The Public Finance Sector
DEBT MANAGEMENT STRATEGY
In the years 2006-2008

Ministry of Finance
Warsaw, September 2005

The Public Finance Sector
DEBT MANAGEMENT STRATEGY
in the years 2006-08

I. INTRODUCTION 3

II. IMPLEMENTATION OF STRATEGY OBJECTIVES IN 2004 AND IN THE FIRST HALF OF 2005 4

II.1. Evaluation of the implementation of objectives 4

II.2. Conclusions from the implementation of objectives 8

III. ASSUMPTIONS OF THE STRATEGY 9

III.1. Macroeconomic situation in Poland with respect to the accession to the Euro zone 9

III.2. Situation on the international financial market 10

IV. RISK FACTORS RELATED TO PUBLIC DEBT 11

IV.1. Risk of negative impact of public debt on economy 11

IV.2. Risk of change of the level of public debt and of its servicing costs 12

IV.3. Risk related to sureties and guarantees granted and certain other operations of the sector 15

V. DEBT MANAGEMENT STRATEGY OBJECTIVE IN THE YEARS 2006-2008 16

VI. STRATEGY TASKS IN A THREE-YEAR HORIZON 20

VII. INFLUENCING PUBLIC DEBT 25

VII.1. Changes in legal regulations 25

VII.2. Debt of public finance sector entities other than the State Treasury 26

VIII. FORECASTED EFFECTS OF THE STRATEGY IMPLEMENTATION 30

VIII.1. Forecasts of debt and debt servicing costs 30

VIII.2. Changes with respect to risk 32

VIII.3. Threats to the Strategy implementation 33

Annex 1. Glossary 34

Annex 2. Legal regulations on public debt in Poland and within the EU 37

Annex 3. Institutional framework for public debt management in the EU Member States 40

Annex 4. General government deficit and debt and yields on 10-year bonds in the EU Member States 45

Annex 5. Long-term foreign currency government debt rating in the EU Member States 46

Annex 6. Debt of the public finance sector in Poland before and after consolidation within the sector 47

I. INTRODUCTION

The *Public Finance Sector Debt Management Strategy in the years 2006-2008* covers the strategy of managing the State Treasury debt and the strategy of influencing public debt. In accordance with the Public Finance Act, the Minister of Finance supervises the level of public debt. In the case of the State Treasury debt, the Minister of Finance has at his disposal instruments that allow him to directly manage this debt, while in the case of other entities of the public finance sector, being autonomous in contracting liabilities, such supervision is of an indirect nature.

Upon accession to the European Union Poland made a commitment to observe the fiscal discipline the rules of which are set forth in the Stability and Growth Pact. In the summer of 2004 the European Commission stated that the excessive deficit existed in Poland and recommended its reduction below the 3% limit by 2007 at the latest. In its convergence programme Poland made a commitment to implement the Commission recommendations. The implementation of the convergence programme and reduction of the deficit shall be of fundamental importance for the *Public Finance Sector Debt Management Strategy.*

The present *Strategy* differs from the previous document mainly with respect to the following areas:

1) One of the two objectives was abandoned: *Keeping the volume of public debt at a safe level* - as a general rule Poland as a Member State has to observe the EU rules with respect to the general government deficit and debt levels.
2) As a result of change of the macroeconomic environment, the approach to implementation of the objective *Minimisation of debt servicing costs* became more flexible with respect to the restrictions resulting from exchange rate risk.
3) Change of macroeconomic conditions, modification of the financing structure of borrowing needs and operations on debt resulted in a substantial correction of the projection of debt level and of debt servicing costs in the following years (reduction), as well as of debt parameters (significant improvement).
4) Change of the legal conditions in 2006 – the *Public Finance Act* of 30 June 2005 excludes the risk-weighted payments under sureties and guarantees from the category of liabilities included in the statutory debt-to-GDP ratio. Public debt will become the basic category of debt. At the same time changes will be introduced in restrictions on incurring liabilities by local government units.
5) The task of establishing an agency/bureau for debt management, i.e. separation of debt management from the structure of the Ministry of Finance, was added.
6) The layout and the contents of the Strategy were reorganized.

II. IMPLEMENTATION OF STRATEGY OBJECTIVES[1] IN 2004 AND IN THE FIRST HALF OF 2005

II.1. Evaluation of the implementation of objectives

1. Keeping the volume of public debt at a safe level

Changes in the outstanding public debt in the period discussed resulted almost solely from changes in the State Treasury debt.

The change in the State Treasury debt resulted from the necessity to finance budget deficit (PLN 41.4 billion in 2004 and PLN 18.5 billion in the first half of 2005) and budget outlay not related to the redemption of debt (PLN 14.9 billion and PLN 6.0 billion respectively) with relatively high gross proceeds from privatisation in 2004 (PLN 10.3 billion) and low proceeds during the first six months of 2005 (PLN 0.9 billion). Table 1 presents the main categories of public debt in absolute terms and the debt-to-GDP ratio.

Table 1. Public debt and debt-to-GDP ratio (end of period)

Specification		December 2003		December 2004		June 2005
		PLN m	% GDP	PLN m	% GDP	PLN m
State Treasury debt		378,943.8	**46.4%**	402,860.3	**45.5%**	437,499.2
By place of issue	- domestic	251,165.9	**30.8%**	291,658.5	**33.0%**	311,860.0
	- foreign	127,777.9	**15.7%**	111,201.7	**12.6%**	125,639.2
By resident	- domestic	213,999.4	**26.2%**	232,352.4	**26.2%**	242,148.3
	- foreign	164,994.4	**20.2%**	170,507.8	**19.3%**	195,350.9
Public debt		408,631.3	**50.1%**	432,282.1	**48.8%**	465,497.1*)
Public debt increased by risk-weighted payments under sureties and guaranties		**420,040.7**	**51.5%**	**444,136.6**	**50.2%**	**476,919.8*)**

*) preliminary data

An increase in the State Treasury debt by PLN 23.9 billion in 2004 was a consequence, on the one hand, of an increase in domestic debt by PLN 40.5 billion and, on the other hand, a decrease in foreign debt by PLN 16.6 billion. Despite a positive balance of foreign financing in the amount of PLN 3.1 billion, a substantial decrease in foreign debt resulted from a considerable strengthening of the Zloty in the second half of 2004. Together with a high nominal growth of GDP and lower than expected borrowing needs of the State Budget, it resulted in a decrease in the debt-to-GDP ratio by 0.9 percentage points. During the first six months of 2005 the State Treasury debt increased by PLN 34.6 billion, domestic debt grew by PLN 20.2 billion and foreign debt by PLN 14.4 billion.

2. Minimisation of debt servicing costs over a longer time horizon

This objective was understood as:

a) minimisation of costs within the horizon specified by redemption dates of instruments with the longest maturities and substantial share in the debt - through the optimal selection of instruments of debt management, their structure and dates of issuance,
b) actions taken towards increasing the effectiveness of the market of the Treasury Securities so that their servicing costs were as low as possible for the adopted issuance strategy.

[1] *The Public Finance Sector Debt Management Strategy in the years 2005-2007* approved in September 2004.

In the first sense, minimisation of debt servicing costs involved adjustment of the structure of issuance of Treasury Securities to the conditions on domestic and international financial markets. Sales structure on the domestic market aimed at avoiding excessive supply in the respective segments of the yield curve which would result in excessive debt servicing costs.

The situation at the turn of 2003 and 2004 when the market of medium- and long-term fixed-rate instruments could not reach equilibrium (limited demand, substantial growth in yields) was a specific one in this respect. Therefore, it was sensible to limit the supply in this market segment and to apply alternative sources of financing:

- new floating-rate bonds with maturities of 3 and 7 years,
- increased foreign financing,
- private placement issuance.

Alternative sources of financing enabled to minimise debt servicing costs and maintain the refinancing risk at the existing level (without increasing the issuance of short-term instruments), whereas the interest rate risk temporary increased. The demand for medium- and long-term fixed-rate bonds started to increase already in January 2004, and since March such bonds have again been offered on sale auctions. From the second half of 2004 the sales of medium- and long-term bonds have been supported by a decrease in yields along the curve.

The reduction in debt servicing costs was supported by an introduction in August 2004 of a new instrument for debt management, i.e. inflation-linked bonds. The new instrument enables to eliminate from debt servicing costs the risk premium demanded by investors purchasing traditional non-indexed bonds.

Minimisation of foreign debt servicing costs was carried out through replacing high-cost liabilities with cheaper instruments, taking into account the level of risk.

In October and December 2004 the World Bank currency pool loans, in the amount over USD 843 million equivalent, were early redeemed. In 2005 an early repayment of a significant portion of liabilities towards the Paris Club creditors was carried out. The liabilities amounting to EUR 4.4 billion were repaid to 10 countries (in the case of Canada only a part of debt was redeemed). The main benefit of this decision was the reduction of the refinancing risk, yet the operation also contributed to the reduction of interest payments. The average interest rate of the redeemed debt was around 5%, whereas the interest rate of bonds issued to finance the buy-back was 4.23% on average.

Among the most important measures aimed at minimisation of debt servicing costs in the second sense (i.e. an increase in efficiency of the market of Treasury Securities) were the following:

- policy of reducing number of issuances while increasing the face value of each benchmark (the policy was temporarily suspended in the first quarter of 2004),
- increasing the value of individual bond issuances on international markets,
- strategic alliance of CeTO S.A., the organizer of an electronic platform for Treasury Security trading, with the European MTS platform, allowing foreign banks participating in MTS to participate in electronic trading of Polish Treasury Securities, and
- decision made in October 2004 on admitting foreign banks to the Primary Dealers' competition for 2006.

Minimisation of debt servicing costs was carried out with adopted restrictions on the level of:

1) domestic currency refinancing risk

The average maturity of marketable debt significantly increased from 2.66 at the end of 2003 to 3.15 at the end of 2004 and to 3.38 at the end of June 2005. A particularly significant

increase in the average maturity has taken place since September 2004 and mainly resulted from:

- a decrease in outstanding Treasury bills (by PLN 1.2 billion in 2004 and by PLN 7.6 billion in the first six months of 2005),
- an increase in sales of medium- and long-term bonds (i.e. 5 years and more); at the end of the subsequent six-month terms of the period described they constituted respectively 51.7%, 60.0% and 59.1% of bonds sold on sale auctions,
- large scale of switching and buy-back auctions. In 2004 bonds nearing maturity were early redeemed in total face value of PLN 20.3 billion and during six months of 2005 in the value of PLN 7.2 billion and
- introduction of 3- and 7-year floating-rate bonds and 12-year inflation-linked bonds.

The share of Treasury Securities with maturity of 1 year or less dropped from 37.9% at the end of 2003 to 29.6% at the end of 2004 and to 27.1% at the end of June 2005. The share of Treasury bills in State Treasury domestic debt also significantly decreased from 19.1% to 16.1% and to 11.1% respectively.

2) exchange rate risk

The share of foreign debt in total State Treasury debt according to the place of issue criterion decreased significantly in 2004 (from 33.7% to 27.6%), whereas during the first six months of 2005 it slightly increased (to 28.7% at the end of June). Such changes mainly resulted from:

- a significant strengthening of the Zloty against other currencies in the second half of 2004 and its slight weakening in the first half of 2005,
- a leading role of issuance of domestic debt in the financing of borrowing needs,
- an increase in issuance of bonds on foreign markets in the first half of 2005 to finance the early redemption of debt towards the Paris Club creditors.

The share of the Euro, i.e. the future national currency of Poland, in foreign debt increased from 58.4% in 2003 to 62.5% at the end of 2004 and to 67.7% at the end of June 2005.

3) foreign currency refinancing risk

The average maturity of foreign debt slightly decreased in 2004, from 5.73 to 5.49 years, whereas in the first half of 2005 it significantly increased to 7.87 years. The rise in the first half of 2005 resulted from the early redemption of the part of debt towards the Paris Club with original redemption dates in 2005-2009, and an increased issuance of bonds, mainly long-term, for refinancing of the early redemption. In the first half of 2005 foreign bonds of approximately EUR 7.3 billion equivalent were issued.

The amount of foreign bonds having been issued in 2005 will exceed the amount, which originally was to be approximately equal to the amount of the foreign debt principal payments. Additionally obtained foreign currency funds were mainly used for financing of the early. redemption of debt towards the Paris Club. The final level of issuance in 2005 has not been set yet. It has been assumed, however, that some funds from the issuance of foreign bonds would be used for financing of the State borrowing needs, thus reducing domestic financing.

The early redemption of debt towards the Paris Club will significantly contribute to improving the foreign debt maturity structure in the coming years, thus also reducing the refinancing risk. Without the early redemption the foreign debt principal payments in the coming years would amount to EUR 3-4 billion per year. This amount was reduced by approximately one-third. The average maturity of the debt issued to finance the early redemption of debt towards the Paris Club was approximately 17 years; the average maturity of early redeemed liabilities was approximately 2.5 years. A similar effect, although on a smaller scale was achieved by an early redemption of the World Bank currency pool loans at the end of 2004, which would have been redeemed in 2005-2009.

4) interest rate risk

Duration of domestic marketable debt significantly increased, from 2.12 to 2.44 years at the end of 2004, and to 2.68 at the end of June 2005. It resulted from the following factors:

- a substantial increase in the average maturity of debt (from 2.66 to 3.38 years) resulting from the issuance of medium- and long-term fixed-rate bonds,
- a reversal in July 2004 of the upward trend in interest rates (the level of interest rates at the end of June 2005 dropped by 2.1-2.8 percentage points as compared to the beginning of 2004 and by 3.6-4.3 percentage points as compared to their highest levels from July 2004) and
- an increase in the share of floating-rate marketable instruments (from 6.7% to 8.4% and 9.0% respectively) in the State Treasury domestic debt.

The average term to refixing (ATR) increased respectively from 2.44 to 2.80 in 2004, and to 2.98 in the first half of 2005.

The interest rate risk in the case of the foreign debt was reduced through increasing the share of fixed-rate debt from approx. 60% at the end of 2003 to 66.5% at the end of 2004 and to 76.1% at the end of June 2005. ATR for foreign debt increased from 4.21 to 4.70 years in 2004 and to 7.22 at the end of June 2005. Such a change resulted from:

- scheduled and early redemption of debt towards the Paris Club, which was partly a floating-rate debt and
- new issuances of bonds (all the bonds issued are fixed-rate bonds).

5) State budget liquidity risk

Maintenance of the safe level of liquidity of the State budget and management of liquid assets were mainly carried out by using the following instruments:

- switching auctions (for the reduction of refinancing risk at the redemption of large issuances),
- PLN deposits with NBP,
- PLN deposits with commercial banks through BGK, covering buy/sell back transactions (since May 2004) and interbank deposits (since July 2005), and
- interest-bearing foreign currency deposits with NBP.

6) other risk, in particular credit risk and operational risk

There are two types of transactions carried out by the State Treasury which generate credit risk, i.e. transactions on financial derivatives and non-collateralised PLN deposits.

