2002

Annual Report. Public Debt.

Introduction

The Ministry of Finance's *Annual Report 2002 on Public Debt* is a second edition of a publication that aims at acquainting the Readers with matters referring to the public debt, the reasons for incurring financial commitments by the State, methods of the State Treasury debt management and also execution of respective provisions of the State Budget Act from the perspective of debt manager 's activities. Like the first edition *the Report* consists of three chapters and an Annex provided only in an electronic form.

Chapter 1 presents general legal basis regulating debt incurring by entities of the public finance sector. It also includes a detailed analysis of the public finance sector debt and of the State Treasury debt in particular. It concentrates on changes of the level and structure of the debt, as well as on the costs of the State Treasury debt servicing in the year 2002.

Chapter 2 focuses on the guidelines set in the *Public Finance Sector Debt Management Strategy for the years 2002 -2004*, especially from the objectives' point of view, with effects of their achievement in the previous year.

Chapter 3 points out sources of the State budget borrowing needs financing. The execution of the financing in 2002 is also presented in a comprehensive way.

The electronic Annex to the *Report* is covers, among others:

- complete set of legal acts governing the debt drawing and servicing, as well as issuing of the Treasury securities,
- description of debt instruments offered currently by the Minister of Finance together with a characteristics of earlier issues and with a description of their sales methods,
- a report on events that took place in the area of Treasury securities issuance, including, first of all the sales on the primary market and the secondary market performance of these securities in the year 2002.

In order to provide the Readers with increased transparency and improved visualization of the problems discussed, the *Report* includes tables with detailed figures and is illustrated with charts.

We hope the *Annual Report 2002 on Public Debt* will prove to be a useful and interesting source of information on the essence of public debt and will meet the Readers expectations in this filed. We will greatly appreciate any comments on the form and scope of the publication. They will be taken into account in the works on the next edition of the *Report*.

CHAPTER I. Public debt

1.1. Factors Shaping Public Debt in 2002

The past year was one of the difficult for the public debt manager due to adverse economic situation and a essential change of some macroeconomic parameters during the year.

As a result of a worldwide economic slowdown, as well as the low level of the domestic demand growth dynamics, the Gross Domestic Product (GDP) in Poland by the end of 2002 reached PLN 772.2 billion,[1] what stands for a growth of 1.4% in comparison to end of 2001.

The high budget deficit (PLN 39.40 billion) and lower than planed receipts from privatization (PLN 1.97 billion compared to planned PLN 6.60 billion) generated the need to increase substantially issuance of Treasury securities in order to finance State budget's borrowing needs in 2002. In consequence, the higher growth of debt in Treasury securities (T-s) will result with a higher level of debt servicing costs in the future, and will have an unfavorable influence on the State budget balance in the up-coming fiscal years, due to the increase of "rigid" budgetary expenditures.

Foreign exchange rate fluctuations during the past year, especially Polish Zloty against the Euro and the US Dollar, were also not without an impact on the level of public debt and the debt servicing costs.[2]

Despite the unfavorable macroeconomic situation, the market conditions in 2002 were conducive to Treasury securities issuance. The most important factors were:

- a significant decline in the inflation rate - the annual CPI index for the end of the year 2002 in comparison to the end of 2001 fell by 2.8 percentage points to the 0.5% level,
- eight subsequent interest rate cuts, conducted by the Monetary Policy Council - the reference rate at the end of December 2002 was at 6.75%, the rediscounting rate at 7.5%, the Lombard rate at 8.75% and the deposit rate at 4.75%,
- the decline of the current account deficit do the level of USD 6.7 billion,
- increased demand on the primary market auctions (2 - 3 times surpassing the issuers supply).

The above factors caused the yields of the Treasury securities sold at auctions to fall.[3] Lower yields meant higher price bids at auctions, which allowed financing the increased State budget's borrowing needs, without the excessive growth of debt in nominal terms. At the same time it was possible to conduct switching operations on the existing debt.

Over the entire 2002 the spreads[4] between long-term interest rates in Poland and the corresponding rates in European Union Member States shrank. As a result, since the end of September Poland has been meeting the convergence criterion for interest rates. As at the end of December 2002, the spread between the yield of Polish 10-year bonds and the average yield of corresponding instruments in Germany, Belgium and Finland was 128 basis points.[5]

The low GDP growth rate,[6] combined with a significant growth of indebtedness (by PLN 43,986.5 million), caused a further decrease in the difference between the public debt to GDP relation and the first prudential band of 50%, defined in the public finance act.[7]

1.2. Legal Basis of the Public Debt

The general rules governing public debt are set out in Chapter X, Public Finance, of the Constitution of the Republic of Poland.

The Constitution introduces a principle banning the taking of loans or the granting of guarantees or sureties resulting in the public debt exceeding 3/5 of the gross domestic product. The Council of Ministers is granted the exclusive right to take legislative initiative with regard to the Budget Act, the budget provisional arrangements Act, amendments to the Budget Act, the law on incurring public debt and the law on granting sureties and financial guarantees by the State Treasury. Furthermore the Constitution introduces a ban on financing State budget deficit through incurring liabilities with the central bank.

[1] The GDP growth was possible mainly due to a growing foreign demand (a 13% annual growth in exports).
[2] Over 30% of the Polish public debt is denominated in foreign currencies.
[3] The yields of 52 week bills, 2 year zero-coupon bonds (OK) and 5- year fixed-rate bonds (PS) on the last auctions of 2002 fell to respectively: 5.693% (decline from 10.838% in comparison to the last auction in 2001), 5.841% (decline from 10.021%) and 5.764% (decline from 9.677%).
[4] Spread means the difference in interest rates, expressed usually in basis points, where 1 bp = 1/100 of a percentage point.
[5] According to the Maastricht Treaty, within a period of one year long-term interest rates in EU countries cannot exceed the average interest rate in EU member states with the lowest inflation rates by more than 200 bp.
[6] In 2001 the GDP growth in comparison to the end of the year 2000 was 1%.
[7] More on this matter in sub-chapters 1.6. and 1.8.

The basic law which regulates comprehensively the public debt is the Public Finance Act of November 26, 1998 (Journal of Laws 2003, No. 15, Item 148, as amerded. The Act regulates the following in particular:

- the subject and entity scope of public finance,
- basic definitions related to public debt,
- the rules of public debt calculation and reporting,
- the financing of State budget borrowing needs,
- prudential and remedial procedures,
- general rules of incurring obligations by public finance sector entities,
- the rules and procedures for issuance of securities and for drawing loans and credits by the State Treasury,

1.3. Definition of the Public Debt

Public debt includes nominal debt of public finance sector entities, after elimination of financial flows between sector entities (consolidated gross debt). It is calculated in terms of the nominal value.

The value of securities issued is calculated in terms of their nominal value, understood as:

- the amount of principal performance under issued securities, due for payment on the redemption date,
- the amount of principal performance under issued securities in which financial obligations are indexed or capitalized taking into account the increment in principal resulting from the manner in which a given security is indexed or capitalized, accrued at the end of a reporting period.

The amount of credits and loans drawn is calculated in terms of the nominal value understood as the amount of principal performance under a loan or credit drawn, due for payment on maturity.

The amount of deposits taken is calculated as the deposit amount which, according to a contract, debtors are required to pay to creditors on the date on which the deposit matures; it is the amount on which interest accrues.

The amount of due and payable obligations, excluding the obligations under guarantees and sureties, includes the amount of obligations, excluding overdue interest, which are neither prescribed nor written off.

The nominal value of indexed or capitalized obligations (e.g. bonds or credits with capitalized interest) corresponds to the nominal value (amount of the principal performance) including the increment in principal resulting from the indexation or capitalization mechanism, calculated at the end of a reporting period.

Debt expressed in foreign currencies must be converted into the domestic currency at the average exchange rate of such currencies, announced by the National Bank of Poland, in effect on the last working day of a given reporting period.

1.4. Subject Scope of the Public Debt

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

1) securities stipulating only monetary performance (apart from equities), broken down into short-term and long-term,
2) loans (including securities with limited transferability), broken down into short-term and long-term,
3) credits, broken down into short-term and long-term,
4) deposits accepted, broken down into transferable deposits (immediately convertible) and other deposits,
5) matured payables, in particular those resulting from laws and court ruling, as well as sureties and guarantees granted.

The Minister of Finance defined in an ordinance of April 9, 1999 (Journal of Laws 1999, No. 38, Item 364) the detailed rules of classifying the debt titles taken into account in public debt, including State Treasury debt, setting out in particular the basic subject and entity-related categories of debt, and maturities.

1.5. Entity Scope of the Public Debt

Proper designation of the public finance sector is especially important for defining the scale of the public finance sector deficit and the public debt. The Public Finance Act provides a closed-end catalogue of entities classified in the public finance sector.

The public finance sector includes:

1) bodies of: public authorities, government administration, law protection and state control, courts and tribunals, as well as local government units and their bodies and unions,
2) budgetary units and their auxiliary estates as well as budgetary establishments,
3) Earmarked funds,
4) State institutions of higher education,
5) research & development units,
6) independent public health care establishments,
7) State or local government institutions of culture,
8) ZUS (The Social Insurance Institution), KRUS (The Farmers Social Insurance Fund) and their managed funds,
9) Healthcare Funds,[8]
10) The Polish Academy of Science and its established organizational units,
11) State or local government legal entities established under separate acts for public tasks execution, with the exception of enterprises, banks, and companies organized under commercial law.

Currently, the Polish legislation contains no normative division of the public finance sector into subsectors. However, given that until January 2001 there was a statutory division of the public finance sector into government and local government, for purposes of this document the public finance sector may be divided into the following:

- *government sector*, which includes bodies of public authorities, government administration, state control and law protection, courts and tribunals, The Polish Academy of Science and its established organizational entities, the Social Security Fund, the Farmers Social insurance Fund and funds managed by them, The Healthcare Funds and the entities listed in Items 2-7, 11 for which the founding or regulatory authority is a body of government administration or other entities included in the government sector,
- *local government sector*, which includes local government units and their authorities and unions, as well as the entities listed in Items 2, 3, 6, 7 and 11, for which the founding or regulatory authority is a local government unit.

1.6. Means of influence on the Public Finance Sector Debt

The Public Finance Act mandated the Minister of Finance to exercise control over the public finance sector with regard to compliance with the constitutional principle banning the taking of loans and the granting of guarantees and sureties resulting in the public debt exceeding 3/5 of the gross domestic product.

The basic rules of public debt management, prudential and remedial procedures, adopted in the event of an excessive debt, as set out in the Public Finance Act, meet the requirements of Article 216 of the Constitution and the so-called European Union convergence criteria formulated in the Maastricht Treaty (European Union Treaty), inter alia, with regard to the relation of public debt to gross domestic product. According to the Maastricht Treaty and the enclosed Protocol on the excessive deficit procedure, member states are required to maintain their public debt at a level below 60% of the gross domestic product (GDP). The Polish Constitution and the Public Finance Act impose even stricter limitations; the relation of public debt, including anticipated payments under guarantees and sureties granted by public finance sector entities, can not exceed 3/5 of the GDP. To this end, the Minister of Finance is equipped with relevant prerogatives enabling proper management of the State Treasury debt.

With respect to those public finance sector entities whose debt is included in the public debt and is not included in the State Treasury debt - hence, mainly the debt of the local government sector - only indirect forms of influencing it may be considered.

[8] Dated from April 1, 2003 Healthcare Fund's obligations were assumed by The National Health Fund.

The prudential and remedial procedures concerning the relation of the public debt increased by anticipated payments under guarantees and sureties are the following:

1) the relation to GDP in year X is greater than 50% but not more than 55%:

a) a limit on the relation of the State budget deficit to its incomes is introduced, this relation in the draft State budget adopted by the Council of Ministers for the year X+2 cannot be higher than in the budget year X+1,

b) the relation of deficit to incomes, adopted in the State budget for the budget year X+2, is the upper limit on the relation of each local government units (LGU) deficit to its in comes tha may be adopted in the budget of such LGU.

