The Public Finance Sector
DEBT MANAGEMENT STRATEGY
in the years 2005 – 2007

Warsaw, September 2004

The public finance sector
DEBT MANAGEMENT STRATEGY
in the years 2005-2007

I. INTRODUCTION

The *Public Finance Sector Debt Management Strategy in the years 2005-2007* covers the strategy of managing the State Treasury debt and the strategy for influencing public finance sector debt. In accordance with the Public Finance Act, the Minister of Finance exercises control over the level of public debt. In the case of State Treasury debt, the Minister of Finance holds instruments allowing for direct debt management, while in the case of other debt of the public finance sector entities, being autonomous in contracting liabilities, such control is of an indirect nature.

The Strategy presented herein has retained the structure of documents published in previous years. It contains an assessment of the execution of debt management objectives in the year 2003 and the first half of 2004, an analysis of risk associated with the level of debt as well as its structure, debt management objectives for the years 2005-2007, tasks and instruments available for their implementation. It also presents forecasts of the level of debt, its structure and servicing costs. The causes and consequences of an increase in public debt as well as threats associated with this increase are also discussed.

The strategic objectives for the years 2005-2007 have not changed compared to those presented in the previous document. As a result of the first threshold set forth in the Public Finance Act being exceeded, actions aimed at hindering further growth of public debt to GDP ratio, such as the reform of public finances and a limiting of State Budget borrowing needs become more important. It is expected that during the horizon of the Strategy the debt to GDP ratio will continue to grow until 2006 only to stabilize itself at this level in 2007. Macroeconomic environment, in particular the return to fast economic development, should constitute the main factor easing the impact of public finance reforms and having a positive impact on stabilizing and subsequently lowering the debt and GDP ratio.

Forecasts regarding the level of public finance debt are presented in two versions in the document herein, i.e., in accordance with currently applicable Polish methodology (based on solutions foreseen in the Public Finance Act) as well as EU methodology. The need to present forecasts regarding the public finance debt in two versions arises from work being carried out aiming at implementing to the Public Finance Act the EU solution concerning the scope of the public finance sector and debt categories.

Execution of the public finance reform program should allow for initiating preparations, during the time frame presented in the Strategy herein, for the next step of EU integration, i.e., entry into the Euro zone.

II. IMPLEMENTATION OF STRATEGY OBJECTIVES IN 2003 AND FIRST HALF OF 2004

II.1 Evaluation of the objectives implementation

1. Maintaining public debt at a safe level

The need to finance a high budget deficit (PLN 37.0 billion in 2003 and PLN 19.9 for the first half of 2004) and outlays not associated with repayment of debt together with low proceeds from privatization (PLN 3 billion in 2003 and PLN 1.9 billion during the first half of 2004) as well as a weakening of the Polish Zloty resulted in continued growth of public debt. The most important categories of public debt are presented below both in absolute terms and in relation to GDP.

Table 1. Public debt in absolute terms and relative to GDP

	XII 2002		XII 2003		VI 2004[1)]
	PLN million	% of GDP	PLN million	% of GDP	PLN million
State Treasury debt	327 904.2	**42.0%**	378 943.8	**46.5%**	411 234.2
- domestic	219 347.0	**28.1%**	251 165.9	**30.8%**	276 905.6
- foreign	108 557.2	**13.9%**	127 777.9	**15.7%**	134 328.6
Public debt	352 610.6	**45.1%**	408 637.7	**50.2%**	438 842.7
Public debt increased by risk-weighted payments under sureties and guarantees	**364 734.5**	**46.7%**	**420 047.1**	**51.6%**	**450 672.9**

1) corrected data compared to Minister of Finance announcement dated on September 2004

The increase in public debt in the year 2003 was the result of an increase in domestic debt (up PLN 31.8 billion) as well as foreign debt (up PLN 19.2 billion). The increase in foreign debt was the result of weakening Zloty as well as a new bonds issuance on foreign markets – the balance of foreign financing was PLN 6 billion. Domestic debt during the first half of 2004 increased by PLN 25.7 billion, with foreign debt also increasing by PLN 6.6 billion[1].

The debt (including risk-weighted payments under sureties and guarantees) to GDP ratio reached a level of 51.6% in 2003, thus exceeding the 50% level – the first safety threshold stated in the Public Finance Act, causing the implementation of prudential and remedial procedures (see Chapter IV).

2. Minimization of debt servicing costs within the long time horizon

This objective is understood 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,

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 conditions on domestic financial market. The offer was so structured that excessive supply in the respective segments of the yield curve would not lead to additional pressure to increase this curve. This occurred during the first half of 2003 with a drop in yields across the curve. The increase in interest rates during the second half of 2003 as well as a drop in demand for medium and long-term instruments resulted in financing through the use of floating interest debt instruments as well as – for a certain amount of time – instruments having shorter redemption periods being favourable.

[1] The increase in foreign debt was above all the result of new bond issues, repayment of debt as well as the strengthening of the Zloty against the EURO and USD.

The sale of long-term structured coupon bonds in private placement mode having swap hedging on interest rates was successfully carried out in March 2004. Sales of bonds in private placement mode is used as a supplementary instrument for financing borrowing needs and to *inter alia*, minimize debt servicing costs.

Minimizing the cost of foreign debt servicing meant replacing expensive financial instruments with less expensive ones taking into account the level of risk. This was achieved through a premature buy-back of Brady bonds of PDI type (USD 1 089.2 million in April 2003) and DCB (USD 393 million in October 2003).

The main actions undertaken towards minimization of debt servicing costs in the second meaning included:

- implementation of a policy of reducing the number of bond issues, at the same time increasing the face value of issues,
- implementation of the System of Treasury Securities Dealers (Primary Dealers) in early 2003,
- continuing efforts aimed at reducing fees collected by the National Depository for Securities (NDS).
- alleviation of legal and organizational hindrances for development of a repo market for Treasury bonds and Treasury bills (NBP introducing a zero rate for reserves on repo transactions carried out by banks with non-bank entities after June 30, 2004).

Minimisation of debt servicing costs took place with the adoption of restrictions regarding the level of:

1) domestic currency refinancing risk

The value of the basic measure of refinancing risk, i.e. the average time to maturity (ATM) of marketable debt expressed in years, dropped from 2.74 at year end 2002 to 2.66 at year end of 2003 and grew to 2.71 at the end of June 2004. The drop in ATM was mainly the result of a reduction in sales of medium and long-term (i.e., more than 5 years) bonds during the second half of 2003 and I quarter 2004 due to a drop in demand for these types of securities. The reaction of investors to the situation with public finances caused serious perturbations in this part of the market and led to a significant drop in demand and an increase in yields. Interest rate increase on foreign markets also affected increase in domestic yields. The following helped to stop the downward trend of ATM in 2003 and the turn around during the first half of 2004:

- switching auctions. Bonds amounting to PLN 6.8 billion were issued in 2003 whereas during the first half of 2004 this amounted to PLN 5.8 billion. 5- and 10-year bonds had the largest share of it (PLN 5.5 billion and PLN 4.9 billion respectively). Switching auctions also helped to reduce payment “peaks” arising from original redemption periods,
- initiating the sale of 3- and 7-year floating interest rate bonds in January 2004 as a result of dropping demand for fixed rate securities,
- issue of 10-year coupon bonds in a private placement mode having swap hedging on interest rates.

The share of TS maturing up to 1 year dropped from 38.0% at year end 2002 to 37.9% at year end 2003 and 37.3 in the middle of 2004. The share of Treasury bonds in the State Treasury domestic debt also dropped (from 19.2% in 2002 to 19.1% in 2003 and 18.4% in the middle of 2004).

2) exchange rate risk

The share of foreign debt in overall State Treasury debt increased from 33.1% in 2002 to 33.7% in 2003 mainly as a result of a significant weakening of the Zloty – in particular against the Euro. This share though dropped to 32.7% at the end of June 2004 mostly due to a strengthening of the Zloty. The share of State Treasury foreign debt denominated in Euro increased from 46.7% at year end 2002 to 58.4% at year end 2003 and

dropped to 58.2% at the end of June 2004. The share of Euro denominated debt in overall debt also increased accordingly from 15.5% to 19.1% to drop in June 2004 to 18.5%. This is a positive development in respect to Poland's future entry into the Euro zone as it will eliminate the foreign exchange risk associated with this part of the debt. In regards to bonds issued in the years 1997 – 2003, 61% of all issues at year end 2003 were denominated in Euro, 30% in US dollars, 7% in Pound Sterling and 2% in Japanese Yen.

3) foreign currency refinancing risk

ATM for foreign debt changed slightly compared to 2002 and was 5.73 years at year end 2003 and 5.58 years at the end of June 2004, thus remaining at a safe level. ATM for all TS issued on foreign markets was 9.17 years at year end 2003 and 8.25 years at the end of June 2004. The average level of principle repayments on foreign debt in the year 2005-2007 will amount to approximately Euro 3.1 billion p.a.

Sales of private placement bonds as well as initiation of a EMTN program to facilitate easier issues on foreign markets were carried out in order to further diversify foreign markets for bonds and to increase their sales.

4) interest rate risk

Average duration of domestic marketable debt, being a measure of debt servicing costs sensitivity to interest rates' fluctuations, decreased slightly from 2.15 to 2.12 at year end 2003 and 2.09 in the middle of 2004. The following factors had an influence on the change in duration:

- a change in ATM (from 2.74 to 2.66 and 2.71 respectively),
- a reversal in interest rate trends in the middle of 2003, from growing to dropping yields,
- a reduction in the share of floating rate securities from 10.3% to 6.7% at year end 2003 followed by a growth to 8.1% during the first half of 2004.

In the case of the State Treasury foreign debt, about 60% of debt was based on fixed rate interest rates. This is true in regards to approximately 42% of liabilities to creditors from the Paris Club, 91% of foreign bonds and almost all other liabilities. Reduced, i.e., below market value, interest rates for Paris Club loans constitute a factor limiting interest rate risk associated with floating rate liabilities.

5) State budget liquidity risk

The maintaining of a safe level of budget liquidity and management of liquid assets was achieved above all through the use of the following instruments:

a) switch auctions (limiting refinancing risk associated with redemption of large placements),
b) Zloty deposits with NBP,
c) Zloty deposits in commercial banks collateralised with TS (a new instrument implemented in May 2004),
d) foreign currency deposits with NBP,
e) a foreign currency revolving bridge loan (an instrument securing State budget foreign currency liquidity until the time of in-flow of funds from issues and privatization).

6) Other risks, especially credit and operational risks

In order to limit credit risk associated with swap transactions, ISDA agreement are only signed with entities having the highest credit rating.

A procedure for selection of a bank to organize a private placement bonds issuance with the possibility of having non-standard coupons with interest rate swap hedging was announced in February 2004. A prerequisite for the issue was that the issue of synthetic instrument consisting of bonds and derivatives, allow for a cost reduction compared to standard bonds, i.e., that such an issue helps to reduce debt servicing costs. The cost of the savings on debt servicing costs is the credit risk associated with the uncertainty that the bank being a party to the agreement will not fulfil its obligations arising from the swap agreement.

This risk though is limited by selecting only partners having very high credit ratings. The first private placement issuance of 10-year bonds of a face value of PLN 750 million was carried out in March 2004.

Deposits placed on the interbank market were entirely collateralised with TS, thus did not generate a credit risk.

The implementation of an IT system for management of State Treasury debt and integrated database helped to limit operational risk.

7) Distribution of debt servicing costs in time

In 2003 servicing costs of the State Treasury debt accounted for 3.0% of GDP (compared to 3.1% in 2002), of which 2.5% of GDP was for servicing of domestic debt (compared to 2.6% in 2002). A lack of significant changes in debt servicing costs was the result of an increase in the level of debt on the one hand and reduction in interest rates during the period from the end of 2000 to May 2003 on the other.

II.2. Conclusions from the objectives implementation

The dynamics of debt growth in 2003 was not hindered due to a greater, compared to previous years, demand for debt by the State budget and low proceeds from privatisation. Public debt in respect to GDP exceeded the first safety threshold, i.e., 50%, provided for the Public Finance Act and was at a level forecasted in the debt management strategy prepared in 2003.

The objective of minimizing debt servicing costs was mainly achieved through appropriate issuance policy. During the second half of 2003, as a result of certain level of uncertainty among market participants regarding the situation of public finance, an insignificant deterioration of the majority of risk parameters (an increase in the share of foreign debt, a decrease in average maturity periods and duration) was the price for smooth financing of the borrowing needs, taking into account minimization of costs in the long run. An improvement in investor sentiment together with the introduction of new instruments and a large volume of switching auctions during the first half of 2004 resulted in the ATM of domestic debt to increase. A strengthening of the Zloty, despite a positive foreign financing balance, caused a reduction in the share of foreign debt.

III. ASSUMPTIONS OF THE STRATEGY

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

The main macroeconomic factors influencing the nominal level of public debt, its relation to GDP and servicing costs are rate of economic growth, interest rates and foreign exchange rates.

Following slowdown in the years 2001-2002, economic growth in 2003 reached 3.8%. Real GDP growth during the first half of 2004 was 6.5% with estimates for all of 2004 being approximately 5.7%. A high level of economic growth is also forecasted for subsequent years, with GDP growth in the years 2005-2007 being between 4.8% and 5.6%. The components of economic growth though will change. The growth in exports will drop, remaining however at a high level (14.2% in 2004 and 12.0% in 2005). Greater domestic demand, in particular investments, will grow faster.

The weakening of the Zloty against the US dollar and the Euro in 2003 – mostly a result of the situation of public finances – had a negative impact on the level and relation of debt to GDP in 2003. A gradual appreciation of the Zloty against the Euro is foreseen in the horizon of the strategy.

An increase in inflation during the first half of 2004 (arising from *inter alia* the process of prices in Poland levelling out compared to Western European prices following Poland's accession to the EU, an increase in oil prices on international markets as well as faster GDP growth) caused the Monetary Policy Council to increase central bank's basic interest rates which was followed by growth in interest rates on the financial market. The rate of CPI growth in 2004 is forecasted to be 3.4% (annual average) and 4% at year end. Growth in CPI in subsequent years though should be lower. Forecasted CPI growth at year end 2005 is 2.8%. It was assumed in 2005 Budget Act that interests rates on the open market operations at year end 2005 will be approximately 7,5%.

In 2005 the State budget deficit is also expected to fall to 3.7% GDP from 4.9% in 2004. A drop in the deficit below 3% GDP is planned for 2007.

The forecasted fundamental macroeconomic indicators used for the preparation of the Strategy herein (complied with assumptions to the 2005 Budget Act) are presented in the table below.