Bonds with non-standard coupons, hedged with a swap transaction, were issued in March 2004. A synthetic instrument consisting of the bond and derivative enabled to reduce the costs towards the standard bond, i.e. contributed to the reduction of debt servicing costs. A credit risk related to the threat that a bank being a party to a contract fails to perform its financial obligations resulting from a swap transaction is the price for savings on debt servicing costs. However, this risk is reduced through the selection of a partner with very high creditworthiness and by guarantees issued by a third entity.

Deposits on interbank market until July 2005 were fully collateralised with Treasury Securities, and thus they did not generate the credit risk. The credit risk related to the non-collateralised deposits has been reduced through the system of limits for particular banks and through a proper time structure of deposit. Moreover, deposits are placed solely with banks with the status of Primary Dealers.

7) distribution of debt servicing costs over time

In 2004 State Treasury debt servicing costs constituted 2.6% of GDP (against 3.0% in 2003), of which 2.1% of GDP were domestic debt servicing costs (against 2.5% in 2003). A decrease in debt servicing costs to GDP ratio resulted mainly from a substantial nominal growth of GDP (by 8.5%), a decrease in interest rates till the mid-2003, strengthening of the Zloty, as well as the structure of sold Treasury Securities. The structure of TS sales in the years 2004-2005 has been an important factor contributing to an even distribution of domestic debt servicing costs over the following years.

An even distribution of debt servicing costs over time was taken into account when new Treasury Security issuances took place. In particular coupons of new wholesale bonds issued were close to the yields to limit the accumulation of a discount at their redemption (cash based accounting).

II.2. Conclusions from the implementation of objectives

Despite the high borrowing needs of the State Treasury the rate of growth of debt in 2004 was reduced and public debt increased by risk-weighted payments under sureties and guaranties decreased from 51.5% to 50.2%. The decrease mainly resulted from:

- a strengthening of the Zloty,
- a high nominal growth of GDP,
- a lower than expected increase in the borrowing needs of the public finance sector.

The objective of the minimisation of debt servicing costs was mainly implemented through the appropriate issuance policy. In the first quarter of 2004 issuances of short-term floating-rate bonds prevailed, then there was a gradual return to medium and long-term bonds. Despite a temporary deterioration of certain parameters of the market risk, in the described period the refinancing, interest rate and foreign exchange risks were substantially reduced. The average maturity and duration of marketable domestic debt at the end of the first half of 2005 reached the levels planned to be implemented under the last-year strategy in 2006 and 2007 at the soonest. As a result of the early redemption of the part of debt towards the Paris Club creditors financed by the issuance of long-term bonds on foreign markets the structure of foreign debt was subject to substantial improvement. The average maturity of foreign debt at the end of June 2005 reached the upper level of the value of that indicator in the EU Member States.

III. ASSUMPTIONS OF THE STRATEGY

III.1. Macroeconomic situation in Poland with respect to the accession to the Euro zone

Main macroeconomic factors influencing the nominal value (in PLN terms) of public debt are: the level of public deficit and the changes of exchange rate. Moreover, changes of debt-to-GDP ratio are influenced by the real GDP growth and changes of the level of prices. The main factors influencing debt servicing costs are: interest rates and foreign exchange rates, as well as inflation (the latter to a smaller extent).

Expected adoption of the Euro is of great importance both for the development of the macroeconomic situation in Poland and for the public debt management. The adoption of the common currency by a EU Member State requires meeting the convergence criteria. The evaluation whether a given country has obtained a high level of nominal convergence involves checking whether it has met the criteria of:

- price stability,
- foreign exchange rate stability,
- the level of long-term interest rate, and
- budget discipline (through limitations imposed upon the public deficit and debt levels).

In addition, compliance of national legislation with the Community legislation is verified.

Fiscal deficit

According to the forecast of the Ministry of Finance the State budget deficit will decrease in 2005 against 2004 by PLN 10.6 billion and, according to Polish methodology, will amount to PLN 30.8 billion (3.3% of GDP). In subsequent years, the deficit is to reach the following values: PLN 32.6 billion (3.3% of GDP) in 2006, PLN 28.1 billion (2.7% of GDP) in 2007 and PLN 15.1 billion (1.4% of GDP) in 2008.

The forecast for general government deficit (EU methodology) for the period of 2005-2008 is respectively: 3.4% of GDP, 2.8% of GDP, 2.0% of GDP and 0.8% of GDP (with Open Pension Funds within the sector of general government) and 5.4% of GDP, 4.8% of GDP, 3.9% of GDP and 2.7% of GDP (Open Pension Funds outside the sector).

Growth of GDP

Following the slowdown in 2001-2002 in 2003 an economic revival began and 2004 was a period of further acceleration of the economic growth (with the real GDP growth of 5.4%). The forecasts for 2005-2006 assume real GDP growth of 3.3% and 4.3% respectively. In 2007-2008 it should accelerate to 4.6% and 5.0% respectively.

Inflation

After the period of a growing inflation in 2004 (4.4% December to December) the forecasts for the subsequent years assume a drop in inflation and its stabilization at approx. 2%. It is expected that inflation measured by CPI (December to December) shall reach respectively: 1.2% in 2005, 1.5% in 2006, 2.2% in 2007 and 2.5% in 2008. On the basis of the inflation path forecasted for 2006-2008, it is expected that the criterion of price stability will be met.

Foreign exchange rates

Increase in Poland's creditworthiness, sound macroeconomic foundations and decreasing disparity of interest rates should reduce PLN exchange rate fluctuations, facilitating meeting of the exchange rate criterion. It should be taken into account that during Poland's participation in ERM II some speculation attacks, resulting in strong but short-term exchange rate fluctuations, are possible

Interest rates

The second half of 2004 and the first half of 2005 were the periods of a dynamic drop in interest rates on the Zloty market. It should be expected that with approaching date of

introduction of the Euro, the process of the convergence of interest rates will continue. The effect of convergence will be supported by a reduction of the supply of Treasury Securities on the domestic market (resulting from the reduction of the borrowing needs and from an increased foreign financing).

The forecasts of main macroeconomic assumptions adopted for the preparation of the current Strategy are presented in Table 2.

Table 2. Main macroeconomic assumptions

Specification	2004	2005	2006	2007	2008
Real GDP growth (%)	5.4%	3.3%	4.3%	4.6%	5.0%
GDP at current prices (PLN billion)	885.3	925.4	976.0	1,037.0	1,111.3
State budget deficit (% of GDP)	4.7%	3.3%	3.3%	2.7%	1.4%
State budget deficit (PLN billion)	41.4	30.8	32.6	28.1	15.1
Deficit/surplus of local government units (% of GDP)	0.01%	-0.2%	-0.2%	-0.1%	-0.1%
Net privatisation proceeds (PLN billion)	7.4	3.6	3.9	3.1	3.1
Average annual CPI (%)	3.5%	2.1%	1.5%	1.9%	2.5%

III.2. Situation on the international financial market

In 2004 a strong economic expansion on a global scale took place. At the same time some countries started to tighten their fiscal and monetary policies, in particular the United States, where the Federal Reserve Bank raised interest rates (at the moment of preparation of the Strategy) in total by 275 basis points. The rate of global growth is expected to slow down in 2005 from 3.5% in 2004 to 4.0%.

Maintaining sound macroeconomic foundations, limited inflation pressure and good results of companies in most developed countries added to the stable situation on financial markets. Still low short-term interest rates and their small fluctuations encouraged investors to seek financial instruments with a higher risk.

Similar trends should continue in the nearest period, although forecasts of growth carry a level of uncertainty resulting from a global lack of equilibrium in financial flows and from possible supply shocks.

IV. RISK FACTORS RELATED TO PUBLIC DEBT

As public debt management takes place in conditions of uncertainty concerning the future level of many decision-influencing factors it is inextricably associated with risk management. Risk management of public debt involves preventing the risk from exceeding the acceptable level during the implementation of the *Strategy* objective of the long-term minimisation of debt servicing costs.

The risk concerns in particular:

- macroeconomic environment (e.g. the growth rate in Poland and in the world, inflation, crises in the world economy),
- budget environment (e.g. the volume of budget borrowing needs, including budget deficit in subsequent years, proceeds from privatisation),
- market environment (e.g. the level of domestic and foreign interest rates, foreign exchange rates, demand for Treasury Securities), and
- institutional and legal environment (e.g. changes in legislation in force, European integration, organizational framework for debt management).

The existence of risk related to public debt may be considered in two dimensions, as:

- a threat of negative impact of public debt on economy, and
- a source of uncertainty as to the level of public debt and its servicing costs.

In addition one may distinguish the risk related to potential debt resulting from the possibility of execution of guarantees and sureties granted by the entities of public finance sector.

IV.1. Risk of negative impact of public debt on economy

The risk of negative impact of public debt on economy increases with the level of debt. Inappropriate structure of debt may additionally contribute to the increase in risk.

The main negative results of excessive public debt include:

1) consideration of Poland as a high-risk country and a negative impact on the level and volatility of interest rates and foreign exchange rates,
2) negative consequences of Poland's violation of the Maastricht criterion concerning the general government debt, mainly implying a delay in Poland's planned accession to the Euro zone,
3) negative consequences of debt-to-GDP ratio exceeding the safety thresholds of 50% and 55% provided for in the Public Finance Act, as well as the constitutional limit of 60%,
4) crowding out of private capital from the access to domestic savings,
5) a threat that large State borrowing needs will hit a demand barrier on the financial market,
6) a possibility of a debt crisis and a partial or total loss of capacity of a timely servicing of debt.

Debt-to-GDP ratio in Poland is lower as compared to the EU average, where debt-to-GDP ratio amounted in 2004 to 64.7% for EU-15, 63.8% for EU-25 and 70.7% for the Euro zone. Nevertheless, Poland is a country with a lower than the EU-average creditworthiness, thus the safety level of debt is respectively lower.

The level and structure of public debt are mainly influenced by the liabilities incurred by the State Treasury. Table 3 presents the main factors influencing the change of debt-to-GDP ratio in previous years.

Table 3. Factors influencing changes of debt of the State Treasury in the years 2002-2004

in relation to GDP

Specification	2002	2003	2004
State Treasury debt to GDP ratio	**42.0%**	**46.4%**	**45.5%**
Change in ST debt/GDP ratio	4.6pp	4.5pp	-0.9pp
Factors influencing changes in the ratio			
1. Primary balance of the State budget (deficit)	2.0%	1.6%	2.1%
2. Interest (debt servicing costs)	3.1%	3.0%	2.6%
3. Nominal GDP growth	-1.0%	-1.8%	-3.6%
4. Other factors, including above all:	0.6%	1.7%	-2.0%
4.1. State budget financing needs other than the deficit*)	0.3%	0.8%	0.7%
4.2. Net privatisation proceeds	-0.3%	-0.4%	-0.8%
4.3. Changes of foreign exchange rates	0.8%	1.4%	-2.3%
4.4. Other State Treasury debt	-0.3%	-0.2%	0.0%

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

Note: positive (negative) values cause an increase (decrease) in the debt-to-GDP ratio;

IV.2. Risk of change of the level of public debt and of its servicing costs

At a specified level of the State borrowing needs, the level of public debt, its servicing costs and risk related to their deviation from expected values result from the adopted structure of financing (i.e. types of debt instruments applied) and operations performed on debt.

Types of risk related to debt servicing costs, hindering the objective of the minimisation of costs, include:

a) refinancing risk,

b) exchange rate risk,

c) interest rate risk,

d) State budget liquidity risk,

e) other risk, in particular credit risk and operational risk, and

f) risk resulting from the distribution of debt servicing costs over time.

Ad a) Refinancing risk

Domestic currency refinancing risk, which in 2000-2003 remained at a similar, relatively high level, has been recently subject to substantial reduction. The average maturity, which at the end of 2000 amounted to 2.60 years and at the end of 2003 to 2.66 years, at the end of June 2005 increased to 3.38 years. The share of Treasury Securities with maturities not exceeding 1 year in domestic debt was respectively 33.7%, 37.9% and 27.1%, which in nominal terms amounted to PLN 44.8 billion, PLN 93.2 billion and PLN 83.3 billion respectively.

Despite a substantial progress in reduction of refinancing risk and the average maturity approaching the lower level of the value in EU-15, the level of refinancing risk is still higher than in the case of the EU Member States. For example, the average maturity in Finland is

approx. 4.4, in the Netherlands - 6.2, in Italy - 6.3, in Germany - 6.4, in Spain - 6.6, and as much as 12.4 in Great Britain.

Measures aimed at reduction of refinancing risk may be implemented on two levels: through reduction of supply of short-term instruments or through increased participation of medium-term and, in particular, long-term bonds (10 years and more) in the financing of borrowing needs. Due to a substantial drop of debt in Treasury bills in the second half of 2004 and in 2005 and to the irrelevance of further actions in this respect, a lengthening of the average maturity of domestic debt shall be carried out mainly through a gradual reduction of supply of bonds with the shortest maturities (not exceeding 3 years) and increased issuance of Treasury Securities with longer maturities.

The early redemption of a part of liabilities towards the Paris Club and increased issuances of bonds with long maturities substantially reduced the foreign currency refinancing risk. The average maturity of foreign debt attained, in the middle of 2005, a safe level of 7.87 years. The amount of principal payments of foreign debt within the period covered by the Strategy will reach approx. EUR 2-2.4 billion equivalent per year. With the increased access to foreign markets, related to Poland's accession to the EU, their refinancing involves a little risk.

Ad b) Exchange rate risk

The share of foreign debt (according to the place of issue criterion) in the State Treasury debt has been decreasing systematically from the beginning of the transformation and it amounted to 28.7% in mid 2005. The exchange rate risk is, however, statistically high. The weakening of the PLN against all foreign currencies by 1% would result in an increase in debt by PLN 1.3 billion (0.14% in relation to GDP) in mid 2005 and an increase in debt servicing costs in the whole year by around PLN 57 million. Moreover, it should be noted that the exchange rate risk is connected not only with the market fluctuations of floating exchange rate but also with the possibility of significant weakening of the national currency in case of extraordinary events. The higher is the total level of debt and the lower the general level of the country's development (see subchapter IV.1), the more probable extraordinary events become, and the more severe they are the higher is the share of foreign debt.

In evaluation of the exchange rate risk and assessment of the role of foreign debt in the issuance policy, the currency structure of foreign debt should be taken into account, as well as the schedule of Poland's entry into the Euro zone. From this point of view, it must be stated that in the view of approaching entry of Poland into the Euro zone it may be justified to increase the share of debt denominated in the EUR not only in the foreign debt but also in the total debt.

Ad c) Interest rate risk

Due to the dominant role of fixed-rate instruments, the interest rate risk on the domestic market has been subject to similar changes as the refinancing risk in recent years. Duration of national marketable debt amounted to 1.69 years at the end of 2000 and 2.12 years at the end of 2003, and increased to 2.68 years in the first half of 2005. ATR increased from 2.01 to 2.44 and 2.98 years, respectively.

