public debt was dominated by the central government debt (some 96.0%), while the share of local government debt remained at a stable level of some 4%.

In 2002, State Treasury debt recorded the largest increase in nominal terms (by PLN 44.1 billion, i.e. 15.6%). A similar trend continues in 2003. Among other central government sector entities, the most sizable debt increases were reported by the Social Insurance Institution (ZUS) (by PLN 1.8 billion in 2002, and by PLN 0.9 billion in the first half of 2003), mostly due to arrears in transfer of contributions to Open Pension Funds (OFE), and by government agencies' debt, especially of the Agricultural Market Agency (by PLN 1.0 billion and PLN 0.1 billion, respectively).

In 2002, the local government sector debt reported fast growth (by 30.3%). A substantial (almost PLN 3.0 billion) increase in debt occurred in the case of local government units. In the first half of 2003, the indebtedness of those entities rose insignificantly, by some PLN 0.05 billion.

Table 4. Public debt after consolidation (PLN million)

	Specification	Dec. 2001	Dec. 2002	June 2003	Change Dec. '02 – Dec. 01		Change June '03 – Dec. 02	
					PLN million	%	PLN million	%
	Public debt	302,106.7	352,615.5	388,929.8	50,508.8	16.7%	36,314.3	10.3%
1.	***Central government debt***	***291,320.5***	***338,557.1***	***374,393.8***	***47,236.5***	***16.2%***	***35,836.8***	***10.6%***
1.1.	*State Treasury debt*	*282,617.1*	*326,755.1*	*361,873.0*	*44,138.0*	*15.6%*	*35,117.8*	*10.7%*
1.2.	*Other central government debt*	*8,703.4*	*11,801.9*	*12,520.8*	*3,098.5*	*35.6%*	*718.9*	*6.1%*
1.2.1.	ZUS and ZUS-managed funds	7,173.5	9,014.6	9,932.2	1,841.1	25.7%	917.6	10.2%
1.2.2.	Health Funds/National Health Fund	154.4	289.7	159.5	135.3	87.6%	-130.1	-44.9%
1.2.3.	State earmarked funds with legal personality (excl.1.2.1.)	192.8	339.2	137.1	146.4	75.9%	-202.0	-59.6%
1.2.4.	State higher schools	186.4	216.1	164.5	29.7	15.9%	-51.6	-23.9%
1.2.5.	Research and development units	254.3	207.1	215.2	-47.2	-18.6%	8.1	3.9%
1.2.6.	Independent public health care institutions	389.7	420.1	496.0	30.4	7.8%	75.9	18.1%
1.2.7.	State cultural institutions	4.3	2.9	1.7	-1.4	-32.2%	-1.2	-41.0%
1.2.8.	Polish Academy of Sciences and organisational units established by it	11.6	5.7	8.1	-5.9	-51.0%	2.4	42.4%
1.2.9.	Other state legal persons	336.3	1,306.5	1,406.4	970.2	288.5%	99.8	7.6%
2.	***Local government debt***	***10,786.2***	***14,085.5***	***14,536.0***	***3,272.3***	***30.3%***	***477.5***	***3.4%***
2.1.	*Debt of local government units*	*9,008.8*	*12,002.3*	*12,048.4*	*2,993.5*	*33.2%*	*46.1*	*0.4%*
2.2.	*Other debt of the local government*	*1,777.4*	*2,056.2*	*2,487.6*	*278.8*	*15.7%*	*431.4*	*21.0%*
2.2.1.	Local government appropriated funds with legal personality	2.7	5.4	3.3	2.7	102.4%	-2.1	-38.8%
2.2.2.	Independent public health care institutions	1,709.1	1,989.1	2,428.6	280.0	16.4%	439.4	22.1%
2.2.3.	The local government institutions of culture	34.0	32.9	28.9	-1.1	-3.3%	-4.0	-12.1%
2.2.4.	Other local government legal persons	31.6	28.7	26.8	-2.9	-9.0%	-2.0	-6.9%

IV. CAUSES AND CONSEQUENCES OF THE INCREASE IN DEBT-TO-GDP RATIO

In recent years, the growth rate of public debt has been outpacing that of GDP. In accordance with forecasts presented in chapter III, this process will be gradually slowing down. Nevertheless, it is bound to result in the debt/GDP ratio entering subsequent prudential bands provided for in the *Public Finance Act* and approaching the constitutional limit of 60%.

IV.1. Regulations relating to the public debt in Poland and in the European Union

In the Polish legislation the main regulations relating to public debt have been laid down in:

1) the Constitution of the Republic of Poland – Article 216(5) bans contracting loans and granting guarantees and sureties resulting in the public debt exceeding three-fifths of gross domestic product;
2) *the Public Finance Act* – introduces definitions and specifies principles relating to public debt as well as regulates prudential and remedial procedures in case of exceeding subsequent debt/GDP threshold levels (50%, 55%, 60%).

According to the Act's provisions, public debt covers nominal debt of the public finance sector specified after consolidation, i.e. after eliminating financial flows between entities of this sector[5]. This debt contains liabilities due to 1) securities, 2) loans, 3) deposits, 4) matured payables (namely undisputed liabilities whose payment date has expired, and which have not been overdue or cancelled).

The Public Finance Act introduces prudential and remedial procedures aimed at preventing the constitutional limit from being exceeded. Due to risk generated by contingent debt, the limits set forth in the Act relate to the amount of public debt increased by anticipated payments under sureties and guarantees granted by public finance sector entities.

The Act provides for the following procedures:

1) <u>the ratio in year *x* is higher than 50%, and not higher than 55% of GDP:</u>
   a) a limit is imposed on the state budget deficit/state budget revenue ratio; in the draft Budget Act adopted by the Council of Ministers for the year x+2 this ratio must not be higher than in the year x+1,
   b) the deficit to revenue ratio, adopted in the State Budget Act for the next budget year, is the upper limit on the ratio of each local government unit's deficit to its revenue that may be adopted in the budget of such a unit.
2) <u>the ratio in year *x* is higher than 55%, and lower than 60% of GDP</u>:
   a) The Council of Ministers adopts the draft budget for the year x+2, accepting as the deficit's upper limit its level ensuring a decrease in the ratio of the State Treasury debt, increased by the anticipated payments under sureties and guarantees granted, to GDP as compared with such a ratio announced for the year x,
   b) the upper limit of the ratio of deficit of each local government unit to its incomes, which may be approved in the local government unit's budget, becomes reduced by means of its multiplying by coefficient "R", calculated as follows:

      $R = (0.6 - SPD/GDP) : 0.05$

      Where: GDP – gross domestic product, SPD - state public debt, increased by the amount of anticipated payments under sureties and guarantees granted by units of this sector, refer to figures announced for the previous budget year;
   c) The Council of Ministers presents a remedial programme ensuring a fall in the ratio of public debt, increased by the anticipated payments on account sureties and guarantees granted by public finance sector entities, to GDP.

[5] The public finance sector's scope (closed catalogue of units) has been also specified by the Act.

3) <u>the ratio in year x is equal to or higher than 60% of GDP:</u>
   a) The draft Budget Act for the year x+2 does not include the state budget deficit while the budgets of local government units are approved without containing the deficit,
   b) A ban on granting new sureties and guarantees is introduced for entities of the public finance sector,
   c) The Council of Ministers presents a remedial programme to the Parliament whose basic objective is to elaborate and implement actions aimed at reducing the public debt-to-GDP ratio below 60%.

In the European Union the main issues involved with public debt (*general government* debt) in the Member States are regulated by the following legal acts:

1) the Maastricht Treaty (Article 121) – the level of general government debt and restrictions relating to deficit constitute the criteria on the basis of which the Commission examines the observance of budgetary discipline in the Member States. The Commission evaluates whether the general government debt-to-GDP ratio does not exceed the base value, unless this ratio is decreasing to a sufficient degree and is approaching the base value at a satisfactory rate.
2) the *Protocol on the excessive deficit procedure* annexed to the Maastricht Treaty specifies: a) the base value of the public debt- to-GDP ratio at 60%, b) the general definition of debt.
3) Council Regulation on the application of the Protocol on the excessive deficit procedure, annexed to the Maastricht Treaty:
   a) provides a precise definition of the general government debt as a consolidated gross debt of this sector calculated according to the nominal value,
   b) specifies categories of financial liabilities constituting general government debt; these are:
      - currency and deposits,
      - securities other than shares excluding financial derivatives ,
      - loans,
   c) provides a definition of nominal value.

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

a) different scopes of the *general government* and the public finance sectors:
   - Open Pension Funds (OFE) are not included among the public finance sector (in accordance with the Public Finance Act), while they should constitute an element of the general government sector (negotiations with the EU in this respect are under way) [6],
   - The Agricultural Market Agency is an entity of the public finance sector, however it is not a part of the general government sector,
   - Research and development units included among the public finance sector are not general government sector entities,
b) a different scope of beneficial liabilities constituting public debt – unlike debt calculated in accordance with Polish regulations, debt calculated in accordance with EU regulations does not cover matured payables (in accordance with EU principles they are an expenditure on accrual basis).

In Poland, restrictions on debt limits relate to the public debt increased by anticipated payments under sureties and guarantees In the EU, the base values do not take into account contingent debt.

[6] Due to the general nature of ESA 95, that document does not take into account specific features of the pension system introduced in Poland. This is why if the Eurostat did not meet Poland's request for considering OFE as a part of the *general government* sector, TS making up a major share of their portfolios could not reduce public debt as a result of consolidation.