Table 2. Forecasted fundamental macroeconomic variables in the years 2004-2007

	2004	**2005**	**2006**	**2007**
Real GDP growth (%)	5.7	5.0	4.8	5.6
GDP at current prices (PLN billion)	884.0	952.6	1 023.3	1 105.1
State budget deficit (% of GDP)	4.9	3.7	3.1	2.7
State budget deficit (PLN billion)	43.7	35.0	32.0	30.0
Deficit of local government units (% of GDP)	-0.4	-0.3	-0.3	0.0
Privatization proceeds (PLN billion)	7.0	4.5	4.5	4.5
Average annual CPI (%)	3.4	3.0	2.7	2.5
Rate of open market operations (%) • period average • end of period	 5.80 7.00	 7.40 7.50	 7.40 7.25	 7.00 6.75
PLN/USD • period average • end of period	 3.75 3.65	 3.68 3.72	 3.70 3.73	 3.79 3.85
PLN/EUR • period average • end of period	 4.60 4.45	 4.42 4.39	 4.29 4.25	 4.24 4.24

III.2. Situation on the international financial market

The world economic recovery which took place in the second half of 2003 was mainly the result of strong macroeconomic policy stimulation, both fiscal and monetary. The driving force behind worldwide growth were the USA as well as South-East Asian countries , above all China. The Japanese economy also performed better than expected. The beginning of 2004 brought a strengthening of this positive tendency and its expansion to other countries and regions. The economy in the Euro zone compared to this performed rather weakly, although during the 1st qtr. of 2004 economic growth accelerated, mainly as a result of growing private consumption and net exports with investment activity though remaining at a low level.

It is expected that following the clear recovery of the worldwide economy in 2003, the economy will continue to develop, mainly as a result of higher economic growth in OECD countries. The GDP growth in the USA is expected to be 4.3% compared to 3.0% in 2003 whereas Japan will have 4.2% GDP growth compared to 2.4% the previous year. The economy in the Euro zone will grow much slower, although growth will be significantly higher than one year ago – 1.9% versus 0.5%.

The pace of GDP growth though is expected to diminish in all OECD countries in 2005. Economic growth in the USA and Japan will be 3.3% and 2.6% respectively, while growth in the Euro zone will be 2.2%.

The slow recovery of the world economy from the slowdown which took place in the years 2001-2002 contributed to the increase in inflationary pressures. It was further fuelled by loose fiscal policies in the largest world economies as well as one-time factors such as high costs of natural resources or increases in indirect taxes. It is expected that the average rate of inflation in OECD countries, including the USA, will increase in the year 2004. Compared though to the USA, inflation in the Euro zone will be lower and remain at levels comparable to those in 2003. Pressure on growth of domestic prices due to high costs of natural resources will be eased by a stronger Euro.

The main threat to world GDP growth are further increases in oil prices which may limit the purchasing power of households and profit of the companies. A deficit on the USA current account remains at a high level. Reducing the scale of this unbalance – be it by weakening the US dollar or limiting internal demand – will not only have a negative impact on the US economy, but also the economy of other countries. Geopolitical pressure, which may disturb processes currently taking place in the world economy, continues.

III.3. Changes in public debt in 2003 and in the first half of 2004

The debt of public finance sector entities (public debt) increased to PLN 408.6 billion from PLN 352.6 billion (i.e., by 15.9%). A significant growth in debt by PLN 30.2 billion (i.e., 7.4%) was also recorded during the first half of 2004.

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

Specification	XII 2002	XII 2003	VI 2004	Change XII'03-XII'02		Change VI'04-XII'03	
				PLN million	%	PLN million	%
Public debt	**352 610.6**	**408 637.7**	**438 842.7**	**56 027.1**	**15.9%**	**30 205.0**	**7.4%**
Domestic debt							
Place of issue criterion	243 528.0	280 080.3	303 684.2	36 552.2	15.0%	23 603.9	8.4%
Resident criterion	214 509.2	242 913.8	254 908.0	28 404.6	13.2%	11 994.2	4.9%
Foreign debt							
Place of issue criterion	109 082.6	128 557.4	135 158.5	19 474.8	17.9%	6 601.1	5.1%
Resident criterion	138 101.4	165 723.9	183 934.7	27 622.4	20.0%	18 210.8	11.0%
PLN/USD exchange rate	*3.8388*	*3.7405*	*3.7470*				
PLN/EUR exchange rate	*4.0202*	*4.7170*	*4.5422*				

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

This continued growth took place in regards to State Treasury debt, independent public healthcare institutions and the Polish Academy of Sciences (see Chapter X).

A drop though in the debt of the National Health Fund, public earmarked funds (excluding ZUS), research and development units as well as State legal entities created on the basis of separate Acts was recorded in 2003 as well as the first half of 2004.

No clear tendencies regarding the trend in indebtness were observed in other entities.

Table 4. Public debt after consolidation (PLN million)

	Specification	XII 2002	XII 2003	VI 2004	Change XII'03-XII'02		Change VI'04-XII'03	
					PLN million	%	PLN million	%
	Public debt	**352 610.6**	**408 637.7**	**438 842.7**	**56 027.1**	**15.9%**	**30 205.0**	**7.4%**
1.	**Central government debt**	**338 552.1**	**392 089.5**	**422 464.4**	**53 537.4**	**15.8%**	**30 374.8**	**7.7%**
1.1.	**State Treasury Debt**	**326 750.2**	**378 511.7**	**410 604.4**	**51 761.4**	**15.8%**	**32 092.7**	**8.5%**
1.2.	**Other central government debt**	**11 801.9**	**13 577.9**	**11 860.0**	**1 776.0**	**15.0%**	**-1 717.9**	**-12.7%**
1.2.1.	ZUS and ZUS-managed funds	9 014.6	11 225.4	9 608.1	2 210.8	24.5%	-1 617.3	-14.4%
1.2.2.	Health Funds/National Health Fund	289.7	152.2	12.6	-137.5	-47.5%	-139.6	-91.7%
1.2.3.	State earmarked funds with legal personality (excl.1.2.1.)	339.2	95.4	9.9	-243.8	-71.9%	-85.5	-89.7%
1.2.4.	State higher schools	216.1	169.4	172.0	-46.8	-21.6%	2.6	1.6%
1.2.5.	Research and development units	207.1	182.1	161.7	-25.0	-12.1%	-20.4	-11.2%
1.2.6.	Independent public health care institutions	420.1	496.5	647.4	76.5	18.2%	150.9	30.4%
1.2.7.	State cultural institutions	2.9	2.8	4.1	-0.1	-2.4%	1.3	45.4%
1.2.8.	Polish Academy of Sciences and organizational units established by it	5.7	8.3	13.6	2.6	45.9%	5.3	63.9%
1.2.9.	Other state legal persons	1 306.5	1 245.8	1 230.6	-60.8	-4.7%	-15.1	-1.2%
2.	**Local government debt**	**14 058.5**	**16 548.2**	**16 378.3**	**2 489.7**	**17.7%**	**-169.9**	**-1.0%**
2.1.	**Debt of local government units**	**12 002.3**	**13 797.9**	**13 246.0**	**1 795.6**	**15.0%**	**-551.9**	**-4.0%**
2.2.	**Other debt of local governments**	**2 056.2**	**2 750.3**	**3 132.3**	**694.0**	**33.8%**	**382.0**	**13.9%**
2.2.1.	Local government earmarked funds with legal personality	5.4	0.0	3.5	-5.3	-99.1%	3.5	-
2.2.2.	Independent public healthcare institutions	1 989.1	2 704.3	3 048.7	715.1	36.0%	344.4	12.7%
2.2.3.	Local government institutions of culture	32.9	20.2	22.6	-12.7	-38.6%	2.4	12.0%
2.2.4.	Other local government legal entities	28.7	25.7	57.4	-3.0	-10.6%	31.7	123.4%

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

IV.1. Regulations relating to 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 3/5 of gross domestic product;
2) *the Public Finance Act* – introduces definitions and specifies principles relating to incurrence of the public debt and regulates prudential and remedial procedures in case of exceeding subsequent debt/GDP threshold levels (50%, 55%, 60%).

Table 5. Legal limits on debt-to-GDP ratio

Legal procedures regarding limits on public debt increased by risk-weighted payments under sureties and guarantees are as follows:

1) the ratio in year *x* is greater than 50%, and not greater than 55% of GDP:
   a. state budget deficit/state budget revenue ratio in the draft budget act adopted by the Council of Ministers for the year x+2 can not be higher than in the year x+1,
   b. the state deficit to revenue ratio, adopted in the budget act for the year x+2, is the upper limit of the deficit to revenue ratio adopted by each local government unit in their budgets for the year x+2.
2) the ratio in year *x* is greater than 55%, and lower than 60% of GDP:
   c. the deficit level in the adopted draft budget act for the year x+2 must ensure 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 the ratio announced for the year x,
   d. the upper limit of the deficit to revenue ratio of each local government unit for the year x+2 is calculated by multiplying the state budget deficit to revenue ratio adopted for the year x+2 by coefficient "R", calculated as:
      R = (0.6 - PD/GDP) : 0.05
      where: GDP – gross domestic product, PD - public debt, increased by risk-weighted payments under sureties and guarantees granted by units of this sector, relate to figures announced for the previous budget year (year x);
   e. The Council of Ministers presents a remedial programme ensuring a fall in the ratio of public debt to GDP;
3) the ratio in year x is equal to or greater than 60% of GDP:
   a. the state budget and budgets of local government unit for the year x+2 must be at least balanced;
   b. a ban on granting new sureties and guarantees by public finance sector entities is introduced;
   c. The Council of Ministers presents a remedial programme to the Parliament which main objective is to prepare and implement actions aimed at reducing the public debt-to-GDP ratio below 60%.

The fundamental regulations regarding public debt in the EU are contained in the following documents:

1) the Maastricht Treaty (Article 104) – 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.;
2) the *Protocol on the excessive deficit procedure* annexed to the Maastricht Treaty giving the general definition of debt as well as the base value of the public debt- to-GDP ratio at 60%;
3) Council Regulation on the application of the Protocol on the Excessive Deficit Procedure (EDP), annexed to the Maastricht Treaty – giving the general definition of public debt with particular emphasis on specifying categories of debt.
4) The *European System of Accounts (ESA 95)* statistical regulation defines, *inter alia*:

a) the *general government* sector – criteria used by ESA95 relate above all to functions carried out by given entities and the manner in which they are financed. The main criterion is the basic activity of these entities– redistribution of national income and assets – whereas in the case of other entities, the 50% rule (i.e., less than 50% of production costs are financed from sales' revenues/income) is applied.

b) a definition of all categories of financial liabilities.

EU member states are required to submit to the European Commission on a bi-annual basis (by March 1 and by September 1) data regarding public debt (as well as deficit) calculated in accordance with EU methodology[2].

Table 6. Key differences between Polish and EU regulations regarding public debt

POLISH REGULATIONS (Public debt increased by risk-weighted payments under sureties and guarantees)	**EU REGULATIONS** (*general government* debt - EDP procedures)
1) scope of public finance sector	
the Public Finances Act creates a closed catalogue of entities included in the public finance sector	the general government sector is defined in ESA95[3]; a closed catalogue of entities has not been introduced
differences in the scope of sectors depending on regulations	
-	open pension funds[4]
Agricultural Market Agency	-
research and development units	-
2) liabilities accounted for in public debt	
• monetary based securities (excluding shares) • loans (including securities whose disposal is limited) • deposits • matured payables (i.e., liabilities whose payment period has passed but which have not been expired or written off)	• securities other than shares excluding financial derivatives • loans • cash and deposits
differences in debt categories depending on regulations	
matured payables	-[5]
3) potential debt	
differences relating to accounting potential debt in GDP-to-debt ratios	
legal limitations regarding the GDP to public debt ratio take into account potential debt generated by issued sureties and guarantees	EU limitations do not take into account for potential debt associated with issued sureties and guarantees

[2] This is the so-called Questionnaire on deficit and debt (a.k.a. fiscal notification). Poland was sending the filled out questionnaire to the European Commission as well as Eurostat prior to becoming a member of the EU.

[3] Council Regulation No 2223/1995 on the European System of National and Regional Accounts in the Community.

[4] A Eurostat decision dated March 2, 2004 states that capital pension systems with defined contribution should not be included in the general government sector. At the same time, this decision defines exceptions to the rule based on government guarantee systems. The final decision regarding pension system classification will be undertaken separately for each country after becoming acquainted with the details of such systems. For Poland's reporting purposes to the EU, OFE's at present are treated as general government sector entities.

[5] Matured payables constitute expenditures on accrual basis and thus are included in the deficit calculated in accordance with EU methodology.

Table 7. Transition from Polish methodology of calculating public debt (Public Finances Act) to EU methodology (Excessive Deficit Procedure)

in relation to GDP

Specification	2001	2002	2003
Public debt increased by risk-weighted payments under sureties and guarantees	**41.0%**	**46.7%**	**51.6%**
differences between sector scope, *including:*	***-1.8%***	***-2.7%***	***-3.5%***
Agricultural Market Agency debt (*excludingmatured payables*)	0.0%	-0.2%	-0.1%
Open pensions fund investments in general government sector securities	-1.8%	-2.5%	-3.3%
research and development units' debt (*excluding matured payables*)	0.0%	0.0%	0.0%
differences regarding debt categories			
matured payables	-1.2%	-1.3%	-1.3%
differences regardingcontingent debt			
anticipated paymentsunder sureties and guarantees issued by sector entities	*-1.2%*	*-1.6%*	*-1.4%*
General government **debt –** according to EDP	**36.7%**	**41.1%**	**45.4%**

Work is currently underway aimed at introducing changes to Polish methodology of calculating public debt to bring it closer to or to unify it with methodology used for EU reporting. A change in principles requires above all a change in Polish legal regulations regarding the sector entities as well as the scope of public debt (debt categories). Actions undertaken in this directions should limit the necessity to maintain debt statistics in two different approaches[6].

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

During the past few years, growth of the public debt has exceed GDP growth. As a result, since 2001 the debt-to-GDP ratio has been growing.

Table 8. Public debt in the years 2001-2003

Specification	2000	2001	2002	2003
real GDP growth	40%	1.0%	1.4%	3.8%
nominal GDP growth	10.9%	5.1%	2.7%	4.3%
change in public debt (nominal)	2.5%	7.8%	16.7%	15.9%
change in anticipated payments under sureties and guarantees issued by sector entities (nominal)	14.4%	0.1%	27.7%	-5.9%
Public debt increased by risk-weighted payments under sureties and guarantees issued by public sector entities				
in PLN billions	289.8	311.6	364.7	420.0
in relation to GDP	**40.0%**	**41.0%**	**46.7%**	**51.6%**
General government debt – according to EDP				
in PLN billions	266.7	279.1	321.3	369.7
in relation to GDP	**36.8%**	**36.7%**	**41.1%**	**45.4%**

The level and dynamics of public sector debt growth depends above all on the scale of new liabilities incurred by the State Treasury. The key factors influencing State Treasury debt compared to GDP over the last few years are presented in table 9.

[6] Unless otherwise stated in the strategy values and limits regarding the public debt to the current legal status in Poland, e.g. Polish methodology of debt calculation.

Table 9. Factors influencing the growth of ST debt in the years 2001-2003

in relation to GDP

Specification	2001	2002	2003
State Treasury debt to GDP ratio	**373%**	**420%**	**465%**
Change in ST debt/GDP ratio	05%	46%	45%
The composition of debt to GDP ratio change			
1. Primary State budget balance	15%	20%	16%
2. Interests	27%	31%	30%
3. Nominal GDP growth	-19%	-11%	-20%
4. Other factors influencing change in ratio, above all:	-19%	07%	20%
4.1. State budget credit requirements not associated with financing the deficit [1)]	01%	03%	08%
4.2. Net privatization proceeds	-09%	-03%	-04%
4.3. foreign exchange rate movements	-11%	08%	14%
4.4. debt write-offs [2)]	-04%	00%	00%
4.5. other State Treasury debt	-05%	-03%	-02%
Memo average interest of ST debt [3)]	74%	73%	63%

Notes: positive (negative) values cause an increase (drop) in the debt-to-GDP ratio

[1)] mainly: balance of incoming funds (from the previous year and subsequent year), balance of granted loans, repayments of compensation for non-indexation of wages in the budgetary sphere at the beginning of the 1990s;

[2)] in 2001 a part of Poland's debt towards Brazil was written off due to premature repayment of debt;

[3)] ratio of debt servicing costs incurred in the given year to debt volume at the end of the given year;

The increase in public debt in the year 2004 is above all the result of:

1) high borrowing needs of the State Treasury arising mainly from:
   - the budget deficit,
   - subsidies to FUS (Social Insurance Fund) to cover the loss of contributions to Open Pensions Funds
2) borrowing needs of local government entities,
3) financial problems faced by public healthcare.