In the countries that were UE Member States before the last enlargement (EU-15) the duration is higher than in Poland: 2.8 years in Sweden, 3.4 years in Portugal and 7.8 years in Great Britain. In Denmark the middle value of the target duration range is 3 years and in Belgium it is 4 years. Duration of Polish domestic State Treasury debt essentially approached the level of duration in the EU countries in which the indicator was the lowest. Within the Strategy horizon it will be necessary to specify the desired target level of duration. The need may also arise to separate the management of refinancing risk (extension of average maturity) and of interest rate risk (maintaining duration close to the target value). It will require using interest rate swaps.

Significant majority of foreign State Treasury debt (76.1% in mid 2005) is fixed-rate debt, which, together with a significantly extended average maturity, results in insignificant interest rate risk. ATR of foreign debt amounted to 7.22 years at the end of June 2005.

Ad d) State budget liquidity risk

Liquidity risk management consists of two types of actions:

- keeping the liquidity reserve at the possibly lowest but safe level – it is achieved by an improvement of the process of planning and monitoring of state budget liquidity, by creating an appropriate infrastructure and applying organizational solutions, including the planned introduction of a single state budget account and online monitoring of particular budgetary entities' accounts. This will reduce costs arising from the necessity to maintain a larger stock of liquid reserves and the risk of illiquidity in case of unpredictable situations.
- Managing liquid assets, which should generate budgetary revenues that will counterbalance, to the largest possible extent, the costs connected with maintaining the specified, safe level of liquidity.

The main instrument for managing state budget liquidity is maintaining financial liquid assets on budgetary accounts and depositing surpluses in short-term deposits with NBP and commercial banks. The level of these deposits results from irregular transfers on budgetary accounts (revenues and expenditure as well as proceeds and outlay) over time. This level is to ensure the financial security for the budget's demand for funds without the need for sudden changes in the issuance of Treasury Securities.

Ad e) Other risks

Other risks include all not yet mentioned sources of uncertainty related to the management of the public debt, the safe level of which constitutes a barrier to the realisation of the *Strategy* objectives.

1. Credit risk

Credit risk related to the management of State Treasury debt and state budget liquidity occurred in Poland in 2004, when the liquid state budget assets began to be deposited with commercial banks and the first transaction with the use of derivatives was completed. Since July 2005, apart from deposits collateralised with Treasury Securities, also non-collateralised deposits have been made.

The reduction of credit risk associated with such transactions is enhanced by defining a list of entities with high creditworthiness, which may become partners of transactions, as well as specifying the limits on engagement, dependent on the risk associated with particular partners and types of transactions.

2. Operational risk

In order to reduce this risk, the integration of debt management into one organizational unit is sought, the structure, applied procedures and supervision of which should combine the solutions used in market institutions and public administration.

Increasing complexity and sophistication of public debt management instruments, as well as the progressing process of the European integration require an adaptation of institutional and organizational structure of debt management in order to reduce the operational risk. It is particularly important in the case of derivatives and deposit transactions carried out on the financial market. Modern public debt management requires the existence of an efficient technical infrastructure and organizational procedures that ensure fast evaluation of risk and appropriate reactions to changing market conditions. The lack of such infrastructure and procedures is a source of operational risk, which excludes or seriously reduces the use of modern debt management instruments, which have been used in developed countries for

years. The experience of developed countries shows that from the point of view of cost and risk, the task of public debt and state budget liquidity management is best performed by an autonomous entity that is responsible for public debt management and authorised to perform all the related tasks.

Ad f) Distribution of debt servicing costs over time

Debt servicing costs should be evenly distributed over time, so that their volatility does not have a destabilizing effect on the construction of state budget. In a cash-based budgetary accounting system, the stabilization of costs over time is positively influenced by avoiding issuances of securities with high discount, which becomes a cost at the redemption of securities. Accumulation of debt servicing costs resulting from high discount of fixed rate coupon bonds occurs in 2005 and 2006 when the average discount from already issued debt amounts to respectively 17.4% and 10.7% of the redeemed nominal value (including zero-coupon bonds, respectively 11.8% and 10.9%).

Efficient instruments of managing the distribution of debt servicing costs over time include switching and buy-back auctions, which have been used since 2001 in order to reduce the refinancing risk. Their scale increased significantly in 2004 and 2005.

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

Granting of sureties and guarantees by public finance sector entities, including first of all the State Treasury, entails the risk that if a guarantee or a surety is executed it increases the debt servicing costs and the borrowing needs of the entity which grants a given guarantee or surety. Therefore, guarantees and sureties constitute the potential debt i.e. they may increase the public debt if they are executed.

In addition, according to regulations in force until the end of 2005, the amount of risk-weighted payments under sureties and guarantees increases the amount of public debt, the relation of which to GDP constitutes the reference point for safety thresholds of 50%, 55% and 60%, specified in the Public Finance Act.

In 2004 the amount of potential liabilities of the State Treasury arising from sureties and guarantees decreased and the average portfolio risk slightly increased, which resulted in a slight growth of the amount of risk-weighted payments under sureties and guarantees. However, their relation to GDP decreased (from 1.39% in 2003 to 1.33% in 2004).

The principles formulated in previous strategies allowing to reduce risk related to granting guarantees and sureties of the State Treasury remain valid, and the benefits from using them as an instrument of economic policy are retained:

- concentration of granting sureties and guarantees on supporting development-oriented investments in infrastructure and environmental protection, mainly those carried out with the support of the EU funds (loans and bonds guaranteed by the State Treasury should allow to receive the EU funds amounting to their multiple value),
- reduction of the role of sureties and guarantees granted under special ‘sector’ laws, which pose a particular risk for the State Treasury,
- the risk-weighted payments under sureties and guaranties granted by the State Treasury to GDP ratio should not exceed 2%.

An additional source of risk associated with an increase in public debt may be various types of transactions carried out by public finance sector entities. Such transactions include in particular public private partnership and securitization. Issues related to public private partnership were regulated in the *Act of 28 July 2005 on public private partnership* (see chapter VII.1).

V. DEBT MANAGEMENT STRATEGY OBJECTIVE IN THE YEARS 2006-2008

The objective of the Strategy, which will govern the debt management, will remain as follows: **minimisation of debt servicing costs over a longer time horizon with accepted limitations regarding the level of:**

a) refinancing risk,

b) exchange rate risk,

c) interest rate risk,

d) state budget liquidity risk,

e) other risks, in particular credit risk and operational risk,

f) distribution of debt servicing costs over time.

This objective is understood in two aspects, as:

- minimisation of costs within the horizon specified by the redemption dates of instruments with the longest maturities and substantial share in debt, through the optimal selection of the currency structure of new issuances, debt management instruments, their structure and dates of issue;
- permanent activities aimed at an increase in the TS market efficiency contributing to the decrease in TS yields. Differences in yields between Polish Treasury Securities and securities issued by countries with the lowest interest rates on the EU market should in future result solely from the differences in the country's credit risk evaluation and not from barriers and limitations in organization and infrastructure of the market of Treasury Securities.

The objective remained unchanged as compared to the previous Strategy. Depending on the market situation, the implementation of the objective of the cost minimisation in the context of restrictions resulting from the exchange rate risk may be modified due to adopted macroeconomic assumptions, the perspective of entry into the Euro zone and the situation on foreign markets. A more flexible approach would entail the possibility of increased financing of the state budget borrowing needs on foreign markets.

Conditions enabling an increase in foreign financing

The time horizon of the Strategy will be to a large extent coherent with the deadlines arising from the preparations for Poland's entry to the Euro zone. Activities aimed at the fulfilment of the convergence criteria, and in particular Poland's full participation in the Economic and Monetary Union (EMU), will have a significant impact on the currency structure of debt and the exchange rate risk resulting from it. Therefore, it is possible to depart from the principle of issuing debt on foreign markets solely to refinance maturing foreign debt, especially that needs arising from refinancing the maturing foreign debt in the *Strategy* horizon have been reduced by the early redemption of part of the debt towards the Paris Club creditors.

Assumed levels of foreign financing in the years 2005-2008

It was assumed that funds acquired on foreign markets to finance the net borrowing needs of the state budget between 2006 and 2008 will constitute less than half of those needs. It is also important that the actual share of foreign financing will depend on the market situation. Foreign financing may, therefore, be significantly lower than assumed in Table 4.

Table 4. Balance of foreign financing

	2005	2006	2007	2008
Balance of foreign financing (PLN billion)	14.2	20.1	17.8	14.0

Objectives of an increase in foreign financing:

a) minimisation of debt servicing costs within a longer time horizon through:

- increasing the financing at historically low interest rates on foreign markets, especially in the Euro zone (lower than domestic interest rates),
- reducing the TS domestic issuance to the level determined by the demand represented by the domestic non-banking sector in 2006 (and below this level in the following years) will significantly diminish the negative impact of public debt issuances on interest rates,

b) improvement of domestic debt parameters through:

- reduction of the refinancing risk and interest rate risk to the level of these parameters in the EU Member States,
- more flexible shaping of the distribution of debt servicing costs over time (after the increase to PLN 28.5 billion in 2006, the debt servicing costs will fall to around PLN 28.1 billion in 2007 and will remain on this level in 2008 – therefore they will have a positive impact on the reduction of budget deficit in 2007 and 2008).

Other implications of an increased foreign financing are:

a) Limitation of the foreign capital inflow on domestic TS market

The share of foreign capital in domestic TS market has been growing systematically in recent years. In mid September 2005 foreign investors owned domestic bonds worth PLN 74.4 billion i.e. 28.2% of all sold marketable bonds. From the beginning of this year their domestic bond portfolio has grown by PLN 12.4 billion (i.e. by 20%) and their share in marketable bonds has increased by 0.8 percentage points. The increase in foreign capital on domestic TS market means both the pressure for PLN appreciation and the susceptibility of the currency market and the interest rate to changes in the transfers of this capital. Limitation of foreign capital inflow on domestic TS market should take place as a result of reduction of TS supply and the decrease in spreads between Polish TS and parallel bonds issued in the Euro zone.

b) Increase in the exchange rate risk of the State Treasury debt

It was stated in Chapter IV that the exchange rate risk is high. However, while evaluating the exchange rate risk one should also take into account the currency structure of foreign debt and the schedule of Poland's entry to the Euro zone when the Euro will become the national currency. The increase in foreign financing will not result in a significant increase in the exchange rate risk. With the financing structure adopted in the *Strategy*, the weakening of the PLN against all currencies by 1% would result in the increase in the debt in 2006, 2007 and 2008 by PLN 1.5 billion, PLN 1.6 billion and PLN 1.7 billion respectively, which means that the debt ratio to GDP would change by 0.15%, 0.15% and 0.16% respectively. With the structure assuming the maintenance of foreign financing at the level of around PLN 5 billion in 2006, 2007 and 2008, the weakening of the PLN against all currencies by 1% would result in the increase in debt by PLN 1.3 billion, PLN 1.4 billion and PLN 1.4 billion respectively (change of debt to GDP ratio would amount to 0.13% each year).
The entry to the Euro zone will at the same time mean a rapid decrease in the exchange rate risk since the debt nominated in the EUR will become the debt in the national currency. Due to those reasons, the temporary increase in the exchange rate risk should be considered acceptable.

c) Consequences resulting from the exchange of foreign currencies into the PLN

Exchange of foreign currencies into the PLN may take place through sale of currencies to the National Bank of Poland [NBP] (which entails an increased money supply and increased scale of open market operations) or the sale of foreign currencies on the

financial market (which may influence the strengthening of the Zloty). In such a situation it is important:

- to form an appropriate relation between the sale of currencies to NBP and on the market,
- to coordinate public debt management and monetary policy,
- to conduct a transparent information policy with respect to financial market.

A part of foreign currencies obtained from the increased issuance of bonds on foreign markets will be used to finance foreign debt servicing costs and will not be converted into the PLN (around PLN 5.3 billion in 2006, 7.1 and 7.8 billion in the following years).The remaining amount of funds in foreign currencies should be converted into the PLN in a way that will ensure the accomplishment of the debt management objective by limiting its impact on monetary policy and the exchange rate of the Zloty. The accomplishment of this aim should be positively influenced by a limited amount of currencies converted into the PLN (according to the adopted assumptions it is the equivalent of around PLN 14.8 billion in 2006 i.e. around PLN 10 billion more than it would be if the previous policy was retained), a flexible shaping of sale of foreign currencies to the NBP or on the market, as well as a limitation of foreign capital inflow on domestic TS market.

With the initial assumption that around a half of the additional amount of acquired foreign funds will be converted through the NBP and the other half on the market, the amount of foreign currencies sold on the market should be lower than the assumed decrease in the foreign capital inflow on TS market. Adding to this the distribution of the sale of foreign currencies throughout the year and the ability to avoid selling during unfavourable market conditions, the potential pressure for the Zloty appreciation may have solely psychological basis.

Minimisation of costs will be subject to constraints related to the debt structure. Therefore, the following was assumed:

a) as regards the refinancing risk
    - the average maturity of the domestic debt reaching the lower level of this indicator in the EU Member States,
    - further reduction of the share of Treasury bills in domestic debt through maintaining the debt at the average level of around PLN 24 billion,
    - aiming at an even distribution of payments arising from serviced and redeemed domestic and foreign debt in subsequent years (coordination of issuance policy with respect to maturity dates of bonds issued),
    - the current level of foreign debt refinancing risk does not restrain cost minimisation;

b) as regards the exchange rate risk
    - a possible increase in exchange rate risk before entering the euro zone (taking advantage of historically low interest rates on selected foreign markets). Joining the Euro zone should mean a drop in exchange rate risk as debt nominated in the EUR will become debt in the local currency,
    - concentration of issuances in the euro to build up liquid benchmarks on the market;

c) as regards the interest rate risk
    - duration of domestic debt reaching the level of duration in the EU countries followed by a proper shaping of the ratio between the level of interest rate risk and debt servicing costs depending on the current and expected level of interest rates,
    - maintaining a reduced interest rate risk for foreign debt;

d) as regards the state budget liquidity risk

- maintenance of a safe level of state budget liquidity and efficient management of liquid assets;

e) as regards other risks, in particular the credit risk and operational risk,

- settling transactions in derivatives with domestic and foreign entities with high credibility,
- state budget liquidity management taking into account the credit risk generated by non-collateralised transactions,
- reduction of the operational risk related to institutional and organizational structure of debt management – establishment of a debt management agency/bureau,
- reduction of operational risk related to technical infrastructure;

f) as regards the distribution of debt servicing costs over time

- reduction of volatility of debt servicing costs over time. The policy of issuing new medium- and long-term bonds and of early redemption of maturing debt should influence an even distribution of debt servicing cost beyond the *horizon* of this *Strategy*,
- setting the bond coupons at the level close to the yield over the issuing period of the bond.

VI. STRATEGY TASKS IN A THREE-YEAR HORIZON

The most important tasks of the Strategy resulting from the implementation of adopted objective include the following:

1. Increase in liquidity, efficiency and transparency of the TS market.
2. Development of the System of Primary Dealers.
3. Efficient communication with participants of financial markets.
4. Development of the system for managing state budget liquidity.
5. Increase in efficiency of TS issuances on international financial markets.
6. Establishment of a debt management agency/bureau as an entity operationally independent from the Ministry of Finance.