2) the relation to GDP in the budget year X is greater than 55% but less than 60%:

a) the draft budget submitted by the Council of Ministers is to ensure a decreasing relation of the State Treasury debt plus anticipated payments under State Treasury guarantees and sureties to the GDP in the budget year X+2 in comparison with the year X,

b) the adoptable deficits of respective LGUs' budgets are also subject to limitations,

c) the Council of Ministers presents a recovery program supposed to ensure a declining relation of public debt, increased by anticipated payments under sureties and guarantees granted by public sector entities, to the GDP.

3) the relation to GDP in the budget year X is equal or higher than 60%:

a) the draft State budget for the year X+1 does not include a State budget deficit while the budgets of LGUs are adopted without including the deficit,

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

c) the Council of Ministers presents a recovery program to the Parliament, whose basic objective is to develop and implement projects aimed at reducing the relation of public debt to below 60% of GDP.

Given the above, the Public Finance Act introduces the following restrictions on incurring financial obligations by local government units and other entities of the public finance sector, which have an impact on the debt amount and structure:

- LGUs may only take credits and loans and issue securities for specific purposes indicated in the Act,
- credits and loans taken, and securities issued, the receipts from which are to finance current deficit, must be repaid or redeemed in the same year in which they were taken or issued,
- LGUs may take credits and loans and issue securities with the repayment period or maturity exceeding one year, provided that receipts from them may be used only and exclusively to finance spending not covered by LGUs planned income,
- the cost of servicing long-term obligations must be incurred at least once a year,
- the discount on securities issued by LGUs cannot exceed 5% of the nominal value,
- in the case of securities or credits or loans with a maturity of over one year, interest cannot be capitalized,
- LGUs and other entities of the public finance sector, excluding the State Treasury, may only incur those financial obligations whose nominal value expressed in PLN is determined on the transaction date,
- if an LGU applies for a credit or a loan, or intends to issue securities, the LGU must obtain an opinion of the regional clearing chamber on its ability to repay the credit or the loan, or to redeem securities,
- regional clearing chambers render opinions on the ability to finance the deficit proposed by LGUs and on the accuracy of the LGU's debt forecast enclosed with the budget. The opinion is announced to the general public. If the opinion of a regional clearing chamber is negative the LGU's founding body is required to adopt an appropriate resolution,
- the total amount of credit and loan payments, as well as potential payments under guarantees granted by an LGU, falling due in a given budget year, together with interest on such credits and interest on the discount payable in that year, as well as the LGU's issued securities redeemable in a given budget year, cannot exceed 15% of the LGU's income planned for that budget year,
- if the total amount of public debt plus the amount of anticipated payments under guarantees and sureties granted by public finance sector entities exceeds 55% of the GDP, the amount payable under the total debt service burden in a given year cannot exceed 12% of the LGU's planned income, unless the financial burdens in question result entirely from obligations incurred prior to the date the above relation was announced,
- the total LGU's debt at the end of a budget year cannot exceed 60% of its income in that budget year.

1.7. General Principles of Taking Credits and Loans, and Issuing Securities by the State Treasury

The general principles and procedures for issuing securities, and for taking credits and loans by the State Treasury are regulated in Chapter II of the Public Finance Act, Public Debt.

The exclusive right to issue Treasury securities involving monetary performance and to take loans and credits on behalf of the State Treasury is vested in the Minister of Finance.

The exception are loans and credits incurred on the basis of an international treaty which requires that the borrower be a Government; in such a situation, the Council of Ministers authorizes the Minister of Finance to sign the treaty and determines the terms of its implementation.

The amounts of loans or credits taken and of the securities issued are subject to limits defined in annual budget laws.

Treasury securities which the Minister of Finance is authorized to issue are divided in terms of their maturity into:

- *short-term instruments* - Treasury bills offered for sale on the domestic primary market at a discount and redeemed at the nominal value. Their maturity is up to 364 days (inclusive),
- *long-term instruments* - Treasury bonds being securities offered for sale on domestic and international markets, bearing interest in the form of a discount and/or coupon. Their maturity is at least one year (365 days).

The Public Finance Act differentiates the following types of Treasury securities which the Minister of Finance may issue on behalf of the State Treasury:

1) Treasury bonds understood as securities offered for sale on domestic and international markets, bearing interest in the form of a discount and/or coupon,
2) Treasury bills understood as short-term securities offered for sale on the domestic primary market at a discount and redeemed at the nominal value after the lapse of their maturity,
3) Treasury securities offered for sale exclusively to resident individual persons, and upon accession to the European Union, also to non-resident individual persons.

The general terms of issue of Treasury securities are defined in ordinances, and the detailed conditions are announced in issue letters published by the Minister of Finance. Making an issue letter public is a condition for an issue to be effective. Making public is considered to include publication of issue letters in nationwide press and their placement on the Ministry of Finance's web pages.

Based on the mandate stipulated in Article 55 of the Public Finance Act, in 1999 the Minister of Finance adopted five ordinances regulating the general issue terms for specified groups of Treasury securities:

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

The ordinances set out the options at the Minister of Finance's disposal in defining specific terms of issue. They outline the general conditions of structuring the instruments, sales procedures, investor groups to whom Treasury securities are offered, the rules or securities handling and redemption (including repurchase and advance or early redemption).

Since Treasury securities are a form of a loan they are sold on the primary market at a charge, upon the investor paying the amount determined on the basis of the selling price and the number of Treasury securities being sold. Treasury securities are issued on the date of the financial settlement for the securities declared to be purchased. The number of Treasury securities issued is equal to the number of Treasury securities sold.

Under the Act, redeemed bonds are cancelled. Only the Treasury securities purchased by the State Treasury for State Treasury debt management purposes are not subject to cancellation.

1.8. Public Finance Sector Debt Analysis[9]

The level of public debt is one of basic factors affecting significantly the entire country's economy. Presented in terms of its relation to the GDP, public debt is a major macroeconomic indicator used to evaluate the condition of the economy and the stability of country's public finance. On its basis it is possible to assess whether a given country is able to service its obligations in a regular manner. The higher the debt the higher the cost of debt servicing, which may further increase the level of budget deficit, and thus the public debt. A continuing or even growing deficit causes that debt servicing costs are becoming an increasingly important item of budget expenditures. Given its specificity, such expenditures are "fixed" since their amount is strictly related to the nominal value of debt and the particular security terms of issue.

Analyzing the public finance sector debt it is possible to break it down into central government sector and local government sector. The revised Public Finance Act in effect since January 2001 makes it possible to obtain comprehensive data on the debt of public finance sector entities, shown in a manner which allows for the exclusion of financial flows among them. Table 1 presents changes in public debt before consolidation, for 2001-2002.

Table 1. The public debt in 2001-2002 - before consolidation (in nominal value)

Item	Dec. 2001	Jun. 2002	Dec. 2002	Structure Dec. 2002	Change Dec. '02 - Dec. '01	
	PLN mn	PLN mn	PLN mn	%	PLN mn	%
Public debt	**314,715.7**	**354,484.8**	**366,868.1**	**100.0**	**52,152.4**	**16.6**
I. Central government sector debt	**299,847.8**	**339,038.8**	**347,016.2**	**94.6**	**47,168.4**	**15.7**
1. State Treasury debt	283,937.5	320,880.1	327,923.8	89.4	43,986.3	15.5
1.1. Domestic ST debt	185,028.4	211,920.5	219,366.7	59.8	34,338.3	18.6
1.2. Foreign ST debt	98,909.1	108,959.5	108,557.2	29.6	9,648.1	9.8
2. Other central government sector debt	15,910.3	18,158.7	19,092.4	5.2	3,182.1	20.0
II. Local government sector debt	**14,867.9**	**15,446.0**	**19,851.8**	**5.4**	**4,984.0**	**33.5**
1. Local government units debt	12,266.4	12,745.7	16,723.9	4.6	4,457.5	36.3
2. Other local government sector debt	2,601.5	2,700.4	3,127.9	0.9	526.4	20.2

At the end of 2002, in comparison with the end of 2001, the debt of the public finance sector (prior to consolidation) increased by PLN 52,152.4 million, i.e. 16.6%. This was mainly the effect of a growth in the government sector debt by PLN 47,168.4 million, resulting chiefly from the increase in the State Treasury debt (by PLN 43,986.3 million). Domestic ST debt went up by PLN 34,338.3 million, while foreign debt by PLN 9,648.1 million.

It is necessary to note a relatively high increase in the local government sector debt. Over a period of 12 months, it increased by PLN 4,984.0 million, i.e. 33.5%. Over 89% of the increase was accounted for by the growth in the local government units' debt (LGU), while the remaining portion was generated by entities supervised or managed by LGUs.[10]

The changes introduced in 2001 with regard to reporting on public debt allow for a fuller consolidation of the public finance sector debt. Before 2001, based on the available data, only partial debt consolidation in the government sector was possible. The data on the public debt as at the end of December 2002 make it possible to consolidate the entire public finance sector and to reference such data to those from the end of 2001.

9 Preliminary data available as at May 31, 2003.

10 These entities include local government earmarked funds having legal sonality, independent public health care institutions, local government institutions of culture and local government legal entities established under other laws to perform public tasks, excluding establishments, banks and commercial law companies.

Table 2.The public debt in 2001 – 2002 - after consolidation (in nominal value)

Item	Dec. 2001	Jun. 2002	Dec. 2002	Structure Dec. 2002	Change Dec. '02 - Dec. '01	
	PLN mn	PLN mn	PLN mn	%	PLN mn	%
Public debt	**302,106.7**	**341,454.0**	**353,843.4**	**100.0**	**51,736.7**	**17.1**
I. Central government sector debt	**291,320.5**	**329,996.2**	**338,572.7**	**95.7**	**47,252.2**	**16.2**
1. State Treasury debt	282,617.1	319,023.1	326,770.8	92.3	44,153.7	15.6
1.1. Domestic ST debt	183,708.0	210,063.6	218,213.7	61.7	34,505.6	18.8
1.2. Foreign ST debt	98,909.1	108,959.5	108,557.2	30.7	9,648.1	9.8
2. Other central government sector debt	8,703.4	10,973.2	11,801.9	3.3	3,098.5	35.6
II. Local government sector debt	**10,786.2**	**11,457.8**	**15,270.7**	**4.3**	**4,484.5**	**41.6**
1. Local government units debt	9,008.8	9,642.5	13,213.6	3.7	4,204.8	46.7
2. Other local government sector debt	1,777.4	1,815.2	2,057.1	0.6	279.7	15.7

1.8.1. State Treasury Debt

The overall State Treasury (ST) debt comprises ST's total financial obligations toward domestic and foreign entities under securities issued, credits and loans taken, as well as matured payables.

ST's debt at the end of 2002 was equal to PLN 327,923.8 million in nominal terms[11] (in terms of USD at the exchange rate as of 31.12.2002 : USD 1 = PLN 3.8388 – approx. USD 85.4 billion). In comparison with the end of 2001, the debt increased by PLN 43,986.3 million, i.e. 15.5%.

ST DEBT ACCORDING TO THE PLACE OF ISSUE[12]

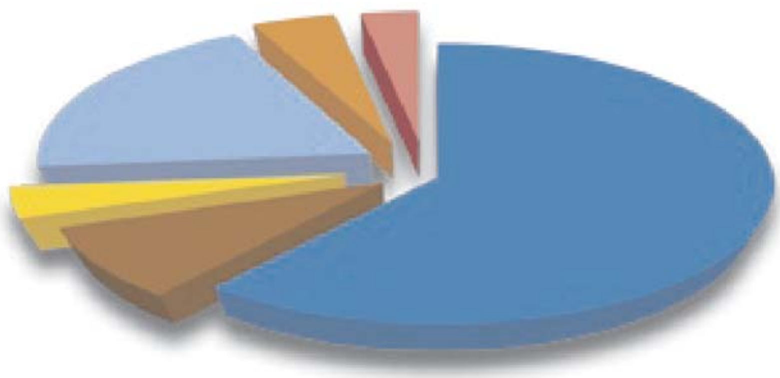
ST debt according to the place of issue criterion takes into account the place of incurring obligations, regardless of who the creditor is.

ST debt according to the place of issue criterion at the end of 2002 was at PLN 219,366.7 million and increased since the end of 2001 by PLN 34,338.3 million. The debt consists of the following:

1) debt in Treasury securities (T-s) - PLN 212,371.4 million (approx. 96.8% of the domestic debt), of which:
   - debt in marketable T-s – PLN 195,887.5 million (89.3% of the domestic debt),
   - debt in savings bonds – PLN 7,718.2 million (3.5% of the domestic debt),
   - debt in non-marketable T-s – PLN 8,765.7 million (4.0% of the domestic debt),
2) other debt – PLN 6,995.4 million (3.2 % of the domestic debt).