The rate of public debt growth over the time horizon of the strategy will above all, as in recent years, be determined by the financing of the borrowing needs of the State Treasury. As a result of the significant reduction in the State budget deficit (to a level of approximately PLN 30 billion in 2007), the growth rate of public debt should also be lessened (see Chapter IV.3).

Due to the assumed fast rate of economic growth, the debt-to-GDP ratio is expected to drop in 2007 following an increase in the years 2005 and 2006.

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

A consequence of the public debt breaking through the first safety threshold in 2003 is the necessity to maintain the proper budget deficit to revenues ratio adopted in the 2005 State and local government budgets. In each case this ratio can not be higher than 29.3%.

A problem gaining greater importance in conjunction with the growing level of debt is the issue of financing borrowing needs. Due to limited proceeds from privatization, such requirements are mostly financed through debt issuance. A large supply of TS in turn results in higher risk associated with TS investments and thus an increase in yields. In addition, the

risk associated with the appearance of demand barriers on the domestic financial market also arises.

The high deficit together with a growing level of public debt also causes consequences arising from Poland's membership in the EU. The Maastricht Treaty (Art. 104) imposes a requirement on member States to avoid excessive budget deficits. In particular, these countries should maintain budgetary discipline by fulfilling to criteria: the deficit-to-GDP and debt-to-GDP ratio (in accordance with EU definitions) should not exceed the reference rates of 3% and 60% respectively. The Maastricht Treaty also defines the so-called Excessive Deficit Procedures aimed at counteracting excessive deficits, including also financial sanctions. This procedure has been defined more precisely in the Stability and Growth Pact (in particular in Council resolution No 1467/97 dated July 7, 1997).

In May 2004, the European Commission passed a report[7] in which it was stated that the Polish general government sector deficit in the year 2003 was 4.1% of GDP, thus exceeding the 3% reference value. It was also stated that the causes behind the exceeding of the reference rate were not extraordinary events beyond the control of Polish government, nor were they the result of a recession (which might have deterred the commencement of excessive deficit procedures). In addition, the Commission foresaw continued deficit growth in the year 2004.

In July 2004, the ECOFIN (Financial and Economic Committee) Council issued a recommendation in which it stated that Poland should remedy the excessive deficit by the year 2007, with this being in conjunction with the *Convergence Program*[8] presented by Poland in May 2004. The Council states that Poland should limit the excessive deficit as soon as possible and that by November 5, 2004 it should present an action plan ensuring the imposing of a limit on the deficit next year (to the level foreseen in the Convergence Program, i.e., 4.2% GDP). It is also the Council's opinion that the growth in debt should also be slowed down. Non-execution of the Convergence Program may deprive Poland access to the Cohesion Fund.

[7] Report prepared in accordance with requirements imposed by Art. 104 of the Maastricht Treaty.

[8] Convergence Program passed by the Council of Ministers on 30.04.2004 and approve at the ECOFIN meeting on 05.07.2004.

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 the implementation of the 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 from 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

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 servicing depends on many factors, including: the level of economic development, economic growth rate, social and political stability, international relations, quality of functioning of public institutions, 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 means a threat to achievement of the objective of keeping the public debt at a safe level, with all its negative consequences. They include:

- a possible outbreak of a debt crisis followed by a partial or total loss of capacity to timely servicing debt;
- a threat that in the following years high borrowing needs of the State Treasury will hit a financial market demand barrier. Consequences of such an event may be:
  - inability to finance borrowing needs at reasonable costs,
  - the Issuer having limited control over issuance structure and risk profile;
- 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, including, in particular, restrictions on the flexibility to structure the state budget, resulting from remedial procedures envisaged by the law;
- 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 Euro zone;

- Poland's perception as an increased-risk country, including the downgrading (or lack of expected upgrading) of debt rating for Poland, which is reflected 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 sector in access to domestic savings, resulting from considerable borrowing needs of the State and, as a consequence slower economic growth than possible, resulting from the lower than potential level of investment financed with credit;
- negative impact on the level of market interest rates and on efficiency of monetary policy. Considerable borrowing needs of the State budget may keep interest rates at a level higher than the desirable one.

The public debt-to-GDP ratio in Poland is lower than compared to the EU, where in 2003 the public debt-to-GDP ratio for the 15 EU countries amounted 64.3%, 63.3% for the expanded European Union and 70.7% for the Euro zone. Nevertheless, Poland is a country with lower creditworthiness, and thus the debt level considered safe is correspondingly lower. A major threat here is the growing tendency of debt. In 2003 the ratio of public debt, increased by risk-weighted payments under sureties and guarantees, to GDP rose by 4.9 percentage points (4.3 percentage points according to EU methodology), whereas the total growth in the years 2002-03 was 10.6 percentage points (8.7 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 high economic and political stability (the effect of Poland being a member of 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. High borrowing needs of the State budget put pressure on a rise in medium and long-term interest rates. During the period between mid-2003 and mid-2004, 5-year bond's yields grew by about 2.5 percentage points, whereas 10-year bond's yields by about 2.2 percentage points. This growth was partially caused by a general growth in yields on key markets, including the European market, but the main reason was investors demanding margins of risk associated with high borrowing needs remaining for the upcoming years. The spread between Polish and German benchmark bonds increased by about 1.9 p.p. for 5-year maturities and about 1.6 p.p. for 10-year maturities. Towards the end of the III quarter of 2004 there was a drop in nominal interest rates (0.35 p.p. for 5-year maturities and 0.47 p.p. for 10-year maturities compared to mid-2004 values) as well as a drop in spreads (0.08 and 0.10 p.p. accordingly).

In a situation of significant uncertainty associated with borrowing needs in medium term, investors have overestimated risk or, not being able to assess such risk, limited demand for medium and long-term TS. This has led to the necessity of either accepting high debt servicing costs or transitional shortening of ATM or duration. This situation occurred towards the end of 2003 when demand for medium and long-term fixed rate bonds on the domestic market collapsed.

A prerequisite for achievement of the first strategy objective, i.e. maintaining public debt at a safe level is the carrying out of effective public finance reforms aimed at reducing expenditure side and budget deficit, as well as creating conditions for stable economic growth.

V.2. Risk related to debt servicing costs

At a specified level of borrowing needs of the State budget, 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 carried out 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 objective of costs minimisation, 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

Refinancing risk is associated with issuance of debt aimed at financing the State budget borrowing needs associated with redemption of existing debt. This risk is associated both with the ability to redeem matured debt as well as the conditions of its refinancing (in particular costs generated by new issues of debt). The higher the payment due for redemption of debt and the closer to the maturity date, the higher the risk associated with refinancing such a transaction. The volume of public debt as well as its structure over time also have an impact on the level of refinancing risk. Extending the maturity of debt as well as smoothing debt repayments over time helps to limit refinancing risk.

Measures of refinancing risk include average duration as well as volume and share of short-term debt, including debt having a maturing within 1 year, in overall debt. These two measures complement each other. The size and share of short-term debt give an indication of how much funds will have to be gained in a short time in order to repay such debt. ATM on the other hand gives information when existing debt will become short-term debt. It should be noticed that both of these measures are simplified indicators of refinancing risk. They do not take into consideration how evenly repayment is spread over time. Thus there is a need to carefully monitor the maturity profile in order to avoid peaks of debt repayment.

Domestic currency refinancing risk remained at a similar, relatively high, level over the last few years. ATM of marketable debt at the end of 1999 was 2.47 years and 2.71 years in mid-2004. The highest value, i.e., 2.87 years, was achieved in April 2003. This is still significantly different than ATM of 15 EU countries where this value was equal to 3.9 years in Austria, 4.8 years in Finland, 5.3 years in Germany, 5.9 years in the Netherlands, 6.2 years in Italy, 6.3 years in Belgium and 11.9 years in Great Britain.

The share of TS having maturity of up to 1 year is relatively high. In the middle of 2004 it amounted to 37.3% which in absolute terms is PLN 101.0 billion. With domestic debt growing, maintaining this ratio at a similar level would mean a significant increase in refinancing risk.

Refinancing risk can be limited by changing debt structure in favour of instruments having a longer maturities, at the same time reducing the role of short-term instruments. The cost of this is usually acceptance of higher debt servicing costs arising from a risk premium associated with a longer investment horizon. The more developed and liquid the market is, the lower cost premium. Thus it is very important to strive towards extending the yield curve. At present, the longest instrument available on the domestic market are 20-year fixed rate bonds, the longest liquid instrument being 10-year fixed rate bonds.

A prerequisite for limiting refinancing risk is slowing down a fast growth of debt volume. The ability to issue long-term instruments is not only based on current borrowing

needs, but also investor expectations as to their medium-term volumes. In fulfilling this requirement it should be assumed that further development of the market will be aimed at limiting refinancing risk in the future. The deepening of the market though will be helped by the investor base widening as a result of integration with the EU. Then, the level of refinancing risk will be result of decisions made regarding costs which may be undertaken in order to reduce refinancing risk through long-term issues.

Ad b) Exchange rate risk

Exchange rate risk exists due to the fact that State Treasury debt also consists of instruments denominated and settled in foreign currencies. Exchange rate risk is measured by the sensitivity of debt volume and its servicing costs to changes in exchange rates, a natural consequence of taking into consideration the existence of floating exchange rates regime in Poland. Appreciation or depreciation of the Zloty against a given currency results in a proportional increase or decrease of debt (expressed in Zloty) in the given currency. Taking into consideration the currency structure of Poland's foreign debt, a 1% change in the EUR/PLN exchange rate would result in approximately a 0.6% change in debt volume , whereas a 1% change in the USD/PLN exchange rate would result in approximately a 0.2% change in the level of debt. In the case of debt servicing costs of foreign debt, a 1% change in the EUR/PLN exchange rate would cause, taking into consideration the current debt structure, a change of approximately 0.58% in costs whereas a 1% change in the USD/PLN exchange rate would result in a change of approximately 0.34%. An analysis of exchange rate risk in the case of a Strategy exceeding one year should not only take into consideration the possibility of short-term fluctuations of exchange rates, but also long-term trends associated with the shaping of the PLN exchange rate which assume gradual real appreciation of the Zloty to other currencies.

After Poland's entry into the Euro zone the exchange rate risk associated with Euro denominated debt will be eliminated. Therefore, the share of debt denominated in Euro is very important for measuring exchange rate risk. At present about 60% of total foreign debt is denominated in Euro and this share is expected to grow in the upcoming years.

Exchange rate risk is extremely important taking into consideration that a significant share (32.7% in mid-2004) of State Treasury debt is foreign debt as well as the fact that the public debt-to-GDP ratio is approaching subsequent safety thresholds provided for in the Public Finance Act. As can be seen looking at data contained in Table 9 (see Chapter IV.2), changes in exchange rates have results in this ratio in respect to State Treasury debt to grow by 1.4 percentage points in 2003 and was one of the causes for the first safety threshold to be exceeded.

Ad c) Foreign currencies refinancing risk

ATM 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 even though it is slightly dropping, it remains at a level similar to European standards, reaching5.73 years at year end 2003. The average level of repayments of capital instalments of foreign debt in the years 2005-2007 is about €3.1 billion annually.

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 rates. 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 of 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.

Up to the middle of 2003, interest rate risk continued to be systematically reduced. The average duration of market debt at the end of 1999 was 1.55 years and 2.33 years in May 2003. Later, as a result of the change in the interest rate trend towards upward, a reduction in ATM as well as an increase in sales of floating rate bonds, duration began to drop and achieved a level of 2.09 years in the middle of 2004. The level of risk is considered to be too high and the sensitivity of debt servicing costs to changes in interest rates too large. Duration in 15 EU countries was higher than in Poland and amounted to - 2.6 years in Finland, 2.9 years in Sweden, 3.0 years in Austria, 3.2 years in Denmark, 4.2 years in Belgium, 4.9 years in Ireland and 7.3 years in Great Britain.

In respect to foreign debt, the majority of the debt portfolio (about 60% at year end 2003) had fixed rates. Reduced, i.e., below market value, interest rates for Paris Club loans constitute a factor limiting interest rate risk. Additionally, the share of fixed rate debt continues to.

Interest rate risk also has an impact on debt service costs. A 1 p.p. change in interest rates would result in an approximately 4.7% change in foreign debt servicing costs (in 2005).

Ad e) State budget liquidity risk

Liquidity risk management consists of two types of actions:

- keeping 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 entities 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 budgetary revenues in order to counterbalance, to the biggest extent, the costs involved with maintaining a specified, safe level of liquidity.

The main instrument for managing State Treasury liquidity is maintaining financial liquid assets on the State budget account and depositing surpluses in short-term deposits with NBP and commercial banks. The level of these deposits should ensure financial security for the State budget borrowing needs and make it independent of transitional emergency situations when borrowing on the financial markets is impossible or inefficient.

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 operational risk.

1. Credit risk

Credit risk is associated with the danger that the other party to the transaction will not fulfil its obligations – either in full or in part. In the case of debt management, this is associated with transactions in which amounts due are the subject of the transaction. This is the case with derivatives, in particular swaps, i.e., exchange of cash flows between the parties to the agreement. Another situation in which credit risk arises is management of liquid assets, e.g., by making deposits in banks or acquirement of securities.

Following the first deposits with commercial banks starting in 2004 as well as the conducting of the first transactions involving derivatives, credit risk – a factor not present previously in regards to public debt and liquidity management in Poland – arose. In the case of deposits this risk is the price paid for higher income from interest rates in commercial banks compared to deposits held with the central bank, thus resulting in more efficient liquidity management. In the case of derivatives, credit risk is the price paid for the ability to flexibly adjust the market risk profile (mainly interest rate and exchange rate) to current needs, or – as was the case with the first private placement issue secured with interest rate

swaps – reducing debt servicing costs by satisfying the needs of a specific group of investors.

The limiting of credit risk associated with such transactions will be enhanced by defining a list of entities (having a high rating) that can become partners of transactions, as well as limits to involvement quotas, dependent on risk associated with a given kind of transaction. It is also indispensable to ensure organisational and technological facilities supporting active credit risk management and to be able to react quickly to changing market conditions having an impact on the market value of signed transactions. Funds currently deposited in commercial banks are collateralised by TS and do not generate credit risk.

2. Operational risk

Operational risk is the risk that costs associated with debt management or the levels of remaining types of risk will increase as a result of insufficient infrastructure and organization being inadequate to debt control and its management. Steps should be taken to integrate debt management into one organizational unit which structure and procedures would be a combination of those used in market institutions and state administration in order to limit this type of risk.