As a result of the listed differences, currently the public debt in Poland, according to the EU criteria (general government debt), is lower than that calculated in accordance with Polishlegal regulations.

IV.2. Reasons for the increase in debt-to-GDP ratio

The level of the debt-to-GDP ratio (debt in the broadest meaning, namely the public debt increased by anticipated payments under sureties and guarantees) is determined by three major elements:

1) the public finance debt level,
2) the anticipated payments under sureties and guarantees (contingent debt),
3) the nominal GDP level.

Ad 1) The fast growth rate of debt forecast for the coming years is determined, first of all, by borrowing requirements of the state budget, especially by the level of budget deficits.

Apart from that, as of 2004 on the outlays side of the state budget two new items will mainly appear:

- subsidy to Social Insurance Fund (FUS) for covering the loss of contributions to OFE (in an amount of PLN 11.4 billion in 2004 , and PLN 11.5 billion in 2005 and 2006, each), and
- prefinancing[7] (PLN 4.5 billion, PLN 2.2 billion and PLN 1.1 billion, respectively).

The debt growth will also result from:

- financing of the multi-role fighter aircraft programme through contracting liabilities,
- the level of local government units' deficit,
- the takeover by the State Treasury and conversion into TS of ZUS liabilities to OFE; the net effect of this operation will be the increase in the sector's debt mostly by the value of converted interest rate on these liabilities (at present this interest is not included in the debt),
- possible continuation of the existing trends in indebtedness of other entities of the sector.

Ad. 2) Anticipated payments under sureties and guarantees are a factor exerting considerable impact on the debt/GDP ratio. In accordance with the *Strategy of granting sureties and guarantees*, as of 2005 their annual level will account for up to 2% of GDP.

Ad. 3) The growth rate of GDP forecast for 2004-2006 will be outpaced by the debt growth, despite the assumed fast rate of economic growth. As a result, the debt-to-GDP ratio is bound to increase at the adopted assumptions.

IV.3. Consequences and threats of increase in the debt-to-GDP ratio

The fast growth rate of public debt may result in crossing subsequent debt/GDP thresholds within a horizon covered by the strategy. In case of unfavourable developments, the 55% debt to-GDP ratio threshold may be exceeded as soon as 2004.

Consequences of such a scenario will be the following:

1. Exceeding in 2003 of the 50% debt-to-GDP ratio means launching prudential procedures in 2004. The state budget deficit to the state budget revenue in 2005 may not be higher than the corresponding ratio in 2004. The above ratio will be the upper limit of the deficit of each local government unit to its incomes.
2. Exceeding in 2004 of another threshold (55%) would mean adopting by the Council of Ministers in the draft Budget Act for 2006 a deficit ensuring that the ratio of State Treasury

[7] Prefinancing of tasks implemented with involvement of funds from the EU budget means a necessity of financing certain actions with domestic funds, to be subsequently reimbursed by the EU. This is a significant amount, especially in the context of the common agricultural policy, since direct payments to production in the year "n" are financed with domestic funds, to be reimbursed only in the first quarter of the year "n+1".

debt increased by anticipated payments under sureties and guarantees to GDP would be lower than in 2004. This would mean that at the adopted assumptions in 2006 the state budget should be at least balanced. The ratio of each local government unit's deficit to its revenues will be then reduced in accordance with the *Public Finance Act* provisions. The government will also be obliged to present to the Parliament a remedial programme aimed at reduction of the debt level.

Factors influencing the rise in risk of exceeding subsequent thresholds include:

1. High sensitivity of the debt-to-GDP ratio:
   - to the exchange rate,
   - to changes in the level of deficit and net privatisation proceeds,
   - to the growth rate of GDP.
2. Lower than assumed privatisation proceeds..
3. Passing laws and carrying out operations which result in an increase in the public debt without taking into account their burden for public finance.
4. Considerable risk of uncontrolled contracting of liabilities by entities of the sector other than the State Treasury.

It should be pointed out that the possibility of financing high deficits and maturing debt largely depends on the degree of the financial market development and on demand coming from investors, including foreign investors, for whom the country credits risk (sovereign credit rating) is relevant. The outflow of foreign investors may result in difficulties with financing of borrowing requirements of the budget, in a rise of debt servicing costs in the following years and in disturbances on the currency market.

V. PUBLIC DEBT RISK ANALYSIS

Public debt management takes place in conditions of uncertainty concerning future values of many factors having their impact on decisions that are taken. This is why debt management is inseparately connected with risk management. In accordance with objectives laid down in the previous strategy, debt management is associated with preventing the risk from exceeding a level considered acceptable for implementation of strategy objectives: keeping debt at a safe level and minimisation of debt servicing costs in a long-time horizon rather than with risk minimisation.

This risk concerns in particular:

- The macroeconomic environment (e.g. the economic growth rate in Poland and in the world, the level of inflation, the world economy crises),
- The budgetary environment (e.g. the size of budget deficit in subsequent years, privatisation proceeds),
- The market environment (e.g. level of domestic and foreign interest rates in respective segments of the yield curve, exchange rates, demand for Treasury Securities),
- The institutional and legal environment (e.g. changes in the binding law, European integration, organisational framework of debt management).

The existence of risk results from both the public debt volume including contingent debt related to sureties and guarantees granted, and its structure. This refers to potential threats of not meeting the assumed objectives, i.e. keeping debt at a safe level and minimisation of debt servicing costs.

V.1. Risk related to public debt volume

There is no single debt level that would be generally accepted as safe in the theory of economy, or in the economic policy practice. Usually, a debt level is considered to be safe if it enables timely servicing and refinancing over a long period. This level depends on the size of the country's economy, hence a commonly applied measure of debt is to relate its absolute value to GDP.

The level of public debt relative to GDP which ensures its safe service depends on many factors, including: the level of economic development, economic growth rate, social and political stability, international relations, quality of public institutions functioning, level of inflation and interest rates, structure of the debt by instrument and entity, development of the domestic financial market, access to the international financial market. The lower the general level of the country's development, the higher the risk of disturbances in timely debt repayment and its refinancing. That is why financial markets require from such countries a successively lower debt-to-GDP ratio and a higher rate of return on capital financing public debt than from the developed economies.

Considerable risk involved with public debt size means a threat to achievement of the objective of keeping the public debt size at a safe level, with all its negative consequences. They include:

- a possible outbreak of a debt crisis involved with a partial or total loss of capacity to timely servicing debt,
- a threat that in the following years high borrowing requirements of the State due to refinancing of maturing debt and financing of high budget deficit will hit a financial market demand barrier, involving inability to finance borrowing requirements at reasonable costs,
- negative consequences of exceeding by the public debt-to-GDP ratio of 50% and 55%, thresholds provided for in the *Public Finance Act*, as well as the constitutional 60% limit, in particular including:
    - ➢ restrictions on the flexibility to structure the state budget, resulting from remedial procedures envisaged by the law, which may have an adverse result on development-oriented expenditures, including that for co-financing of aid funds from the EU budget, as well as the necessity to increase fiscal burdens, having a negative impact on long-term growth prospects,

- temptation to amend the law in order to ease the burden of restrictions associated with prudential and remedial proceedings, which may lead to downgrading of Poland's creditworthiness, as a consequence of higher costs of borrowing due to the required risk premium,

- negative consequences of exceeding by Poland the nominal convergence criterion, (the so-called Maastricht criterion) meaning, first of all, a postponement of Poland's planned accession to the Economic and Monetary Union,
- Poland's perception as an increased-risk country, including the downgrading (or lack of expected upgrading) of debt rating for Poland, which finds its reflection in a higher level of interest rates and, by the same token, higher debt servicing costs, and lack of access to a broader investor base,
- crowding out private companies in access to domestic savings, resulting from considerable borrowing requirements of the State and, as a consequence slower economic growth than possible, resulting from the lower than potential level of investment financed on credit terms,
- negative impact on the level of market interest rates and on efficiency of monetary policy. Considerable borrowing requirements of the State may keep interest rates at a level higher than the desirable one.

The public debt-to-GDP ratio in Poland is lower compared to this ratio of the EU, amounting to 62.3% (69.0% for the euro area). Nevertheless, since Poland is a country with lower creditworthiness, the debt level considered safe is correspondingly lower. In the case of Poland the debt-to-GDP ratio is higher than for most countries with a similar rating. A major threat here is the growth rate of debt. In 2002 the ratio of public debt increased by anticipated payments under sureties and guarantees, to GDP rose by 5.7 percentage points (4.4 percentage points according to EU methodology).

Despite sharp increase in the debt level, the risk of losing by Poland the capacity to timely servicing its debt is small. Such an assessment results from the domestic financial market potential, Poland's perception by investors as a part of an economic area characterised by higher economic and political stability (the effect of Poland's accession to the EU) and a consistently pursued policy of reducing risk related to its structure. Nevertheless, there is a real threat of other negative occurrences resulting from increase in the public debt volume. The growth rate of public debt recorded in the recent period makes the threat of inability to finance the rapidly growing borrowing requirements at reasonable more realistic cost.

Carrying out an effective public finance reform, especially of the expenditure side, towards reducing budget deficit, as well as creating conditions for stable economic growth is a condition for achievement of the first strategy objective, i.e. keeping public debt at a safe level.