[11] Debt presentation in nominal terms is consistent with the requirements of Article 9 of the Public Finance Act.
[12] State Treasury debt data are presented according to the place of issue criterion and the residency criterion.

Chart 1. Structure of domestic ST debt according to the place of issue criterion at the end of 2002



The most important changes in the structure of domestic debt by instruments in 2002 include:

1) **a significant increase of debt in marketable fixed -rate bonds** by PLN 36,237.4 million, which caused the share of these bonds in domestic debt to increase from 52.7% at the end of 2001 to 61.0% at the end of 2002,
2) **an increase of debt in Treasury bills** by PLN 6,815.2 million with a slight increase in the share of these instruments in domestic debt from 19.0% at the end of 2001 to 19.2% at the end of 2002,
3) **a decline of debt in marketable floating-rate bonds** by PLN 5,855.0 million, which translated into a drop of these bonds' share in domestic debt from 14.0% at the endof 2001 to 9.2% at the end of 2002,
4) **a decline of debt in non-marketable bonds** by PLN 2,534.5 million; i.e. by over 22%, which further decreased the share of these instruments in domestic debt by 2.1 percentage points to a level of 4%,
5) **a decline in other domestic State Treasury debt** by PLN 1,984.7 million, i.e. by over 22%, with a simultaneous drop in its share in domestic debt from 4.9% at the end of 2001 to 3.2% at the end of 2002. The drop resulted mainly from:

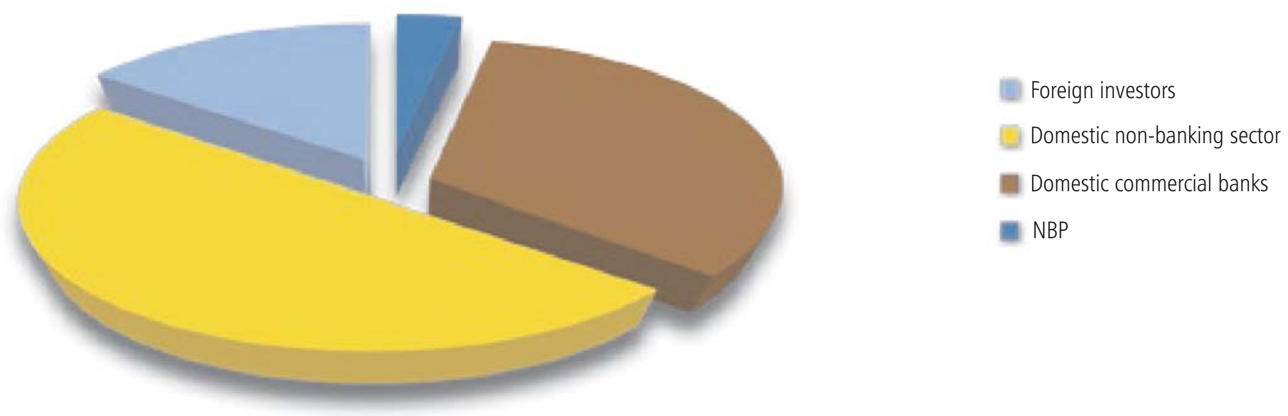
   - a decline in debt due to the failure of wage increase in the budgetary sphere, by PLN 2,575.9 million, as a result of the debt repayment program continued since 2000,
   - a decline in matured obligations by nearly PLN 302 million,
   - an increase in the Lebour Fund's debt by PLN 895.7 million.

6) **an increase in debt under savings bonds** by the amount of PLN 1,659.9 million (i.e. over 27%), which caused the share of these bonds in domestic debt to grow from 3.3% at the end of 2001 to 3.5% at the end of 2002.

The ST debt in terms of entities (identifying major groups of State Treasury creditors) underwent the following changes **in 2002**:

1) **a significant increase in domestic debt towards the non-banking sector** by PLN 22,390.8 million, i.e. 25.7% in comparison with the end of 2001, up to a level of PLN 109,363.0 million. Its share in domestic debt increased from 47.0% at the end of 2001 to 49.9% at the end of 2002,
2) **a significant increase in domestic debt in T-s acquired by foreign investors,** by PLN 10,650.1 million, i.e. 51.3% in comparison with the end of 2001 – up to a level of PLN 31,393.2 million. At the end of 2002, the share of debt in T-s acquired by foreign investors in the domestic debt accounted for 14.3% compared to 11.2% at the end of 2001,

Chart 2. State Treasury domestic debt by holder, at the end of 2002

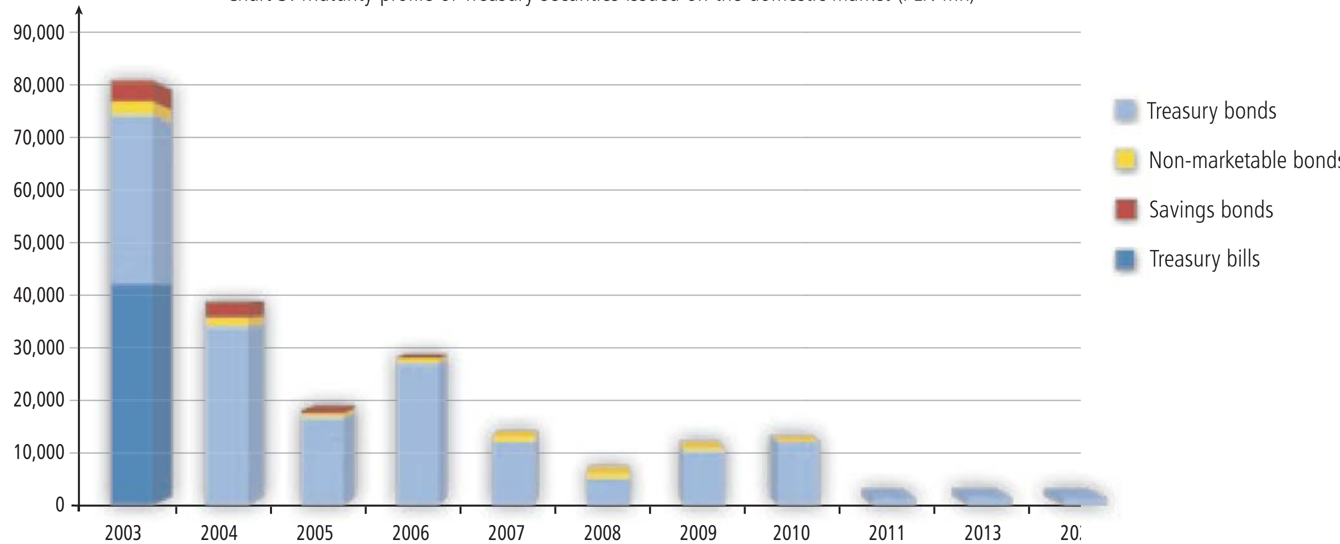


3) **an increase in debt toward domestic commercial banks** by PLN 12,728.0 million, i.e. 21.5% in comparison with 2001, up to a level of PLN 71,882.1 million. The share of debt toward commercial banks in the total domestic debt in 2002, in comparison with the end of 2001, underwent a slight growth from 32.0% to 32.8%,
4) **a considerable decrease in debt toward the National Bank of Poland** by PLN 11,430.6 million, i.e. 62.9% in comparison with the end of 2001, up to a level of PLN 6,728.4 million. At the same time, the share of this debt in domestic debt declined from 9.8% at the end of 2001 to 3.1% at the end of 2002.

As the end of December 2002, **the average maturity of marketable T-s** issued on the domestic market and denominated in PLN was **2.73 years** compared to 2.51 years in December 2001. With regard to particular types of securities, the average maturity was the following (in years):

- Marketable bonds – 3.36 (3.12 in December 2001),
- Treasury bills – 0.47 (0.52 in December 2001).

Chart 3. Maturity profile of Treasury securities issued on the domestic market (PLN mn)



In the same period, **the duration of marketable T-s issued on the domestic market and denominated in PLN** increased from 1.75 years at the end of 2001 to **2.16 years** at the end of 2002, and was the following:

- **Marketable bonds** – 2.61 (2.13 in December 2001),
- **Treasury bills** – 0.47 (0.51 in December 2001).

In 2002, **foreign ST debt according to the place of issue criterion**, expressed in USD, increased by USD 3,466.7 million (an increase of 14.0%) in comparison with the end of 2001 and reached USD 28,278.9 million. The change in this debt resulted from repayment of some foreign obligations, the taking of new obligations and the change in the USD exchange rate in relation to other currencies in which some of the foreign ST debt is denominated.

Table 3. Foreign State Treasury debt (USD mn, at the year-end exchange rates)

	As at 31 December		Change in 2002	
	2001	2002	USD mn	%
Foreign ST debt	**24,812.3**	**28,278.9**	**3,466.7**	**14.0**
1. T-s issued abroad	5,861.7	7,603.4	1,741.7	29.7
- Brady bonds	4,048.1	2,698.3	-1,349.7	-33.3
- foreign bonds	1,813.6	4,905.0	3,091.4	170.5
2. Credits in convertible currencies	18,950.6	20,675.6	1,725.0	9.1
- Paris Club	16,302.8	17,182.6	879.8	5.4
- IFI*	2,457.4	3,005.7	548.3	22.3
of which: the World Bank	1,739.5	1,879.6	140.1	8.1
- other creditors	190.4	487,3	296.9	155.9

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

Table 4. Foreign State Treasury debt (in PLN mn at the year-end PLN/USD exchange rate)

Item	As at 31 Decemberw		Change in 2002	
	2001	2002	PLN mn	%
Foreign ST debt	**98,909.1**	**108,557.2**	**9,648.1**	**9.8**
1. T-s issued abroad	23,366.4	29,187.7	5,821.4	24.9
- Brady bonds	16,136.8	10,358.3	-5,778.5	-35.8
- foreign bonds	7,229.6	18,829.4	11,599.8	160.5
2. Credits in convertible currencies	75,542.7	79,369.4	3,826.7	5.1
- Paris Club	64,987.7	65,960.5	972.8	1.5
- IFI	9,795.9	11,538.2	1,742.4	17.8
of which: the World Bank	6,934.0	7,215.3	281.2	4.1
- other creditors	759.1	1,870.7	1,111.6	146.4
PLN/USD	3.9863	3.8388	-0.1475	-3.7

Foreign ST debt in 2002 comprised two major items:

1) debt in T-s issues – PLN 29,187.7 million (USD 7,603.3 million),
2) debt in credits received – PLN 79,369.4 million (USD 20,675.6 million).

The debt in **T-s issues** comprised the debt under Brady bonds (issued in 1994 in implementation of the agreement on reduction and restructuring of Polish debt to commercial banks affiliated with the Paris Club) and bonds issued on international capital markets.

Changes in foreign debt under T-s issues in 2002:

1) a decline of debt in Brady bonds by USD 1,349.7 million (PLN 5,778.5 million) to USD 2,698.3 million (PLN 10,358.3 million), among other things, due to early redemption of PDI Brady bonds for the total of USD 1,300 million,
2) an increase of debt in bond issues on international capital markets by USD 3,091.4 million (PLN 11,599.8 million), to USD 4,905.0 million (PLN 18,829.4 million).

The amount of debt under **Brady bonds** at the end of 2002 comprised the following instruments: PAR (Collateralized Par Bonds) at USD 744.7 million, RSTA (Collateralized RSTA Bonds at USD 448.6 million; PDI (Past Due Interest Bonds) at USD 1,112.1 million and DCB (Debt Conversion Bonds) at USD 393.0 million.

The amount of debt under **bonds issues on international capital markets** at the end of 2002 comprised bonds denominated in EUR (50.1%), USD (36.7%) and GBP (13.1%) issued between 1997 and 2002.

The change in the debt under the above instruments resulted from:

- the March 2002 issue of 10-year bonds for the total nominal value of EUR 750 million,
- the July 2002 issue of 10-year bonds for the total nominal value of USD 1,000 million; the issue was increased by further USD 400 million in September,
- the November 2002 bonds issue for the total nominal value of GBP 400 million, maturing in 2010,
- US dollar to Euro depreciation.