The growing complexity and sophistication of public debt management instruments as well as the process of European integration requires adaptation of institutions and organisations of debt management in order to reduce operational risk and adjust organisational structure to changes of the present days. This is particularly important in the case of derivatives and deposit transactions carried out on financial markets. Modern public debt management requires that efficient technical infrastructure and organizational procedures exist which ensure fast evaluation of risk and appropriate reactions to changing market conditions. The lack of such gives birth to operating risk which rules out or seriously limits the ability to use modern debt management instruments which have been in use for years in developed countries. The contracting out of services to external institutions to manage debt is a source of inefficiency arising from the splitting of the decision-making process at the strategic and operational level as well as costs associated with remunerating for agents. Experience gained by developed countries shows that from a risk and cost standpoint the task of public debt and State budget liquidity management is best managed by an autonomous entity which is responsible for public debt management and authorized to carry out all tasks associated with this. The institutional framework for debt management in EU countries is discussed in Annex 1.

The adaptation of organizational structures should be accompanied by on-going development of debt management methodology. Application of the so-called benchmark portfolio to assess the volume and structure of debt has become a noticeable trend in developed countries.

Ad g) <u>Distribution of debt servicing costs over time</u>

Debt servicing costs should be evenly distributed over time, so that their volatility does not have a destabilizing effect on construction of the State budget. In a cash-based budgetary accounting system stabilization 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 in the years 2000-2001. Active management of distribution of debt servicing costs over time is possible and recommended. Switching auctions and bond buy-backs, in use since 2001, are instruments adding to the flexibility of cost distribution structuring.

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

Risk of a dual nature is associated with guarantees and sureties granted by entities of the public finance sector including, in particular, those granted by the State Treasury:

1) The volume of risk-weighted payments under guarantees and sureties due to increase in the total volume of guarantees and sureties or probability of their execution, adds to the volume of public debt (the primary category to which legal regulations relate to),

2) executed guarantees and sureties constitute debt servicing costs.

The activities of the State Treasury to date in the field of sureties and guarantees do not pose threats to public finances. 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 in regards to those sectors of the economy that require restructuring, and at the same time are characterised by high financing risk. As a consequence, the volume of anticipated payments arising from sureties and guarantees and their ratio to GDP went up in 2002 (from 1.29% in 2001 to 1.57%). In 2003, as a result of a drop in potential liabilities arising from sureties and guarantees, the anticipated volume of payments and their ratio to GDP amounted to 1.39%, although risk for the entire portfolio increased slightly.

In order to reduce the risk associated with granting State Treasury guarantees and sureties, at the same time maintaining benefits associated with their use as an economic policy instrument, one should:

- concentrate the granting of sureties and guarantees on support for development-oriented investments in infrastructure and execution 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 enable to receive a multiple worth of EU funds),
- maintain the principle that the relation between State Treasury risk-weighted payments under guarantees and sureties to GDP will not exceed 2%,
- 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.

An additional source of risk associated with an increase in public debt may be various types of transactions carried out by public sector entities. These types of transactions include public private partnerships as well as securitization.

The impact of agreements signed in conjunction with public private partnerships on the public debt depends above all on how risk is spread between the parties to such an agreement. Transactions, in which the majority of risk associated with the subject of the agreement is carried by the public sector entity are a source of creation of public debt. Work is currently underway on legislature which will regulate issues associated with public private partnerships.

Securitization transactions carried out by public sector entities may on the one hand have a positive impact from the point of view of asset management, on the other hand though they may also generate public debt. Depending on the subject of the agreement, such transactions may have a direct (e.g., in case of securitization of future flows) or indirect (in the form of granted guarantees or sureties) impact on public debt.

VI. DEBT MANAGEMENT STRATEGY OBJECTIVES IN THE YEARS 2005-2007

The objectives set forth in last year's *Strategy* remain unchanged:

1. **Maintaining the volume of public debt at a safe level.**
2. **Minimisation of debt servicing costs over a longer time horizon with accepted limitations regarding the level of:**

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

Ad. 1) Maintaining the volume of public debt at a safe level

In the context of this objective, debt management constitutes one of the elements of government economic and financial policies and is not limited to actions aimed at shaping debt structure in a manner ensuring minimization of cost at accepted risk levels.

In the previous *Strategies*, 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 (as a consequence arising from exceeding limits regarding debt level imposed by the Public Finance Act). As a result of fast growth of debt in the years 2001-2003, debt exceeded the first safety threshold described in the Public Finance Act (50% of GDP). This means that the State as well as local governments in preparing their budgets for the year 2005 must take into account limitations imposed on them by the Public Finance Act, i.e., the deficit-revenues ratio cannot be higher than 29.3% (see Chapter IV).

Actions aimed at limiting the growth of public debt in the timeframe covered by the Strategy herein will be carried out in the following areas:

- legislative changes resulting in limiting the State budget borrowing needs as well as ensuring more efficient allocation of funds,
- solutions aimed at resolving in a general and comprehensive way continued growth of public debt (in particular in regards to independent public healthcare units [SPZOZ]),
- policies aimed at maintaining high economic growth in subsequent years.

The limiting of the State budget borrowing needs as the main factor influencing growth of public debt must be spread-out over time with expected results, i.e., stabilization of the debt-to-GDP ration, occurring in the medium-term horizon. Favorable macroeconomic situation should be a factor helping government in the execution of the program to limit budget expenditures and reform of the public finance sector is , in particular a high rate of GDP growth.

The rate of public debt growth over the time horizon of the strategy herein will above all, as in recent years, be determined by State budget borrowing needs. It is predicted that the debt-to-GDP ratio will continue to grow until the year 2006 despite a drop in the deficit. The positive results of public finance reforms, in particular a significant reduction in State budget borrowing needs should in time horizon of the Strategy lead to a slow-down in the rate of debt growth which will mean that, under the assumed high level of economic growth, the upward tendency of the debt-to-GDP ratio will be stopped in the year 2007.

Ad. 2) Minimisation of debt servicing costs over a longer time horizon with accepted limitations regarding the level of risk. 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 servicing 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 needs subject to limitations involved with the debt structure. Within the risk constraints the following was assumed:

a) domestic currency refinancing risk,
   - increasing ATM of domestic debt - at a rate depending on the market situation development,
   - 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,
   - appropriate relation between domestic debt and foreign debt as well as gradual increase in the share of Euros in the currency structure of foreign liabilities;

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

d) interest rate risk,
   - an increase in domestic debt duration at a rate depending on the market situation development,
   - further reduction of interest rate risk for foreign debt through contracting most new liabilities at a fixed rate;

e) state budget liquidity risk,
   - maintaining state budget liquidity at a safe level given efficient management of liquid assets;

f) other risks, in particular credit risk and operational risk,
   - transactions with domestic and foreign entities with the highest creditworthiness and limitation of operational risk related to technical infrastructure and institutional arrangements of debt management,

g) distribution of debt servicing costs over time
   - limiting the volatility of the relation between debt servicing costs and GDP. Maintaining a stable ratio in the strategy horizon will be made difficult due to a large volume of discount paid on matured bonds as well as interest on existing debt. These factors translate into a significant growth in debt servicing costs in the year 2006. Issuance policy associated with medium- and long-term bonds should result in a more even distribution of debt servicing costs in the horizon of the strategy.

VII. STRATEGY TASKS IN A THREE-YEAR HORIZON

The most important strategy tasks arising from the execution of the assumed objectives are:

1. Further improvement in the liquidity, efficiency and transparency of the TS market.
2. Development of a System of Treasury Securities Dealers (Primary Dealers).
3. Development of a system for managing State budget liquidity.
4. Strengthening Poland's position on the international financial markets.

1. Further improvement in liquidity, efficiency and transparency of the TS market.

Membership in the EU should significantly accelerate the integration process of the domestic TS market with that of EU countries. In order to reap benefits of participation in a common European market though, activities aimed at adapting public debt management as well as the TS market to EU standards must be continued. Actions aimed at improving the efficiency of the TS market are on-going activities and should be aimed at improving both the primary as well as secondary 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 supply 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 needs. Activities aimed at increasing the attractiveness of the TS market and facilitating the integration of Poland's financial market with those in the EU will be carried out through:

- Continuing the TS issuance policy aimed at limiting the number of bond issues, at the same time gradually increasing their volume to a level constituting the equivalent of Euro 5 billion (creation of so-called *benchmark* issues). Instruments aimed at achievement of this goal will be appropriately planned TS issuance calendar, switching auctions and complementary auctions.
- Further development of the Electronic TS Market (ETSM). An important impulse for development of ETSM should be the strategic alliance between CeTO S.A. and MTS which organizes electronic trading of treasury securities in more than a dozen European countries. Thanks to this alliance, foreign banks using the MTS platform on the European market will obtain access to ETSM together with the ability to carry out electronic trading in Polish TS. The expanding of the group of entities entitled to operate on the ETSM should help significantly in increasing the efficiency of this market and ensure better pricing of securities, in particular due to an increase in market liquidity as well as turnover volumes. Commissioning of the MTS-CeTO market is planned for the second decade of November 2004.

Improvement of the TS market infrastructure by alleviating legal and technical barriers as well as streamlining settlement mechanisms. Thanks to changes to the Public Trading in Securities Act as well as planned changes to regulations of the National Depository for Securities (NDS), it will be possible for a foreign institution to obtain the status of a settlement participant, thus reducing the cost of trading in Polish TS for foreign investors (no need to use domestic brokers in settlements with NDS). Further actions aimed at further reductions in fees charged by NDS must also be continued. In order to make clearing and settlement transaction easier for foreign investors it would be useful to initiate cooperation between NDS and other European clearing houses.

2. Development of the System of Treasury Securities Dealers (Primary Dealers)

The year 2004 is the second year in which the Primary Dealers system is in operation. At present, 11 banks which have obtained the status of Primary Dealers and one State bank (BGK S.A.) which is not a Primary Dealer have access to the primary market system. At the same time, a competition was announced on January 1, 2004 to select Primary Dealers for the year 2005. This will be the last competition limited to domestic banks. The new Primary

Dealer Rules foresee that foreign banks may also try to achieve the status of a Primary Dealer. Participation of foreign banks in the Primary Dealer's system should serve to increase competition between banks which in turn should lead to more efficient operation of the system.

3. Development of a system for managing State budget liquidity

Liquidity management of the State budget as of January 1, 2005 will be conducted through a unified State budget account (Tresor system). This system will ensure on-going access to information regarding State budget proceeds, expenditures and submitted requests for funds as well as allow for more efficient management of budgetary funds.

A very important task associated with management is further improvement of forecasting regarding budgetary flows.

The system for management of liquid assets will also be improved and operate in accord with limitations associated mainly with budgetary conditions (level of risk taken in various transactions – mostly credit risk, volume of liquid funds) as well as market conditions (situation in the banking sector in regards to liquidity).

4. Strengthening Poland's position on the international financial markets

Foreign financing will mainly be conducted through benchmark issues of bonds on key international markets as well as through debt incurred in the form of new loans taken from international financial institutions.

Bond issues on the international market will be mostly designated towards refinancing repayment of principle installments (mainly associated with liabilities towards Paris Club creditors maturing in the years 2005-2009) will change the profile of foreign debt, replacing non-marketable debt with marketable debt. Issuance policy will take into consideration risk factors associated with debt (interest rate risk, refinancing risk and foreign exchange risk). Therefore the intent is to place issues having an appropriately long redemption period. Issuance policy associated with foreign bonds will take into consideration Poland's planned entry into the Euro zone. The moment this entry takes place, that part of debt which is denominated in Euro will become a domestic currency debt, thus reducing the foreign exchange risk. Therefore it is assumed that the majority of issues will be denominated in Euro. Another benefit arising from issuing bonds on the European market is the ability to improve their liquidity by listing them on the NewEuro MTS electronic platform commissioned in 2003. In June 2004, 3 bonds issued by Poland were listed on this platform. The drive towards minimizing costs at the assumed level of risk though inclines continuation of the policy of diversification, taking advantage of favorable conditions for issuance of debt securities in currencies other than the Euro.

New loans will mainly be drawn from international financial institutions (in particular the European Investment Bank) and designated towards, *inter alia*, financing structural reforms as well as investments in industries which are key for economic development (e.g. the transport sector), pre-financing and co-financing of projects being carried out with the support of EU structural funds as well as projects associated with environmental protection and development of small and medium-size enterprises.

VIII. NEW INSTRUMENTS FOR IMPLEMENTING THE STRATEGY OBJECTIVES

The basic instruments for implementing the strategy objectives and tasks include: 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) Development of methods and instruments supporting debt management

- following implementation of the IT system as the fundamental IT infrastructure, work will be continued on a risk management system; it means development of the debt and risk management methodology based on IT infrastructure in place, optimisation and simulation models as well as decision making procedures;
- actions aimed at the creation of a benchmark portfolio as a long-term reference portfolio will allow for conducting of evaluation regarding the efficiency of undertaken decisions compared to costs and risks associated with the execution of current operations.

2) Legal/organizational solutions

- legal and organizational adaptation of the State budget liquidity management system;
- actions aimed at further adaptation of the legal and organizational infrastructure to allow for wider use of derivatives;
- use of EU funds in the management of State budget liquidity.

3) Derivative instruments

- determining the principles and advisability of using derivatives as instruments to change the risk profile associated with debt structure (interest rate risk, foreign exchange risk and refinancing risk);
- using derivatives to hedge non-standard bond issues in the *private placement* system.

4) Management of State budget liquidity

- implementation of a unified budget account;
- development of liquidity management instruments (deposits in commercial banks secured by TS).

IX. FORECASTED DEBT AND DEBT SERVICING COSTS

The presented forecasts arise from execution of the strategic objectives. They are based on the assumptions presented in Chapter III.1 (Table 2) regarding developments of Poland's macroeconomic situation. Debt servicing costs in the years 2006-2007 are presented within certain brackets as they depend on *inter alia* the TS issuance structure.

Table 10. Forecasted public debt and State Treasury debt service costs in the years 2004-2007

	2003	2004	2005	2006	2007
1. State Treasury debt					
a) PLN billion	378.9	427.4	483.8	531.0	578.2
b) relative to GDP	46.5%	48.4%	50.8%	51.9%	52.3%
2. Public debt					
a) PLN billion	408.6	461.6	520.1	565.7	608.2
b) relative to GDP	50.2%	52.2%	54.6%	55.3%	55.0%
3. Public debt increased by risk-weighted payments under sureties and guarantees					
a) PLN billion	420.0	473.5	534.9	581.4	624.6
b) relative to GDP	51.6%	53.6%	56.1%	56.8%	56.5%
4. General government debt (according to EU methodology)					
a) PLN billion	369.7	412.1	459.3	494.3	526.7
b) relative to GDP	45.4%	46.6%	48.2%	48.3%	47.7%
5. State Treasury debt servicing costs (cash basis)					
a) PLN billion	24.14	26.75	27.40	33.70 – 34.34	35.10 – 35.85
b) relative to GDP, of which:	2.96%	3.03%	2.88%	3.29% - 3.36%	3.18% - 3.24%
- domestic debt	2.50%	2.38%	2.25%	2.69% - 2.74%	2.53% - 2.59%
- foreign debt	0.46%	0.65%	0.63%	0.61% - 0.62%	0.64% - 0.65%

Sensitivity of the debt to GDP ratio as well as debt servicing costs to GDP to key variables is as follows:

1) sensitivity of debt and servicing costs exchange rate – a weakening or strengthening of the Zloty by 1% to the Euro in a given year (together with a proportional weakening/strengthening against other currencies in which foreign debt is denominated) has an impact on the growth or drop of the debt-to-GDP ratio in the years 2005-2007 of 0.13-0.14 p.p., whereas in regards to the debt servicing costs-to-GDP ratio – about 0.01 pp;
2) sensitivity of debt servicing costs on interest rates – a 1 p.p. change in interest rates (parallel shift of the curve by 1 p.p. compared to the base scenario) results in a change in the cost-to-GDP ratio of 0.05 p.p. in 2005, 0.15 p.p. in 2006 and 0.29 p.p. in 2007;
3) sensitivity of the debt-to-GDP ratio to changes in real GDP growth by 1 p.p. for the years 2005-2007 is 0.5 p.p. in 2005, 0.9 p.p. in 2006 and 1.4 p.p. in 2007;
4) sensitivity of the debt-to-GDP ratio to changes in the borrowing needs of the State budget or net privatization proceeds by PLN 1 billion is between 0.09 and 0.11 p.p. during the years 2005-2007.