1. Increase in liquidity, efficiency and transparency of TS market

Activities aimed at most efficient functioning of the TS market are a permanent task and relate to both primary and secondary market because of their interrelation. The integration with the European market creates an additional pressure because, on the one hand, it allows to increase market capacity and to gain an access to new groups of investors whereas, on the other hand, it poses challenges connected with strong competition from other issuers.

The period of preparations for membership in the Euro zone, which to a significant extent is covered by this Strategy, refers also to the functioning of the TS market. Upon adoption of the common currency, the domestic market will become a segment of the European TS market and benchmark bond quoting will set the points on Polish Euro yield curve. Experience of the Euro zone issuers proves that spreads towards basic securities (i.e. issued by Germany) result mainly from two factors:

- creditworthiness of the country,
- organization of the TS market in a given country and the infrastructure in operation.

The first factor depends mainly on general macroeconomic policy of the authorities and on condition of the public finance and thus is not directly affected by the debt management entity, whereas the latter is largely influenced by the debt management entity. It concerns such aspects as issuance policy, organization of primary market (including primary dealers) and of secondary market (settlement system, TS trading systems).

Activities aimed at increasing the attractiveness of the TS market and facilitating the integration of Poland’s financial market with the Euro zone will be carried out through:

- Continuation of the medium- and long-term TS issuance policy aimed at reducing the number of bond issuances while gradually increasing their value.

  The minimum value of medium- and long-term fixed rate bonds issuances will amount to EUR 5 billion equivalent, which at the same time constitutes a minimum level required for the introduction of bonds denominated in the Euro into trading on EuroMTS platform. Currently the value of four bond issuances on the domestic market approached or exceeded 5 billion EUR. On the EUR market Polish issuances are traded on NewEuro MTS, the electronic platform (including one issuance amounting to EUR 5.25 billion). The instruments for fulfilment of this task will include an appropriate construction of the TS issuance calendar, switching auctions, additional auctions and reopening of already existing issuances.

- Further development of the electronic TS market.

  In 2004 the works on the strategic alliance of CeTO S.A., the organizer of an electronic platform for TS trading, with the European MTS platform were finalized. MTS Sp.A. acquired a 25% stake in CeTO equity capital ensuring the Telematico platform for trading in Polish Treasury Securities. The new system was launched on 25 November 2004. The essential benefits of adopting the MTS technology may be expected in the horizon of the

Strategy. The implementation of the project enables foreign banks participating in MTS to be actively involved in electronic trading in Polish TS.

Currently the work has been continued within the MTS group on further improvement of the Telematico platform (new module for conditional transactions will be implemented on individual markets in autumn this year).

- Improvement of the TS market infrastructure by removing legal and technical barriers as well as streamlining the settlement mechanisms.

  Works undertaken by the National Depository for Securities [Krajowy Depozyt Papierów Wartościowych – KDPW] on the project of cooperation with the European clearinghouse Euroclear are to make it possible to settle transactions in Polish TS by the institution present on the majority of European markets. For foreign investors it will mean that the rules governing the functioning of the Polish market will become similar to those applied on the European market.

2. Development of the System of Primary Dealers

Currently, eleven domestic banks that obtained the status of Primary Dealers and one state-owned bank (BGK S.A.) without this status operate within the System of Primary Dealers. These banks have an exclusive access to the primary market. On December 1, 2004 a competition aimed at selecting Primary Dealers for 2006 began. This is the first competition in which foreign banks could participate.

The quality of the functioning of the Primary Dealers system is one of the elements of the TS market organization and thus of the activities related to the accomplishment of the objective of minimisation of debt servicing costs. It is essential that the regulations on privileges and obligations of the bank-participants and on the issuer's tasks lead to an establishment of a transparent system ensuring stable TS allocation on the primary market and a building of a liquid and deep secondary market. The inclusion of banks with large experience in performing Primary Dealer functions on developed markets in the EU countries can be of great importance. Changes in this respect which took place in dealer systems in other EU countries have proved that the global nature of international banks' operations, the experience in the cooperation with government issuers, the scale of transactions conducted in TS and a wide portfolio of foreign non-banking customers should positively influence the growth of competition among the banks and the quality of the Primary Dealers system. The efficient organization of the Primary Dealers system should allow:

- to lower the debt servicing costs through eliminating spreads towards Treasury Securities issued by other countries which may result from an insufficient organizational and infrastructural development of the Polish TS market,
- to increase the safety of financing of the state budget borrowing needs,
- to increase the attractiveness of the Polish market,
- to successfully compete with other government issuers in acquiring funds from institutional investors.

3. Efficient communication with financial market participants

Obstacles in an access to information are a fundamental obstacle for an effective price arbitration. On the market of highly homogenous product such as the market of the State Treasury bonds, this difficulty acts against the issuer through the decrease in an effective demand. An efficient strategy of communication with investors, both domestic and foreign, allows the issuer to obtain higher prices and thus contributes to the minimisation of debt servicing costs.

4. Development of the system for managing state budget liquidity

The improvement of the system for liquidity management is a permanent task regarding the activities in respect to infrastructure, procedures and instruments. This task is understood as a set of activities intended to secure state budget liquidity while efficiently using the liquid assets. Such activities include:

- improvement in forecasting of budget transfers,
- development of technical and organizational infrastructure,
- streamlining the system of efficient depositing of surplus cash,
- extending the range of instruments available to raise funds promptly in the event of distortions in the execution of budget inflows .

The state budget liquidity management will be conducted under the conditions specified by:

- the legal framework laid down in the new Public Finance Act,
- execution of the budget and maintaining liquid assets in the PLN and foreign currencies,
- the level of credit risk (through inter-bank deposits) and operational risk (related mainly to the settlement of funds and TS that collateralise the transactions),
- the situation on the inter-bank market with respect to liquidity,
- functioning of the single state budget account. It will enhance the access to information on budgetary inflows and will enable a temporarily use of funds from the accounts of budget holders.

5. Increase in efficiency of TS issuances on international financial markets

The increase in efficiency of TS issuances on international financial markets will first of all be achieved by actions aimed at maximum narrowing of spreads between the Polish T-bonds and benchmarks on a given market. It means an acquisition of funds at the lowest possible cost and stems from both the perception of Poland by foreign investors, which results from the improvement of economic indicators and the stabilizing impact of the EU membership, and the issuance policy. Those factors influenced the significant decrease in spreads in 2004 and 2005. For example, on the Euro market, which is the most important for Poland, the spread of Polish bonds fell from around 0.5 to around 0.2 percentage points towards German government bonds (Bunds).

The issuance policy of the Ministry of Finance will include:

- an offer of instruments adjusted to the expectations of different groups of investors with respect to the structure, maturity and currency. It will take into account the debt-related risk (i.e. interest rate risk, refinancing risk and exchange rate risk). The issuance policy with respect to the choice of the currency will be influenced to a large extent by the plans of Poland’s entry to the Euro zone;
- creation of large and liquid issuances. Creation of liquid benchmarks will mainly refer to the Euro market (the reference value for the issuances will be EUR 5 billion, as on the domestic market);
- diversification of the issuance policy by taking advantage of favourable conditions for the issuance of debt instruments denominated in currencies other than the Euro. The diversification of markets will enable a natural distribution of risk and avoiding such a situation in which a certain market segment would not be able to satisfy the expectations and borrowing needs of the state budget.

6. Establishment of a debt management agency/bureau as an entity operationally independent from the Ministry of Finance

In the EU Member States public debt is considered one of key issues in the context of the country's macroeconomic stability – the level of debt is one of the convergence criteria. At the same time specific features of public debt management like among others close relations with financial market and a particular importance of risk management have been more clearly appreciated. The reduction of the market risk means in practical term a change of emphasis from a rather passive administration to an active debt portfolio management with the use of modern financial instruments (including financial derivatives). It requires, however, an appropriate institutional structure of a unit dealing with debt management, adjusted in terms of organization to the operations on developed financial markets. As a consequence, some reforms have been introduced with the aim to adjust the structure of debt management units to tasks they are entrusted with[2]. Key elements in this case include:

- operational autonomy of the debt management units which ensures the flexibility in market operations. A supervising minister approves the objectives on the strategic level while the agency is free to choose instruments of their implementation;
- appropriate technical infrastructure;
- qualified personnel ensuring the quality of operations not lower than standards applied in commercial financial institutions.

At present in 14 out of 25 countries of the enlarged EU (EU-25) the agency model is applied (in 11 out of 15 EU Member States before the enlargement). This model combines all the above-mentioned elements, although some significant differences occur in particular countries with respect to detailed solutions applied.

In Poland the debt management has changed from a passive administration to an active management with the use of constantly increasing set of financial instruments (including derivatives) and operations on debt components (such as early redemption, exchange of debt). The institutional form of debt management remained however unchanged. Under the present institutional structure of debt management possibilities of further progress with respect to the State Treasury debt management and taking advantage of the effects of financial market development and integration remain limited. Further changes in the quality of debt management, including an efficient use of modern instruments, require an establishment of an autonomous unit with a considerable operational autonomy: i.e. the Public Debt Management Agency/Bureau. It results from the following factors:

- The necessity to separate the fiscal policy (structuring budgetary revenues and expenditure) from the public debt management (a choice of methods of financing the state budget borrowing needs) due to a possible conflict between the short-term budgetary objectives (e.g. reduction of current debt servicing costs) and the long-term debt management objectives (minimisation of debt servicing costs in a long-run, reduction of risk related to the State Treasury debt).
- An increasing complexity and sophistication of public debt management instruments. Modern public debt management requires that efficient technical infrastructure and organizational procedures exist which ensure the appropriate evaluation of risk and adequate reactions to changing market conditions. The lack of such infrastructure and procedures is a source of the operational risk, which prevents or seriously limits the use of modern debt management instruments.

Development of institutions which constitute the debt management environment (primary and secondary market, the settlement system, primary dealers) reached a relatively mature stage. At an early development stage the combination of debt management tasks and strong

[2] The organization of debt management in the EU countries and the institutions responsible for debt management are discussed in Annex 3.

administrative position of the Ministry of Finance helped to prepare legal solutions and to efficiently influence the institutional environment. Upon the completion of the initial development stage, the importance of this factor has decreased and does not counterbalance the negative consequences of a potential conflict of fiscal and debt management policies.

The institutional changes are recommended in order to successfully compete for investors with other issuers on the integrating European financial market. Separation of debt management from the current fiscal policy and an increase in debt management efficiency will lead to a decrease in debt servicing costs and debt-related risk.

VII. INFLUENCING PUBLIC DEBT[3]

VII.1. Changes in legal regulations

The most important legislative changes that have an impact on incurring liabilities by public finance sector entities include:

1. Entry into force (on January 1, 2006) of the *Public Finance Act of 30 June 2005*

   The changes with respect to incurring liabilities introduced by this Act concern mainly local government units (JST) and include:

   a) the following items were excluded from the 15% limit (12% if the public debt exceeds 55% of GDP) on expenditure and outlay related to servicing and repaying of liabilities to the revenues planned for a given year:

      - repayment of principal instalments of loans (credits) and redemption of securities incurred or issued to cover the temporary deficit of a local government unit during a year,
      - sureties and guarantees granted to local government legal persons which carry out tasks of local government units using resources from the EU structural funds or the Cohesion Fund;

   b) if local government units apply for a loan (credit) or issuance of securities, an opinion of the regional clearing chambers on their capability to repay this liability must be obtained;

   c) the management of local government units is obliged to prepare a forecast of total debt outstanding at the end of a budget year and for the following years which results from planned and already incurred liabilities;

   d) local government units are obliged to specify in the budget resolution the limit of liabilities resulting from incurred loans (credits) and securities issued.

2. Entry into force of the *Act of 28 July 2005 on public private partnership*

The Act regulates the cooperation of public entities with private partners in order to carry out a public task. It is envisaged that public private partnership agreements will be signed mainly by local government units. The main aim of concluding such agreements will be investments, in particular in environmental protection and road infrastructure. The impact of the agreements on the public debt will depend on the division of particular types of risk between the parties of the agreement. Necessary elements of the analysis of risks will be stated in executing Acts.

3. Entry into force of the *Act of 15 April 2005 on public aid and restructuring of public health care units*

On the basis of the provisions of the Act and in order to acquire funds for financial restructuring the independent public health care units can:

a) issue bonds,
b) contract loans,
c) contract bank loans,
d) apply to a local government unit for a guarantee for the repayment of the principal of bonds issued by this health care unit,
e) apply to Bank Gospodarstwa Krajowego (BGK) for a guarantee for the repayment of interest on bonds from the funds of the National Credit Guarantee Fund.

---

[3] In this chapter the phrase *'public finance sector entities'* refers to this sector but the State Treasury, unless otherwise stated.

The independent public health care units can receive a loan from the state budget for financing of liabilities related to the process of restructuring specified in the Act.

VII.2. Debt of public finance sector entities other than the State Treasury

The debt of public finance sector entities in the recent period both before and after consolidation within the public finance sector is presented in Annex 6.

At the end of June 2005 the debt of entities other than the State Treasury amounted to 7.6% of the debt of public finance sector entities before consolidation (6.2% of the public debt, i.e. the debt of the public finance sector after consolidation) against 8.6% (7.0%) at the end of 2004. Basic changes in the debt of units with the highest debt level are discussed below.

Table 5. Debt of public finance sector entities other than the State Treasury before consolidation within the sector (PLN million, end of period)

Specification	December 2003	December 2004	June 2005	Change Dec'04-Dec'03		Change June'05-Dec'04	
				PLN million	%	PLN million	%
Debt of other public finance sector entities	**36,956.4**	**37,678.4**	**36,189.4**	**722.0**	**2.0**	**-1,489.0**	**-4.0**
1. Other central government entities	**15,157.0**	**13,200.5**	**12,586.6**	**-1,956.4**	**-12.9**	**-613.9**	**-4.7**
Social Insurance Institution (ZUS) and funds managed by ZUS	11,225.4	10,061.3	9,729.6	-1,164.1	-10.4	-331.7	-3.3
National Health Fund	1,047.1	758.4	577.2	-288.6	-27.6	-181.3	-23.9
State earmarked funds with legal personality (excl. ZUS)	95.4	0.7	0.0	-94.7	-99.3	-0.7	-100.0
State higher schools	192.9	214.2	165.9	21.4	11.1	-48.4	-22.6
Research and development units	293.5	258.0	276.2	-35.5	-12.1	18.2	7.0
Independent public health care units	721.1	938.4	993.2	217.3	30.1	54.8	5.8
State cultural units	7.1	38.2	49.3	31.1	434.5	11.1	29.1
Polish Academy of Science (PAN) and units established by it	19.0	18.8	7.3	-0.3	-1.5	-11.5	-61.3
Other State legal entities	1,555.5	912.5	788.1	-643.0	-41.3	-124.4	-13.6
2. Local government entities	**21,799.4**	**24,477.9**	**23,602.8**	**2,678.5**	**12.3**	**-875.1**	**-3.6**
2.1. Local government units	***17,276.8***	***19,104.7***	***17,841.0***	***1,827.9***	***10.6***	***-1,263.8***	***-6.6***
2.2. Other local government entities	***4,522.6***	***5,373.2***	***5,761.8***	***850.6***	***18.8***	***388.7***	***7.2***
Local government earmarked funds with legal personality	38.5	76.1	69.5	37.6	97.5	-6.6	-8.7
Independent public health care units	4,411.8	5,230.5	5,624.4	818.7	18.6	393.8	7.5
Local cultural units	45.3	28.7	31.4	-16.7	-36.8	2.7	9.5
Other local government legal entities	26.9	37.9	36.6	11.0	40.8	-1.3	-3.4

1) Debt of local government units

In 2004 local government units achieved a budget surplus (PLN 117.2 million) although they had planned a deficit (PLN 5,278.2 million). At the same time the outstanding debt of these units increased by PLN 1,827.9 million. In the first half of 2005 the surplus of local

government units amounted to PLN 6,026.8 million and the debt decreased by PLN 1,263.8 million. The tendency to incur liabilities especially in the last quarter of the year has continued which is connected with the distribution of deficits of those units over year.