The average maturity for all Treasury bonds issued on international markets was **11 years and 24 days** at the end of 2002.

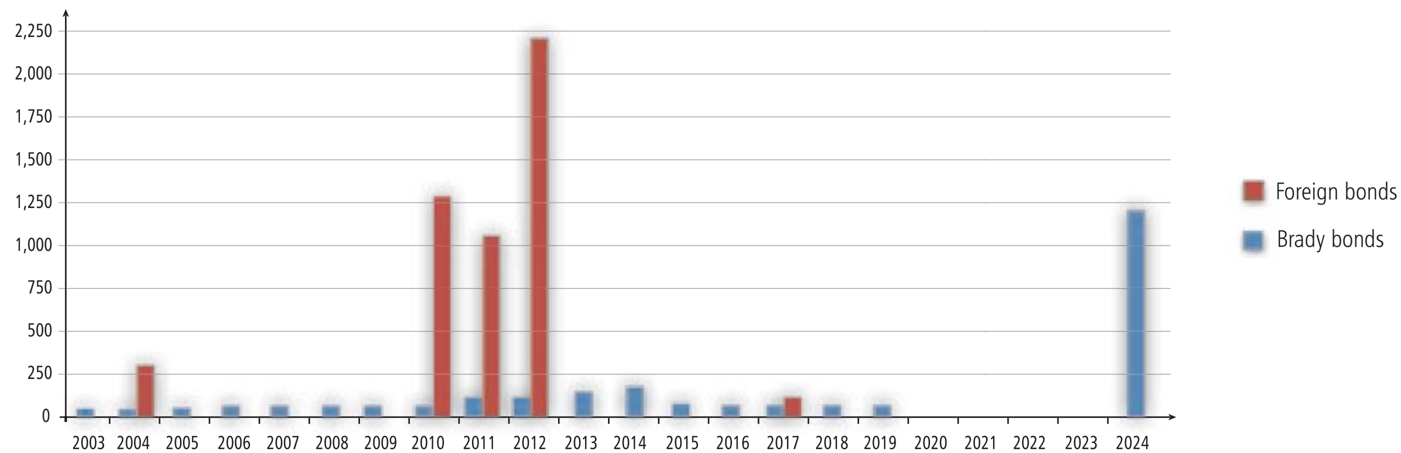
The **changes in foreign debt under foreign credits** in 2002 resulted from the following:

1) USD 1,286.9 million taken in new credits,
2) repayment of USD 1,820.6 million in credits,

3) US Dollar depreciation to other currencies in which part of the foreign ST debt is denominated.

The largest portion of debt under credits taken was accounted by the debt toward creditors affiliated with the Paris Club. Since 1991 this debt has been serviced on an on-going basis. At the end of 2002, it represented over 83% of the entire foreign debt of the State Treasury.

Chart 4. Maturity profile of Treasury securities issued on international capital markets (USD mn)



STATE TREASURY DEBT ACCORDING TO RESIDENCY

Since December 2000, the data on State Treasury debt are also presented according to the residency criterion, broken down into domestic debt (to residents) and foreign debt (to non-residents).[13] Foreign debt according to the residency criterion includes all securities in foreign investors' portfolios, regardless of the place where such instruments were issued.

At the end of December 2002, **domestic ST debt (to residents)** was equal to **PLN 190,347.9 million** and increased in comparison with December 2001 by PLN 23,223.2 million. In the same period, **foreign ST debt (to non-residents)** increased by PLN 20,763.1 million to a level of **PLN 137,575.9 million** at the end of 2002.

The share of foreign debt in the ST total debt was 42% compared to 41.1% at the end of 2001. This growth was mainly caused by residents' larger holdings of Treasury bonds issued on the domestic market (by PLN 10,527.1 million) and of bonds issued for foreign markets (by PLN 6,257.2 million). In total, the T-s share in foreign debt at the end of 2002 was at 42.3%. The remaining and largest share of foreign debt consisted of credits.

The main portion (nearly 88%) of the domestic debt consists of marketable T-s. Treasury bonds issued for foreign markets and Brady bonds in the portfolios of residents (domestic commercial banks) accounted for less than 1.3% of the total domestic debt.

The differences in the foreign debt's share in total debt according to the residency criterion and according to the place of issue criterion are due to the fact that the debt to foreign investors (nonresidents) in T-s issued on the domestic market was higher than that to domestic investors (residents) in T-s issued on foreign financial markets.

[13] The terms "resident" and "nonresident' are defined in the Foreign Exchange Law of July 27, 2002 (Journal of Laws 2002, No. 141, Item 1178).

Table 5. Sate Treasury debt according to the place of issue criterion (in nominal value)

	Dec. 2001	Structure Dec. 2001	Dec. 2002	Structure Dec. 2002	Change Dec. 2002 - Dec. 2001	
	PLN mn	%	PLN mn	%	PLN mn	%
State Treasury debt	**283,937.5**	**100.0**	**327,923.8**	**100.0**	**43,986.3**	**15.5**
I. Domestic ST debt	**185,028.4**	**65.2**	**219,366.7**	**66.9**	**34,338.3**	**18.6**
1. Debt in T-s	176,689.9	62.0	212,371.4	64.8	36,323.0	20.6
1.1. Marketable T-s	158,689.9	55.9	195,887.5	59.7	37,197.6	23.4
- Treasury bills	35,215.6	12.4	42,030.8	12.8	6,815.2	19.4
- Treasury bonds	123,474.3	43.5	153,856.7	46.9	30,382.4	24.6
1.2. Savings bonds	6,058.3	2.1	7,718.2	2.4	1,659.9	27.4
1.3. Non-marketable T-s	11,300.1	4.0	8,765.7	2.7	-2,534.4	-22.4
2. Other domestic ST debt	8,980.0	3.2	6,995.4	2.1	-1,984.6	-22.1
II. Foreign ST debt	**98,909.1**	**34.8**	**108,557.1**	**33.1**	**9,648.0**	**9.8**
1. Debt in T-s	23,366.4	8.2	29,187.7	8.9	5,821.3	24.9
2. Debt in credits	75,542.7	26.6	79,369.4	24.2	3,826.7	5.1

Table 6. Sate Treasury debt according to the residency criterion (in nominal value)

	Dec. 2001	Structure Dec. 2001	Dec. 2002	Structure Dec. 2002	Change Dec. 2002 - Dec. 2001	
	PLN mn	%	PLN mn	%	PLN mn	%
State Treasury debt	**283,937.5**	**100.0**	**327,923.8**	**100.0**	**43,986.3**	**15.5**
I. Domestic ST debt	**167,124.7**	**58.9**	**190,347.9**	**58.0**	**23,223.2**	**13.9**
1. Debt in T-s	158,146.0	55.7	183,383.2	55.9	25,237.2	16.0
1.1. Marketable T-s	140,787.6	49.6	166,899.4	50.9	26,111.8	18.5
- Treasury bills	34,283,0	12.1	40,975.3	12.5	6,692.3	19.5
- Treasury bonds issued on the domestic market	103,663.8	36.5	123,519.1	37.7	19,855.3	19.2
- Brady bonds and bonds issued on foreign markets	2,840.8	1.0	2,405.0	0.7	-435.8	-15.3
1.2. Savings bonds	6,058.3	2.1	7,718.2	2.4	1,659.9	27.4
1.3. Non-marketable bonds	11,300.1	4.0	8,765.7	2.7	-2,534.4	-22.4
2. Other domestic ST debt	8,978.7	3.2	6,964.7	2.1	-2,014.0	-22.4
II. Foreign ST debt	**116,812.8**	**41.1**	**137,575.9**	**42.0**	**20,763.1**	**17.8**
1. Debt in T-s	41,268,7	14.5	58,175.8	17.7	16,907.1	41.0
Of which:						
- Treasury bills	932.6	0.3	1,055.5	0.3	122.9	13.2
- Treasury bonds issued for the domestic market	19,810.5	7.0	30,337.6	9.3	10,527.1	53.1
- Brady bonds and bonds issued on foreign markets	20,525.6	7.2	26,782.8	8.2	6,257.2	30.5
2. Debt in credits	75,542.7	26.6	79,369.4	24.2	3,826.7	5.1
3. Other debt	1.4	0.0	30.7	0.0	29.3	2,092.9

1.8.2. State Treasury Debt to the Gross Domestic Product[14]

The relation of the ST debt to the GDP increased by 4.7 percentage points and reached 42.5% at the end of December 2002, compared to 37.8% at the end of 2001. At the same time, the relation of ST debt inclusive of anticipated payments under State Treasury sureties and guarantees to the GDP increased from 39.1% at the end of 2001 to 44.0% at the end of 2002.

Table 7. State Treasury debt in 2000-2002 in nominal value (PLN mn) and in relation to the GDP

Item	Dec. 2000	Dec. 2001	Dec. 2002
Total State Treasury debt	**266,816.8**	**283,937.5**	**327,923.8**
- in relation to the GDP (%)	37.5	37.8	42.5
Domestic State Treasury debt	145,981.6	185,028.4	219,366.7
- in relation to the GDP (%)	20.5	24.6	28.4
Foreign State Treasury debt	120,835.2	98,909.1	108,557.2
- in relation to the GDP (%)	17.0	13.2	14.1
GDP	**712,321.5**	**750,785.9**	**722,248.4**

Table 8. State Treasury debt enlarged by anticipated payments under ST sureties and guarantees in nominal value (PLN mn) and in relation to the GDP

Item	Dec. 2000	Dec. 2001	Dec. 2002
ST debt including anticipated payments under State Treasury securities and guarantees	276,202.6	293,274.1	339,979.7
Relation to the GDP (%)	38.8	39.1	44.0

1.8.3. State Treasury Debt in 2002- Key Issues

1) **A growth of the ST debt** by PLN 43,986.3 million in comparison with the end of 2001 up to a level of **PLN 327,923.8 million**, caused by the high budget deficit (PLN 39.40 billion) and lower than planned privatization receipts (PLN 1.97 billion compared to planned PLN 6.60 billion). Greater borrowing needs of the budget in 2002 were mainly financed through Treasury securities issues (this debt increased by PLN 42,144.2 million),
2) **A significant growth in the ST debt to the GDP relation** from 37.8% at the end of December 2001 to **42.5%** at the end of 2002 – resulting from the increase in the ST debt and the slow pace of economic growth in 2002,
3) **A significant increase in the domestic debt to the non-banking sector** by PLN 22,390.8 million, i.e. by 25.7% in comparison with the end of 2001, up to a level of **PLN 109,363.0 million,**
4) **A significant increase in the domestic debt in T-s acquired by foreign investors**, by PLN 10,650.1 million, i.e. by 51.3% in comparison with the end of 2001 – up to a level of **PLN 31,393.2 million,**
5) **Partial early redemption of Brady bonds.** In October 2002, the Ministry of Finance carried out a partial early redemption of PDI Brady bonds with the nominal value of **USD 1,300.0 million,**
6) **Issue of 20-year fixed-rate bonds.** In April 2002, fixed-rate bonds with maturity falling on September 23, 2022 and with an annual coupon of 5.75% were issued. The instrument was issued as an implementation of the Public Finance Sector Debt Management Strategy[15] and was a response to the demand voiced by investors, in particular those from the domestic non-banking sector, for long-term fixed income instruments.

[14] In 2002, the Central Statistical Office changed the GDP calculation methodology. The GDP figures for 2000-2002 are given according to the CSO's new methodology.
[15] For more information, see: Chapter II . Debt Management Strategy in this document.

1.8.4. Other Central Government Sector Debt

The data concerning the government sector excluding the ST[16] indicates a systematic increase in that debt (from PLN 15,910.3 million at the end of 2001 to PLN 19,092.4 million at the end of 2002, prior to consolidation). At the same time the share of liabilities of these entities in the total public finance sector debt increased (from 5.1% in 2001 to 5.2% in 2002, prior to consolidation).

In the period between December 2001 and December 2002, the highest debt among central government sector entities, excluding the State Treasury, was reported by ZUS (Social Insurance Institution) and ZUS-managed funds. At the end of December 2002, these entities' debt reached a level of PLN 15,014.6 million (PLN 9,014.6 million after eliminating financial flows among public finance sector entities) as compared to PLN 13,173.5 million in December 2001 (PLN 7,173.5 million after consolidation).