X. INFLUENCING PUBLIC FINANCE SECTOR DEBT[9]

X.1. Changes in legal regulations

The key changes adopted in the Public Finance Act regarding the contracting of debt by public sector entities and following Poland's entry into the EU are as follows:

1) changes regarding pre-financing

- the ability to draw loans from the State budget for pre-financing of programs and projects being carried out using funds coming from the EU budget (structural funds and Cohesion Fund, and, in the case since the Agricultural Market Agency (ARR) and Agricultural Restructuring and Modernization Agency (ARiMR) from the European Agricultural Guarantee and Orientation Fund) has been introduced for public sector entities;
- the Act states that a loan granted for pre-financing of EU programs and not used in accordance with its designated purpose must be refunded to the State budget within 7 days of the improper use of such a loan consumption is noticed together with interest as for outstanding tax liabilities (this provision does not apply to payment agencies such as ARR and ARiMR);

2) changes relating to local government units

- securities and credits or loans contracted in conjunction with the use of funds defined in an agreement signed with an entity having at its disposal European Union structural funds or the Cohesion Fund[10] are exempt from limitations associated with debt incurred by local government units (i.e., 12%-15% limit for the debt service-to-planned revenues ratio and 60% of the debt/revenues limit imposed by Art. 113 and 114);
- a provision is added stating that if funds coming from European Union structural funds or the Cohesion Fund are not transferred or following their transfer there is a ruling to return such funds, the local government unit cannot issue securities, contract a loan or grant a surety until legally imposed limits regarding debt are fulfilled (limits defined in Art. 113 and 114);

Due to the growing debt of independent public healthcare units (SPZOZ), work is currently underway on a comprehensive reform of public healthcare in Poland. This includes work currently underway in the Parliament on the government draft of the public healthcare and restructuring of public healthcare units act. In accordance with this draft:

- debt incurred by SPZOZ's between January 1, 1999 and March 31, 2003 will be restructured,
- SPZOZ's will, in order to be able to secure funds for restructuring, be able to:

a) issue bonds;
b) draw bank loans;
c) ask local government units to grant sureties on repayment of liabilities arising from the issuance of bonds by these healthcare units;
d) request Bank Gospodarstwa Krajowego (BGK) to grant a surety for payment of interest on bonds from the National Loan Surety Fund,
e) receive a loan from the State budget; the main purpose of introducing this solution is to help in settling liabilities arising from Act on a Negotiated System for Determining Average Salary Increases from Entrepreneurs as well as modifying certain other Acts (the so-called "203 Act").

[9] Unless stated differently, the term public finance sector entity in this chapter relates to this sector with the exclusion of the State Treasury.

[10] Liabilities arising from this, although not being included in the report, fulfill the requirements imposed by Art. 113 and Art. 114 of the Public Finance Act and constitute a local government debt and as such are included in limits associated with public debt (Art. 45 of the Act).

In addition, work regarding regulation of principles for public-private partnerships are underway. The draft of the act, currently underway in the Parliament, introduces, *inter alia* the requirement to define the sharing of risk by the individual parties in signed agreements. This factor is key to being able to evaluate the impact of a given agreement on the public debt.

X.2. Debt of public finance sector units other than the State Treasury

Among public finance sector units (other than the 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

There is a steady tendency among the local government units to concentrate the issuance of debt on the last quarter of the year. This tendency is directly associated with the uneven distribution of budgetary balance within a year.

Table 11. Balance of local government units on quarterly basis

	I quarter	II quarter	III quarter	IV quarter	Year
Balance of local government units (PLN million)					
2002	3 205.8	-913.1	32.1	-5 472.7	-3 147.9
2003	3 287.3	-871.0	-127.9	-4 102.4	-1 813.9
2004	5 165.5	189.4			

The majority of local government debt consists of credits and loans (a stable share in debt of about 80.0%). The share of securities continues to grow in conjunction with a drop in matured payables.

Table 12. Debt of local government units

	XII 2002	XII 2003	VI 2004
Debt of local government units (PLN million)	**15 358.4**	**17 276.8**	**16 455.1**
credits and loans	12 237.5	13 785.7	12 966.7
securities	2 381.0	2 817.8	2 921.2
Remaining debt, of which:	740.0	673.3	567.2
Matured payables	*712.4*	*648.4*	*544.0*

Liabilities are mostly incurred on the domestic market although the share of foreign debt is gradually increasing (from 3.2% at year end 2002 to 4.7% at the end of June 2004). Debt with maturity above one year continues to maintain a dominating share of total debt (about 87% of debt).

The aggregate debt to revenue ratio is significantly below the 60% limit imposed by law.

Table 13. Local government units' debt to revenues

	XII 2002	XII 2003	VI 2004[1)]
Debt/revenue ratio	19.2%	21.8%	19.0%

[1)] debt of local government units at the end of June 2004 compared to planned 2004 revenues

In 2003, 18 units (compared to 20 in 2002) exceeded the 60% limit imposed by law. The main causes were:

1) excessive, compared to the financial capabilities of the given unit, drawing of loans for execution of investment in past years,
2) lower than planned revenues.

In certain cases, the threat of losing liquidity by the local government unit may also be the result of sureties and guarantees issued by these units (at the end of June 2004 the value of liabilities arising from sureties and guarantees granted amounted to PLN 974.8 million compared to PLN 996.0 million at year end 2003 and PLN 878.3 million at year end 2002).

2) Debt of ZUS and funds managed by it

Since 2003, debt incurred by ZUS and funds managed by ZUS consists of matured liabilities as well as loans drawn in commercial banks.

Table 14. Debt of ZUS and funds managed by it PLN million

	XII 2002	XII 2003	VI 2004
Debt of ZUS and funds managed by it, of which:	**15 014.6**	**11 225.4**	**9 608.1**
loans from commercial banks	2 388.8	4 756.0	3 818.5
loans from State Treasury funds	6 000.0	-[1)]	
Matured payables	6 625.8	6 469.5	5 789.6

[1)] as of January 1, 2003, loans from State Treasury funds to FUS, together with interest, have been written off; at present, FUS cannot draw loans from the State budget;

Loans from commercial banks, aside from subsidies from the budget, are an additional source of financing. They are of a short-term nature.

Matured payables are above all the result of difficulties associated with timely transferring of funds arising from pension contributions to OFEs. These liabilities (incurred between 1999 and 2002) together with accrued interest, are as of November 2003 taken over by the State Treasury and subsequently being converted into TS (10-year floating interest bonds).

Table 15. Conversion of FUS debt to OFE into TS

PLN million

	XII 2003	III 2004	VI 2004
Face value of issued TS (accrued, as at end of given period)	387.7	646.8	729.3

In the strategy horizon, a drop in debt of ZUS and funds managed by it can be expected. This drop will be the result of:

1) a forecasted reduction in debt arising from bank loans,
2) a continuation of the process of ZUS debt towards OFEs being taken over by the State Treasury and being converted into TS.

3) Debt of independent public healthcare units

Table 16. SPZOZ debt PLN million

	XII 2002	XII 2003	VI 2004
Debt of independent public healthcare units, of which:	**3 545.8**	**5 132.9**	**5 945.7**
securities	17.5	7.0	12.2
credits and loans	279.7	394.8	423.1
other, of which:	3 248.6	4 731.1	5 510.4
matured payables	*3 248.0*	*4 729.7*	*5 508.9*

The main source of debt for independent public healthcare units is untimely payment of liabilities. These liabilities constitute more than 60% of liabilities to non-public sector entities with the majority of them being for delivery of goods and services. Further changes in SPZOZ debt will be dependent on the efficiency of actions aimed at reforming the public healthcare system.

4) Other units

The highest level of debt among other units is in the Agricultural Market Agency [*ARR*] and the National Health Fund [*NFZ*]. The main source of ARR debt are loans drawn for intervention purchases of grain. All credits drawn by the Agency are secured by the State Treasury.

NFZ's, legal successor to the Sickness Funds debt is mostly the result of loans drawn by these entities from the State budget in the year 2000. Repayment of these loans has been deferred until 2007.

The debt of other public sector entities is mainly the result of untimely repayment of liabilities.

XI. THREATS FOR IMPLEMENTATION OF STRATEGY OBJECTIVES

The Strategy presented herein will be executed in new external conditions arising from Poland's entry into the EU. The continuation of the integration process will require that actions aimed at fulfilling convergence criteria, in particular those associated with limiting public finance debt, be implemented. Fiscal adjustments during the strategy horizons stem from the necessity to implement actions foreseen in the Public Finances Act after exceeding subsequent safety thresholds.

Threats associated with execution of the objectives presented in the strategy are above all associated with:

1) the situation in public finances as well as limitations on the scope or too slow implementation of actions aimed at hampering the rate of debt growth.
2) the macroeconomic situation developing differently than assumed as well as a negative impact of external factors.

Ad 1.

Incomplete or too slow implementation of comprehensive program of public finance reforms accepted by government aimed at diminishing the State budget borrowing needs as well as slowing down the growth of debt in other public finance entities would to a major degree hinder the ability to carry out both the first objective, i.e., maintaining debt at a safe level as well as objective of minimizing debt servicing costs within the accepted limitations. The fulfillment of a scenario in which during the years 2005-2007:

- State budget borrowing needs remaining at a similar level to current levels,
- proceeds from privatization remaining at the level achieved during the years 2001-2003,
- debt of public finance sector entities other than the State Treasury (in particular healthcare) continuing to grow without limitation,
- sureties and guarantees being designated mainly towards the support of traditional branches of the economy, thus generating a substantial risk of them being called

would, in the current legal environment, lead the debt-to-GDP ratio to approach the limits imposed by the Constitution in 2006 as well as a significant growth in cost of debt servicing and an increase in risk associated with debt structure.

Such a scenario could also lead to a change in the currently favorable tendencies regarding Poland's macroeconomic development which – in accordance with the accepted assumptions – should be a supporting factor in the process of public finance reforms and lead to a drop in the debt-to-GDP ratio.

Ad 2.

Macroeconomic risk factors:

a) unfavorable development of the domestic macroeconomic situation, e.g.:
   - lower than assumed GDP growth during the years 2005-2007,
   - inflation growing faster than assumed,
   - depreciation of the Zloty,
   - an increase in domestic interest rates
b) a deterioration or lack of expected improvement in the worldwide economy (in particular in EU countries) making execution of the assumed GDP growth impossible to achieve,
c) an increase in foreign interest rates.

XII. EFFECTS OF STRATEGY IMPLEMENTATION

The key result arising from implementation of this strategy will be the reversal, as of 2007, of the upward trend in the public debt/GDP ratio. In 2007, it is expected that the State Treasury debt will achieve the following selected parameters:

- ATM of domestic marketable debt will grow from 2.66 years in 2003 to about 3.2 – 3.6 years,
- the duration of marketable domestic debt will increase from 2.12 years at the end of 2003 to about 2.6-2.9 years,
- the share of the banking sector in domestic debt will decrease from 34.3% at the end of 2003 to about 25%, the share of domestic non-banking sector will increase from 49.3% at the end of 2003 to about 53.0%, and the share of foreign investors will increase from 16.4% to about 22.0%.

Annex 1. Institutional framework for debt management in EU countries

Public debt management in EU countries is, due to macroeconomic threats and risk associated with debt structure, an important element of social-economic policies. The actions of decision makers are directed towards both limiting the level of debt as well as marketable, credit and operational risk. One of the effects of the aforementioned tendencies are reforms being carried out in a number of countries aimed at adapting the institutional structure of debt management to arising challenges .

An additional catalyser in this process is development of the financial markets resulting in, *inter alia*, growing importance of financial derivatives in risk management as well as increased use of these instruments in public debt management. Limiting market risk means in practice transferring the bulk of rather passive "administering" of debt to active debt portfolio management consisting of taking advantage of the current market situation to achieve goals associated with debt management. This though requires the appropriate institutional and organizational structures, adapted to acting on highly developed financial markets, to be put into place.

There is no unified institutional model regarding State Treasury debt management in place in EU countries. An analysis though of used solutions allows for identification of three fundamental types of organizations:

- the bank model in which debt management remains with the central bank,
- the government model in which debt management remains within the structure of one ministry (usually the Ministry of Finance or State Treasury),
- the agency model in which matters associated with debt management are entrusted to a specialized institution (agency) whose fundamental (although not always sole) task is debt management.

The bank model is the most strongly criticized one. This criticism is the result of potential conflicts of interest which may take place between monetary policies and public debt management. The central bank in such a situation may:

- treat debt management in an instrumental manner, concentrating instead on monetary policy goals,
- be less inclined to increase interest rates in situations of inflationary risk (as this would increase debt related costs) or in fact influence the interest rates or increase market liquidity just prior to a TS auction in order to achieve a better price and lower financing costs.

In both cases, execution of tasks imposed on the central bank is not optimal. In addition, even if monetary policies and debt management are placed in different departments and the so-called "Chinese Wall" is used, there may arise suspicions that information unknown to the market regarding interest rates was used in conjunction with debt management, thus reducing trust in the issuer and resulting in investors requesting an additional risk premium for Treasury securities.

The argument used by supporters of this solution, consisting of placement of debt management in the central bank, is the conviction that the central bank is better prepared for activities on the financial markets than units remaining within the structures of a ministry.

The government model is used successfully in conditions typical for "developing" economies or economies undergoing transformations where development of financial markets is low, although not only[11]. This is due to the significant ability of government to influence the creation of appropriate legal and institutional infrastructures necessary for the efficient functioning of a financial market. However, the down sides of this solution are becoming more and more visible in developed and stable economies:

[11] The government model operates in countries like Spain and Italy.

- the threat associated with placing short-term budgetary goals before long-term goals associated with debt management, thus possibly leading to an increase in both risk associated with debt structure as well as long-term debt servicing costs,
- lack of sufficient flexibility as well as ability to react quickly enough to changes in market conditions (extremely important in case derivatives are used for debt management) arising from the significant bureaucracy of administrative entities,
- difficulties in recruiting and retaining appropriately trained specialists due to uncompetitive hiring conditions for State administrative employees compared to finance sector (banks, investment funds, etc.) can offer.