Table 6. Balance and change of debt of local government units on quarterly basis (PLN million)

Period	Specification	1. quarter	2. quarter	3. quarter	4. quarter	Year
2003	Balance	3,287.3	-871.0	-127.9	-4,102.4	**-1,813.9**
	Change of debt	-294.1	137.4	774.4	1,300.7	**1,918.5**
2004	Balance	5,174.0	181.0	759.5	-5,997.3	**117.2**
	Change of debt	-697.3	-124.5	856.0	1,793.6	**1,827.9**
2005	Balance	5,799.0	227.8			
	Change of debt	-836.3	-427.5			

Table 7. Number of units with a surplus / deficit (end of period)

Period	Deficit		Surplus		Total	
	No. of units	*PLN billion*	*No. of units*	*PLN billion*	*No. of units*	*PLN billion*
2003	*1,667*	*-2,8*	*1,141*	*1,0*	*2,808*	*-1,8*
2004	*1,550*	*-2,8*	*1,258*	*2,9*	*2,808*	*0,1*
2. quarter 2005	*244*	*-0,2*	*2,564*	*6,2*	*2,808*	*6,0*

The structure of debt of local government units is dominated by loans (credits) with a small share of securities. At the same time the debt related to matured payables has systematically decreased.

Table 8. Debt of local government units (end of period)

Specification	December 2003		December 2004		June 2005	
	PLN million	%	PLN million	%	PLN million	%
Total debt of local government units (PLN million)	**17,276.8**	**100.0**	**19,104.7**	**100.0**	**17,841.0**	**100.0**
1) loans and credits	13,785.7	79.8	15,590.0	81.6	14,298.7	80.1
2) securities	2,817.8	16.3	3,134.4	16.4	3,183.0	17.8
3) other debt, of which:	673.3	3.9	380.3	2.0	359.3	2.0
3.1) matured payables	648.4	3.8	361.7	1.9	343.4	1.9

The share of foreign debt in total outstanding debt of these units has gradually increased but remains on a relatively low level. At the end of June 2005 it amounted to 8.4% against 8.1% at the end of 2004 and 4.3% in 2003. The debt consists mainly of liabilities with maturity exceeding a year (88.5% in June 2005 as compared to 90.0% at the end of 2004 and 88.1% in 2003).

Total outstanding debt of local government units to their revenues ratio has remained significantly below the statutory limit of 60%.

Table 9. Debt of local government units to their revenues

Specification	December 2002	December 2003	December 2004	June 2005*)
Debt-to-revenue ratio	19.2%	21.8%	20.9%	17.6%

*) *debt of local government units at the end of June 2005 compared to revenues planned for 2005.*

However, in 2004 in 16 local government units (as compared to 18 in 2003) the debt to revenues ratio exceeded 60%. Like in the previous years the main reasons included:

1) excessive (in comparison with the financial capacity of a given unit) incurrence of loans (credits) to finance investments in the previous years,
2) lower than planned revenues.

Table 10. Number of indebted local government units with respect to debt-to-revenue ratio

Year	Group of units	Total No. of units	No. of indebted units					
				Debt-to-revenue indicator (i)				
			total	i<10%	10%<i<30%	30%<i<50%	50%<i<60%	i>60%
2003	1) municipalities (gminy)	2,413	2,264	840	1,001	347	59	17
	2) cities with the county status (miasta na prawach powiatu)	65	65	7	38	15	5	-
	3) counties (powiaty)	314	301	172	109	18	1	1
	4) provinces (wojewodztwa)	16	16	6	9	1	-	-
	Total	**2,808**	**2,646**	**1,025**	**1,157**	**381**	**65**	**18**
2004	1) municipalities (gminy)	2,413	2,304	727	1,121	389	51	16
	2) cities with the county status (miasta na prawach powiatu)	65	65	9	33	21	2	-
	3) counties (powiaty)	314	298	150	119	29	-	-
	4) provinces (wojewodztwa)	16	16	9	6	1	-	-
	Total	**2,808**	**2,683**	**895**	**1,279**	**440**	**53**	**16**

In 2004 the value of non-due liabilities of local government units resulting from guarantees granted increased to PLN 1,009.3 million (against PLN 996.0 million at the end of 2003). At the end of first half of 2005 these liabilities totalled PLN 1,230.9 million.

2) Debt of Social Insurance Institution [ZUS] and funds managed by ZUS

Outstanding debt of these entities is practically solely the debt incurred by the Social Insurance Fund [FUS].

Table 11. Debt of Social Insurance Institution [ZUS] and funds managed by ZUS (PLN million)

Specification	December 2003	December 2004	June 2005
Debt of ZUS and funds managed by it, of which:	**11,225.4**	**10,061.3**	**9,729.6**
Loans from commercial banks	4,756.0	4,626.4	4,985.5
Matured payables	6,469.5	5,434.9	4,744.1

Credits contracted by FUS are short-term. They constitute an additional source, apart from contributions and state budget subsidies, of financing of benefits paid out by FUS.

Matured payables of FUS result mainly from the difficulties with a timely transfer of a part of contributions to Open Pension Funds (OFE) between 1999 and 2002. Since November 2003 these liabilities, along with accrued interest, have been taken over by the State Treasury and subsequently converted into T-bonds (10-year floating rate bonds).

Table 12. Conversion of debt of FUS towards OFE into Treasury Securities (PLN million)

Specification	December 2003	December 2004	June 2005
Face value of issued T-bonds (outstanding at the end of period)	387.7	1,178.4	1,611.5

3) Debt of independent public health care units

Matured payables resulting from not settling liabilities on time remain the main component of debt of independent public health care units (SPZOZ). At the same time the debt of those units in securities (issued mainly by SPZOZ from the local government sector) has systematically increased. Around 60% of debt of SPZOZ consist of liabilities towards entities outside the public finance sector, mainly for the supply of goods and services.

Table 13. Debt of independent public health care units

Specification	December 2003		December 2004		June 2005	
	PLN million	%	PLN million	%	PLN million	%
Debt of independent public health care units, of which:	**5,132.9**	**100.0**	**6,168.9**	**100.0**	**6,617.5**	**100.0**
1) securities	7.0	0.1	12.4	0.2	9.6	0.1
2) loans and credits	394.8	7.7	470.8	7.6	521.1	7.9
3) others, *of which*:	4,731.1	92.2	5,685.8	92.2	6,086.8	92.0
3.1) matured payables	4,729.7	92.1	5,684.1	92.1	6,084.8	91.9

Table 14. Debt of independent public health care units from central and local sectors

Specification	December 2003		December 2004		June 2005	
	PLN million	%	PLN million	%	PLN million	%
Debt of independent public health care units, of which:	**5,132.9**	**100.0**	**6,168.9**	**100.0**	**6,617.5**	**100.0**
1) up to one year (including one year)	4,823.4	94.0	5,805.7	94.1	6,199.0	93.7
2) beyond one year	309.5	6.0	363.2	5.9	418.5	6.3
1. Independent public health care units from the central sector	721.1	14.0	938.4	15.2	993.2	15.0
1.1. up to one year (including one year)	714.5	13.9	931.4	15.1	986.6	14.9
1.2. beyond one year	6.6	0.1	7.0	0.1	6.6	0.1
2. Independent public health care units from the local sector	4,411.8	86.0	5,230.5	84.8	5,624.4	85.0
2.1. up to one year (including one year)	4,108.9	80.0	4,874.3	79.0	5,212.5	78.8
2.2. beyond one year	303.0	5.9	356.2	5.8	411.9	6.2

4) Other units

Among other units the Agricultural Market Agency [AMA] and the National Health Fund [NFZ] are the most indebted entities. Debt of the AMA results mainly from loans for financing of the Agency's activities related to interventions on the agricultural market. All these loans are have been guaranteed by the State Treasury. At the end of 2005 the AMA debt in loans amounted to PLN 459.3 million, against PLN 585.0 million at the end of 2004.

Loans contracted by the Sickness Funds in 2000 from the state budget remain the main part of debt of the National Health Fund. March 2007 is the deadline for their repayment..

The outstanding debt of other public finance sector entities is mainly the result of untimely repayment of their liabilities (matured payables).

VIII. FORECASTED EFFECTS OF THE STRATEGY IMPLEMENTATION

Forecasted effects of the *Strategy* implementation cover forecasts of public debt and debt servicing costs, as well as changes in risk related to public debt as the expected result of the implementation of the objective of the *Strategy* with adopted macroeconomic and budgetary assumptions. The most important threats to the *Strategy* implementation are also presented.

VIII.1. Forecasts of debt and debt servicing costs

Within the Strategy horizon the tendency of increasing public debt to GDP ratio will be restrained – in accordance with the adopted assumptions this ratio will reach a maximum level in 2007. The debt servicing costs will reach a temporary maximum in 2006 and then their value will decrease in 2007 and remain at the same level in 2008. It will enable to decrease the debt servicing costs to GDP ratio from 2.9% in 2006 to 2.5% in 2008.

Forecasts of the public debt and the State Treasury debt servicing costs between 2004 and 2007 are presented in table 15. The forecasts of the debt and debt servicing costs to GDP ratio are illustrated in chart 1 and 2 respectively.

Table 15. Forecasts of the public debt and State Treasury debt servicing costs in the years 2005-2008

	2004	2005	2006	2007	2008
1. State Treasury debt					
a) PLN billion	402.9	438.6	485.6	520.5	548.9
b) relative to GDP	45.5%	47.4%	49.8%	50.2%	49.4%
2. Public debt					
a) PLN billion	432.3	468.1	516.4	551.4	581.1
b) relative to GDP	48.8%	50.6%	52.9%	53.2%	52.3%
3. Public debt increased by risk-weighted payments under sureties and guaranties					
a) PLN billion	444.1	481.4	532.9	568.8	599.3
b) relative to GDP	50.2%	52.0%	54.6%	54.8%	53.9%
4. General government debt (UE methodology, OFE within the sector)*)					
a) PLN billion	386.2	411.1	449.6	475.5	492.9
b) relative to GDP	43.6%	44.4%	46.1%	45.9%	44.4%
5. General government debt (UE methodology, OFE outside the sector)					
a) PLN billion	423.2	461.1	511.6	547.9	577.4
b) relative to GDP	47.8%	49.8%	52.4%	52.8%	52.0%
6. State Treasury debt servicing costs (on cash basis)					
a) PLN billion	22.7	26.7	28.5	28.1	28.1
b) relative to GDP, of which:	2.6%	2.9%	2.9%	2.7%	2.5%
- domestic debt	2.1%	2.3%	2.4%	2.0%	1.8%
- foreign debt	0.5%	0.6%	0.5%	0.7%	0.7%

**)till March 2007 a transition period will have applied during which Poland can include Open Pension Funds (OFE) within the sector of general government; Eurostat decision on classification of funded pension schemes in case of government responsibility or guarantee (Eurostat News Releases No 30/2004from 2 March 2004 and No 117/2004 from 23 September 2004).*

In comparison to the Strategy for the years 2005-2007 from September 2004, the forecasted State Treasury debt servicing costs, outstanding debt, debt to GDP ratio and risk parameters have substantially improved. It results from:

- significant differences between the forecasts and actual execution in 2004 and 2005 of macroeconomic and budgetary variables (including a lower level of interest rates, lower state budget borrowing needs, strengthening of the Zloty, a slower increase in debt of public finance sector entities other than the State Treasury),
- operations on debt between September 2004 and September 2005 (early redemption of a considerable part of debt towards the Paris Club creditors and practically of all domestic non-marketable debt in T-bonds),

- a modification of the structure of financing the state budget borrowing needs in 2005 and in subsequent years (larger foreign financing, a significant decrease in outstanding Treasury bills, an increase in issuance of medium- and long-term bonds),
- change of macroeconomic and budgetary forecasts for 2006 and 2007.

Chart 1. Public debt-to-GDP ratio

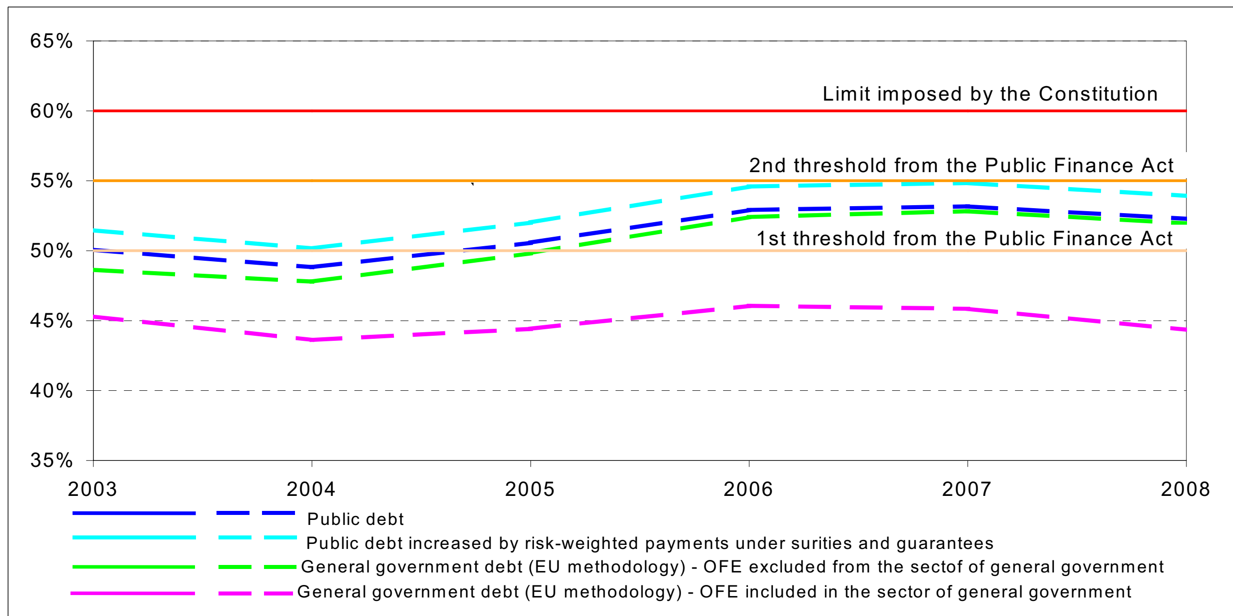
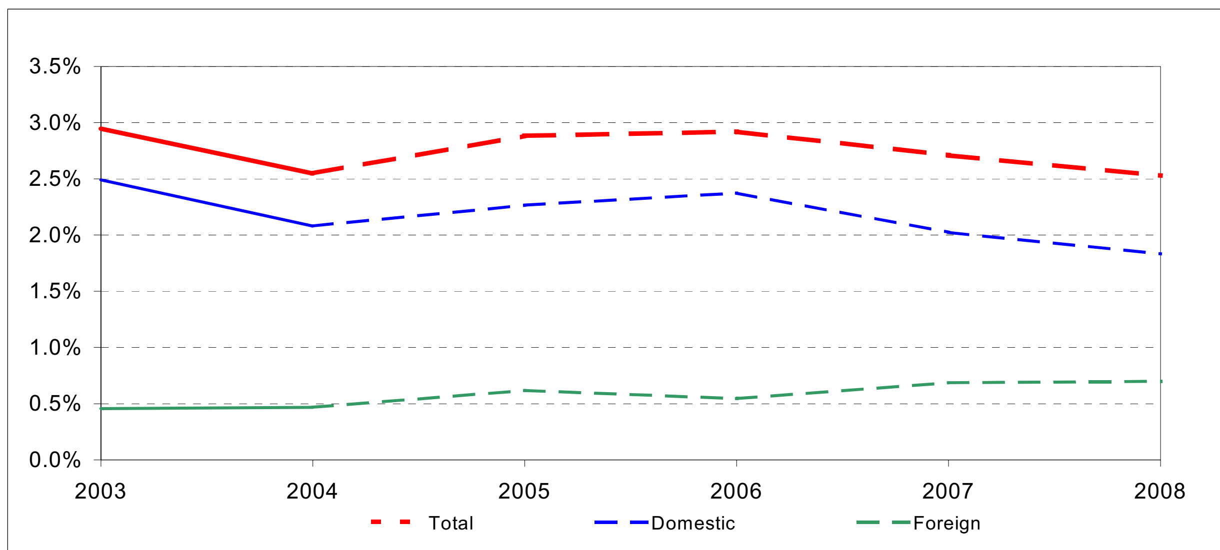