The level of other central government sector debt was under the significant impact of obligations incurred by the Healthcare Funds. At the end of December 2002, they reached PLN 1,284.1 million (PLN 289.7 million after consolidation) compared to PLN 1,052.8 million at the end of 2001 (PLN 154.4 million after consolidation). One could observe a considerable increase in the debt of other legal entities established under separate laws to perform public tasks, especially in the second half of the year, PLN 1,318.3 million at the end of 2002 (PLN 1,306.5 million after consolidation) compared to PLN 386.8 million at the end of 2001 (PLN 336.3 million).

In the period under discussion, the debt of State-owned earmarked funds with legal personality (apart from ZUS and ZUS-managed funds) increased up to PLN 339.2 million.

The central government sector entities which reported a decline in debt include research and development centers (a decline by PLN 39.5 million) and The State Academy of Science (PAN), as well as PAN-established organizational entities (a decline by PLN 2.5 million).

Table 9. Other central government sector debt in 2001 – 2002 – before consolidation

Item	Dec. 2001	Jun. 2002	Dec. 2002	Change Dec. 2002 - Dec. 2001	
	PLN mn	PLN mn	PLN mn	PLN mn	%
Other debt of the government sector	**15,910.3**	**18,158.7**	**19,092.4**	**3,182.1**	**20.0**
- ZUS and ZUS managed funds	13,173.5	15,084.9	15,014.6	1,841.1	14.0
- Healthcare Funds	1,052.8	1,053.3	1,284.1	231.3	22.0
- The State earmarked funds with legal personality (excluding ZUS)	192.8	231.8	339.2	146.4	75.9
- State institutions of higher education	237.9	215.0	244.0	6.1	2.6
- Research & development unist	368.6	381.2	329.1	-39.5	-10.7
- Independent public health care institutions	476.0	575.8	542.9	66.9	14.1
- State institutions of culture	5.5	3.7	6.3	0.8	14.2
- The Polish Academy of Science and its estabilished organisational units	16.5	16.2	13.9	-2.5	-15.4
- Other state legal persons	386.8	596.7	1,318.3	931.5	240.8

1.8.5. Local Government Sector Debt

The debt of the local government sector comprises the debt of local government units (LGUs) and other debt of the local government sector.[17] This debt as at the end of 2002, prior to consolidation, was equal to PLN 3,127.9 million, or PLN 2,057.1 million after consolidation. The largest debt in this item was reported by independent public health care institutions supervised by LGUs. At the end of 2002, their debt reached PLN 3,003.3 million, or PLN 1,990.0 million after consolidation.

At the end of December 2002, LGUs debt was equal to PLN 16,723.9 million (PLN 13,213.6 million after consolidation), compared to PLN 12,266.4 million at the end of 2001. The debt of the entire local government sector was at PLN 19,851.8 million prior to consolidation (PLN 15,270.7 million after consolidation).

[16] Debt prior to consolidation in the public finance sector.
[17] The data on the debt of other local government sector entities were available for the first time in 2001.

Table 10. Debt of the local government sector in 2001 – 2002 - before consolidation

Item	Dec. 2001	Jun. 2002	Dec. 2002	Change Dec. 2002 - Dec. 2001	
	PLN mn	PLN mn	PLN mn	PLN mn	%
Debt of the local government sector	**14,867.9**	**15,446.0**	**19,851.8**	**4,984.0**	**33.5**
I. Debt of local government units	**12,266.4**	**12,745.7**	**16,723.9**	**4,457.5**	**36.3**
1. Domestic debt	11,989.2	12,443.9	16,178.6	4,189.4	34.9
1.1. Securities	1,552.3	1,671.8	2,252.4	700.1	45.1
1.2. Credits and loans	9,637.2	10,045.1	13,180.5	3,543.3	36.8
1.3. Other debt	799.7	727.0	745.7	-54.0	-6.7
2. Foreign debt	277.2	301.8	545.3	268.1	96.7
2.1. Securities	122.8	139.4	139.8	16.9	13.8
2.2. Credits and loans	154.3	162.4	405.5	251.2	162.8
2.3. Other debt	0.1	0.0	0.0	-0.1	-96.1
II. Other local government sector debt	**2,601.5**	**2,700.4**	**3,127.9**	**526.4**	**20.2**
1. Special purpose funds legal personality	36.4	22.1	35.6	-0.8	-2.3
2. Independent public health care institutions	2,464.5	2,560.6	3,003.3	538.8	21.9
3. Local government institutions of culture	62.3	53.7	58.1	-4.2	-6.8
4. Other local government legal persons	38.3	64.0	31.0	-7.3	-19.1

Given its small share (4.3% at the end of 2002, i.e. 0.7 pp more than at the end of 2001), the local government sector debt comprised in the public debt did not have a significant impact on the latter. However, its dynamics over the past two years gives rise to concerns. In the said period, that sector's debt increased nearly 63% while the entire public debt went up by 26%. In 2002 alone, the local government sector debt increased over 41% while the PD, 17% (see: Table 2).

Poland's accession to the European Union will open access for local governments to EU aid funds. It must be remembered, however, that this form of aid depends on the financial situation of beneficiaries. In order to obtain these funds a unit must ensure its own share of financing for intended projects. In the situation of a systematically growing debt of local government units, they may not be able to co-finance investment projects.

1.8.6. Public Debt to the Gross Domestic Product

The public debt to GDP relation was at 45.8% at the end of December 2002, compared to 40.2% at the end of 2001. At the same time, the relation of the PD including anticipated payments under sureties and guarantees granted by public finance sector entities to the GDP increased from 41.5% to 47.4% at the end of 2002.

Table 11. The public debt in 2000-2002 in nominal terms (in PLN mn) and in relation to the GDP

Item	Dec. 2000	Dec. 2001	Dec. 2002
Public debt (PLN mn)	280,473.8	302,106.7	353,843.4
Relation to the GDP (%)	39.4	40.2	45.8
Public debt including anticipated payments under securities and guarantees granted by public finance sector entities (PLN mn)	289,964.0	311,602.8	365,967.3
Relation to the GDP (%)	40.7	41.5	47.4
GDP (PLN mn)	712,321.5	750,782.9	772,248.4

1.8.7. Public Debt under the European Union criteria

The basic issues concerning the public debt in the European Union Members States are reflected in the Maastricht Treaty (The Treaty on the European Union) and the appended Protocol on excessive deficit procedure. In accordance to these documents the Member States are under the obligation to keep public (general government) debt at a level below 60% of GDP. The definitions of the public finance (general government) sector, as well as the categories of financial commitments can be found in the European System of Accounts (ESA95).

There are four basic differences between the public debt under the domestic methodology (i.e. based on the Public Finance Act) and the general government debt, according to the EU criteria:

- the anticipated payments under sureties and guaranties do not increase the debt of the general government,
- matured payables (namely liabilities whose payment date has elapsed and which have not been prescribed or written off), constitute in Poland one of the public debt categories, in EU are treated as expenditures on accrual basis and thus are not included in the debt (they only affect net borrowing/net lending of the general govement),
- open pension funds (OFE) are not included among the public finance sector (according to the Public Finance Act), while they should constitute an element of the general government sector (negotiations with the EU in this respect are in progress),
- the Agricultural Market Agency is an entity of the public finance sector, however according to the ESA95 it is not a part of the general government sector.

Owing to the listed differences the Polish public finance sector debt, according to the EU criteria (i.e. debt of general government), is lower than the public debt (enlarged by the anticipated payments under sureties and guarantees granted by public finance sector entities), specified in the Public Finance Act.

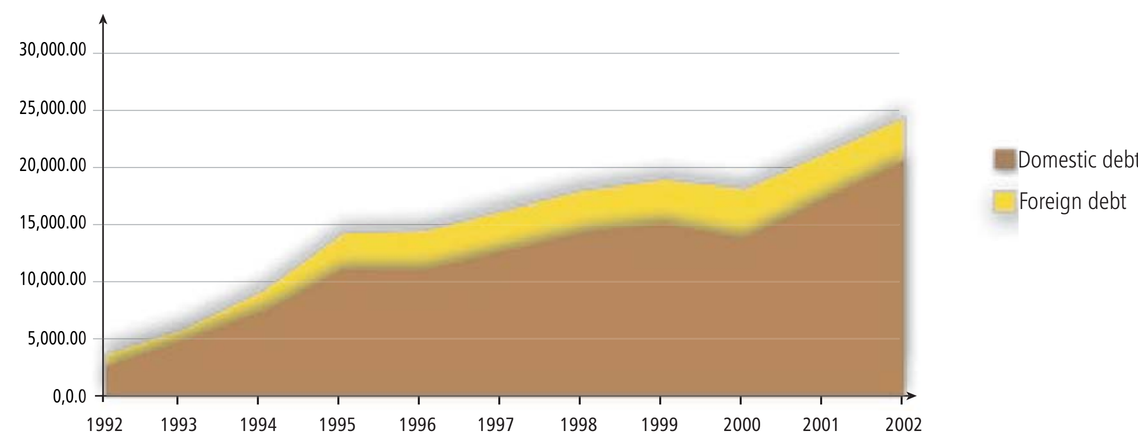
In 2002, the public debt according to the EU criteria (general government debt) amounted to PLN 322.5 billion (i.e. 41.8% of GDP).

1.9. State Treasury Debt Servicing in 2002

The increase in domestic and foreign debts in 1991-2002, and resumption of full debt servicing have caused a disproportionately higher dynamics in the debt servicing costs. As a result, year by year the cost of State Treasury debt servicing has been becoming an increasingly important item in State budget expenditures, and its systematic growth had an impact on the level of annual budget deficits.

In 2002, similar to the previous year, the budget failed to show a primary surplus[18] since the expenditures public debt servicing were lower than the budget deficit level.

Chart 5. Debt servicing cost according to domestic and foreign debt portions (place of issue criterion, in PLN mn)



[18] A primary budget surplus means that, excluding the cost of public debt servicing, expenditures in a given year would be lower than budget incomes, hence the budget would close with a surplus.

The public debt servicing cost is the largest budget item which depends partly on market variables, such as:

- Treasury bill yields and interest rates on interbank deposits (LIBOR, WIBOR, etc.) – e.g. floating-rate Treasury securities,
- the prices of convertible currencies (i.e. foreign currency exchange rates) – this applies to all foreign currency obligations.

Given the above, some costs are not known in advance and a precise amount of expenditures cannot be planned. For prudence considerations, the public debt manager is required to establish a provision for unforeseeable variations in convertible currency exchange rates and interest rates on financial markets.

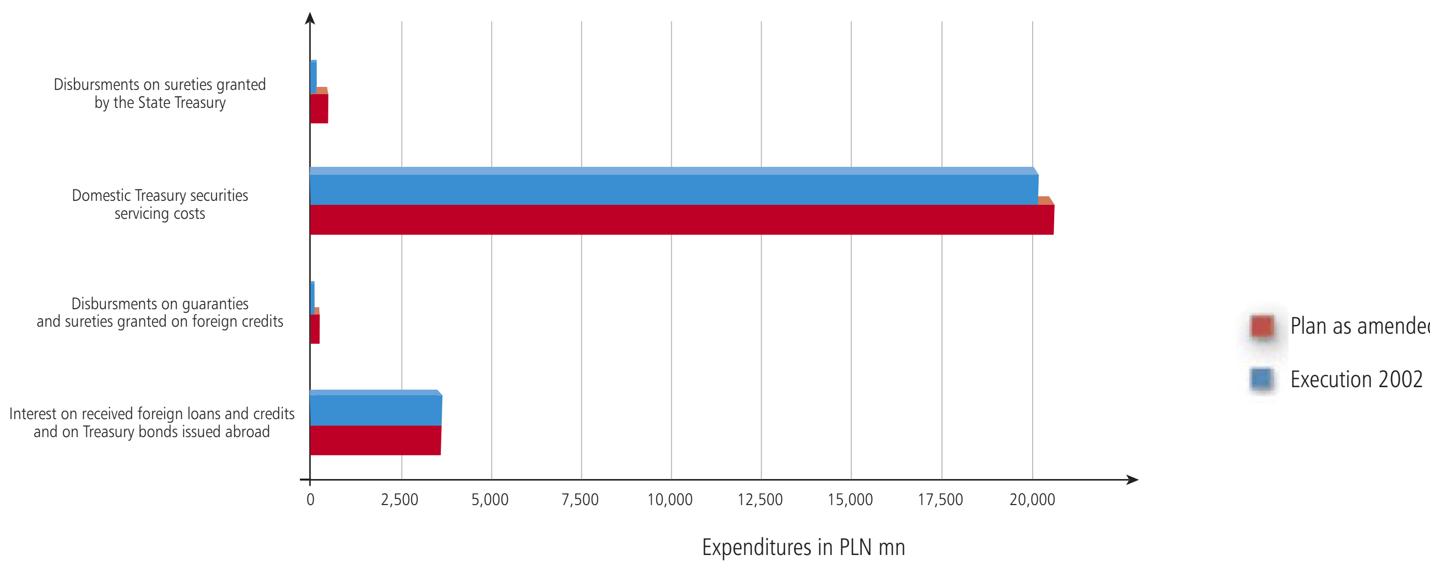
The need to maintain a provision stems also from the need of an active approach to public debt management (for more, see: Chapter II). This term should be understood mainly to include operations executed on the debt, such as conversion of existing obligations into new obligations (switching operations), early redemption, etc., in the situations where market conditions are sufficiently favorable for the issuer. A rigid limit of expenditures with a provision that is too small may effectively prevent these type of activities.