V.2. Risk related to debt servicing costs

At a specified level of borrowing requirements of the State, the level of debt servicing costs, as well as the risk associated with their deviation from the expected value, results from the adopted structure of financing (i.e. types of debt instruments) and transactions on debt. The public debt instrument structure may also influence the level of debt itself.

Risks involved with public debt costs, posing a restriction to the costs minimisation objective, include:

a) domestic currency refinancing risk,
b) exchange rate risk,
c) foreign currencies refinancing risk,
d) interest rate risk,
e) state budget liquidity risk,
f) other risks, in particular credit and operational risks,
g) risk resulting from distribution of debt servicing costs over time.

Ad a) Domestic currency refinancing risk

Over the last couple of years the domestic currency refinancing risk remained at a similar, relatively high level. The average marketable debt maturity was 2.47 years at the end of 1999 and 2.82 years in mid-2003. An apparent upward trend of this indicator was recorded in the second half of 2002, which to a major extent was attributable to bonds switching auctions. The share of TS redeemable up to 12 months is relatively high. In mid-2003 it was 34.1%, which in absolute figures amounted to PLN 81.5 billion. With the growing size of domestic debt, keeping this indicator at a similar level means a considerable rise in refinancing risk.

In order to reduce refinancing risk it is required to change the debt structure to the benefit of instruments with longer maturity, at the same time limiting the role of short-term instruments. This usually happens at the expense of higher debt servicing costs, resulting from the risk premium for longer horizon of investment. It should be remembered that development of Treasury securities market is a long-term process. In Poland, it has been continuing since the early 1990s. With growing confidence in the issuer and growing demand from investors, the TS market expands into subsequent segments. Each new segment of the market was shallow and not very absorptive at first, but gained on importance over time. This process contributes to a decline in yield of long-term bonds, as well as to a lower volatility of their prices, this way providing conditions for reduction of refinancing risk.

In recent years, increased borrowing requirements of the State exceeded by far the absorptiveness of medium- and long-term market segments. As a result, despite a significant increase in debt in bonds with longer maturities, their share in debt was going up insignificantly, as a major share of financing still had to be based on Treasury bills and bonds with shorter redemption dates.

It should be assumed that further market growth will contribute to reduction of refinancing risk in the future, provided that the fast growth rate of debt is stopped. Deepening of the market will be facilitated by the broadening of investor base in connection with European integration. Then, the refinancing risk level will be the result of decision as to the level of costs worth incurring to diminish refinancing risk through long-term issues. If the fast increase in the volume of public debt is not stopped, in the medium-term perspective the domestic financial market may be unable to ensure safe refinancing of maturing debt, especially the threat of not meeting the Maastricht criteria will delay the date of Poland’s accession to the monetary union and of getting broader access to the European market.

Ad b) Exchange rate risk

Exchange rate risk is associated with existence within State Treasury debt of instruments denominated and settled or indexed to foreign currencies. In the present debt structure, a major share and, since the end of April 2004, the entire debt in foreign currencies results from foreign financing.

The current level of exchange rate risk of State Treasury debt is directly connected with the applicable exchange rate regime. Since April 2000, floating rate regime has been in use in Poland, which practically means that there is possibility of very strong fluctuations of exchange rates of particular currencies against the zloty. Exchange rate risk analysis in the case of strategy longer than one year should take into account not only the possibility of short-term exchange rate fluctuations, but also long-term trends in the exchange rate of the Polish currency, for which a gradual real appreciation against foreign currencies is projected.

It should be noted that in the nearest future it is not justified to completely eliminate the exchange rate risk, as this would also have negative consequences, such as a relative rise in debt servicing costs or growth of other risks.

Exchange rate risk in reference to foreign debt can be analysed in two basic approaches:

1) State Treasury debt level,
2) State Treasury debt servicing costs.

Exchange rate risk in the context of foreign debt level

In order to determine the exchange rate risk in this case it is relevant to find out the sensitivity of foreign debt level to fluctuations in exchange rates of foreign currencies, in which it is denominated. The overall level of this risk may be affected both by controlling the foreign debt level in nominal terms, and by appropriate structuring of this debt.

A single, simplified measure of the exchange rate risk has been in use so far, namely the share of debt denominated in foreign currencies in total debt. Poland's accession to the EU in 2004, will result in joining the exchange rate mechanism (ERM2). As a result, this will enforce stabilisation of the zloty exchange rate against the euro, within the framework of the adopted band of fluctuations. Hence, the share of debt denominated in euro in the total State Treasury debt is introduced as an additional measure of exchange rate risk.

The share of foreign debt in total debt fell from 59.1% at the end of 1999 to 34.0% in mid-2003. The share of liabilities denominated in euro in foreign debt went up from 33.7% towards the end of 1999 to 55.5% in mid-2003

Exchange rate risk in the context of foreign debt servicing costs

This approach indicates the sensitivity of foreign debt servicing costs to exchange rate fluctuations in respect to both the amount of payments in nominal terms and their currency. The nominal level of foreign debt servicing payments is insignificant compared to both that debt's level (some 3%) and total budget expenditures (some 2.4%, excluding guarantee payments).

Ad c) Foreign currencies refinancing risk

The average maturity of foreign debt and the amount of debt repayments falling due annually can be adopted as measures of this risk. In the case of average maturity of foreign debt it can be stated that it remains at a level similar to European standards, reaching some 6.0 years in mid-2003, with the average maturity of marketable debt being definitely higher and amounting to some 10.4 years. The average level of repayments in a given budget year within a horizon covered by the strategy is advantageous, since it remains at a level below €3.8 billion.

Ad d) Interest rate risk

Interest rate risk is a risk of a change in the value of payments for debt servicing, due to changes in interest rate levels. It stems from the necessity of refinancing the debt due to mature in the future at interest rates that are unknown and from the volatility of coupon payments against floating rate TS.

The interest rate risk is measured by duration. This ratio indicates the length of the average period of adjusting debt servicing costs to the change in level of interest rates. Thus, it is a measure of debt servicing costs sensitivity to interest rates volatility. The higher the level of interest rates and the larger the share of short-term and floating rate instruments, the higher the interest rate risk and the lower the duration.

In recent years the interest rate risk has diminished considerably. Domestic debt duration was 1.55 year at the end of 1999 and 2.32 years in mid-2003. The level of risk is still considered too high, and sensitivity of debt servicing costs to interest rate changes is considered too high. Development of the domestic TS market and Poland's increasing creditworthiness associated with planned accession to the EU, and subsequently to the Monetary Union, result in deepening of market segments with longer redemption periods. For this reason, market capacity will lose on relevance as a barrier to reduction of refinancing risk and interest rate risk through issuance of long-term fixed-rate bonds. This requires specifying a target level of acceptable interest rate risk, resulting from preferences as to the level of debt servicing costs and the risk involved with them. Irrespective of the yield curve shape, longer duration is always associated with a higher anticipated cost, due to the risk premium expected by investors lending assets for longer periods. In the EU Member States the duration ratio assumes significantly higher values, from about 2.7 years in Sweden, through some 3 years in Portugal and Finland, to about 7.2 years in the United Kingdom.

Interest rate risk in the area of foreign debt illustrates the share of floating rate liabilities and liabilities maturing within a year, to be refinanced at current interest rates, in the total debt portfolio. In mid-2003, the share of these liabilities was 43.1% (of which 40.2% at floating rate).

Nevertheless, the interest rate risk is limited by two factors. The first of them is the average maturity of foreign debt, i.e. the period in which interest on newly-contracted liabilities is set to refinance maturing debt. Thanks to that, foreign debt is to a considerable extent immune to interest rate risk. Reduced interest rates within the Paris Club are another stabilising factor.

Interest rate risk is being gradually reduced by contracting new, mostly fixed-rate liabilities. There are also cases of applying other solutions, such as agreements restricting future growth of interest rates or setting them in advance.

Ad e) State budget liquidity risk

Holding liquid financial assets at the state budget account and opening short-term deposit accounts with the NBP for surplus assets are the main instrument of state budget liquidity management. The level of these deposits guarantees safety of financing of the State's borrowing requirements and makes the state budget immune to interim crises which prevent or render ineffective the raising of funds by borrowing on the financial market.

The liquidity risk management consists of two types of actions:

- striving to keep a safety reserve at the possibly lowest level - this is helped by improving the process of planning and monitoring state budget liquidity, building adequate infrastructure and organisational solutions, including planned introduction of a single state budget account and possibility of online monitoring of budgetary units accounts. This shall reduce costs arising from the necessity to keep a larger stock of liquid reserves and the potential risk of liquidity shortage in case of emergency.
- managing liquid assets, which should generate budget revenue in order to counterbalance, to the biggest extent, the costs involved with maintaining a specified, safe level of liquidity – it is recommended to extend the scope of applied instruments into deposits with commercial banks and possibility to engage in other money market operations. The interest rate on deposits with the NBP, being a revenue of the state budget, simultaneously reduces NBP risk and the level of payment from profit paid to the state budget.

Ad f) Other risks

Other risks include all not yet mentioned sources of uncertainty related to public debt management, the safe level of which constitutes a barrier to the objective of minimising the expected costs of debt servicing. The most important risks in this category are the credit risk and the operational risk.

In view of transactions on derivative instruments planned for the future, credit risk reduction will be contributed to by defining a list of entities allowed to become partners of transactions, as well as limits to involvement quotas, depending on risk associated with a given kind of transactions. It is also indispensable to provide organisational and technological facilities for monitoring the market value of transactions and swift reactions to changeable market conditions.

