

THE PUBLIC FINANCE SECTOR DEBT MANAGEMENT STRATEGY in the years 2018-2021

Ministry of Finance

Warsaw, September 2017

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I. INTRODUCTION

Pursuant to Article 75 of the Public Finance Act of 27 August 2009, the Minister of Development and Finance is obliged to develop annually a 4-year strategy on managing the State Treasury (ST) debt and influencing the public debt. This document is presented by the Minister of Development and Finance to the Council of Ministers for approval, and then it is submitted by the Council of Ministers to the Sejm, together with the justification to the draft Budget Act.

Public debt management is conducted at two levels:

- in a broader sense, debt management is a part of the fiscal policy and covers decisions on what portion of State budget expenditures is to be financed through debt, accordingly, what should be the level of public debt (this aspect is discussed in documents updated on an annual basis, dedicated to the government economic programme, especially in the justification to the draft Budget Act and the Convergence Programme Update);
- in a narrower sense, debt management means determining the way of financing the State budget borrowing requirements and designing the debt structure by selecting markets, instruments and dates of issuance.

The macroeconomic and fiscal assumptions adopted in the *Strategy* are compliant with the assumptions of the draft Budget Act for 2018.

Table 1. Public debt and debt servicing costs – the Strategy’s key forecasts

Item	2016	2017	2018	2019	2020	2021
	(execution)					
1. Public debt						
a) in relation to GDP	52.1%	51.7%	51.7%	51.3%	49.1%	46.2%
2. The amount specified in the article 38a (3) of the Public Finance Act*						
a) in relation to GDP	49.6%	50.4%	50.6%	50.0%	47.8%	44.8%
3. General government debt						
a) in relation to GDP	54.4%	53.8%	54.2%	54.0%	51.8%	48.9%
4. State Treasury debt servicing costs**						
a) PLN bn	32.1	30.4	30.7	32.0 - 32.8	33.4 - 34.1	35.5 - 36.3
b) in relation to GDP	1.73%	1.57%	1.49%	1.47% - 1.50%	1.44% - 1.47%	1.44% - 1.47%

*) The amount of public debt recalculated using the yearly average of foreign currency exchange rates for the year concerned and reduced by the value of State budget liquid funds raised to finance the borrowing requirements for the following budget year.

***)Forecasts of the debt servicing costs for the years 2019-2021 account for the exchange rate risk provisions.

Under the adopted assumptions, in 2017 the public debt-to-GDP ratio shall decrease to 51.7% and stabilize at that level in 2018; in the subsequent years, it will gradually fall to 46.2% in 2021. The ratio of the amount specified in Article 38a (3) of the Public Finance Act to GDP shall reach the level of 50.4% in 2017 and 50.6% in 2018, to decrease gradually to 44.8% in 2021.

The general government debt-to-GDP ratio will amount to 53.8% in 2017 and 54.2% in 2018, to be followed by its subsequent decrease to reach the level of 48.9% in the timeframe of the Strategy.

In nominal terms, the limit of ST debt servicing costs set in the draft Budget Act for 2018 will be close to the limit for 2017 (PLN 30.7bn against PLN 30.4bn). In relation to GDP, debt servicing costs will decrease from 1.57% in 2017 to 1.49% in 2018. It is assumed that in the timeframe of the Strategy, the debt servicing cost-to-GDP ratio will decrease to the level of 1.44% - 1.47%.

This *Strategy* is a continuation of the strategy developed last year. The objective of minimization of the long-term debt servicing costs subject to the adopted risk constraints remained unchanged. The tasks aimed at implementation of the *Strategy's* objective, associated with the development of the financial market have been maintained, i.e. ensuring liquidity, efficiency and transparency of the Treasury Securities (TS) market. Moreover, measures aimed at effective management of the State budget liquidity have been distinguished as an independent task.