The 2002 Budget Act[19] stipulated debt servicing expenditures at PLN 25,032.0 million (nearly 20% more than the actual expenditures in 2001), of which PLN 21,150.0 million i.e. 84% accounted for the domestic debt portion, and PLN 3,882.0 million – for the foreign debt portion. The actual debt servicing expenditures in 2002 were lower by PLN 983.7 million and amounted to PLN 24,048.3 million. (See: Chart 6).

The lower than planned expenditures in 2002 resulted mainly from:

- the PLN/USD and PLN/EUR exchange rates being more favorable than planned for payments made,
- interest rates being lower than planned,
- smaller than planned use of credits from international banks and financial institutions,
- much lower than planned payments under guarantees for foreign credits repayment and domestic sureties granted by the State Treasury.

Chart 6. Plan and execution of the 2002 Budget Act as to debt service expenditures



19 The Minister of Finance introducet two cuts in the planned amount of debt service.

CHAPTER II. Debt Management Strategy

Debt management, given the maturity of its components, should be considered in at least a medium-term horizon. Efficient management requires the adoption of a strategy, setting out objectives and tasks, as well as instruments for their implementation. It must also take into account the conditions in which debt management will be carried out.

2.1. Objectives of the Debt Management Strategy for the year 2002

The essential objective of debt management is to ensure financing of State budget's borrowing needs at the lowest possible cost and at a rational risk level. Debt management objectives and their hierarchy are considerably influenced by macroeconomic and market conditions. Thus, both the formulation of objectives and their prioritization may change from one period to another.

Debt management objectives for 2002 are set out in the *Public Finance Sector Debt Management Strategy, 2002-2004*, adopted together with the 2002 Budget Act. Given the deepening of unfavorable trends in the areas of macroeconomics and public finance in comparison with 2001 (low level of the GDP growth, higher budget deficit with lower receipts from privatization), which have a strong impact on the debt level and its servicing costs, as well as their relation to the GDP, the strategy differentiates two groups of objectives: basic and additional (contingent).

Debt management objectives set out in the Public Finance Sector Debt Management Strategy, 2002-2004

BASIC OBJECTIVES	**ADDITIONAL (CONTINGENT) OBJECTIVES**
1. To minimize debt servicing costs	4. To limit domestic currency refinancing risk
2. To limit the exchange risk and foreign currency refinancing risk	5. To limit the inerest rate risk
3. To optimize State budget liquidity management	6. To make debt structure more flexible
	7. To reduce monetization

The main emphasis in the debt servicing costs was placed on their minimization within the horizon determined by the maturity of longer-term Treasury securities. The objective was to be implemented with a simultaneous reduction of the cost burden for public finance (as a limiting condition) and elimination of the causes for the debt interest rate remaining at a higher than minimum level obtainable on the market. The effectiveness of implementing this objective was a priori limited given the need to incur high fixed expenditures to service previous years' issues.

Limiting the exchange risk and the foreign currency refinancing risk was to be obtained by satisfying budget's borrowing needs, to the maximum extent possible, on the domestic market. It was also assumed that fund raising on foreign markets should not exceed the foreign debt principal due for payment in a given budget year.

Optimum management of State budget's liquidity was to be achieved by securing the budget against loss of liquidity and by ensuring timely execution of budget expenditures. At the same time, the opportunity cost of maintaining funds in non-interest bearing accounts was to be limited to the minimum level resulting from accepted security against the risk of liquidity loss.

Additional objectives were to be implemented to the extent permitted by the situation on financial markets.

The change in certain macroeconomic conditions made it necessary in 2002 to revise the objectives in drafting a new debt management strategy. Given the need to finance high budget deficit, with much lower than planned privatization receipts, a significant increase in indebtedness in Treasury securities was impossible to avoid. With the prevailing low GDP rate, it became realistic that the 50% threshold for the relation of public debt including anticipated payments under sureties and guarantees to the GDP might be approached in 2002 and exceeded in 2003. On the other hand, the growing debt was unavoidably related to a growth in servicing costs, and hence, in fixed budget expenditures, thus bearing negatively on the State budget result in subsequent years.

Despite the adverse macroeconomic factors, favorable market conditions prevailed in 2002 for T-s issues. The decline in the current account deficit and the inflation rate, and cuts in basic interest rates of the central bank in 2002 resulted in a decline in T-s yields throughout the yield curve's length and an increased demand for such securities. A factor which contributed to the decline in yields was the progress in negotiations on EU accession and the resulting inflow of foreign capital waiting for a convergence of interest rates with those of the Euro zone.

The above mentioned conditions shaped the new debt management strategy (developed in 2002). *The Debt Management Strategy for 2003-2005* formulates its objectives so that their implementation could limit both the risk of debt increase and could represent a continuation of the efforts to minimize costs and build a debt portfolio with the risk level similar to those of EU countries. As a result, two basic objectives were adopted. In comparison with the strategy developed in 2001 (for 2002-2004), the 2002 strategy considers some of the previously defined objectives as limiting conditions for basic objectives.

Basic objectives in the strategy for 2003 – 2005 are defined as:

1. Maintenance of the public debt at a safe level,
2. Minimization of debt servicing costs in a long horizon, subject to restrictions related to the level of:
   a) domestic currency refinancing risk,
   b) foreign exchange risk and foreign currency refinancing risk,
   c) interest rate risk,
   d) State budget liquidity risk,
   e) other types of risk, in particular credit and operating risks,
   f) distribution of the debt servicing costs over time.

The 2002 strategy places a considerable emphasis on the analysis of risks related to public debt. The following is discussed in detail:

- risks related to public debt,
- risks related to debt servicing costs (including market risks related to the debt structure), and,
- risks related to sureties and guarantees granted.

Given the danger of the debt to the GDP relation exceeding the first prudential band defined in the Public Finance Act (50%), the document also points to the reasons for an increase in the debt to GDP relation.

In connection with the upcoming accession to the EU, a separate chapter is devoted to the basic regulations applicable to debt in Poland and the EU. For the first time debt forecasts for the period covered by the strategy are presented in compliance with both Polish and EU requirements.

2.2. Strategy Implementation - Tasks and Instruments

In terms of the implementation period, the tasks set out in the debt management strategy may be divided into two groups: interim tasks and continuous tasks.
Considering both the 2001 strategy (for 2002-2004) and the 2002 strategy (for 2003-2005), continuous tasks include:

1) Improving liquidity, effectiveness and transparency of the securities market,
2) Development of a system for State budget liquidity management,
3) Continued conversion of non-marketable debt into marketable instruments,
4) Development of a system for retail instruments sale.

Interim tasks (i.e. subject to change depending on timing) include:

5) *Implementation of a system of Treasury securities dealers* (2001 strategy), replaced in the 2002 strategy by: *Improvement of the Treasury securities dealers system.* In 2002, operating rules for the T-s dealers system were designed and a selection of 12 banks as T-s dealers was carried out. The T-s dealer system began its operation in January 2003,
6) *Continued work on resolving the problem of foreign debt servicing in the period of payments accumulation, i.e. 2004-2009* (2001 strategy), replaced in the 2002 strategy by: *The launch of a program for refinancing foreign debt payments falling due in 2004-2009 in a manner which would be best from the point of view of costs and risks incurred.*

The tasks formulated in the debt management strategy are meant primarily to improve the functioning of the T-s market both from the issuer's and investors' perspectives. They aim first of all to adapt the Polish market to the EU standards as well as IMF and OECD guidelines and recommendations. The changes being introduced refer both to the issue policies (mainly, reduction of the number of issues while simultaneously increasing their value up to the PLN equivalent of approx. EUR 5 billion, mainly by conducting switching auctions) as well as the rules of the T-s market itself (T-s dealer system, introduction in 2002 and further development of an electronic trading platform for T-s, elimination of technical and legal barriers and those related to the settlement infrastructure).

Implementation of the debt management strategy objectives and tasks requires selection of the appropriate instruments. These include decision-making procedures, debt instruments, operations on debt components as well as legal-organizational instruments. Major instruments formulated in the strategy for 2003-2005 include:

1) implementation of an IT debt management system, mainly for the purpose of automating data collection and processing, facilitating (by means of appropriate utilities) analyses, risk management and applying simulation methods in debt management; the system implementation work is expected to be completed in September 2003; the system will make it possible to limit operating risks involved in debt management,
2) implementation and development of optimization methods and techniques meant to aid debt management (both standard and own solutions),
3) introduction of legal and organizational changes, including revision of the public finance act to establish the legal grounds for actions meant to improve the effectiveness of debt management,
4) application of derivative instruments in risk and liquidity management. Currently, a legal infrastructure (conclusion of ISDA and framework agreements with potential transaction partners) and a technical infrastructure are being prepared to enable transactions on derivatives,
5) introduction of new debt instruments both on the retail and wholesale markets.

2.3. Strategy 2002 – Execution of Objectives and Assessment

Implementation of the strategy objectives in 2002 was the following:

1) Minimization of debt servicing costs within the assumed horizon

Minimization of debt servicing costs consisted of adjusting the T-s issue structure to the conditions prevailing on the financial market in 2002. The sales structure was such as to prevent excessive supply in particular yield curve segments from resulting in the acceptance of excessive debt servicing costs. This objective was helped by the financial market situation ensuing from a slump in interest rates throughout the yield curve.

Subordinate to the cost minimization objective was the rescheduling of the Treasury bonds issue offered at auctions, starting from September 2002. The main assumption underlying the changes is to continue an issue of one series of medium and long-term bonds (starting from 5-year maturities) until the bonds reach the value of around PLN 20 billion (approx. EUR 5 billion). This minimizes the liquidity premium, i.e. the higher than attainable yields that investors demand in the case of small and non-liquid issues. At the same time, the strategy assumes limitation of the refinancing risk and the liquidity risk arising from a buildup of large series redemptions, by continuing bond conversion operations and by distributing payments under newly issued series evenly over particular months.

2) Limitation of the foreign exchange risk and the foreign currency refinancing risk

Limitation of the foreign currency refinancing risk entailed that the basic place of debt issues was the domestic market (the financing balance for the domestic debt at the end of the year was PLN 35,955 million, and for the foreign debt, PLN 3,448 million). Funds obtained on the foreign market should not exceed foreign debt principal payments falling due in a given budget year and payments under bonds denominated in USD, held by the NBP. Additional monies obtained on foreign markets should be allocated to early repayment of selected components of the existing foreign debt (in October, a call option was used to carry out an early redemption of Brady bonds for the nominal value of USD 1,300 million). In 2002, the share of foreign debt in total debt (according to the place of issue criterion) declined from 34.8% to 33.1%. Also the share of debt denominated in foreign currencies dropped from 39.4% at the end of 2001 to 35.1% at the end of 2002. The funds for foreign debt refinancing came mainly from bonds issues on international markets (Eurobonds, bonds issued in USD on the US market and bonds issued in GBP on the British market).