The constantly growing complexity and sophistication of public debt management instruments and the continuing European integration will also require adjustments of the institutional and organisational structure of debt management, with a view to reduce operational risk and adjust organisational structures to current requirements. This should be accompanied by permanent development of debt management methodology. Application of the so-called benchmark portfolio to assessment of the volume and structure of debt has become a noticeable trend in developed economies.

Ad g) Distribution of debt servicing costs over time

Debt servicing costs should be evenly distributed over time, so that their volatility did not have a destabilising effect on state budget structuring. In the budgetary accounting system on a cash basis cost stabilisation over time is positively affected by avoiding issues of securities subject to high discount, which becomes a cost upon redemption of securities. In the coming years, a part of increased debt servicing costs will result from a high discount on maturing 5-year bonds, issued at the turn of centuries. Active management of distribution of debt servicing costs over time is possible and recommendable. Bonds switching and buy-back auctions, which have been in use since 2001, are instruments adding to flexibility of cost distribution structuring.

In the future, application of derivative instruments, including interest rate swaps, may also contribute to this purpose.

V.3. Risk related to sureties and guarantees granted and other operations of the sector

Risk of a dual kind is involved with guarantees and sureties granted by entities of the public finance sector including, in particular, those granted by the State Treasury. The amount of anticipated payments under guarantees and sureties adds to the value of public debt, due to increase in the total amount of guarantees and sureties or in probability of their execution. Hence, it may pose a threat to achievement of the first strategy objective. On the other hand, the whole of paid out guarantees and sureties is the debt servicing cost.

The so-far activities of the State Treasury in the field of sureties and guarantees do not pose threats to public finance. Nevertheless, the risk associated with guarantees and sureties granted by the State Treasury has increased recently. This has been largely due to a broad application of these support instruments, in particular to these sectors of the economy which require restructuring, and at the same time are characterised by a high financing risk. As a consequence, the amount of anticipated payments under sureties and guarantees and their ratio to GDP went up (from 1.29% in 2001 to 1.57% in 2002).

In order to reduce the risk associated with granting guarantees and sureties State Treasury, without losing advantages of their application as an economic policy instrument, it is required to:

- concentrate the granting of sureties and guarantees on support for development-oriented investment in infrastructure and implementation of environmental protection projects, first of all those carried out with support of EU funds (loans and bonds secured or guaranteed by the State Treasury should attract a multiple worth of EU funds),
- determine limit of the ratio of anticipated payments under State Treasury guarantees and sureties to GDP,
- limit the role of sureties and guarantees granted under special “sectoral” laws, which are particularly risky for the State Treasury;
- depart from the practice of granting State Treasury sureties and guarantees to support traditional sectors of the economy.

The so-called off-balance sheet transactions, especially securitisation, may become an additional source of risk. When placed on the market, liabilities originating from the public sector will compete with liabilities financing the borrowing requirements of the budget, this way stimulating growth of debt servicing costs and absorbing a part of investors’ demand. Namely, it should be remembered that the debt size the market is able to absorb without disturbances is limited. The analysed liabilities, even if not accounted for as public debt under the binding regulations, would pose an economically equivalent burden. Namely, even if it is not indicated by contractual obligations (of a guarantee kind) there is a risk of the State Treasury being required to cover commitments arising from debt that originates from the mentioned operations.

VI. IMPACT OF POLAND'S ACCESSION TO THE EU ON PUBLIC DEBT MANAGEMENT

Integration with the EU will be a process of much relevance for public debt managers and will have a major impact on:

1. Conditions of debt issue on the domestic market and on the international capital market, including:
   - Poland's perception on international financial markets,
   - development of domestic Treasury Securities market.
2. Trends in borrowing requirements of the state budget and of local government units, in connection with financial flows resulting from EU membership.

VI.1. Conditions of debt issuance on the domestic market and on the international capital market

For the TS market and for external conditions, in which public debt management takes place, Poland's membership in the EU will be of serious relevance. On the one hand, integration of the Polish financial market with the EU market provides an opportunity for getting access to new groups of investors and, on the other hand, Poland as an issuer will have to cope with the competitive pressure from other issuers. The experience of states which at the moment of joining the EU represented a similar stage of economic development indicates that only countries with well-organised, liquid and transparent TS markets can effectively compete with other issuers.

The impact of integration with the EU will be particularly significant in the following areas:

Poland's perception on international financial markets.

- Accession to the EU will mean a better perception of Poland on international financial markets. This will contribute to a cut in costs of acquiring foreign currency funds by the State Treasury, as well as costs of financing borrowing requirements on the domestic market (further convergence of TS interest rates on the domestic market to the yield level on EU markets).
- Poland's improved perception on international financial markets will significantly influence the reduction of the refinancing risk in zlotys and in foreign currencies. This is of particular importance for implementation of the programme of refinancing repayments of foreign debt falling due in the years 2004-2009. Poland's position as an issuer from the EU area will result in getting access to new groups of institutional investors preferring investment in securities of issuers with stable development prospects.
- Other domestic entities will also gain a facilitated access to international financial markets (especially the euro market).

Increase in depth and liquidity of the domestic TS market and adjustment of the TS market infrastructure to standards applicable in the EU.

- Integration with the EU will require legal and organisational changes associated with introduction of the principle of equal access of residents and non-residents to the financial market in Poland. The abolishment of restrictions will result in extension of the retail and wholesale investor base on the primary and secondary markets.
- Integration with the European market of government securities will give rise to changes in the entity structure of the Primary Dealers system. The intensification of international banks' activity will find its reflection in their involvement in the primary TS market.
- Growing interest in the Polish TS market on the part of foreign investors will contribute to a rise in liquidity and depth of the secondary TS market.
- Further increase in the share of non-residents in the structure of debt maybe the consequence of the integration process and abolishment of restrictions.

The Programme of actions adjusting the domestic TS market to standards applicable in the EU countries should cover the following elements:

a) development of a liquid, transparent and effective secondary TS market, including:

- policy of issuing large, liquid benchmark,
- a set of instruments adjusted to growing complexity of debt management and investors' needs,
- integration of the Primary Dealers system and the technical and settlement infrastructure with EU markets,

b) methodological studies on developing an integrated debt management system.

These actions are covered in detail in chapter VII, relating to strategy objectives in a three-year horizon.

VI.2. Financial flows associated with the EU membership

Poland's membership in the EU will be associated with financial flows of high value , both received and paid by Poland. In the period covered by this strategy Poland will be one of the net beneficiaries. This will mean a positive balance of flows on condition of utilisation of facilities offered by the EU within the accession aid.

Flows associated with integration with the EU in a horizon determined by the Strategy will relate to:

Payments from the state budget to the EU:

- Payments of contributions to the EU system of own resources. These payments will be made in zlotys, which eliminates the need for obtaining funds in euros on the market.
- Membership fees paid for participation in EU institutions.

Aid funds from the EU:

- Payments from the EU within the framework of the Common Agricultural Policy (CAP). They cover direct payments, agricultural market interventions, rural development programmes.
- Payments for the so-called cash flow facility for budgetary compensation. This instrument is to alleviate negative consequences for the state budget resulting from mismatch in timing for making contributions to the EU budget and receiving EU aid funds.
- Payments for the so-called Schengen financial facility (support for external border adjustments).
- Payments from the Cohesion Fund and from EU structural funds for implementation of specific programmes. As is the case with pre-accession funds, the assets obtained from these funds will be deposited on separate accounts with a view to implementation of specific programmes.
- Payments for the pre-accession programmes implemented so far within the framework of PHARE, ISPA and SAPARD aid funds (due to shifts in timing associated with procedures of launching and implementation of these programmes, the programmes launched prior to accession to the EU will be implemented in the early years of membership).

Table 5 presents projections of financial flows and Poland's net position.

Table 5.

current prices (PLN billion)

Estimates of actual transfers between the EU budget and Poland				
	2004	**2005**	**2006**	**2004-2006**
Payments from the EU budget				
1. Agriculture	0.55	7.18	9.34	17.07
2. Structural Funds and the Cohesion Fund	4.21	8.44	10.18	22.82
3 Schengen financial facility	0.44	0.44	0.45	1.33
4. Cash flow facility for budgetary compensation	2.11	2.61	2.17	6.89
5. Pre-accession funds	6.34	4.12	3.24	13.69
Projected payments from the EU budget, total	13.64	22.79	25.37	61.81
Poland's payments to the EU budget associated with integration				
Contributions to the system of own resources Membership fees for participation in EU institutions	6.29	12.06	12.81	31.16
Net	**7.36**	**10.73**	**12.57**	**30.66**

Transfers of funds involved with the integration process will, due to their scale, have a strong impact on debt management. This impact will relate to areas associated with:

a) borrowing requirements of the state budget and of local government units,

b) maintaining current liquidity of the state budget,

c) management of the state budget foreign exchange liquidity.

VII. DEBT MANAGEMENT STRATEGY OBJECTIVES IN THE YEARS 2004-2006

The strategy objectives are the following:

1. **Keeping the volume of public debt at a safe level.**
2. **Minimisation of debt servicing costs within a longer time horizon with the accepted limitations concerning the level of:**

a) domestic currency refinancing risk,
b) exchange rate risk,
c) foreign currencies refinancing risk,
d) interest rate risk,
e) state budget liquidity risk,
f) other risks, in particular credit risk and operational risk,
g) debt servicing costs distribution over time.