Chart 2. State Treasury debt servicing costs-to-GDP ratio



Those factors had an impact on the significant downward revision of projections of debt level and its servicing costs as well as on revision of forecasts of risk related to the structure of the State Treasury debt (parameters of domestic debt risk at the end of the first half of 2005 achieved the levels envisaged for 2007 in the previous Strategy).

VIII.2. Changes with respect to risk

Changes of the structure of the State Treasury debt with respect to the exchange rate risk, refinancing risk and interest rate risk are illustrated on charts 3-5. It is envisaged that at the end of 2008 the chosen risk factors should reach the following levels:

- average maturity of domestic marketable debt will increase from 3.15 years at the end of 2004 to around 3.8-4.2 years,
- share of Treasury bills in the domestic debt will decrease from 16.1% at the end of 2004 to around 6.3%,
- duration of the domestic marketable debt will increase from 2.44 years at the end of 2004 to around 3.3-3.7 years,
- due to the increase in foreign financing the share of foreign debt will increase from 27.6% at the end of 2004 to around 32%. The related risk increase is nevertheless limited and due to the perspective of Poland's entry to the Euro zone it will remain at the acceptable level.

Chart 3. The refinancing risk – ATM of marketable domestic debt of the State Treasury

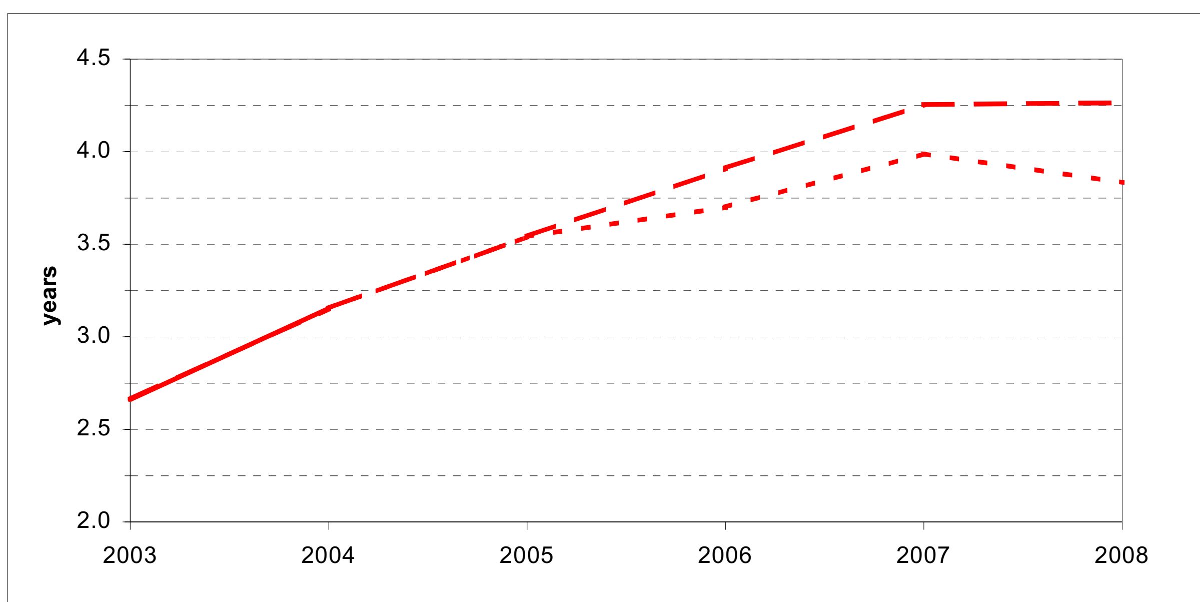


Chart 4. Interest rate risk – duration of marketable domestic debt of the State Treasury

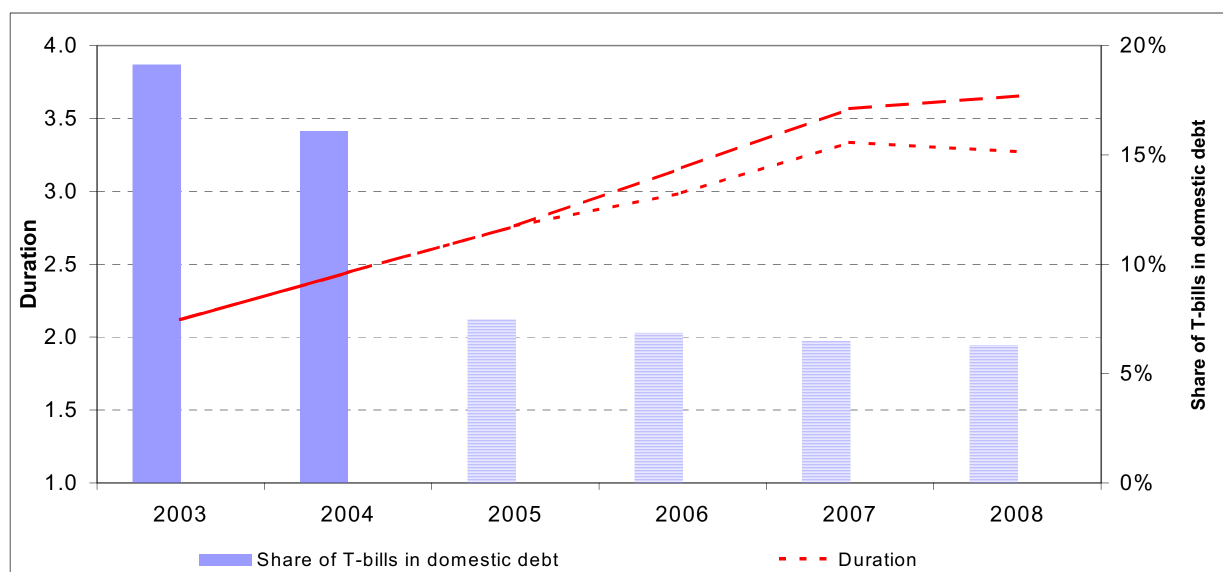
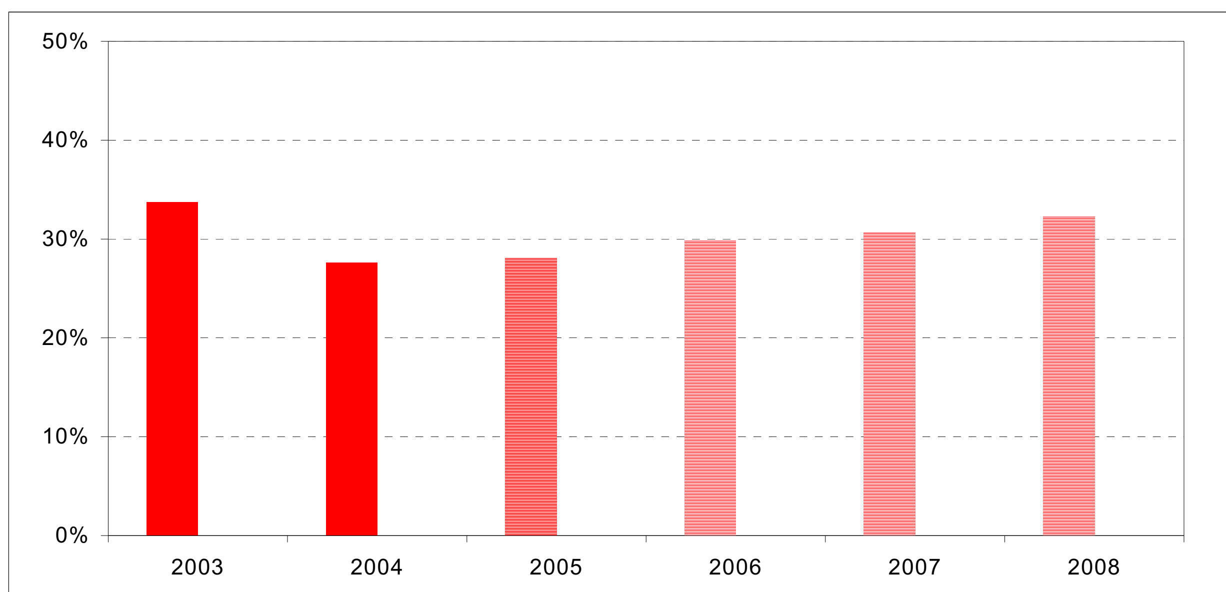


Chart 5. Exchange rate risk – share of foreign debt in debt of the State Treasury



VIII.3. Threats to the Strategy implementation

Threats to the implementation of the Strategy are first of all related to:

1) The situation in the public finance which is influenced by:
   - the level of the state budget borrowing needs (the main component of an increase in the public debt),
   - the rate of growth of debt of public finance sector entities other than the State Treasury,
   - the aim of granted sureties and guarantees (sureties and guarantees granted to support traditional sectors of the economy generate a substantial risk of them being called).
2) Coordination of debt management and monetary policy. The potential modification of the structure of financing of the state budget borrowing needs through an increase in foreign financing may influence foreign exchange rates on the market and monetary policy of the central bank. The scale of conversion of foreign currencies on the market should, however, be limited and lower than the assumed decrease in the inflow of foreign currencies on the domestic TS market. With respect to the assumed scale of transactions on foreign exchange market, flexibility in shaping the sale of foreign currencies should enable to limit the potential impact of this policy on the Zloty appreciation.
3) Development of the macroeconomic situation different from the scenario assumed. It concerns above all the date of Poland's entry into the Euro zone. A considerable delay of the entry to the Euro zone or lack of fixed deadlines related to the integration may contribute to the restrain of the convergence process and may increase the volatility of the PLN exchange rate. These factors along with the increased share of foreign debt would in a consequence negatively influence the debt level and debt to GDP ratio as well as debt servicing costs.

Annex 1. Glossary

ATR (*average time to refixing*) – the measure of interest rate risk related to the public debt. *ATR* is interpreted as the average period, expressed in years, for which the debt servicing costs are set. The larger the share of short-term and floating rate instruments, the higher the interest rate risk and the lower ATR. ATR was introduced in 2005 as a complementary to duration measure of the interest rate risk that covers debt both with indexed and non-indexed principal. *The ATR* of domestic marketable TS is calculated according to the following formula:

$$ATR = \frac{\sum_{r \in R} rNZ_r + \sum_{t \in T} tNS_t + \sum_{j \in J} \frac{1}{12} NI_j I_0}{\sum_{r \in R} NZ_r + \sum_{t \in T} NS_t + \sum_{j \in J} NI_j I_0}$$

where:

r – payment date of the nearest fixed coupon for floating-rate instruments,

t – maturity date for fixed-rate instruments,

j – maturity date for inflation-linked instruments,

R – set of all payment dates of the nearest fixed coupons for floating-rate instruments,

T – set of all maturity dates for fixed-rate instruments,

J – set of all maturity dates for inflation-linked instruments,

NZ_r – face value of floating-rate instruments,

NS_t – face value of fixed-rate instruments,

NI_j – (non-indexed) face value of inflation-linked instruments,

I_0 – current indexation coefficient of inflation-linked instruments' face value.

*Average maturity (*also *ATM – average time to maturity)* – the measure of public debt refinancing risk. Average maturity is the average period, expressed in years, after which the issued debt will be redeemed. The further the deadlines for debt redemption, the lower the refinancing risk and the higher the average maturity. Average maturity of domestic marketable TS is calculated according to the following formula:

$$ATM = \frac{\sum_{t \in T} tN_t I_0}{\sum_{t \in T} N_t I_0}$$

where:

t – maturity date,

T – set of all maturity dates,

N_t – face value paid at *t*,

I_0 – current indexation coefficient of inflation-linked instruments' face value (for non-indexed Treasury securities $I_0 = 1$).

Benchmark

1. (*issuance*) TS issuance of large amount, with a liquid secondary market. Yields (prices) of benchmark bonds are a reference point for yields in a given maturity segment. In the *Strategy* it was assumed that all new issuances of fixed-rate bonds, except for two-year bonds (used for the medium-term liquidity management) should achieve a benchmark status. The minimum nominal value of the issuance ensuring the liquidity was set at an equivalent of EUR 5 billion on the domestic market and EUR 5 billion on the Euro market. On other markets the value of the benchmark depends on practices applied on a given market.

2. *(portfolio)* target characteristics of the public debt portfolio, which constitutes a *reference portfolio* for the existing portfolio and specifies the direction of public debt management. The characteristics of the reference portfolio may include the share of particular currencies, interest rates and types of instruments, as well as the values of synthetic indicators which most often constitute the risk measures, e.g. the average maturity or duration.

Credit risk – associated with the risk that the other party of the transaction will fail to meet its obligations in whole or in part. The risk occurs as a result of transactions in assets. For the entity managing the debt such a situation occurs when financial derivatives are used, swaps in particular. Credit risk also occurs in liquid assets management, e.g. through making deposits with the banks and purchase of securities.