The share of foreign debt according to the residency criterion increased slightly (from 41.1% to 42.0%), mainly as a result of a growing debt to foreign investors under Treasury securities issued on the domestic market and acquired by such investors. In light of Poland's integration with the EU, including the planned adoption of Euro as the domestic currency, further increase of that currency's share in foreign debt was a positive trend (in 2002, from 43.0% to 45.6% of the total foreign debt).

3) Optimization of State budget liquidity management

The basic instruments for State budget liquidity management (deposits with NBP and short-term Treasury bills issues) are complemented by bonds switching and buy-back auctions. As a result of such auctions, in 2002 bonds with the total nominal value of PLN 9,702 million were repurchased (PLN 58 million at a buy-back auction) and bonds with the total nominal value of PLN 9,823 million were issued. Repurchases involved mainly bonds maturing within one year from the switching auction, which to a large extent helped ease the buildup of redemption dates in 2002. Switching auctions were thus also an active instrument of limiting refinancing risks.

4) Limitation of the domestic currency refinancing risk

In 2002, the basic measure of refinancing risk, i.e. the average debt maturity, increased from 2.51 to 2.73 years for the domestic marketable debt. The indicator increased due to:

- bond switching auctions (bonds with close maturities were converted mainly into medium and long-term bonds),
- bonds restructuring. Lengthening maturity of newly issued 5-year bonds from the PS0608 issue (first auction in November 2002) and 10-year bonds from the DS1013 issue (first auction in September 2002) at the first auctions so that the five and ten year terms referred to the average maturity during the period in which a given issue was offered and not to the first auction,
- the issue of a new instrument, a 20-year fixed-rate bond with maturity falling in September 2022. At two auctions, in April and September, the total of PLN 1,400 million of that series was sold.

The total debt was adversely affected by the growing debt in Treasury bills resulting from the need to finance the budget deficit in the situation of smaller privatization receipts.

5) Limitation of interest rate risks

The average duration of domestic marketable debt, which is a measure of sensitivity of debt servicing costs to interest rate changes, increased in 2002 from 1.75 to 2.16 years. This increase resulted from a significant decline in interest rates, a decrease in the share of floating interest instruments (from 14.0% to 9.1%) and a growth in the average debt maturity (from 2.51 to 2.73 years).

6) Making debt structure more flexible

In 2002, the share of non-marketable debt in the domestic debt declined from 11.0% to 7.2%, which was mainly the result of financing State budget borrowing needs solely through marketable debt issues (and savings bonds, their share in the domestic debt increased slightly from 3.3% to 3.5%) and successive repayment of the non-marketable debt (principal payments under non-marketable bonds, compensation payments). Also efforts were made to restructure the existing debt: conversion of State Treasury obligations arising from the return of assets lost by trade unions and welfare organizations upon the introduction of the martial law (the program was launched in 2001, in 2002 PLN 118 million was converted) and early redemption of restructuring bonds for the nominal value of PLN 220 million (in August 2002).

In the case of foreign debt, the share of credits shrank from 76.4% to 73.1%.

7) Reduction of debt monetization

The objective of reducing debt monetization results from the aim of limiting the impact of T-s issues on monetary phenomena in the economy. A measure of debt monetization is the share of the banking sector in the debt holders' structure. In 2002, banking sector's share in the domestic debt decreased from 41.8% to 35.8%. With a stable share of domestic commercial banks (change from 32.0% to 32.9%), the reduction in monetization resulted from a smaller share of debt toward the NBP (from 9.8% to 2.9%), mainly due to the successive redemption of US dollar denominated bonds issued to refinance the debt to Brazil, repurchased early in 2001.

A positive trend was the growing share of the domestic non-banking sector in the domestic debt (from 47.0% to 49.8%). This was due to further development of non-banking financial institutions, including insurance institutions and pension funds.

The above outcome of implementing debt management strategy objectives (for the period 2002-2004) indicate positive changes in the debt characteristics. A progress was made in all objectives. Given mainly the adverse budgetary situation (high deficit, low privatization receipts) and market limitations, the smallest progress was made in limiting the domestic currency refinancing risk. At the same time, the same conditions reduced capabilities for limiting the growth of the relation of debt servicing costs to the GDP.

The consequence of financing the high budget deficit, with privatizations receipts being below expectations, was a significant growth of indebtedness. At the same time, the low GDP growth rate and the growing amount of anticipated payments under sureties and guarantees brought the debt to GDP relation close to the first prudential band of 50%, defined in the Public Finance Act.

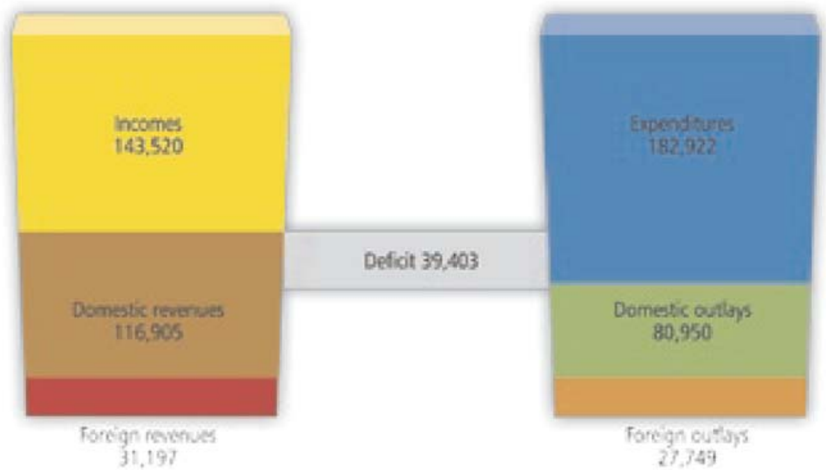
Due to the above circumstances it has become a key issue to limit debt increase to a safe level. This is reflected in the formulation of debt management objectives in the Public Finance Sector Debt Management Strategy for 2003-2005. At the same time, the new conditions have caused the objectives defined in the strategy for 2002-2004, related to reduction of various risks, to become limitations for the objective of minimizing debt servicing costs under the new strategy.

CHAPTER III. Financing of State Budget's Borrowing Needs

The 2002 Budget Act set the amount of budget income at PLN 145,102 million, and expenditures at not more than PLN 185,102 million. The deficit could not exceed PLN 40,000 million. The actual execution was slightly below the plan (Chart 7).

The deficit was financed from domestic (PLN 35,955 million) and foreign sources (PLN 3,448 million). The foreign balance contains amounts related to flows in the foreign exchange account (excluding foreign currency privatization receipts which represent domestic financing). The balance of foreign financing excluding such flows (deposits established and terminated) was at PLN 2,759 million.[20] The above operations are described in greater detail in the section on foreign financing.

Chart 7. State budget balance and borrowing needs in 2002 (PLN mn)



3.1. Domestic Financing in 2002

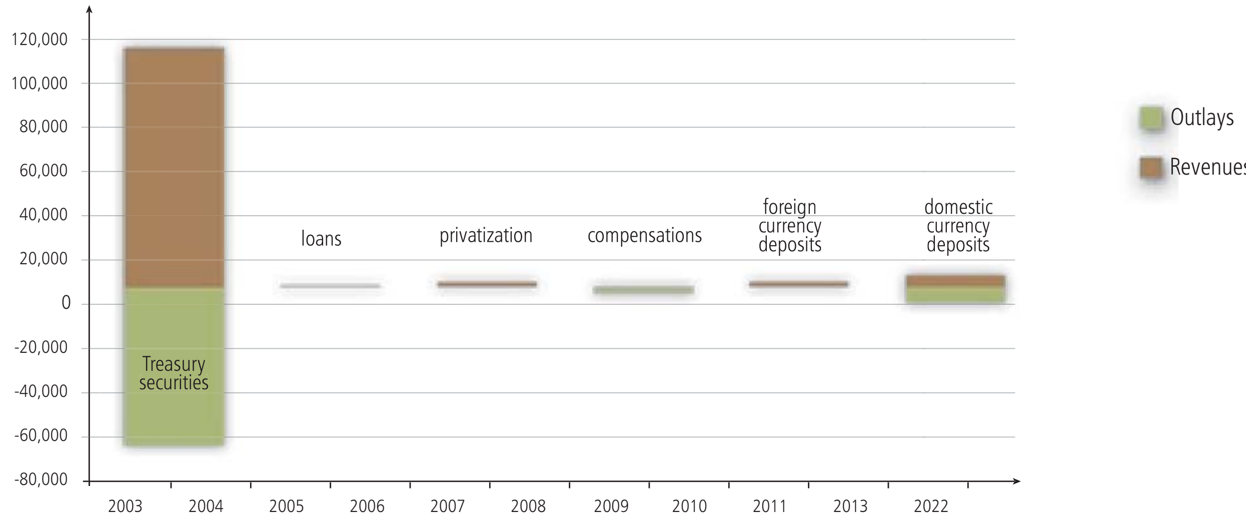
The financing of State budget borrowing needs on the domestic market proceeded in the situation of a steadily growing deficit (apart from the seasonal growth at the beginning of the year), low privatization receipts (only 30% of the plan) and declining interest rates (secondary market yields dropped by approx. 4 pp. for 2 and 5-year bonds and by 3 pp. for 10-year bonds, the yield of 52-week bills on the primary market declined by approx. 5 pp.).

Budget execution in 2002 was considerably better than last year when Budget Act was revised twice to raise the deficit level by 61%. Execution of privatization receipts was similar to the previous year; it was impossible to obtain the entire planned figure. The receipts (PLN 1,972 million) were entirely in PLN and half of them were not received until the 4th quarter. This meant the need to increase Treasury securities issues, and in consequence, the debt and its servicing costs in subsequent years. The factor which reduced the demand for money on the domestic market was the higher than planned positive balance of foreign financing (by PLN 2,268 million). Also declining market interest rates, caused mainly by basic interest rate cuts by the central bank, had a positive impact on the financing of borrowing needs.

The balance of domestic financing was the function of revenues at PLN 116,905 PLN million and payments at PLN 80,950 million. The most important item on both sides was Treasury securities (Chart 8). Their sale generated PLN 107,375 million, while PLN 71,016 million was allocated to the redemption of primary principal, which meant financing at PLN 36,359 million.

20 More on this in sub-chapter 3.2.

Chart 8. Revenues and outlays in the domestic financing in 2002 (PLN mn)



3.1.1. Treasury Securities

Borrowing needs were mainly financed on the basis of auctioned bonds and Treasury bills. Synthetic figures on the sale and redemption of Treasury securities are shown in Table 12.

The most important instrument in budget deficit financing in 2002 consisted of bonds. Similar to last year (89%), an overwhelming majority of realized revenues came from sale of fixed-rate bonds (96%). In April, after the NBP converted some of its indexed bonds into floating-rate securities with a similar construction to the securities issued by the Minister of Finance (PLN 7.8 billion in nominal value and in effect caused market saturation), the sale of 10-year floating-rate securities was suspended. In the same month, 20-year bonds were introduced. However, they do not play a major role in financing; their sale in nominal terms generated PLN 1.4 billion. They are mainly an element of the debt management strategy (improvement of debt characteristics) and issue policies (market demand, longer yield curve).

A major role in financing borrowing needs in 2002 was also played by bond switching auctions. They are an alternative source of revenues from wholesale bonds to standard sales auctions.

Among the bonds offered at auctions (both sales and switching auctions) the largest share was represented by 5-year and 2-year securities. Their sale in nominal terms generated PLN 26.2 billion and PLN 25.9 billion, respectively. The sales structure was consistent with the objectives of the debt management strategy and the prevailing market situation.

In terms of the market on which funds were raised, the dominant role was played by the wholesale market whose share was 91% (81% in 2001). Securities sale to individual investors in 2002 was taking place in the conditions of the new income tax on savings introduced in 2001, weaker economic performance (low economic growth, high unemployment rate), declining nominal interest rates and greater interest in other forms of saving (participation units in investment funds, bank "anti-tax" bonds). As a result, the interest in bonds on the retail market declined and sales in nominal terms were lower than the previous year by PLN 1.6 billion.