Ad. 1) <u>Keeping the volume of public debt at a safe level</u>

In the context of this objective, *debt management* is understood in broad meaning as one of the economic and financial policy objectives of the government. In the previous Strategy, a safe level was considered such a debt volume which does not have a substantial, negative impact on the country's macroeconomic situation, does not cause difficulties with structuring the budget and does not exceed the limits imposed on the debt level by the *Public Finance Act*. The 2003 debt increase associated mostly with the high state budget deficit and low privatisation proceeds will result in exceeding by the public debt of the first threshold envisaged by the *Public Finance Act* at the end of 2003. At the same time, the level of deficits consistent with forecasts presented a year before has not been maintained for the coming years, and new categories of outlays have emerged. Consequently, the statutory debt to-GDP ratio will approach the level of 55% in 2004, and 60% in 2005-2006.

In this situation, the social and economic policy of the government becomes of particular significance. This policy is aimed at GDP growth, the public finance system reform and rationalisation of expenditures, including cuts in expenditures on purposes other than development-oriented programmes. Actions towards implementation of the objective of keeping the debt at a safe level will involve:

- Limiting the level of state budget deficits in subsequent years mostly through:
  - stable increase in revenues resulting mostly from an accelerated GDP growth rate,
  - keeping expenditures at a level correlated with the financial situation of the state, so that their growth rate is lower than that of GDP;
- public finance reform through the implementation of a comprehensive programme of changes to allocation of budgetary funds. This should allow for the possibly biggest absorption of EU funds allocated for implementation of development programmes;
- Limiting new sureties and guarantees granted only to support for investment in infrastructure, including projects co-financed by the EU (this means to a major extent the necessity to limit the activities towards restructuring traditional sectors of the economy). „The Medium-term Strategy of Granting State Treasury Sureties and Guarantees until 2010." adopted by the Council of Ministers assumes that the ratio of anticipated payments of State Treasury under sureties and guarantees to GDP should not be higher than 2.0%. The Strategy also provides for stricter criteria of examination of applications for sureties and guarantees from the point of view of reducing financial risk for the budget and restricting possibilities for granting sureties and guarantees under special acts .
- Checking the process of debt growth in the public finance sector outside of the State Treasury and local government units.

Ad. 2) Minimisation of debt servicing costs within a longer time horizon given the assumed constraints - this objective is defined in two meanings:

- minimisation of the costs within the horizon specified by the redemption dates of instruments with the longest maturities and substantial share in the debt (currently 10 years) - through the optimal selection of debt management instruments, their structure, and dates of issue,
- minimisation of the service costs as permanent actions improving the TS market efficiency, including its adjustment to EU government issuers' standards.

The minimisation of debt servicing costs should be done under the assumption of financing the state budget borrowing requirements, also covering funds for financing contributions to the EU budget, co-financing and prefinancing of aid programmes. Implementation of this objective will take place under the assumption of limitations involved with the debt structure. Within the risk constraints the following was assumed:

a) *domestic currency refinancing risk*
   - increasing average maturity of the debt - at a rate depending on the market situation,
   - striving at an even distribution of payments deriving from debt serviced and redeemed in successive years,
   - reducing the share of Treasury bills in domestic debt,

b) *exchange rate risk*
   - maintaining the principle of obtaining funds from debt issuance on the foreign market mainly to refinance maturing foreign debt,
   - disbursement of loans granted by international financial institutions (IFI) as one of budget deficit financing sources, in the field of investment and restructuring projects, as well as for co-financing and prefinancing of funds from the European Union,
   - making use of other non-market sources for financing of selected projects being important from the point of view of the state,

c) *foreign currency refinancing risk*
   - taking into account current dates of foreign debt maturity when contracting new debt in currencies other than euro,

d) *interest rate risk*
   - an increase in domestic debt duration at a rate depending on the market situation, including demand for fixed-rate medium- and long-term Treasury bonds and a further interest rates convergence,
   - further reduction of interest rate risk for foreign debt through contracting most new liabilities at a fixed rate.

e) *state budget liquidity risk*
   - state budget liquidity at a safe level given effective management of liquid assets,
   - further development of the management system of the state budget foreign currency liquidity in order to ensure payments in foreign currencies, including foreign debt servicing,

f) *other risks* - transactions with domestic and foreign entities with the highest creditworthiness and limitation of operational risk related to technical infrastructure and debt management structure,

g) *distribution of debt servicing costs over time* - reduction of volatility of the debt servicing costs to GDP ratio, including :
   - a fall in the domestic debt servicing costs to GDP ratio in the subsequent years as a joint result of the fall in interest rates at the domestic market and speeding up GDP growth (elements contributing to a fall in the costs/GDP ratio), and of debt increase (an element contributing to a rise in this ratio). Even distribution of debt servicing costs will be positively affected by transactions on domestic debt and sale of medium- and long-term bonds with service costs evenly distributed over time,
   - in the case of foreign debt, the practice of avoidance of contracting high-discount debt will be continued. With budgetary accounting on a cash basis this would mean sharp,

one-off increases in costs at the redemption date. The existing debt structure is characterised by a distribution of cost over time, which is known in advance and their level will depend on interest rate changes and on the structure of newly-contracted liabilities. However, one should reckon with a rise in these costs over refinancing of maturing liabilities at reduced interest rates with liabilitiescontracted at market rates.

VIII. TASKS OF THE STRATEGY IN A THREE-YEAR HORIZON

The following should be considered the most important tasks of the strategy resulting from the implementation of the adopted objectives:

1. Adjustment of the domestic Treasury Securities market to the EU standards (through increasing its liquidity, efficiency, and transparency).
2. Further development of the Primary Dealers system.
3. Development of a system of state budget liquidity management.
4. Continuing the conversion of non-marketable debt to marketable instruments.
5. Development of the system of retail instruments sales.
6. Financing of foreign debt repayments with the cost minimisation and risk reduction objectives taken into account.
7. Premature repayment of selected foreign debt components.
8. Coordination of foreign debt management with other foreign currency flows.
9. Reduction of debt level issue on the domestic market through utilisation of funds from International Financial Institutions (IFI) for financing selected budgetary items.

1. Adjustment of the domestic Treasury Securities market to the EU standards (through increasing its liquidity, efficiency, and transparency)

Feedback effects between the primary and the secondary market of Treasury Securities demand care for the efficiency of the two markets. Markets are efficient if they are liquid and transparent. The liquidity of the secondary market significantly affects the level of prices on the primary market while the structure and level of the securities offered on the primary market affect, in turn, the liquidity of the secondary market. The liquidity of the securities market has a direct effect on debt servicing costs and, due to investors' preferences, on possibilities of financing the borrowing requirements. The endeavours aimed at improving the efficiency of the securities market are a permanent task for any debt manager. The necessity of taking up actions to improve attractiveness of the TS market becomes of special relevance in the context of Poland's financial market integration with markets of the EU Member States. They will be implemented in areas related to:

- Continuation of the TS issuance policy, which consists in limiting the number of bonds issues, with a simultaneous increase in their value to an equivalent of at least €5 billion. This is contributed to by changes to the TS issuance calendar, bonds switching auctions and supplementary non-competitive auctions.
- Development of an electronic platform for TS trading. The Ministry of Finance has commissioned organisation and administration of the electronic platform to the CeTO S.A. company. In the area of developing electronic TS trading, actions oriented towards full integration of the electronic platform with its European counterparts are planned to be implemented.
- Improvement of the TS market infrastructure through efforts to eliminate barriers of technical and legal nature and in the clearing infrastructure. In the field of primary market organisation, it is planned to introduce a system of electronic transfer and processing of bids for T-bills and T-bonds at auctions. This will allow to shorten duration of auctions and, by the same token, to reduce the risk of changing market conditions. Many improvements and new solutions relating to the bonds clearing system were implemented by the National Depository for Securities (KDPW) in 2001-2002. This relates to multi-batch settlements, recording and clearing procedures for repo and buy-sell back transactions or the RTGS (real time gross settlements). However, from the point of view of the Treasury Securities issuer and the market, the efficiency of the introduced implementations is still inadequate especially in the field of the loan market, or the RTGS system. Also an adequate policy of reducing charges collected by the National Depository of Securities is needed, to encourage development of respective market segments. Creation of conditions for co-operation in the area of securities clearing with the European systems of settlements (such as Euroclear and Clearstream) thus enabling large foreign investors to settle transactions in a familiar environment is a

major component resulting from the experience of countries which have completed full integration with the financial market of the euro area.

2. Further development of the Primary Dealers System

The Primary Dealers System started operation on January 1, 2003. The access to the primary market has been restricted to 12 banks having obtained the Primary Dealer status, and to state banks. At the same time, January 1, 2003 marked the start of a procedure for selecting Primary Dealers for 2004.

Another stage of development of the Primary Dealers System will be to allow foreign banks to the competition procedure. The date of opening the system to foreign banks should be conditioned by effective co-operation between institutions supervising the banking system in Poland and similar institutions in other countries.

Apart from increasing the transparency and liquidity of TS market, the Primary Dealers System will allow for a more efficient co-operation with banks in the field of the issuance policy, switching and buy-back of Treasury Securities, as well as budget liquidity management (deposits, repo transactions).

3. Development of a state budget liquidity management system

Introduction of an integrated state budget account (at the beginning of 2005), which will provide complete information about the balance of total budgetary funds available at day-end will be an element improving the efficiency of the state budget liquidity management. Further actions should be aimed at combining all the accounts of all the budgetary units into a system operating online.