Duration – the measure of vulnerability of debt servicing costs to changes of interest rates and thus the measure of interest rate risk related to public debt. *Duration* is interpreted as the average period of adjusting the debt servicing costs to the change of interest rate levels, expressed in years. The higher the level of interest rates and the larger the share of short-term and floating-rate instruments, the higher the interest rate risk and the lower *duration.Duration* of domestic marketable TS is calculated according to the following formula:

$$Duration = \frac{\sum_{s \in S} \frac{rCFZ_s}{(1+i_s)^s} + \sum_{s \in S} \frac{sCFS_s}{(1+i_s)^s}}{\sum_{s \in S} \frac{CFZ_s}{(1+i_s)^s} + \sum_{s \in S} \frac{CFS_s}{(1+i_s)^s}}$$

where:

r=r(s), (rεR) – payment date of the nearest fixed coupon for floating-rate instruments,

s – payment date (of interest or face value),

R – set of all payment dates of the nearest fixed coupons for floating-rate instruments,

S – set of all payment dates (of interest or face value),

CFZ_s - payment (of interest or face value) for floating-rate instruments,

CFS_s – payment (of interest or face value) for fixed-rate instruments,

i_s – zero-coupon interest rate for term *s*.

Exchange rate risk – stems from the existence in the State Treasury debt of instruments denominated and settled in foreign currencies. The exchange rate risk is expressed in the vulnerability of the debt level and debt servicing costs to exchange rate fluctuations, which is a consequence of the floating exchange regime applied in Poland. The Zloty appreciation or depreciation against a given foreign currency results in a proportional increase or decrease in the Zloty terms in debt denominated in this currency and debt servicing costs.

Financial derivatives – financial instruments the value of which depends on the value of other assets called basic instruments. They are used to change the risk profile of the parties concluding a transaction in financial derivatives, i.e. hedging against risk, change of one type of risk to another or an exchange of the cost into the risk (a trade off – a decrease in costs and an increase in risk). The examples of financial derivatives most often used in public debt management include swaps and options.

Interest rate risk - risk that payments due to the debt servicing costs will change as a consequence of a change in interest rates. It stems from the necessity to finance the debt maturing in future at unknown rates and from volatility of coupon payments of the floating-rate debt.

Operational risk – risk associated with the threat that the costs related to the debt management or the level of other types of risk will increase due to an inadequate to the scope of tasks infrastructure, organization and control of the debt management. Operational risk is the type of risk most difficult to measure.

Option – the right (but not the obligation) to purchase or sell a specified asset at an agreed price, which the issuer of the option is obliged to observe with respect to the holder of the option. The options may be themselves financial instruments or they may be built into other instruments, e.g. an option to present the State Treasury with savings bonds for early redemption.

Place of issue criterion – the criterion of the division of public debt into domestic and foreign debt, according to which the domestic debt is the debt issued on the domestic market.

Primary Dealers – a group of institutions selected through a competition that have specific rights and obligations related to the participation in the primary and secondary TS market. The dealers act as intermediaries between the issuer and other entities in TS trading and have the exclusive access to the primary market.

Private placement – an issuance addressed to a selected group of investors.

Reference portfolio – see *benchmark (portfolio).*

Refinancing risk – associated with debt issuance in order to finance the State borrowing needs resulting from the redemption of the existing debt. The risk applies to both the ability to redeem maturing debt and conditions on which it is refinanced (including in particular servicing costs generated by newly issued debt). The larger the payment related to the redemption of maturing debt and the closer the date of redemption, the larger the risk related to refinancing of this debt. The refinancing risk is influenced by the level of outstanding debt and its maturity structure. The extension of the debt maturity and the even distribution of debt redemption over time contribute to the reduction of refinancing risk.

Resident criterion - the criterion of the division of public debt into domestic or foreign debt, according to which the domestic debt is the debt owned by domestic investors (i.e. investors with the place of residence or registered seat in Poland).

Securitization –a financial operation of exchanging payments from owned assets (e.g. future receivables) to outlay from sale of securities. The purchaser of securities acquires the right to cash flows and related risk while the seller exchanges non-liquid assets into cash.

State budget liquidity risk – risk associated with the loss of the state budget's ability to meet the current obligations and to timely execute budget expenditure. In order to reduce this risk the State budget should have an access to the adequate amount of liquid financial assets, enabling the independence from temporary events of crises which prevent or make difficult the acquisition of funds on the financial market at rational cost.

Swap – exchange of streams of payments with specified in advance rules of calculating their value which takes place between the parties of the agreement. *Swap* is a financial instrument from the group of the so-called *financial derivatives. Swap* may be an independent financial instrument or it may accompany other instruments. For example, the exchange of swap payments often accompanies non-standard bond issuances in the private placement system, the structure of which is adjusted to the specific needs of their purchasers.

Annex 2. Legal regulations on public debt in Poland and within the EU

Table 1. Public debt – basic legal regulations

Polish regulations	EU regulations
1. Constitution of the Republic of Poland ➢ ban on contracting loans and granting guarantees and sureties resulting in the public debt exceeding 3/5 of gross domestic product (Article 216(5); 2. Act on Public Finances ➢ regulations on public debt: definitions, basic principles of issuing public debt and debt management, prudential and remedial procedures applied to public debt levels (50%, 55%, 60% of GDP). ➢ definition of the scope of public finance;	1. Treaty on European Union ➢ stock of general government debt and restrictions on general government deficit constitute the criterion on the basis of which the Commission examines the compliance with budgetary discipline in the Member States (Article 104); specifies the Excessive Deficit Procedure (EDP); 2. Protocol on the excessive deficit procedure annexed to the Treaty on European Union ➢ definition of general government debt and reference value of debt to GDP ratio (set at 60%); 3. Council Regulation on the application of the Protocol on the Excessive Deficit Procedure (EDP) annexed to the Treaty establishing the European Community ➢ definition of general government debt, specifying categories of liabilities which constitute it; 4. The European System of Accounts (ESA'95) ➢ definition of categories of financial liabilities, ➢ definition of general government;

Table 2. Limits of the Public finance Act on public debt to GDP ratio

Legal procedures regarding limits on public debt to GDP ratio[1] are as follows:

1) the ratio in year *x* is greater than 50%, and not greater than 55%:
   a. the state budget deficit to state budget revenue ratio in the draft budget act adopted by the Council of Ministers for the year x+2 cannot be higher than in the year x+1,
   b. the state budget deficit to state budget revenue ratio adopted for the year x+2 is the upper limit on the deficit to revenue ratio in the budget act of each local government unit for the year x+2;
2) the ratio in year *x* is greater than 55%, and lower than 60%:
   a. the level of state deficit in the adopted draft budget act for the year x+2 must ensure a decrease in the ratio of the State Treasury debt (till the end of 2005 the State Treasury debt increased by the risk-weighted payments under sureties and guarantees granted) to GDP as compared with the ratio announced for the year x,
   b. the upper limit on the deficit to revenue ratio of each local government unit for the year x+2 is calculated by multiplying the state budget deficit to revenue ratio adopted for the year x+2 by coefficient "R", calculated as:

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

      where: GDP (gross domestic product) and PD (public debt) are amounts announced for the previous budget year (year x);
   c. the Council of Ministers presents a remedial programme ensuring a fall in the ratio of public debt to GDP;
3) the ratio in year x is equal to or greater than 60%:
   a. both the state budget and budgets of local government units for the year x+2 must at least be balanced;
   b. a ban on granting new sureties and guarantees by public finance sector entities is introduced;
   c. the Council of Ministers presents to the Parliament a remedial programme with the main objective to prepare and implement actions aimed at reducing the public debt-to-GDP ratio below 60%.

1) Till the end of December 2005 on public debt increased by risk-weighted payments under sureties and guarantees granted by public finance sector entities; since the entrance into force of the Public Finance Act of June 2005 (January 2006) public debt will become the basic category of debt;

Table 3. Main differences in Polish and EU definitions of public debt

POLISH REGULATIONS public debt	UE REGULATIONS *general government debt*
1) scope of the sector [1]	
➢ Act on Public Finances determines a limited catalogue of entities included in the public finance sector;	➢ sector of general government is defined in ESA95[2]; no limited catalogue of entities has been defined;
differences in the scope of sector depending on regulations	
a) Open Pension Funds (OFE) ➢ are outside the public finance sector;	➢ till March 2007 a transition period applies during which Poland can classify OFE within the general government [3];
b) research and development units ➢ are within the public finance sector;	➢ are excluded from the sector of general government;
2) liabilities which constitute public debt	
➢ securities (excluding shares); ➢ loans and credits (including securities whose disposal is limited); ➢ deposits; ➢ matured payables (i.e. liabilities due but not settled);	➢ securities other than shares excluding financial derivatives; ➢ loans; ➢ cash and deposits;
differences in liabilities depending on regulations	
matured payables	- [4]
3) potential debt	
Differences in treatment of potential debt in debt-to-GDP ratio	
➢ till the end of 2005 limits of the Public Financ Act on debt to GDP ratio take into account potential debt generated by issued sureties and guaranties; ➢ since January 2006 legal limits (the Public Finance Act of 30 June 2005) on public debt-to-GDP ratio should apply just to public debt (i.e. without potential debt generated by issued sureties and guarantees);	➢ EU limits do not take directly into account potential debt generated by issued sureties and guarantees; ➢ when specific criteria are met (in line with ESA'95 rules) potential debt should be treated as debt assumed by the entity which issued surety or guarantee;

1) Some work has been carried out on including some of the funds managed by Bank Gospodarstwa Krajowego within the general government sector. Polish Central Statistical Office holds the responsibility for the scope of general government sector (in line with EU regulations).
2) Council Regulation No 2223/1995 on the European System of National and Regional Accounts in the Community. ESA'95 criteria apply first of all to activities of an entity and their financing. Basic activity of a unit (i.e. redistribution of national income and wealth or being a non-market producer) is taken into account. In other cases 'the 50% rule' should apply (i.e. less than 50% of production costs is covered by sales);
3) Eurostat decision on classification of funded pension schemes in case of government responsibility or guarantee (Eurostat News Releases No 30/2004from 2 March 2004 and No 117/2004 from 23 September 2004).
4) Matured payables are expenditure on accrual basis and thus are included in the deficit calculated in accordance with EU methodology.

Table 4. Differences in Polish and EU definitions of public debt in the years 2002-2004

%PKB

Specification	2002	2003	2004
Public debt increased by risk-weighted payments under sureties and guarantees	**46,7%**	**51,5%**	**50,2%**
differences in the scope of sector, including:	*-2,7%*	*-3,5%*	*-4,2%*
debt of Agricultural Market Agency (*excluding matured payables*)	-0,2%	-0,1%	*change in classification* [1]
Open pensions fund investments in general government securities	-2,5%	-3,3%	-4,2%
debt of research and development units (excluding matured payables)	-0,0%	-0,0%	-0,0%
differences in liabilities			
matured payables	-1,3%	-1,3%	-1,0%
differences in treatment of potential debt			
risk-weighted payments under sureties and guarantees issued	-1,6%	-1,4%	-1,3%
Debt assumption	+0,0%	+0,0%	+0,0%
General government* debt *(EDP)	**41,2%**	**45,4%**	**43,6%**

1) Since May 2004 due to changes in activities of Agricultural Market Agency the unit has been included in the sector of general government (earlier it was classified outside the sector);

Annex 3. Institutional framework for public debt management in the EU Member States

There is no unified institutional model of State Treasury debt management in the EU Member States. An analysis of applied solutions enables to identify three basic types of organizational arrangements:

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

The bank model is the most strongly criticized one. This criticism is the result of a potential conflict of interest that may occur between monetary policy and public debt management. The central bank in such a situation may:

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

In both cases, the execution of tasks imposed on the central bank is not optimal. In addition, even if monetary policy and debt management are entrusted to different divisions and the so-called "Chinese Wall" is used, suspicions can arise that some information on interest rate levels unknown to the market may be used in debt management, thus reducing trust in the issuer and resulting in investors requesting an additional risk premium for Treasury securities.

An argument used by supporters of the solution of placing debt management within the central bank is their conviction that the central bank is better prepared for performing activities on the financial market than units remaining within the structure of a ministry.

The government model is used successfully, though not exclusively in conditions typical for developing economies or economies undergoing transformations where development of the domestic financial market is low[4]. This is due to the significant ability of the government to influence the creation of appropriate legal and institutional infrastructure, necessary for the efficient functioning of the financial market. However, the disadvantages of this solution become increasingly visible in developed and stable economies:

- the threat associated with placing short-term budget goals before long-term objectives of debt management, which may lead to an increase in both the risk associated with debt structure as well as the long-term debt servicing costs,
- lack of sufficient flexibility as well as ability to react quickly enough to changes of market conditions (which is especially important if financial derivatives are used for debt management) arising from the significant bureaucracy of administrative entities,
- difficulties in recruiting and retaining appropriately trained specialists due to uncompetitive employment conditions for state administration employees as compared to those offered by financial sector companies (banks, investment funds, etc.).

The agency model dominates in the EU Member States. The term "agency" is a certain type of generalization (it does not mean a government agency as defined by Polish law) as specialized institutions involved in debt management in given countries are significantly

[4] The government model is used in such countries as Spain or Italy.

different, both in respect to the scope of tasks entrusted to them as well as the level of their institutional independence. Their common feature though is their high level of autonomy in selecting methods used to fulfil the entrusted tasks. The advantages associated with entrusting specialized institutions with debt management include:

- the ability to select optimal solutions as well as to carry out long-term debt management objectives by limiting the impact of short-term fiscal policy goals on management decisions,
- ensuring greater transparency of management operations through the use of better control and reporting mechanisms, thus increasing investor confidence and lowering costs of financing of borrowing needs,
- the need to prepare clear and coherent procedures enabling prompt decision taking on market transactions (a necessary condition for efficient and active debt management),
- the ability to face competition from commercial financial institutions (recruitment and retention of highly qualified specialists).

Entrusting debt management to a specialized institution does not mean that the government (Minister of Finance) loses control over this area of activities. The assignment of the agency is just to professionally carry out guidelines specified by the Minister of Finance and its activities should be audited in order to ensure the compliance with these guidelines. Therefore, in the case of the agency model, preparation of the appropriate legislative and organizational solutions is very important in order to ensure good cooperation between the Minister of Finance who specifies the objectives and the agency that carries them out.

At present in 14 out of 25 Member States of the enlarged EU the agency model is applied (in 11 out of 15 Member States before the enlargement).