The agency model is the most commonly used model in EU countries. The term "agency" though is a certain type of generalization (it does not mean a government agency as defined by Polish law) as specialized institutions involved in debt management in the individual countries are significantly different, both in respect to the scope of tasks entrusted with them as well as the level of independence. Their common trait though is their high level of autonomy in respect to selection of methods used to fulfil entrusted tasks. The most important advantages associated with entrusting specialized institutions with debt management include:

- the ability to select optimal solutions as well as carry out long-term debt management goals by limiting the impact of short-term fiscal policies on management decisions,
- ensuring greater transparency of management operations through the use of better control and reporting mechanisms, thus increasing investor confidence and lowering debt requirement financing costs,
- the need to prepare clear and unequivocal procedures allowing for the undertaking of fast decisions regarding market transactions (a necessary condition for efficient and proactive debt management),
- the ability to face the challenge put forth by commercial institutions (recruitment and retention of highly qualified specialists).

The entrusting of debt management to a specialized institution does not mean that the government (Minister of Finance) looses control over this area of activities. The assignment of the agency is to professionally carry out guidelines laid out by the Minister of Finance and the activities of such an agency should undergo audits in order to ensure execution of these guidelines. Therefore in the case of the agency model, preparation of the appropriate legislative and organizational solutions is very important in order to ensure good cooperation with the Minister of Finance who defines objectives and the agency which carries them out.

Of the current 25 member states of the expanded EU, 14 use the agency model (accordingly 11 of the 15 pre-expansion EU countries). The list of institutions involved in debt management in the EU countries is presented in the table below.

Institutions responsible for management of public debt in EU countries

Country	Model	Institution name
Austria	**Agency**	Österreichische Bundesfinanzierungsagentur
Belgium		Agence de la Dette (Agentschap van de Schuld)
Finland		Valtiokonttori
France		Agence France Trésor
Greece		Debt Office
Netherlands		Agentschap van het ministerie van Financiën
Ireland		National Treasury Management Agency
Latvia		Valsts Kase
Germany		Finanzagentur GmbH
Portugal		Instituto de Gestão do Crédito Público
Slovakia		Štátna pokladnica
Sweden		Riksgäldskontoret
Hungary		Magyar Állampapír
United Kingdom		Debt Management Office
Cyprus	**Bank**	Κεντρικη Τραπεζα Τησ Κυπρου
Denmark		Dansk Nationalbanken
Malta		Central Bank of Malta
Czech Republic	**Government**	Ministerstvo financí
Estonia		Rahandusministeerium
Spain		Ministerio de Economia
Lithuania		Finansų Ministerija
Luxembourg		Ministère des Finances
Poland		Ministerstwo Finansów
Slovenia		Ministrstvo za finance
Italy		Ministero dell'Ecomomia e delle Finanze

Annex 2. Government sector deficit and debt as well as yields on 10-year bonds in EU countries

	2002			2003		
	Deficit/surplus %GDP	debt/GDP %GDP	10-year rate[1)]	Deficit/surplus %GDP	debt/GDP %GDP	10-year rate[1)]
Italy	-2.3	107.9	4.55	-2.4	106.2	4.46
Greece	-3.7	112.5	4.58	-4.6	109.9	4.45
Belgium	0.1	105.8	4.46	0.4	100.7	4.38
Austria	-0.2	66.6	4.47	-1.1	65.1	4.40
Germany	-3.7	60.9	4.33	-3.8	64.2	4.29
France	-3.2	58.8	4.38	-4.1	63.7	4.34
Portugal	-2.7	58.4	4.45	-2.8	60.3	4.40
Netherlands	-1.9	52.6	4.36	-3.2	54.1	4.33
Sweden	0.0	52.6	4.89	0.3	52.0	4.86
Spain	-0.1	54.4	4.42	0.4	50.7	4.34
Finland	4.3	42.6	4.45	2.3	45.6	4.33
Denmark	0.7	48.8	4.61	0.3	45.9	4.52
United Kingdom	-1.7	38.3	4.49	-3.3	39.8	4.94
Ireland	-0.2	32.7	4.46	0.1	32.1	4.36
Luxembourg	2.8	5.7	-	0.8	5.4	-
EU 15	**-2.1**	**62.7**	**4.44**	**-2.7**	**64.3**	**4.47**
Countries that have become EU member states as of May 1, 2004						
Cyprus	-4.6	67.4	5.37	-6.4	70.9	4.75
Malta	-5.9	62.7	5.55	-9.7	71.1	4.71
Hungary	-9.2	57.2	6.50	-6.2	59.1	8.24
Poland	-3.6	41.1	5.73	-3.9	45.4	6.76
Slovakia	-5.7	43.3	5.12	-3.7	42.6	5.42
Czech Republic	-6.8	28.8	4.15	-12.6	37.8	4.82
Slovenia	-2.4	29.5	6.65	-2.0	29.5	5.27
Lithuania	-1.5	22.4	5.87	-1.9	21.6	4.81
Latvia	-2.7	14.1	4.53	-1.5	14.4	5.07
Estonia	1.4	5.3	-	3.1	5.3	-
EU 25	**-2.3**	**61.6**	**4.54**	**-2.8**	**63.3**	**4.62**

[1)] Harmonized long-term interest rates for convergence purposes, i.e., rates on the secondary market (with the exception of Slovenia for the year 2002 as well as Cyprus and Lithuania – primary market) for Treasury bonds having a maturity of approximately 10 years; Treasury bonds of a similar nature do not exist in the case of Luxembourg and Estonia; December average;

[2)] Eurostat. News Release 117/2004 dated September 23, 2004; data has been prepared based on August (2004) fiscal notifications sent by the individual countries to the European Commission.

Annex 3: Long-term foreign currency government debt rating in EU countries

As at September 24. 2004

	Moody's	Standard&Poor's	Fitch
Austria	Aaa	AAA	AAA
Belgium	Aa1	AA+	AA
Cyprus	A2	A	A+
Czech Republic	A1	A-	A-
Denmark	Aaa	AAA	AAA
Estonia	A1	A-	A
Finland	Aaa	AAA	AAA
France	Aaa	AAA	AAA
Greece	A1	A+	A+
Spain	Aaa	AA+	AAA
Netherlands	Aaa	AAA	AAA
Ireland	Aaa	AAA	AAA
Lithuania	A3	A-	A-
Latvia	A2	A-	A-
Luxembourg	Aaa	AAA	AAA
Malta	A3	A	A
Germany	Aaa	AAA	AAA
Poland	A2	BBB+	BBB+
Portugal	Aa2	AA	AA
Slovakia	A3	BBB+	A-
Slovenia	Aa3	AA-	AA-
Sweden	Aaa	AAA	AAA
Hungary	A1	A-	A-
United Kingdom	Aaa	AAA	AAA
Italy	Aa2	AA-	AA

State Treasury debt according to the place of issue criterion (PLN m, at face value)

	XII 2002	VI 2003	XII 2003	VI 2004	VI 2004 in %	change XII 2003 - XII 2002		change VI 2004 -XII 2003	
						PLN million	in %	PLN million	in %
State Treasury debt	327 904,2	362 634,5	378 943,8	411 234,2	100,0%	51 039,7	15,6%	32 290,3	8,5%
Domestic debt	219 347,0	243 793,0	251 165,9	276 905,6	67,3%	31 818,9	14,5%	25 739,7	10,2%
Treasury Securities (domestic market)	212 371,3	238 865,1	245 979,3	271 079,0	65,9%	33 608,1	15,8%	25 099,7	10,2%
Marketable securities	195 887,5	224 434,2	232 564,4	257 478,3	62,6%	36 676,9	18,7%	24 913,9	10,7%
Treasury bills	42 030,8	45 002,6	48 067,4	50 943,3	12,4%	6 036,6	14,4%	2 875,9	6,0%
Marketable bonds	153 856,7	179 431,6	184 496,9	206 535,0	50,2%	30 640,3	19,9%	22 038,1	11,9%
Marketable fixed rate bonds	133 763,5	161 889,5	168 950,8	185 682,1	45,2%	35 187,3	26,3%	16 731,3	9,9%
2-year zero-coupon bonds	37 740,4	49 642,4	52 414,0	57 380,5	14,0%	14 673,6	38,9%	4 966,6	9,5%
5-year fixed rate bonds	67 772,8	80 361,6	81 096,0	77 106,7	18,8%	13 323,2	19,7%	-3 989,3	-4,9%
5-year fixed rate bonds issued in retail network	1 762,6	2 003,4	2 080,9	2 192,2	0,5%	318,3	18,1%	111,3	5,3%
10-year fixed rate bonds	16 375,1	22 692,3	26 258,8	42 176,4	10,3%	9 883,8	60,4%	15 917,5	60,6%
20-year fixed rate bonds	1 400,0	1 545,3	1 545,3	1 722,2	0,4%	145,3	10,4%	176,8	11,4%
4-year fixed rate bonds (converted) [1]	2 560,0	-	-	-	0,0%	-2 560,0	-100,0%	0,0	-
5-year fixed rate bonds (converted) [1]	3 076,3	3 076,3	2 987,5	2 535,8	0,6%	-88,8	-2,9%	-451,7	-15,1%
10-year fixed rate bonds (converted) [1]	3 076,3	2 568,3	2 568,3	2 568,3	0,6%	-508,0	-16,5%	0,0	0,0%
Marketable floating rate bonds	20 093,2	17 542,1	15 546,2	20 852,9	5,1%	-4 547,0	-22,6%	5 306,7	34,1%
3-year floating rate bonds issued in retail network	6 134,1	5 605,8	5 306,9	4 683,2	1,1%	-827,2	-13,5%	-623,7	-11,8%
3-year floating rate bonds	-	-	-	3 950,0	1,0%	0,0	0,0%	3 950,0	-
7-year floating rate bonds	-	-	-	868,8	0,2%	0,0	0,0%	868,8	-
10-year floating rate bonds	9 851,6	9 851,6	10 239,3	10 580,9	2,6%	387,7	3,9%	341,6	3,3%
private placements	-	-	-	750,0	0,2%	-	-	750,0	-
bond denominated in USD'01	4 107,5	2 084,7	-	-	0,0%	-4 107,5	-100,0%	0,0	-
Savings bonds	7 718,1	7 182,3	7 449,6	8 867,0	2,2%	-268,5	-3,5%	1 417,4	19,0%
2-year savings bonds	6 670,3	6 101,0	6 338,4	7 726,3	1,9%	-331,9	-5,0%	1 387,9	21,9%
4-year savings bonds	1 047,8	1 081,3	1 111,2	1 140,6	0,3%	63,4	6,1%	29,5	2,7%
Nonmarketable securities	8 765,7	7 248,6	5 965,4	4 733,8	1,2%	-2 800,3	-31,9%	-1 231,6	-20,6%
Restructuring bonds	5 486,2	4 811,9	4 444,2	4 061,9	1,0%	-1 042,0	-19,0%	-382,3	-8,6%
Bonds issued for Bank BGŻ S.A.	765,1	737,7	705,7	671,9	0,2%	-59,4	-7,8%	-33,9	-4,8%
Bonds denominated in USD ('91)	2 514,4	1 698,9	815,4	0,0	0,0%	-1 699,0	-67,6%	-815,4	-100,0%
Other domestic debt [3]	6 975,8	4 928,0	5 186,6	5 826,6	1,4%	-1 789,2	-25,6%	640,0	12,3%
advances for cars	3,4	3,2	3,2	3,2	0,0%	-0,2	-5,9%	0,0	-0,6%
matured liabilities [2]	406,6	273,6	311,8	225,2	0,1%	-94,8	-23,3%	-86,5	-27,8%
liabilities to the budgetary sphere for non-indexation of wages	4 761,2	3 551,1	1 771,6	1 098,2	0,3%	-2 989,5	-62,8%	-673,5	-38,0%
liabilities to trade unions [3]	4,6	0,0	0,0	0,0	0,0%	-4,6	-100,0%	0,0	-
credit taken by the Labour Fund [4]	1 800,0	1 100,0	3 100,0	4 500,0	1,1%	1 300,0	72,2%	1 400,0	45,2%
Foreign debt	108 557,2	118 841,5	127 777,9	134 328,6	32,7%	19 220,8	17,7%	6 550,6	5,1%
1. Treasury bonds (international markets)	29 187,7	36 489,5	44 267,4	56 560,6	13,8%	15 079,7	51,7%	12 293,2	27,8%
Brady Bonds	10 358,3	6 181,0	4 463,3	4 471,1	1,1%	-5 895,0	-56,9%	7,8	0,2%
International Bonds	18 829,4	30 308,5	39 804,1	52 089,5	12,7%	20 974,7	111,4%	12 285,4	30,9%
2. Loans, of which	79 369,4	82 352,0	83 510,6	77 768,0	18,9%	4 141,1	5,2%	-5 742,5	-6,9%
Paris Club creditors	65 960,5	68 337,1	67 121,5	62 079,8	15,1%	1 161,0	1,8%	-5 041,7	-7,5%
International Financial Institutions, of which	11 538,2	13 127,0	15 279,1	15 090,6	3,7%	3 740,9	32,4%	-188,5	-1,2%
the World Bank	7 215,3	7 447,0	7 476,8	7 160,7	1,7%	261,5	3,6%	-316,1	-4,2%
Other creditors	1 870,7	887,8	1 109,9	597,5	0,1%	-760,8	-40,7%	-512,4	-46,2%

*) State Treasury debt prior to consolidation in the public finance sector

1) On September 30 and December 29, 1999, convertible bonds, USD bonds for redemption of Brady bonds, long-term liabilities towards NBP and bonds issued to implement the agreement with the Paris Club were converted to marketable bonds having redemption dates of - April 29, 2002 (OK0402); December 22, 2002 (TK1202); April 22, 2003 (OK0403); July 22, 2004 (PK0704) and August 22, 2008 (DK0809).