The scope of liquidity management instruments is assumed to grow wider – at the first stage by adding deposits in commercial banks. This will become possible once the banking sector's overliquidity is eliminated, procedures for co-ordination of the Ministry of Finance and the NBP actions are prepared, as well as technical and legal solutions are in place.

At a later stage, the set of liquidity management instruments should be extended as the Polish financial market keeps developing.

4. Continuing the conversion of non-marketable debt to marketable instruments

The conversion of the domestic non-marketable to marketable debt will apply to non-marketable bonds and ZUS (Social Insurance Institution) obligations deriving from overdue contributions to OFE (Open Pension Funds) taken over by the State Treasury. The operation of conversion of liabilities to OFE taken over from ZUS into marketable bonds will be continued in the years 2003-2007, and its start is scheduled for the fourth quarter of 2003.

In reference to non-marketable bonds, there is a possibility of actions aimed at further reducing their share in total debt through continuing of transactions of premature redemption and conversion into marketable debt. Nevertheless, these actions are conditioned by the budget situation in terms of liquidity in at least one-year's horizon, and by the market situation (including the level of interest rates and demand for TS).

5. Development of retail instruments sale system

The system of retail bonds sale, addressed mostly to natural persons, has been considerably revised as of August 1, 2003. These changes result, first of all, from the change of the issuing agent. It will result in a substantial increase in bonds availability through increasing the number of customer service outlets selling retail bonds, and through launching new forms of sale. After having introduced online bonds sales in 2000 (as the fourth country in the world), Poland again is implementing solutions, which have not yet been adopted by other states. In August 2003, bonds sales by telephone orders were launched (apart from Poland, sales by telephone orders have been introduced only in the United Kingdom).

The acceptance of the function by the new issuing agent also involves remote management of bonds by introducing an online register of bonds' buyers, which allows to shorten procedures related to handling bonds, what is advantageous for both the State Treasury and investors.

The scope of buyers entitled to purchases of retail bonds on the primary market has been extended since August 1, 2003 as well. Retail bonds, except saving bonds, can be bought by natural persons, legal persons and companies without legal personality except banks, insurance companies, investment funds, pension funds, brokerage houses, limited liabilities companies

and joint-stock companies. Before that retail bonds on the primary market could be purchased only by natural persons. Restrictions on sales of saving bonds to non-residents will be abolished after accession to the EU.

6. Financing of foreign debt repayments with the cost minimisation and risk reduction objectives taken into account,

Smooth financing of foreign debt repayment will cover:

- Continuation of trends towards refinancing principal repayments on maturing foreign debt with debt issuance on foreign markets, through the so-called structural financing, i.e. by issuing liabilities with at least three-year maturity. The issuance policy will also assume creation of Poland's yield curve on the euro market prior to Poland's accession to the monetary union.
- Utilisation of certain funds associated with transfers from the EU and continuing use of privatisation proceeds within the state budget's currency liquidity management system development.

7. Premature repayment of selected foreign debt components

It is fully justified to continue operations of premature redemption of selected components of foreign debt, with a view to achieve financial benefits by the State Treasury, and to improve foreign debt parameters. Their repayment will provide the following advantage for the State Treasury (these effects may occur separately or jointly):

- reduction of the nominal public debt level; improvement of the debt/GDP ratio – in case of debt repayment with discount,
- reduction of current interest costs of debt servicing – in case of refinancing the operation with liabilities involved with a lower current cost of debt servicing,
- reduction of debt-related risk, including risk refinancing, interest rate risk, exchange rate risk – through an appropriate choice of refinancing sources.

8. Coordination of foreign debt management with other foreign currency flows

Transactions on foreign debt should be closely coordinated with other "quasi-budgetary" currency flows (i.e. linked directly or indirectly to the public sector, e.g. certain kinds of flows from the EU), so as to minimise their negative effect on the economic situation of Poland. In particular it is to counteract unjustified changes of the zloty exchange rate and provide for effective disbursement of foreign currencies flowing into Poland, and at the same time to consolidate them within the state budget's currency liquidity management system.

9. Reduction of debt level issue on the domestic market through utilisation of funds from International Financial Institutions (IFI) for financing selected budgetary items.

Disbursement of long-term loans from international financial institutions (IFI), in particular from the European Investment Bank, the World Bank and the Council of Europe Development Bank will allow to reduce the level of debt issuance on the domestic market. It is assumed that these funds will be to a growing extent used for co-financing of EU funds, financing of infrastructure investments and restructuring projects, as well as for prefinancing.

IX. NEW INSTRUMENTS OF IMPLEMENTING THE STRATEGY OBJECTIVES

The basic instruments of implementing the strategy objectives and tasks cover: decision making procedures, debt instruments, operations on debt components, as well as legal/organisational instruments. New elements are related to development of the market, improvement in technical infrastructure, and progress in the field of debt management methodology. The following should be included among the most important items:

1. IT system for public debt management – the system's implementation (scheduled to be completed in September 2003) is supposed to enable:
- automation of the process of entering and aggregating data within an integrated base,
- on-going debt structure analysis and risk management,
- adoption of simulation methods in debt management.

Introduction of an IT system with a standardised data base will reduce the operational risk related to debt management. Further development of the system will be implemented on an on-going basis, providing for its technological adjustment to requirements resulting from development of the domestic financial market .

2. Implementation and development of optimising methods and techniques to support debt management

Own optimising methods and techniques are being developed along with standard risk analysis and simulation methods. These works will be continued and put to practical use.

3. Legal/organisational solutions, of which mostly amendment of the Public Finance Act to enable, inter alia:
- disbursement of EU funds,
- more efficient management of state budget liquidity,
- adjustment of accounting methods to the specific features of operations on derivative instruments.

4. Derivative instruments for more efficient and flexible risk and cost management (mainly swaps). Transactions on derivative instruments are supposed to enable:
- management of interest rate, exchange rate and refinancing risks related to debt structure, by changing its characteristics,
- management of liquidity by adequate shaping of cash flows related to debt servicing costs and principal payments.

5. New instruments of state budget liquidity management - there are plans for investing free state budget funds in a form of deposits with banks having a Primary Dealer status.

6. New debt instruments to be introduced, depending on the situation in the financial market, the needs of investors, and compliance with strategy objectives. Such instruments can be applied to retail and wholesale market.

Apart from that, due to entering the first year of the period, referred to in previous Strategies as foreign debt repayment peak, all instruments making up the State Treasury foreign debt management system have been presented.

Basic foreign debt management instruments cover:

1. Structural financing instruments:

a) Issues of benchmark-type fixed-rate bonds with a single redemption date, on three major markets: the euro, the US dollar and the Japanese yen. The final amount of particular issues should be sufficiently big to secure appropriate liquidity, which can be obtained by means of subsequent increasing the original issue. From the strategic point of view it is important to maintain continuous access to three above-mentioned markets being the largest sources of capital, so that in case of deterioration of issuance conditions on one of these markets the other two could be used without difficulties. With continuous access to three above-mentioned markets being maintained, the main criterion for choosing one of them should be the present cost of capital.

b) Loans from international financial institutions (IFI), in particular from the European Investment Bank, the World Bank and the Council of Europe Development Bank. These funds will be basically spent on financing infrastructure investments and restructuring projects. Although the cost of capital acquisition from that source should be taken into account, it is not the decisive criterion for its disbursement. Equally important is the access to expertise of credit institutions, as well as supervision of financed projects and introduction to application of the so-called best available practices and international standards. Access to IFI credits (especially from EIB) makes it easier to obtain EU funds for financing of projects.

c) Non-standard sources of financing specific projects, e.g. in the field of national defence. It should be mentioned here, in the first place the financing system of the F-16 multi-role fighter aircraft purchase programme. In the case of this financing source the appropriation of funds cannot be autonomously decided by Poland (as is the case with IFI loans). Intra-governmental nature of this system is also its specific feature.

d) Other types of debt instruments – a whole range of debt instruments issued in all acceptable currencies, e.g. private issuance motivated exclusively by capital cost minimisation criterion, provided that the assumed risk level is met (the so-called opportunistic financing).

Since 2004 amounts exceeding the equivalent of €3 billion (in the case of maturing liabilities refinancing) will be obtained on the foreign market annually (in the case of maturing liabilities refinancing), and are to reach their peak in 2008 (€4.2 billion euro). This means that at least two to four market borrowing operations of a structural type will be required annually.

2. Support instrument for state budget currency liquidity management:

State budget's currency liquidity management operations provide for short-term bridge financing by the time of receipt of planned privatisation proceeds or emergence of favourable conditions which enable a structural type debt issuance. In the present situation this will also allow to minimise debt servicing costs, due to disparity of domestic and foreign short-term interest rates.

In the years covered by the strategy, a system will be in use consisting of a special revolving credit and the Ministry of Finance foreign currency account with the NBP. This account will be used for temporary depositing of foreign currency proceeds from privatisation and from foreign debt issuance.

In the future, this system may be extended when new instruments and opportunities emerge.

3. Conversion of liabilities

Transactions of direct conversion from one kind of liabilities to another should be used when there are no possibilities of debt redemption against cash. Namely, other countries' experience shows that in developed markets debt conversion is less effective and financially efficient than operations of debt early redemption against cash.