Another group of instruments important for the financing of borrowing needs consists of Treasury bills. In 2002, they generated financing at PLN 7,994 million, i.e. PLN 2,143 million more than planned in the Budget Act. This was mainly the result of lower than planned privatization receipts, hence a situation similar to the previous year. The sale was dominated by 52-week bills (85%).

The year 2002 saw the start of redemption of the bonds issued in connection with the conversion of debt to the NBP (converted bonds) and early redemption of debt towards Brazil. The redemption of two tranches of the latter bond at USD 535 million each came to PLN 4,365 million in domestic currency.

Apart from marketable and savings securities, there is also a segment of non-marketable bonds which are now only being serviced (interest and principal payments). In August 2002, an early redemption of Series A restructuring bonds for PLN 220 million took place.

The detailed statistical data on the primary market Treasury securities are enclosed in an annex to this report.[21]

Table 12. Treasury securities issued on the domestic market to finance State budget borrowing needs in 2002 (PLN mn)

	Item	Revenues	Outlays	Balance
	Treasury securities	**107,375**	**71,016**	**36,359**
	1. Treasury bills	**44,509**	**36,515**	**7,994**
	2. Marketable bonds	**60,028**	**30,322**	**29,706**
Wholesale bonds	- 2-year zero-coupon bonds (OK)	22,365	7,617	14,748
	- 5-year fixed-rate bonds (PS,OS)	26,269	9,746	16,523
	- 10-year fixed-rate bonds (DS)	6,558		6,558
	- 10-year floating-rate bonds (DZ)	494		494
	- 20-year fixed-rate bonds (WS)	1,285		1,285
	- converted at NBP		4,980	-4,980
	- denominated in USD (2001)		4,365	-4,365
Retail bonds	- 3-year floating-rate bonds (TZ)	1,691	3,614	-1,923
	- 5-year fixed-rate bonds (SP)	1,367		1,367
	3. Savings bonds	**2,838**	**1,230**	**1,608**
	- 2-year fixed-rate bonds (DOS)	2,666	1,216	1,450
	- 4-year indexed bonds (COI)	172	14	158
	4. Non-marketable bonds		**2,949**	**-2,949**
	- denominated in USD (1991)		1,813	-1,813
	- restructuring		1,054	-1,054
	- to increase BGŻ S.A. bank own funds		81	-81

3.1.2. Other Items of Domestic Financing

Revenues

Other revenues present in 2002 include repayment of the budget loan taken by Orbis S.A. (PLN 6 million) and repayment of the obligations by the State Treasury Agricultural Property Agency (PLN 285 million).

Outlays

In 2002 payment of benefits for periodical absence of wage raises in the budgetary sphere and for loss of certain pension increases and allowances (compensations) continued. The cost to the State budget of the above operation over a period of 9 months was PLN 2,702 million. Also budget funds were used to grant a loan to the Export Credit Insurance Corporation (PLN 35 million).

[21] Statistical annex to the report is only available in an electronic form.

3.2. Foreign Financing in 2002

The balance of foreign financing was at PLN 3,448 million (in 2001, the balance was negative, - PLN 11,312 million). It resulted from realized revenues at PLN 31,197 million and outlays at PLN 27,749 million. However, the above amounts of revenues and outlays do not show precisely the flows related to foreign financing. They are overstated by foreign exchange account operations resulting from budgetary accounting requirements. The above operations involve posting receipts in the foreign exchange account (from sources other than privatization) as outlays, and then from posting the use of such funds for servicing domestic and foreign debt as revenues. Additionally, these are accompanied by exchange rate differances. If these operations were excluded, the foreign account balance would be at PLN 2,759 million, with revenues and PLN 15,961 million and outlays at PLN 13,202 million. The table below shows major items of foreign financing in 2002.

Table 13. Foreign revenues and outlays in 2002 (PLN mn)

Item	Revenues	Outlays	Balance
Foreign financing	**31,197**	**27,749**	**3,448**
1. Treasury bonds on foreign markets	**10,816**	**202**	**10,615**
- Treasury bonds	10,816		10,816
- Brady bonds		202	-202
2. Prepayment of foreign obligations		**5,298**	**-5,298**
- redemption of Brady bonds		5,298	-5,298
3. Foreign credits received	**4,948**	**7,172**	**-2,224**
- Paris Club		4,052	-4,052
- World Bank	251	593	-342
- European Investment Bank	847	63	784
- European Bank for Reconstruction and Development		16	-16
- Council of Europe Development Bank	251		251
- revolving credit	3,599	2,359	1,240
- other		89	-89
4. Sale of collaterals	**153**		**153**
5. Foreign exchange account turnover	**15,236**	**14,547**	**689**
6. Other	**44**	**531**	**-488**

An early redemptin of Brady bonds (issued in 1994 in connection with restructuring of the debt to the London Club) was conducted. The October redemption of PDI bonds (Past Due Interest Bonds) for USD 1,300 million (PLN 5,297.8 million) together with other timely repayment of the second and third principal tranches caused a decrease in the nominal foreign debt under these bonds by USD 1,349.8 million. The 2002 Brady bonds early redemption was the fifth such operation. Earlier operations took place in 1997, 1998, 2000, 2001 and involved mainly bonds secured by US zero-coupon (collateral) bonds. Early redemption of these bonds meant that a certain value of securities was released from the deposit and left at the disposal of the Minister of Finance. The partial redemption of PDI bonds was not accompanied by a release of the collateral since these bonds were not secured in this way. None the less, in August 2002 some zero-coupon bonds with the nominal value of USD 289.5 million, released after redemption of the Brady bonds secured by those instruments in the previous years, were sold. Receipts from this sale amounted to USD 91.6 million (PLN 382.2 million), of which USD 54.9 million (PLN 228.9 million) went to the income account and USD 36.7 million (PLN 153.3 million) to State budget revenues.

Three issues of Treasury securities on foreign markets took place in 2002. In March 2002, 10-year bonds with the nominal value of EUR 750 million were issued, generating sales proceeds (revenues) at EUR 735.7 million (PLN 2,672.9 million). In July 2002, 10-year bonds with the nominal value of USD 1,000 million were issued, increased in September by further USD 400 million. Revenues from the first tranche totaled at USD 989.3 million (PLN 4,020.8 million), while the second tranche generated USD 400 million (PLN 1,662.4 million). In November 2002, an 8-year bonds issue with the nominal value of GBP 400 million took place, generating revenues at GBP 395.5 million (PLN 2,455.9 million).

In October 2002, a drawing of USD 875 million was made on the revolving credit used as a tool to manage State Treasury's foreign exchange liquidity. The funds obtained were used as a bridge loan to finance early redemption of some PDI bonds. After the issue of 8-year bonds with the nominal value of GBP 400 million, some of that credit (USD 600 million) was repaid in November.

In addition to the above discussed early debt redemption operations in 2002, scheduled payments were made under the matured debt (foreign credits received) to Paris Club and other creditors (The World Bank, European Investment Bank, European Bank for Reconstruction and Development, other).

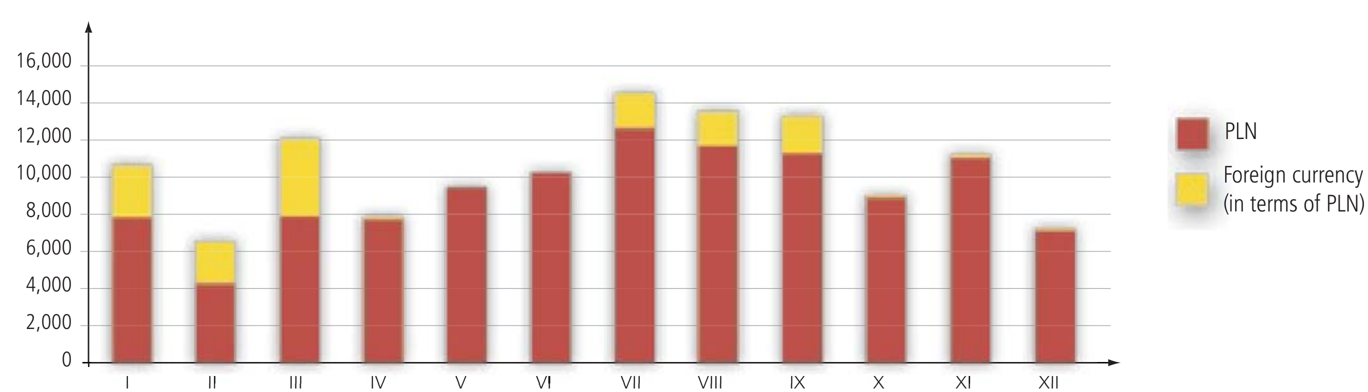
3.3. State Budget Liquidity Management – Domestic and Foreign Currency Funds

The budget liquidity situation in 2002, despite large borrowing needs, was favorable. There was no need to issue bills to help with short-term liquidity, and the balance of zloty deposits was at a level ensuring safe financing of State budget's borrowing needs (Chart 9). In some periods (August), it was also possible to carry out operations meant to reduce the amount of free resources. These took the form of early redemption of restructuring bonds (PLN 220 million), a bond buy-back auctions and a reduction of the Treasury bills supply on the primary market. The flows accumulated at the end of the year ensured safe financing at the beginning of the following year. The budget liquidity management policy was subject mainly to the following factors:

- the need to hold a surplus in the event of market changes or a crisis which could limit or prevent sale at an acceptable cost. Maintaining such a surplus is compensated for by incomes from term deposits,
- the size of borrowing needs in subsequent months, the uncertainty of privatization receipts, a strife toward a stable supply of T-s within one year, taking into account seasonal factors in the demand for T-s,
- the use of bonds switching auctions (and bonds conversion at the NBP in December 2001). They help ease the buildup of Treasury securities redemptions.

In addition to management of the zloty position, also operations on foreign currency deposits were carried out. Their sources included mainly foreign currency resources from 2001, receipts from foreign currency bonds issues and the revolving credit. Unlike in the previous years, there were no deposits established from foreign currency funds obtained from privatization. Foreign currency term deposits were used to finance principal and interest payments under the foreign debt and the bonds denominated in US Dollars, issued in connection with the redemption of Brazil's debt, and operations related to debt management (early redemption of Brady bonds). The level of foreign currency resources varied within the year (Chart 9). At the end of 2002, the government's foreign currency account had approx. USD 42 million.

Chart 9. Month-end balances of domestic and foreign currency funds in 2002 (PLN mn)



Summary

By the end of the year 2002 public debt including anticipated payments under sureties and guarantees granted by public finance sector entities came to **PLN 365,967.3 million.** Which means the level of public debt has increased by PLN 54,364.5 million (i.e. by over 17%) during the past year. In the terms of relation to Gross Domestic Product public debt reached the level of **47.4%** (compared to 41.5% at the end of 2001). The need of financing large budgetary deficits and constantly growing debt servicing costs, along with the low GDP growth dynamics may contribute to further increase of the relation of public debt to GDP, which may lead to a Public Finance Act precaution threshold's breach. For this reason the public debt manager is forced to set the debt management strategy objectives, so that their implementation could limit both the risk of debt increase, could represent a continuation of the efforts to minimize debt servicing costs and would allow building a debt portfolio with the risk level similar to those of European Union countries.

In the previous year progress was made in achieving all the objectives defined in the *Public Finance Sector Debt Management Strategy in the years 2002–2004*, which was adopted with the 2002 Budget Act. Nevertheless, many strategic debt management targets require further intense activity. They are the following:

- improving liquidity, efficiency and transparency of the treasury securities market,
- launching of a program for refinancing foreign debt payments falling due in 2004-2009 in a manner which would be best from the point of view of costs and risks incurred,
- improvement of the Treasury securities dealers system, along with the electronic trading platform,
- development of a State budget liquidity management system,
- development of a retail instruments sale system,
- continuation of converting non-marketable debt into marketable instruments.

Achievement of the up above motioned targets is of growing importance. In the year 2004 Poland will become an EU member, and within the next few years should declare accession to the monetary union. These developments will add a new quality to debt management. Mainly due to Poland's increased credit rating, what will enable to make a wider use of the international market and will reduce the costs of funds. At the same time Poland will have to meet the EU's convergence criteria concerning, inter alia, public debt and budget deficit while the infrastructure of the Treasury Securities market should be adjusted to the EU standards so as to enable full utilisation of the advantages coming from the participation in the European Union's financial system.

List of Tables

List of Charts