2) position includes matured liabilities of budgetary and extra-budgetary units; debt in this position includes inter alia liabilities towards banks arising from refunds of guaranteed premiums on housing deposits as well as interest on housing loans

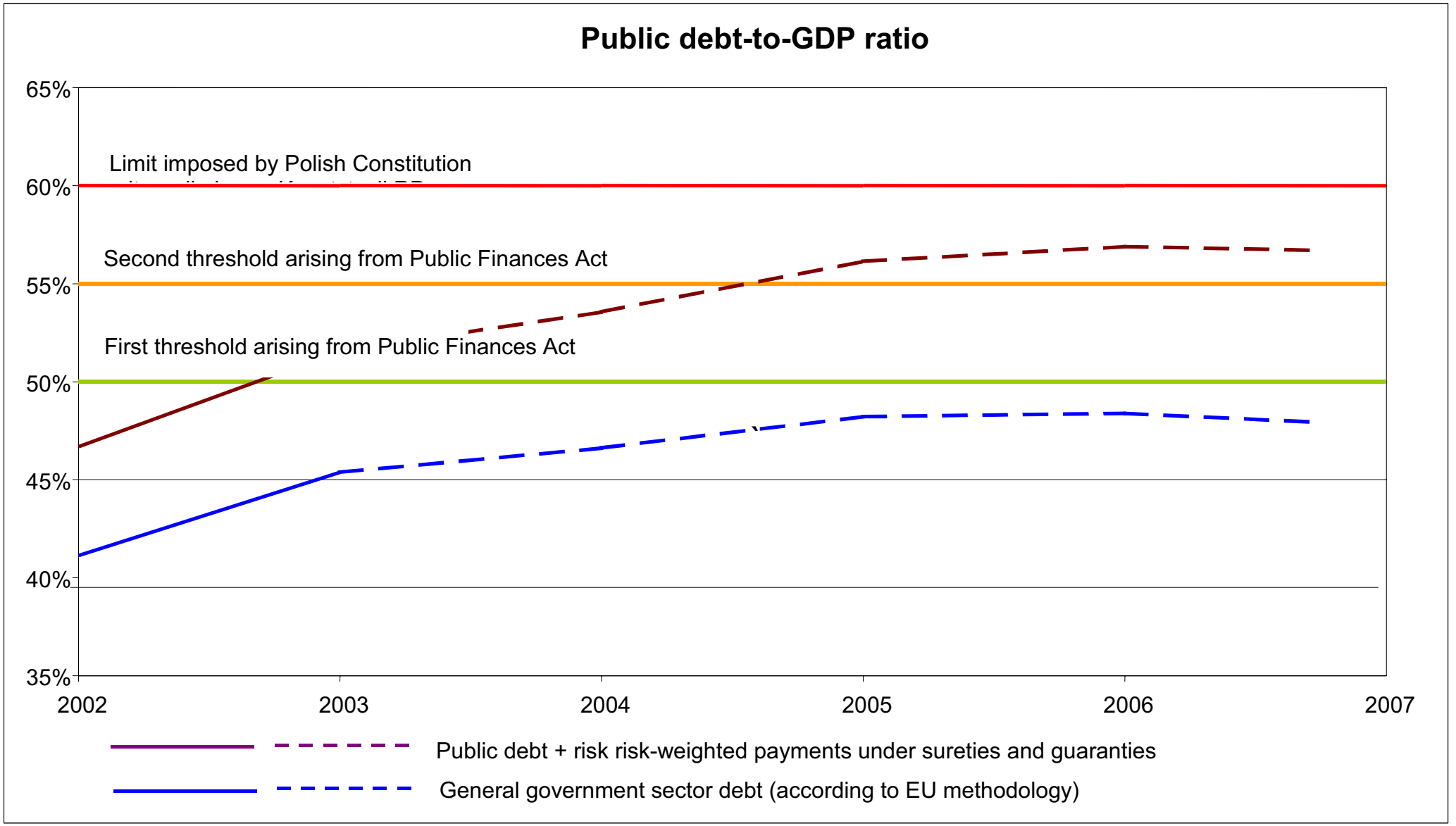
3) liabilities towards trade unions and social organizations arising from compensation for properties lost as a result of imposing martial law; liabilities were converted to Treasury bonds having a face value of PLN 107.2 million, PLN 3.7 million, PLN 117.7 million, PLN 0.6 million, PLN 0.00 million and PLN 5.41 million in August and November 2001, April, October

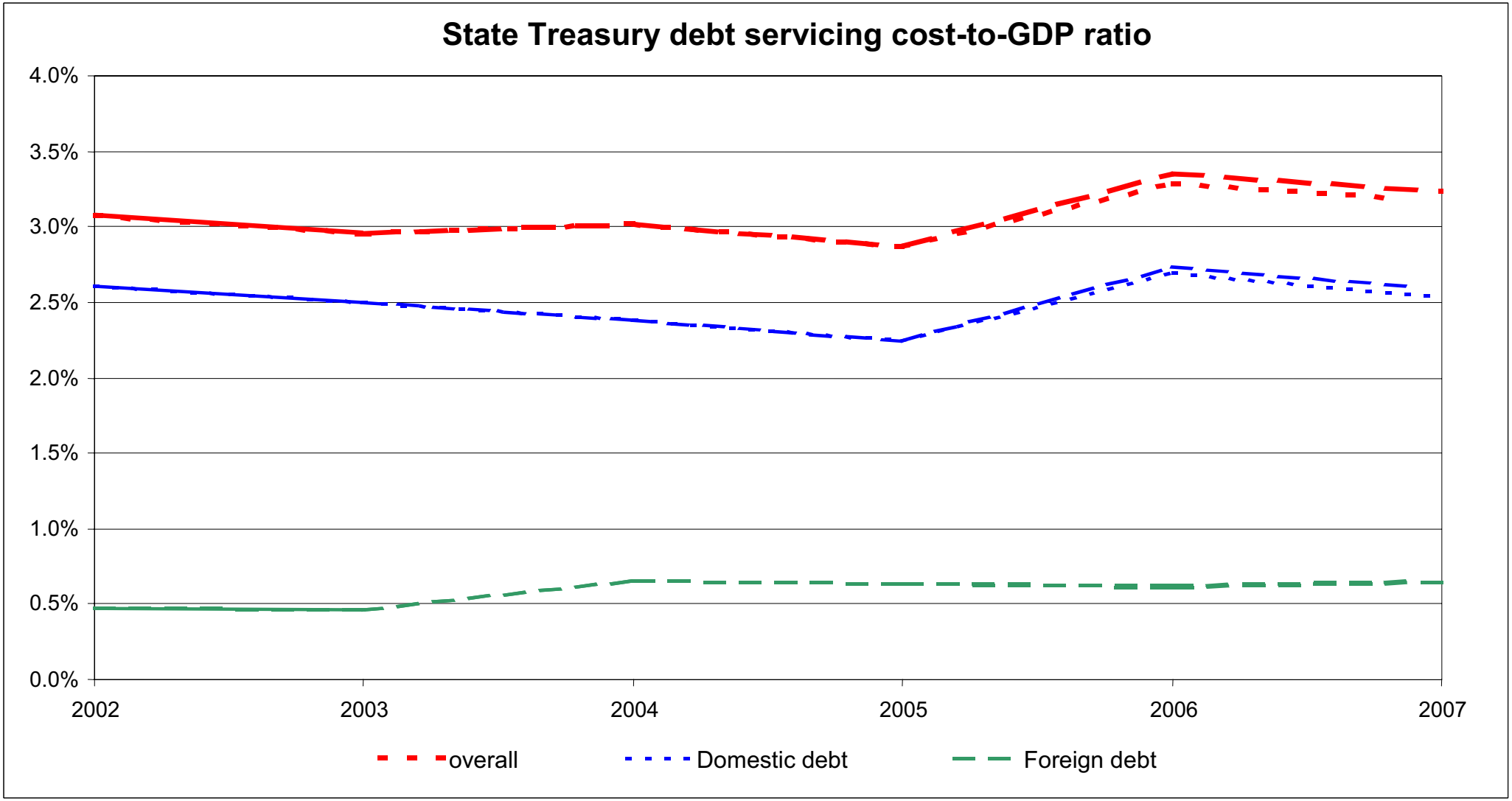
4) arising from loans drawn in commercial banks

Domestic State Treasury debt according to the place of issue criterion: by holder (PLN m, at face value) [1]

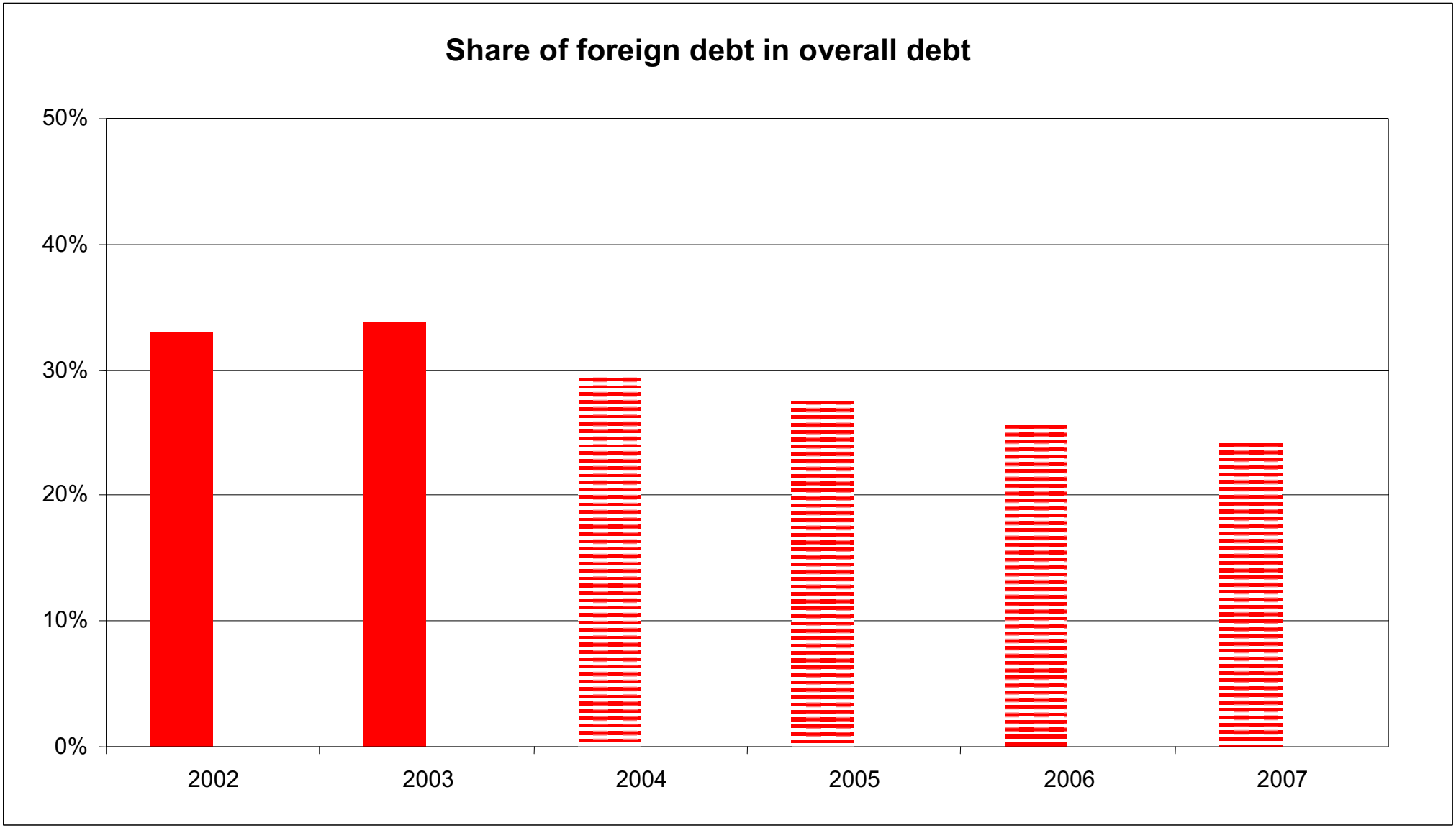
	XII 2002	VI 2003	XII 2003	XII 2003 in %	VI 2004	VI 2004 in %	change XII 2003 - XII 2002 PLN million	change XII 2003 - XII 2002 in %	change VI 2004 - XII 2003 PLN million	change VI 2004 - XII 2003 in %
Domestic State Treasury Debt [2]	219 347,0	243 793,0	251 165,9	100,0%	276 905,6	100,0%	31 818,9	14,5%	25 739,7	10,2%
National Bank of Poland	6 520,0	2 879,6	381,5	0,2%	0,0	0,0%	-6 138,5	-94,1%	-381,5	-100,0%
Treasury securities	6 520,0	2 879,6	381,5	0,2%	0,0	0,0%	-6 138,5	-94,1%	-381,5	-100,0%
Marketable instruments	5 345,4	2 084,7	0,0	0,0%	0,0	0,0%	-5 345,4	-100,0%	0,0	0,0%
fixed rate converted bonds	1 237,9	0,0	0,0	0,0%	0,0	0,0%	-1 237,9	-100,0%	0,0	0,0%
5-year	911,3	0,0	0,0	0,0%	0,0	0,0%	-911,3	-100,0%	0,0	0,0%
10-year	326,6	0,0	0,0	0,0%	0,0	0,0%	-326,6	-100,0%	0,0	0,0%
Bonds denominated in USD ('91)	4 107,5	2 084,7	-	-	-	-	-4 107,5	-100,0%	-	-
Non - marketable instruments	1 174,7	794,9	381,5	0,2%	-	-	-793,1	-67,5%	-381,5	-100,0%
Bonds denominated in USD ('91)	1 174,7	794,9	381,5	0,2%	-	-	-793,1	-67,5%	-381,5	-100,0%
Domestic commercial banks	72 042,1	81 948,6	85 719,9	34,1%	86 761,9	31,3%	13 677,8	19,0%	1 042,0	1,2%
Treasury securities	70 242,0	80 848,6	82 619,9	32,9%	82 261,9	29,7%	12 377,9	17,6%	-358,0	-0,4%
Marketable instruments	62 651,0	74 395,0	77 036,1	30,7%	77 528,1	28,0%	14 385,1	23,0%	492,0	0,6%
Treasury bills	23 690,5	25 763,1	23 878,7	9,5%	19 899,2	7,2%	188,2	0,8%	-3 979,5	-16,7%
2-year zero-coupon bonds	15 584,2	22 846,9	23 004,2	9,2%	23 521,1	8,5%	7 420,0	47,6%	516,8	2,2%
3-year floating rate bonds issued in retail network	195,6	193,2	320,7	0,1%	288,1	0,1%	125,0	72,7%	-32,6	-10,2%
3-year floating rate bonds	-	-	-	-	3 072,0	1,1%	-	-	3 072,0	-
4-year fixed rate bonds (converted)	-	-	-	-	-	-	#ARG!	#ARG!	0,0	0,0%
5-year fixed rate bonds and fungible bonds	15 878,8	18 534,8	21 212,4	8,4%	20 528,2	7,4%	5 333,6	33,6%	-684,3	-3,2%
5-year fixed rate bonds issued in retail network	3,6	6,6	8,2	0,0%	9,4	0,0%	4,5	124,8%	1,3	15,4%
5-year fixed rate bonds (converted)	1 253,1	2 265,2	2 232,9	0,9%	1 972,9	0,7%	979,8	78,2%	-260,0	-11,6%
7-year floating rate bonds	-	-	-	-	143,0	0,1%	-	-	143,0	-
10-year floating rate bonds and fungible bonds	2 891,8	3 044,9	2 987,6	1,2%	3 232,1	1,2%	105,8	3,7%	244,5	8,2%
10-year fixed rate bonds	899,5	1 560,3	3 228,4	1,3%	4 621,5	1,7%	2 328,9	262,9%	1 393,0	43,1%
10-year fixed rate bonds (converted)	316,9	155,0	162,4	0,1%	231,8	0,1%	-154,5	-48,7%	69,4	42,7%
private placements	-	-	-	-	0,0	0,0%	-	-	0,0	-
20-year fixed rate bonds	0,0	5,0	0,5	0,0%	9,0	0,0%	0,5	0,0%	8,4	1543,8%
Non - marketable instruments	7 591,0	6 453,7	5 583,8	2,2%	4 733,8	1,7%	-2 007,2	-26,4%	-850,0	-15,2%
Bonds denominated in USD ('91)	1 339,7	904,0	433,9	0,2%	-	-	-905,8	-67,6%	-433,9	-100,0%
Restructuring bonds	5 486,2	4 811,9	4 444,2	1,8%	4 061,9	1,5%	-1 042,0	-19,0%	-382,3	-8,6%
Bonds issued for Bank BGŻ S.A.	765,1	737,7	705,7	0,3%	671,9	0,2%	-59,4	-7,8%	-33,9	-4,8%
Other domestic debt	1 800,1	1 100,0	3 100,0	1,2%	4 500,0	1,6%	1 299,9	72,2%	1 400,0	45,2%
matured libilities	0,1	0,0	0,0	0,0%	0,0	0,0%	-0,1	-95,9%	0,0	-72,4%
credit taken by the Labor Fund	1 800,0	1 100,0	3 100,0	1,2%	4 500,0	1,6%	1 300,0	72,2%	1 400,0	45,2%
Domestic non-banking sector	109 391,7	122 299,2	123 948,0	49,3%	137 749,1	49,7%	14 556,3	13,3%	13 801,2	11,1%
Treasury securities	104 216,1	118 471,2	121 861,4	48,5%	136 422,6	49,3%	17 645,3	16,9%	14 561,2	11,9%
Marketable instruments	96 498,1	111 289,0	114 411,9	45,6%	127 557,1	46,1%	17 913,8	18,6%	13 145,2	11,5%
Treasury bills	17 284,8	17 851,1	23 386,4	9,3%	30 836,3	11,1%	6 101,6	35,3%	7 450,0	31,9%
2-year zero-coupon bonds	14 304,3	17 720,7	17 843,6	7,1%	22 729,1	8,2%	3 539,3	24,7%	4 885,5	27,4%
3-year floating rate bonds issued in retail network	5 917,7	5 387,3	4 966,5	2,0%	4 377,6	1,6%	-951,2	-16,1%	-588,9	-11,9%
3-year floating rate bonds	-	-	-	-	877,7	0,3%	-	-	877,7	-
4-year fixed rate bonds (converted)	593,1	-	-	-	-	-	-593,1	-100,0%	-	-
5-year fixed rate bonds and fungible bonds	33 783,5	41 524,2	40 802,0	16,2%	36 004,8	13,0%	7 018,5	20,8%	-4 797,1	-11,8%
5-year fixed rate bonds issued in retail network	1 757,5	1 995,4	2 071,3	0,8%	2 180,9	0,8%	313,8	17,9%	109,7	5,3%
5-year fixed rate bonds (converted)	911,9	811,1	754,6	0,3%	562,9	0,2%	-157,4	-17,3%	-191,7	-25,4%
7-year floating rate bonds	-	-	-	-	743,3	0,3%	-	-	743,3	-
10-year floating rate bonds and fungible bonds	6 957,0	6 648,3	7 084,1	2,8%	7 124,6	2,6%	127,2	1,8%	40,4	0,6%
10-year fixed rate bonds	11 217,0	15 431,7	13 584,2	5,4%	17 665,1	6,4%	2 367,2	21,1%	4 081,0	30,0%
10-year fixed rate bonds (converted)	2 432,8	2 413,3	2 405,8	1,0%	2 336,5	0,8%	-27,0	-1,1%	-69,4	-2,9%
private placements	-	-	-	-	507,0	0,2%	-	-	507,0	-
20-year fixed rate bonds	1 338,4	1 505,9	1 513,4	0,6%	1 611,2	0,6%	175,0	13,1%	97,8	6,5%
Savings bonds	7 718,0	7 182,2	7 449,5	3,0%	8 865,5	3,2%	-268,5	-3,5%	1 416,0	19,0%
2-year savings bonds	6 670,3	6 100,9	6 338,4	2,5%	7 725,6	2,8%	-331,9	-5,0%	1 387,2	21,9%
4-year savings bonds	1 047,7	1 081,3	1 111,1	0,4%	1 139,9	0,4%	63,4	6,1%	28,8	2,6%
Other domestic debt	5 175,6	3 828,0	2 086,6	0,8%	1 326,6	0,5%	-3 089,1	-59,7%	-760,0	-36,4%
advances for cars	3,4	3,2	3,2	0,0%	3,2	0,0%	-0,2	-5,9%	0,0	-0,6%
matured liabilities	406,5	273,6	311,8	0,1%	225,2	0,1%	-94,7	-23,3%	-86,5	-27,8%
liabilities to the budgetary sphere for non-indexation of wages	4 761,2	3 551,1	1 771,6	0,7%	1 098,2	0,4%	-2 989,5	-62,8%	-673,5	-38,0%
liabilities to trade unions	4,6	-	-	-	-	-	-4,6	-100,0%	-	-
TSs held by foreign investors	31 393,2	36 665,7	41 116,5	16,4%	52 394,6	18,9%	9 723,3	31,0%	11 278,1	27,4%
Marketable instruments	31 393,2	36 665,7	41 116,5	16,4%	52 394,6	18,9%	9 723,3	31,0%	11 278,1	27,4%
Treasury bills	31 393,1	36 665,6	41 116,4	16,4%	52 393,1	18,9%	9 723,4	31,0%	11 276,7	27,4%
2-year zero-coupon bonds	1 055,5	1 368,4	802,4	0,3%	207,8	0,1%	-253,1	-24,0%	-594,6	-74,1%
3-year floating rate bonds issued in retail network	7 851,9	9 074,8	11 566,1	4,6%	11 130,4	4,0%	3 714,2	47,3%	-435,7	-3,8%
3-year floating rate bonds	30,7	25,3	19,7	0,0%	17,5	0,0%	-11,0	-35,8%	-2,2	-11,0%
5-year fixed rate bonds and fungible bonds	-	-	-	-	0,3	0,0%	-	-	0,3	-
5-year fixed rate bonds issued in retail network	18 110,6	20 302,5	19 081,6	7,6%	20 573,7	7,4%	971,1	5,4%	1 492,1	7,8%
7-year floating rate bonds	1,5	1,4	1,5	0,0%	1,9	0,0%	0,0	0,4%	0,4	26,6%
10-year floating rate bonds and fungible bonds	-	-	-	-	2,5	0,0%	-	-	2,5	-
10-year fixed rate bonds	12,8	158,4	167,6	0,1%	224,3	0,1%	154,7	1205,8%	56,7	33,8%
private placements	4 268,6	5 680,3	9 446,2	3,8%	19 869,8	7,2%	5 177,7	121,3%	10 443,5	110,6%
12-year inflation linked	-	-	-	-	243,0	0,1%	-	-	243,0	-
20-year fixed rate bonds	61,6	34,4	31,4	0,0%	102,0	0,0%	-30,2	-49,0%	70,6	225,2%
Savings bonds	0,1	0,1	0,0	0,0%	1,5	0,0%	-0,1	-52,9%	1,4	3181,5%
2-year savings bonds	0,1	0,0	0,0	0,0%	0,7	0,0%	-0,1	-100,0%	0,7	-
4-year savings bonds	0,0	0,0	0,0	0,0%	0,7	0,0%	0,0	0,0%	0,7	1573,7%