4. Instruments changing debt characteristics

Apart from the mentioned three types of instruments, derivative instruments may be applied if this is indicated by foreign debt management needs and possibilities.

X. FORECAST OF DEBT VOLUME AND DEBT SERVICING COSTS

The presented forecasts result from solutions adopted in the strategy and from implementation of its objectives. Domestic debt servicing costs are presented within certain brackets, as with the adopted macroeconomic assumptions they may vary depending on the TS selling structure and on transactions on debt components.

Table 6.

	2002	2003	2004	2005	2006
1. State Treasury debt					
a) PLN billion	327.9	371.4	425.7	492.0	534.9
b) relative to GDP	42.5%	46.1%	49.4%	53.1%	53.3%
2. Public debt					
a) PLN billion	352.6	400.7	456.5	530.1	576.0
b) relative to GDP	45.7%	49.8%	53.0%	57.2%	57.4%
3. Public debt increased by anticipated payments under sureties and guarantees					
a) PLN billion	364.7	414.7	472.5	549.0	596.2
b) relative to GDP	47.2%	51.5%	54.8%	59.3%	59.5%
4. State Treasury debt servicing costs					
a) PLN billion	24.21	26.11	26.99	29.12-29.62	30.12-30.72
b) relative to GDP, of which:	3.14%	3.24%	3.13%	3.14-3.20%	3.00-3.06%
- domestic debt	2.65%	2.67%	2.44%	2.35-2.40%	2.25-2.31%
- foreign debt	0.48%	0.57%	0.69%	0.80%	0.75%

Table 7.

	2002	2003	2004	2005	2006
General government debt (acc. to the EU methodology)					
a) PLN billion	321.3	360.4	409.9	475.7	514.4
b) relative to GDP	41.6%	44.8%	47.6%	51.4%	51.3%

XI. INFLUENCING THE PUBLIC FINANCE SECTOR DEBT [8]

XI.1. Legal regulations

The Minister of Finance has no direct powers to affect contracting of financial liabilities by public finance sector entities other than the State Treasury. Regulations, contained first of all in the *Public Finance Act*, only provide a general framework for liabilities contracted by them. With an exception of provisions on non-observance of financial discipline the Act virtually does not envisage any sanctions. It mostly regulates the influence of the Minister of Finance on debt contracting by local government units.

Provisions of the *Public Finance Act* related to contracting of liabilities by other public finance sector units can be divided into two groups:

1) restrictions on purposes, type and size of debt,

2) opinion-giving and informative regulations.

Ad. 1) Restrictions on purposes, type and volume of debt

- local government units may contract loans and issue securities only for specific purposes indicated in the act;
- debt contracted by local government units to cover budget deficit arising over a year must be repaid within the same year in which it was contracted;
- service costs of long-term liabilities contracted by other sector units (including local government units) must be incurred at least once a year, and the discount on issued securities must not exceed 5% of the face value; capitalization of interest is not allowed;
- other public finance sector units (including local government units) may contract only such financial liabilities, whose nominal value expressed in zlotys was determined on the day of concluding the transaction;
- the total amount of local government unit's debt servicing costs and principal repayments falling due in a given budget year must not exceed 15% of revenues of a local government unit planned for the budget year; in case the total amount of public debt increased by anticipated payments under sureties and guarantees granted exceeds 55% of GDP, the above mentioned ratio must not exceed 12%;
- the total amount of local government units' debt at the end of a budget year must not exceed 60% of revenues of that unit in that budget year.

Ad 2) Opinion-giving and informative regulations

- in case a local government unit applies for loan or intends to issue securities, on its request the regional chamber of audit (RIO) issues an opinion on its ability to repay that debt;
- RIOs present opinions concerning possibility of financing the deficit by local government units and on correctness of local government units' debt forecast annexed to its budget;
- entities being state legal persons draw up financial plans which, upon their adoption or approval by a body specified in regulations are submitted to the Minister of Finance within 14 days since their adoption or approval.

Legal regulations in the field of contracting liabilities by other public finance sector units are also laid down in laws upon which these entities have been established. Some of them clearly imply a threat of an increase in debt, especially of the State Treasury and local government units, as a consequence of taking over debts of entities supervised (managed) by them. Such a situation occurs in the case of:

- independent public health care institutions (SPZOZ) – liabilities and assets of a SPZOZ after its liquidation become liabilities and assets of an appropriate supervising (managing) body; the currently binding legal regulations do not allow for a bankruptcy of an independent public health care institution;

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[9] Unless it has been stated otherwise, in the present chapter the "public finance sector units/entities" notion refers to entities of that sector excluding the State Treasury.
Annex 2 presents main regulations on contracting liabilities by local governments in the acceding EU countries.

- cultural institution (liabilities and outstandings of a liquidated cultural institution are taken over by its organizer, i.e. the State Treasury or a local government unit);
- research and development units (unsettled liabilities of a liquidated unit add to State Treasury's liabilities).

XI.2. Analysis of debt of public finance sector units other than the State Treasury

Among public finance sector units other than State Treasury the highest debt volume is recorded by local government units, ZUS and ZUS-managed funds, as well as SPZOZ.

1) Debt of local government units

The group of local government units covers above 3,000 entities. The debt of these entities has been showing a sustained upward trend. At the same time, its structure remains relatively stable, being dominated by loans.

Table 8. PLN million

	Dec. 2001	Dec. 2002	June 2003
Total debt of local government units	**12,266.4**	**15,358.4**	**15,196.5**
Loans	9,791.5	12,237.5	11,910.2
Securities	1,675.1	2,381.0	2,431.9
Other debt, of which:	799.8	740.0	854.4
Matured payables	*730.8*	*712.4*	*832.0*

Liabilities are contracted mostly on the domestic market (above 96%). Domestic nature of this debt results mostly from restrictions imposed by the *Public Finance Act.* Until Poland's accession to the EU, a local government unit may, apart from issuing securities finance its debt with loans drawn only in domestic banks. It should be also pointed out that debt with maturity above one year accounts for a dominating share of total debt (some 88%).

The figures calculated for total debt of local government units indicate that this group as a whole fulfils statutory restrictions concerning the debt-to-income ratio. Between 2001 and March of 2003, the amount of total debt of local government units at the end of a budget year relative to these entities incomes did not even approach the 60% limit.

Table 9.

	Dec. 2001	Dec. 2002	June 2003*
Debt/incomes ratio	15.4%	19.2%	19.2%

* relative to incomes planned for 2003

The assessment of situation in the field of local government units' debt on the basis of aggregate data may lead to excessive generalisations, an even wrong conclusions. Namely, among these entities there are such units which are not indebted, units whose debt is approaching statutory limits and single entities, in which the limits set forth in the *Public Finance Act* have been exceeded.

The reasons for the level of indebtedness ratios of some local government units (debt to incomes or debt servicing burden to planned incomes) remaining high should be mostly seen in:

1) investment requirements and liabilities contracted for their financing; they generate a heavy burden on local government units' budgets; the problem is particularly acute in small communities,
2) irregularities in financial management, such as acting beyond the scope of powers by those contracting liabilities posing a burden to budgets of local government units,
3) increase in matured payables,
4) actual revenues being lower than planed.

Growing debt of certain local government units may result in problems with financial liquidity. In an extreme case a unit may go into receivership.

It should be stressed that even with proper financial management of local government units, liquidity problems may arise as a result of taking over liabilities of other entities (SPZOZ or

cultural institutions supervised/managed by local government units). An additional threat may be posed by guarantees and sureties granted by local government units.

2) Debt of ZUS and funds managed by it

At the end of the first half of 2003 the debt of ZUS and funds managed by it accounted for 2.5% of the sector's debt prior to consolidation.

Table 10. PLN million

	Dec. 2001	Dec. 2002	June 2003*
Debt of ZUS and funds managed by it, of which:	13.173,5	15.648,9	9.932,2
Loans from commercial banks	1.704,0	2.388,8	3.004,6
Loan from the state budget	6.000,0	6.000,0	0,0
Matured payables	5.469,5	6.625,8	6.927,6

Problems with regular transfer to OFE of the due share of pension insurance contribution (first of all due to malfunctioning of the ZUS IT system) are the main reason for growing matured payables of these entities.

ZUS payments arrears to OFE for not transferred contributions (estimates) are presented in Table 11.

Table 11. PLN million

	1999	2000	2001	2002
ZUS payments arrears to OFE (arising over a year)	944	2.206	2.429	1.008
Interest on ZUS payments arrears to OFE (accrued over a year)	76	421	1.217	1.154

In the analysed period ZUS also obtained funds for current payments of benefits from the Social Insurance Fund through contracting liabilities (an additional source of funds apart from state budget subsidies). Both loans from state budget funds and bank loans were used for that purpose.

In connection with the growth of ZUS debt to OFE and problems with its settlement it was decided for the State Treasury to take over ZUS liabilities contracted in the 1999 – 2002 period, together with accrued interest. The liabilities taken over by the State Treasury will be converted into Treasury bonds.

3) Debt of independent public health care institutions

Table 12. PLN million

	XII 2001	XII 2002	VI 2003
Debt of independent public health care institutions, of which:	2,940.5	3,545.8	4,431.7
Matured payables	2,744.4	2,722.2	4,084.1

The debt of independent public health care institutions is, first of all the consequence of liabilities not met on time. Problems with their current servicing may arise from e.g. insufficient assets at the disposal of SPZOZ relative to services provided, irregularities in management of available assets (e.g. ill-structured liabilities and assets, problems with vindication of receivables). Their source may also be structural factors such as the network of hospitals in Poland being inadequate to needs, especially wrong scope of services offered by particular establishments (general or specialised hospitals).