Table 5. Institutions responsible for debt management the EU Member States

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

Table 6. Agencies responsible for public debt management in the EU Member Sates

Country	Name of the Agency	Date of establishment	Supervisory body	Organizational structure	Scope of activity
Austria	Österreichische Bundesfinanzierungsagentur	December 4, 1992		The Agency has a State Treasury company status. It is managed by a two-person Board responsible for liquidity and risk management.	- federal debt management - liquidity management - assets and liabilities management - granting loans to provinces - issuing opinions on investment projects of public entities (upon a request of the Ministry of Finance) - carrying out additional tasks stated in the Budget Act
Belgium	Agence de la Dette (Agentschap van de Schuld)	October 1998	Ministry of Finance	The management function is performed by the Executive Committee, which consists of: the Director General of the Treasury and Directors of the Agency. The advisory function is performed by the Strategic Committee.	*Belgian Debt Agency:* - federal debt operational management - implements guidelines on the portfolio structure and risk specified by the Ministry of Finance and proposed by the Strategic Committee *Public Debt Service:* - management of guarantees - cooperation with other public issuers - accounting functions
Finland	Valtiokonttori		Ministry of Finance	The Finance Division responsible for debt management is headed by the Director that is subordinate to the Director General of the State Treasury and the Management Board of the State Treasury.	Finance Division of the State Treasury: - debt management - liquidity management - management of guarantees - state loans - administration of inheritances
France	Agence France Trésor	February 8, 2001	Minister of Economy, Finance and Industry	The Agency is headed by the President appointed by the Minister of Economy, Finance and Industry at the request of the Director of Treasury Division. The body which supports activities of the Agency is the Strategic Committee which advises on main guidelines of the government issuance policy.	- debt management - liquidity management

The Netherlands	Agentschap van het ministerie van Financiën	May 1, 1841	Minister of Finance	The Agency is headed by the President who reports directly to the Minister of Finance. The President of the Agency represents the Ministry of Finance on the financial market, prepares and defines the financing policy and provides the Minister and the management of the Ministry with necessary information and analyses.	- operational debt management - liquidity management
Ireland	National Treasury Management Agency	1990	Minister of Finance	The Agency has a status of a legal person. The President of the Agency is appointed by the Minister of Finance and is directly accountable to him. Within the Agency there is the Advisory Committee appointed by the Minister of Finance. The Agency employees are not civil servants.	- debt management - liquidity management Additional tasks entrusted to the Agency include the management of assets and liabilities of local government units, consulting services, financial servicing of investments of public entities. The government may by a regulation entrust the Agency with other functions belonging to the Minister of Finance.
Latvia	Valsts Kase		Minister of Finance	The Treasurer is appointed and dismissed by the Minister of Finance. The Treasury is obliged to present an annual report on its activities.	- debt management - liquidity management - management of guarantees - organization of the execution of the budget - management of the assets of the state pension scheme
Germany	Finanzagentur GmbH	October 19, 2000	Minister of Finance	The Agency has a State Treasury company status. It is managed by two directors responsible for: - strategy and trading/issuance policy, - finance and risk control and corporate services	- debt management - liquidity management - management of special assets on the financial market
Portugal	Instituto de Gestão do Crédito Público	December 1996	Minister of Finance	The three-person Board of the Agency is appointed by the Council of Ministers for three years. The advisory function is performed by the Advisory Board consisting of the Agency's CEO, the member of the Board of Directors of the Central Bank and experts appointed by the Council of Ministers. The employees are not subject to the civil servants regime.	- management of the central government debt, financing of the budget borrowing needs - advisory functions and technical assistance with respect to debt management for the sector units

Slovakia	Štátna pokladnica	2002/2004	Minister of Finance	The Agency is managed by the Director who is appointed and dismissed by the Minister of Finance.	- debt management - liquidity management (on the operational level)
Sweden	Riksgäldskontoret	1789	Minister of Finance	The Board of the agency, including its Director, is appointed by the government: 4 out of 8 members of the Board represent the Parliament.	- debt management - liquidity management - granting guarantees - an internal bank (provides loans) for state agencies and public enterprises
Hungary	Magyar Állampapír	March 1, 2001	Minister of Finance	The Agency has a State Treasury company status. It is managed by the Board which reports directly to the Minister of Finance.	- debt management - management of the liquidity of the State Treasury account - it may perform the tasks related to issuing and managing the debt guaranteed by the State
The United Kingdom	Debt Management Office	June 1, 1998 (separated from the central bank)	Chancellor of the Exchequer, the Parliament	The Agency is managed by the Executive Committee headed by the Agency's Chief Executive. The Agency's Chief Executive is appointed through a competition. The employees are civil servants.	- debt management - liquidity management - managing the assets on debt management account - advisory functions: advising and preparing expert analyses for other departments and other governments.

Annex 4. General government deficit and debt and yields on 10-year bonds in the EU Member States

	2003			2004		
	General government net borrowing/net lending %GDP	General government debt %GDP	10-year rate[1]	General government net borrowing/net lending %GDP	General government debt %GDP	10-year rate[1]
Greece	-5.2	109.3	4.45	-6.1	110.5	3.77
Italy	-2.9	108.0	4.46	-3.0	105.8	3.79
Belgium	+0.4	100.0	4.38	+0.1	95.6	3.66
Germany	-3.8	64.2	4.29	-3.7	66.0	3.58
France	-4.2	63.9	4.34	-3.7	65.6	3.64
Austria	-1.1	65.4	4.40	-1.3	65.2	3.66
Portugal	-2.9	60.1	4.40	-2.9	61.9	3.64
The Netherlands	-3.2	54.3	4.33	-2.5	55.7	3.63
Sweden	+0.2	52.0	4.86	+1.4	51.2	3.90
Spain	+0.3	51.4	4.34	-0.3	48.9	3.64
Finland	+2.5	45.3	4.33	+2.1	45.1	3.68
Denmark	+1.2	44.7	4.52	+2.8	42.7	3.86
The United Kingdom	-3.4	39.7	4.94	-3.2	41.6	4.58
Irland	+0.2	32.0	4.36	+1.3	29.9	3.62
Luxembourg	+0.5	7.1	3.29	-1.1	7.5	3.64
EU 15	**-2.8**	**64.3**		**-2.6**	**64.7**	
The EU Member States since May 1, 2004						
Malta	-10.5	71.8	4.71	-5.2	75.0	4.70
Cyprus	-6.3	69.8	4.75	-4.2	71.9	6.26
Hungary	-6.2	56.9	8.24	-4.5	57.6	7.17
Poland	-4.5	45.4	6.76	-4.8	43.6	6.00
Slovakia	-3.7	42.6	5.42	-3.3	43.6	4.58
The Czech Republic	-11.7	38.3	4.82	-3.0	37.4	4.05
Slovenia	-2.0	29.4	5.27	-7.9	29.4	4.07
Lithuania	-1.9	21.4	4.81	-2.5	19.7	3.95
Latvia	-1.5	14.4	5.07	-0.8	14.4	4.58
Estonia	+3.1	5.3	4.75	+1.8	4.9	4.28
EU 25	**-2.9**	**63.3**		**-2.6**	**63.8**	

[1] Harmonized long-term interest rates for convergence purposes, i.e. rates on the secondary market (with the exception of Cyprus and Latvia – primary market) for T-bonds with maturity close to 10 years; T-bonds of a similar nature do not exist in the case of Luxembourg and Estonia; data for Luxembourg for 2003: T-bonds with actual maturity close to 3 years, for 2004: basket of long-term bonds issued by private credit institutions with an average actual maturity close to 10 years; for Estonia: an interest rate on loans for non-financial companies and households with maturity over 5 years; December average; Statistics Pocket Book, ECB.

[2] Eurostat, News Release 39/2005 of March 18, 2005; data based on the March 2005 notifications on general government deficit and debt sent to the Commission by the Member States; Due to ongoing discussions with the national statistical authorities data for Italy and Greece was not validated by Eurostat at the moment of publishing; Eurostat noted that ongoing discussions might lead to substantial revisions of data for Portugal, Latvia and Lithuania.

Annex 5. Long-term foreign currency government debt rating in the EU Member States

As on August 29, 2005

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

Annex 6. Debt of the public finance sector in Poland before and after consolidation within the sector

Table 7. Debt of the public finance sector before consolidation

Specification	Dec 2003	structure	Dec 2004	structure	June 2005	structure	Change Dec'04-Dec'03		Change June'05-Dec'04	
	PLN billion	*%*	*PLN billion*	*%*	*PLN billion*	*%*	*PLN billion*	*%*	*PLN billion*	*%*
Debt of the public finance sector before consolidation	**415,900.3**	**100.0%**	**440,538.7**	**100.0%**	**473,688.6**	**100.0%**	**24,638.5**	**5.9%**	**33,149.9**	**7.5%**
I. Central government	**394,100.8**	**94.8%**	**416,060.8**	**94.4%**	**450,085.8**	**95.0%**	**21,960.0**	**5.6%**	**34,025.0**	**8.2%**
1. Debt of the State Treasury	378,943.8	91.1%	402,860.3	91.4%	437,499.2	92.4%	23,916.4	6.3%	34,638.9	8.6%
2. Other central government entities	15,157.0	3.6%	13,200.5	3.0%	12,586.6	2.7%	-1,956.4	-12.9%	-613.9	-4.7%
2.1. Social Insurance Institution (ZUS) and funds managed by ZUS	11,225.4	2.7%	10,061.3	2.3%	9,729.6	2.1%	-1,164.1	-10.4%	-331.7	-3.3%
2.2. National Health Fund	1,047.1	0.3%	758.4	0.2%	577.2	0.1%	-288.6	-27.6%	-181.3	-23.9%
2.3. State earmarked funds with legal personality (excl. ZUS)	95.4	0.0%	0.7	0.0%	0.0	0.0%	-94.7	-99.3%	-0.7	-100.0%
2.4. State higher schools	192.9	0.0%	214.2	0.0%	165.9	0.0%	21.4	11.1%	-48.4	-22.6%
2.5. Research and development units	293.5	0.1%	258.0	0.1%	276.2	0.1%	-35.5	-12.1%	18.2	7.0%
2.6. Independent public health care units	721.1	0.2%	938.4	0.2%	993.2	0.2%	217.3	30.1%	54.8	5.8%
2.7. State cultural units	7.1	0.0%	38.2	0.0%	49.3	0.0%	31.1	434.5%	11.1	29.1%
2.8. Polish Academy of Science (PAN) and units established by it	19.0	0.0%	18.8	0.0%	7.3	0.0%	-0.3	-1.5%	-11.5	-61.3%
2.9. Other State legal entities established under separate acts for public tasks execution, with the exception of enterprises, banks and companies organized under commercial law	1,555.5	0.4%	912.5	0.2%	788.1	0.2%	-643.0	-41.3%	-124.4	-13.6%
II. Local government entities	**21,799.4**	**5.2%**	**24,477.9**	**5.6%**	**23,602.8**	**5.0%**	**2,678.5**	**12.3%**	**-875.1**	**-3.6%**
1. Local government units	17,276.8	4.2%	19,104.7	4.3%	17,841.0	3.8%	1,827.9	10.6%	-1,263.8	-6.6%
2. Other local government entities	4,522.6	1.1%	5,373.2	1.2%	5,761.8	1.2%	850.6	18.8%	388.7	7.2%
2.1. Local government earmarked funds with legal personality	38.5	0.0%	76.1	0.0%	69.5	0.0%	37.6	97.5%	-6.6	-8.7%
2.2. Independent public health care units	4,411.8	1.1%	5,230.5	1.2%	5,624.4	1.2%	818.7	18.6%	393.8	7.5%
2.3. Local cultural units	45.3	0.0%	28.7	0.0%	31.4	0.0%	-16.7	-36.8%	2.7	9.5%
2.4. Other local legal entities established under separate acts for public tasks execution, with the exception of enterprises, banks and companies organized under commercial law	26.9	0.0%	37.9	0.0%	36.6	0.0%	11.0	40.8%	-1.3	-3.4%

Table 8. Debt of the public finance sector after consolidation (public debt)

Specification	Dec 2003	structure	Dec 2004	structure	June 2005	structure	Change Dec'04-Dec'03		Change June'05-Dec'04	
	PLN billion	*%*	*PLN billion*	*%*	*PLN billion*	*%*	*PLN billion*	*%*	*PLN billion*	*%*
Public debt	**408,631.3**	**100.0%**	**432,282.1**	**100.0%**	**465,497.1**	**100.0%**	**23,650.8**	**5.8%**	**33,215.0**	**7.7%**
I. Central government	**392,083.1**	**96.0%**	**413,887.0**	**95.7%**	**447,874.6**	**96.2%**	**21,803.9**	**5.6%**	**33,987.6**	**8.2%**
1. Debt of the State Treasury	378,505.2	92.6%	402,233.0	93.0%	436,676.3	93.8%	*23,727.7*	*6.3%*	34,443.3	8.6%
2. Other central government entities	13,577.9	3.3%	11,654.0	2.7%	11,198.3	2.4%	-1,923.8	-14.2%	-455.7	-3.9%
2.1. Social Insurance Institution (ZUS) and funds managed by ZUS	11,225.4	2.7%	10,061.3	2.3%	9,729.6	2.1%	-1,164.1	-10.4%	-331.7	-3.3%
2.2. National Health Fund	152.2	0.0%	5.6	0.0%	0.0	0.0%	-146.6	-96.3%	-5.6	-100.0%
2.3. State earmarked funds with legal personality (excl. ZUS)	95.4	0.0%	0.7	0.0%	0.0	0.0%	-94.7	-99.3%	-0.7	-100.0%
2.4. State higher schools	169.4	0.0%	161.8	0.0%	135.2	0.0%	-7.6	-4.5%	-26.6	-16.4%
2.5. Research and development units	182.1	0.0%	144.7	0.0%	151.1	0.0%	-37.4	-20.6%	6.4	4.4%
2.6. Independent public health care units	496.5	0.1%	633.1	0.1%	652.0	0.1%	136.6	27.5%	18.8	3.0%
2.7. State cultural units	2.8	0.0%	33.9	0.0%	49.0	0.0%	31.0	1091.9 %	15.1	44.6%
2.8. Polish Academy of Science (PAN) and units established by it	8.3	0.0%	12.3	0.0%	2.8	0.0%	3.9	47.3%	-9.5	-77.2%
2.9. Other State legal entities established under separate acts for public tasks execution, with the exception of enterprises, banks and companies organized under commercial law	1,245.8	0.3%	600.8	0.1%	478.7	0.1%	-645.0	-51.8%	-122.0	-20.3%
II. Local government entities	**16,548.2**	**4.0%**	**18,395.1**	**4.3%**	**17,622.4**	**3.8%**	**1,846.9**	**11.2%**	**-772.7**	**-4.2%**
1. Local government units	13,797.9	3.4%	15,359.3	3.6%	14,409.9	3.1%	1,561.4	11.3%	-949.4	-6.2%
2. Other local government entities	2,750.3	0.7%	3,035.7	0.7%	3,212.5	0.7%	285.5	10.4%	176.8	5.8%
2.1. Local government earmarked funds with legal personality	0.0	0.0%	3.3	0.0%	6.9	0.0%	3.2	6,472.4 %	3.7	112.5%
2.2. Independent public health care units	2,704.3	0.7%	2,980.5	0.7%	3,151.7	0.7%	276.2	10.2%	171.1	5.7%
2.3. Local cultural units	20.2	0.0%	15.3	0.0%	18.4	0.0%	-4.9	-24.4%	3.1	20.3%
2.4. Other local legal entities established under separate acts for public tasks execution, with the exception of enterprises, banks and companies organized under commercial law	25.7	0.0%	36.7	0.0%	35.6	0.0%	11.0	42.8%	-1.1	-3.0%