1) data captures financial flows between sectors
2) State Treasury debt prior to consolidation of public finance sector

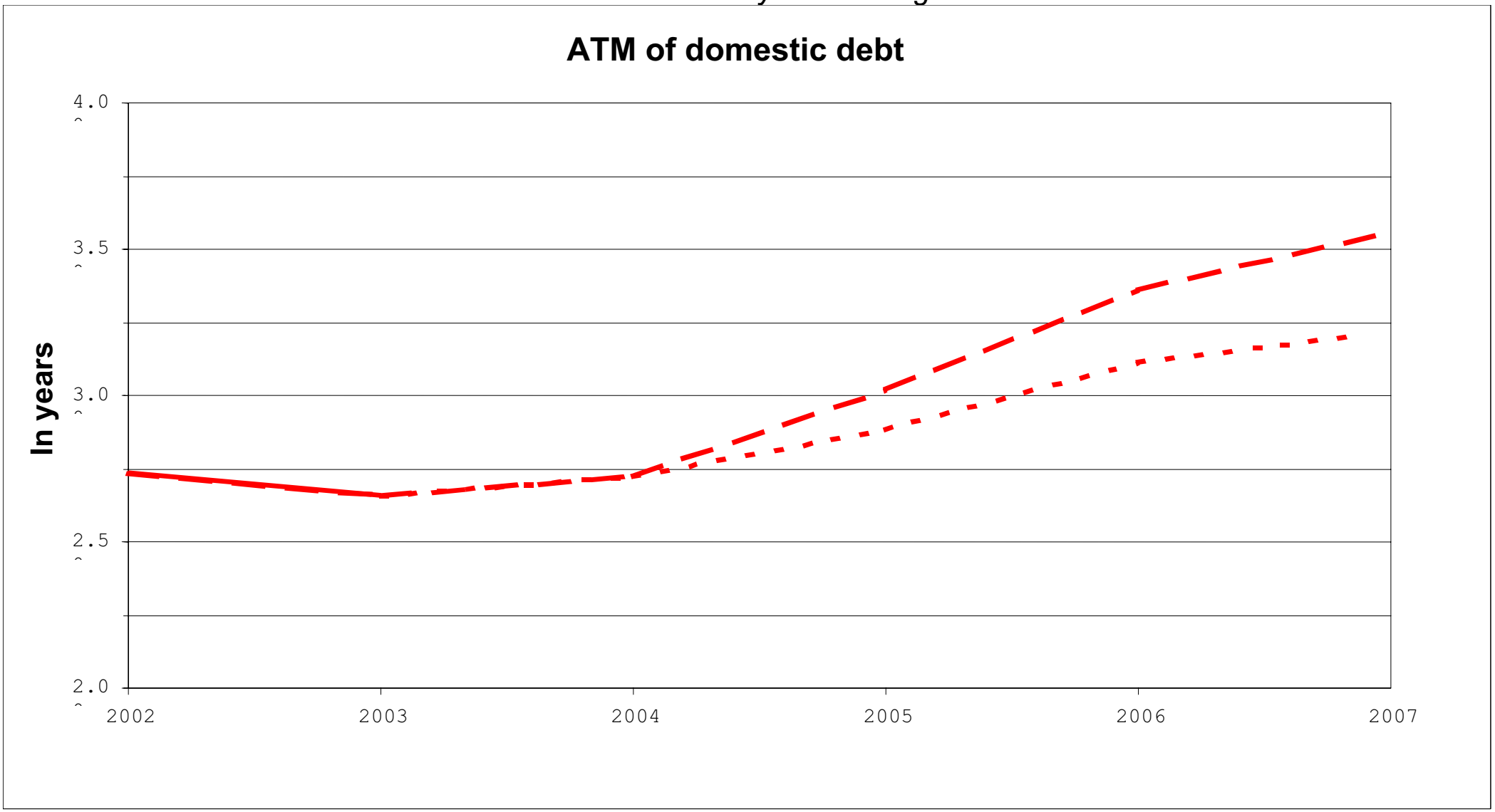

Public debt-to-GDP ratio
65%
60%
55%
50%
45%
40%
35%
Limit imposed by Polish Constitution
Second threshold arising from Public Finances Act
First threshold arising from Public Finances Act
2002
2003
2004
2005
2006
2007
Public debt + risk risk-weighted payments under sureties and guaranties
General government sector debt (according to EU methodology)

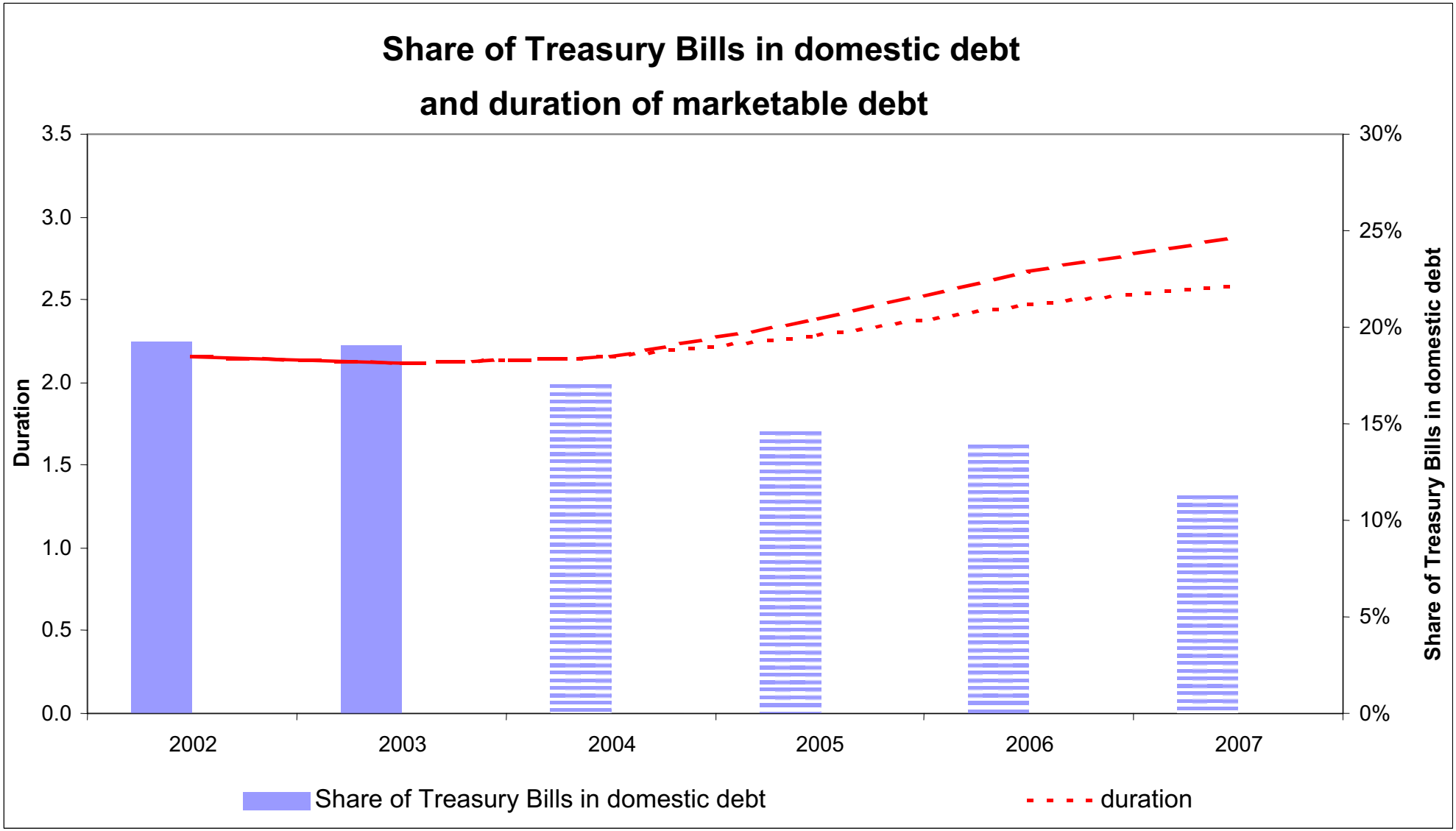

State Treasury debt servicing cost-to-GDP ratio
4.0%
3.5%
3.0%
2.5%
2.0%
1.5%
1.0%
0.5%
0.0%
2002
2003
2004
2005
2006
2007
overall
Domestic debt
Foreign debt

Foreign currency exchange and refinancing risk



Domestic currency refinancing risk




Share of Treasury Bills in domestic debt
and duration of marketable debt
Duration
Share of Treasury Bills in domestic debt
3.5
3.0
2.5
2.0
1.5
1.0
0.5
0.0
30%
25%
20%
15%
10%
5%
0%
2002
2003
2004
2005
2006
2007
Share of Treasury Bills in domestic debt
duration