Growing debt of SPZOZ may pose a threat to financial stability of their supervising/managing units, which take over SPZOZ liabilities in case of their liquidation.

4) Other entities

Among other entities the debt of government agencies gives rise to particular concern, in view of its level and sustained upward trend.

The major debtor in this category is the Agricultural Market Agency (AMA). Its growing debt is mostly the consequence of drawing loans for intervention purchase of cereals. This debt generates additional burden for the public finance sector, due to sureties or guarantees granted by the State Treasury for repayment of a part of loans received by AMA.

The debt of other entities of the sector is mostly the result of their overdue liabilities.

XI.3. Proposals of new regulations

In the present situation it is required to introduce systemic solutions in the field of contracting liabilities by the remaining units of the sector. However, they should not be barriers to their development, under given conditions resulting, inter alia, from the imposed limits. Besides it is also necessary to reconcile two issues: the role of the Minister of Finance as the official responsible for enforcement of the constitutional rule of the upper debt limit with the legal sovereignty of these entities. The proposed amendments must take into account:

- approaching statutory levels by public debt, mostly as a consequence of fast increase in the State Treasury debt (also contingent debt under sureties and guarantees),
- Poland's commitments due to EU membership, especially in the field of obligatory co-financing of EU programmes (this is a particularly crucial issue from the point of view of contracting liabilities by local government units).

Regulations laid down in the new draft *Public Finance Act* are heading towards allowing local government units to fully disburse EU funds, at the same time counteracting excessive debt of local government. The proposed changes provide for, inter alia:

1) Exemption from debt limits imposed on local government units (i.e.. 60% of debt/revenues ratio and 12-15% debt servicing costs/planned incomes ratio) loans contracted in connection with funds promised in an agreement with an entity disposing of EU structural funds and the Cohesion Fund, as well as securities issued for that purpose;
2) Restrictive treatment of disbursement of funds in a form of state budget loan on prefinancing of EU programmes – a loan disbursed without compliance with its appropriation is subject to returning to the state budget, with accrued interest as on tax arrears within 7 days from the day of stating inappropriate disbursement of the loan;
3) Imposition of an obligation to request RIO's opinion on ability to repay the contracted liabilities;
4) Imposition of an obligation to include in the budget resolution a total debt volume forecast at the end of a budget year and in the following years, resulting from planned and contracted liabilities;
5) Introduction of a provision prohibiting the credit collateral applied by local government units in a form of granting creditors a power of attorney to dispose of the bank account of a local government unit, irrevocable until the debt's repayment.

XII. THREATS TO THE STRATEGY IMPLEMENTATION

This Strategy will be implemented under conditions of a changeable external and internalsituation of Poland, hence the fulfilment of objectives and the evolution of main ratios characterising public debt will take place in conditions dependent on the emergence of threats and risk factors presented below. They refer to both the macroeconomic and the public finance sector situation.

Macroeconomic risk factors

a) unfavourable macroeconomic developments in Poland, including:
   - slower than assumed GDP growth rate in 2004-2006,
   - inflation increasing over the assumed level,
b) intensification of exchange rate fluctuations in the period preceding Poland's joining of the ERM 2 mechanism (prior to Poland's accession to the EMU) among other things caused by the so-called convergence play by foreign investors (possibility of speculative attacks),
c) cyclical downswing or stagnation in the foreign economy (especially in the EU Member States), making it impossible to achieve the assumed growth rate of GDP,
d) rise in interest rates on foreign markets.

Threats associated with the public finance position

a) Lack of actions aimed at limiting expenditures to slow down the growth rate of debt through cutting the level of deficits and other borrowing requirements of the state budget. Taking up the public finance system reform, especially on the state budget expenditure side, requires coordination of efforts at the Council of Ministers level, and commitment on the part of the legislator. Postponement of the programme of changes until later years will result in an increased degree of their intensity with a simultaneous lengthening of the horizon for emergence of positive effects.
b) Low privatisation proceeds, meaning the necessity of increasing debt in TS.
c) Actions aimed at paying out various compensations (including compensations for the take over by the State Treasury of private property in 1944-1962 and for the property lost by Polish citizens due to change of the eastern border after 1945) in cash or TS, instead of in a form of tangible benefits.
d) Uncontrolled rise in debt of public finance sector entities other than State Treasury. Implementation of projects with involvement of EU funds will require co-financing by local government units. Funds for this purpose will be probably raised by issue of debt. A high risk of a sharp rise in debt is associated with the deteriorating problem of inability of the health care sector to settle its payments obligations on time.
e) Sharp increase in sureties and guarantees granted by public finance sector entities (especially the State Treasury) for purposes not directly involvement with development programmes, thus giving rise to growing risk of contingent debt.

   The emergence of the above threats will adversely affect the assessment by financial markets of the level of risk associated with investment in TS, this way resulting in higher debt servicing costs and disturbances in smooth financing of the state budget borrowing requirements.

XIII. EFFECTS OF STRATEGY IMPLEMENTATION

The basic effect of implementation of this strategy will be the reversal, as of 2006 of the upward trend in the public debt/GDP ratio. In 2006, the following parameters of the State Treasury debt should be expected to be achieved:

- the share of foreign debt will drop from 33.1% at the end of 2002 to about. 25.9%,
- the average maturity of domestic marketable debt will increase from 2.73 year in 2002 to about 3.0 – 3.5 years
- the duration of marketable domestic debt will increase from 2.16 year at the end of 2002 to about 2.4-2.9 year,
- the share of non-marketable debt in domestic debt will drop from 7.2% at the end of 2002 to some 2.2%,
- the share of banking sect in domestic debt will decline from 35.8% at the end of 2002 to 31.8% (of which that of NBP from 3.0% to zero), the share of domestic non-banking sector will rise from 49.9% at the end of 2002 to some 53.9%, and the share of foreign investors will remain unchanged at the level of 14.3%.

Annex 1. G*eneral government* debt and yield of 10-year bonds in EU Member States and in selected aceeding countries

	2001		2002	
	Debt/GDP	**10-year rate***	**Debt/GDP**	**10-year rate***
Italy	**109.5%**	5.18%	**106.7%**	4.41%
Belgium	**108.5%**	5.19%	**105.8%**	4.30%
Greece	**106.9%**	5.23%	**104.7%**	4.44%
Austria	**67.3%**	5.17%	**67.3%**	4.24%
Germany	59.5%	5.00%	**60.8%**	4.18%
France	56.8%	5.07%	59.0%	4.27%
Portugal	55.5%	5.14%	58.1%	4.32%
Spain	56.8%	5.25%	53.8%	4.25%
Sweden	54.4%	5.34%	52.7%	4.70%
Netherlands	52.9%	5.11%	52.4%	4.20%
Denmark	45.4%	5.15%	45.5%	4.45%
Finland	44.0%	5.20%	42.7%	4.28%
United Kingdom	38.9%	5.05%	38.5%	4.37%
Ireland	36.1%	5.04%	32.4%	4.28%
Luxembourg	5.5%	-	5.7%	-
European Union	**63.0%**	**5.15%**	**62.3%**	**4.34%**
Hungary	53.4%	7.08%	56.3%	6.50%
Poland	37.2%	8.82%	41.6%	5.56%
Slovakia	43.0%	7.63%	39.3%	5.40%
Czech Republic	23.3%	5.34%	27.1%	4.14%
Estonia	4.8%	-	5.8%	-

*) end-year data.

Annex 2. Main regulations relating to contracting liabilities by local governments in the EU acceding countries

The table presents main regulations concerning restrictions on contracting liabilities by local governments in the countries acceding the EU in 2004.

Country	Regulations concerning debt level	Regulations concerning service costs
Czech Republic	Towns are allowed to contract liabilities in domestic and foreign currency;	
Slovakia	1. Contracting of debt is limited mostly to financing capital expenditures; short-term liabilities are allowed to cover current deficits – obligatory repayment in the same year; 2. Total debt must not exceed 60% of budget revenues obtained in the previous year;	Debt servicing costs (on accrual basis) must not exceed 25% of budget revenues obtained in the previous year;
Hungary	Short-term debt may be contracted for financing of necessary expenditures;	Annual long-term debt servicing costs must not exceed 70% of forecast own revenues; no limits on short-term debt;
Slovenia	Contracting of liabilities allowed only in domestic currency; discussions are held on contracting of liabilities on foreign markets; Obligation to inform, the MF on contracting of liabilities;	
Lithuania	Rules are annually set by the Parliament;	
Latvia	Annual limit of contracting of liabilities set by the Parliament; MF consent required for contracting of liabilities;	
Estonia	Debt level debt must not exceed 60% of budget revenues (except liabilities);	Debt servicing costs must not exceed 20% of budget revenues (except new liabilities);
Cyprus	1. Government consent required for contracting of liabilities; 2. Local budgets must be balanced; revenues from contracting of liabilities are to finance capital expenditures; 3. Short-term liabilities must not exceed 20% of current year revenues; Total debt must not exceed 40%of revenues – Government consent required;	
Malta	Required consent of the Minister responsible for local government and of MF for contracting of liabilities; lack restrictions on contracting of liabilities on foreign market ;	

Souce ”Local and regional governments: the 2004 accession countries” ABN-AMRO, 2003.