The following has been assumed for the accomplishment of the *Strategy's* objective for 2018-2021:

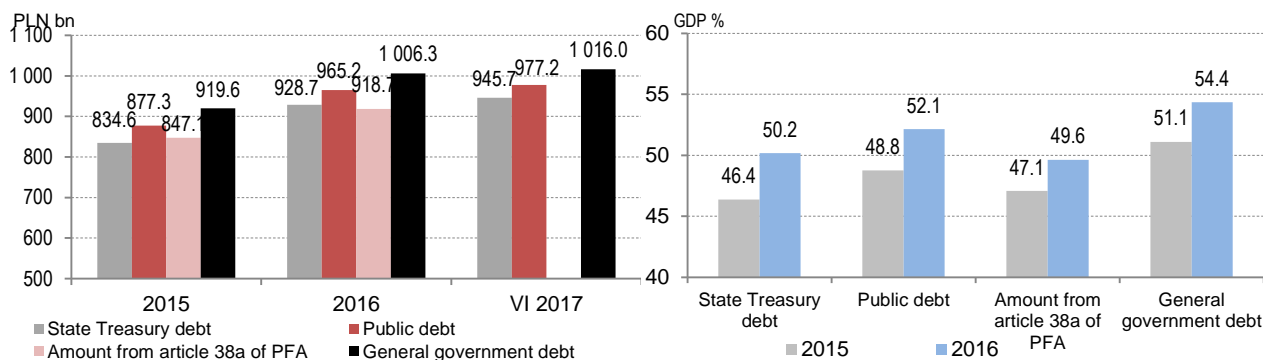
- the flexible approach towards shaping the financing structure in terms of selecting the market, currency and instruments shall be maintained, to the extent that cost minimization is achieved, subject to the assumed risk level limitations and avoiding distortions of monetary policy;
- the domestic market shall remain the main source of financing the State budget borrowing requirements;
- the share of foreign currency debt in the ST debt will be decreased to the level below 30%;
- building large and liquid fixed rate issues, both in the domestic, as well as the euro market, shall be a priority of the issuance policy;
- the average maturity of domestic ST debt shall be maintained at a level of around 4.5 years, subject to market conditions;
- the average maturity of ST debt shall be maintained at a level close to five years.

The *Strategy* comprises four annexes, including the glossary of terms.

II. VOLUME OF PUBLIC DEBT AND COSTS OF ITS SERVICING

At the end of 2016, public debt (domestic definition) reached the level of GDP 52.1% (as compared to GDP 48.8% at the end of 2015), whereas the ratio of the amount arising from Article 38a (3) of the Public Finance Act (public debt recalculated using average exchange rates and reduced by the value of State budget liquid funds raised to finance borrowing requirements for the following budget year) reached 49.6% of GDP (as compared to 47.1% of GDP in 2015). The general government (EU definition) debt-to-GDP ratio amounted to 54.4% (as compared to 51.1% at the end of 2015) and was much lower than the ratio for the whole European Union (83.5%) and the euro area (89.2%)¹.

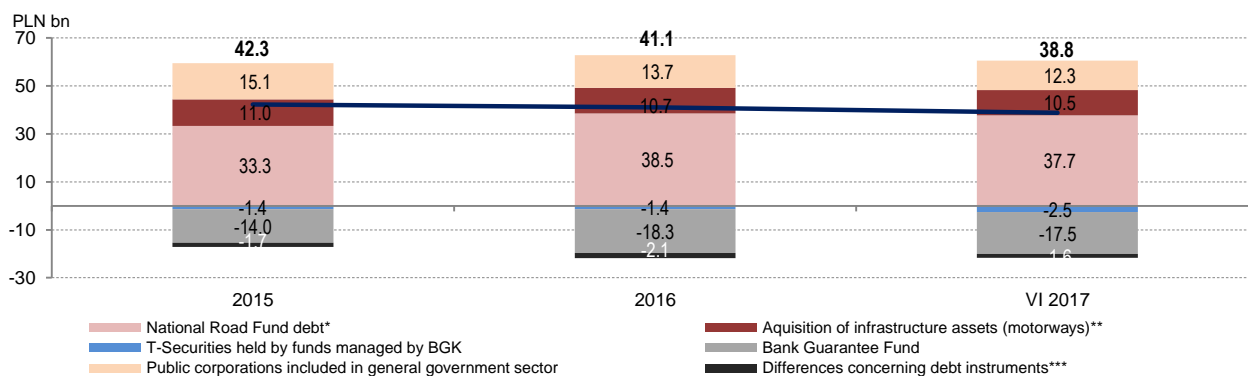
Chart 1. Volume of public debt in years 2015-2017



The differences between public debt and the general government debt arise from the following factors:

- other scope of public finance sector, including, inter alia, recognizing in the sector, according to the EU definition, of the National Road Fund – KFD (whose indebtedness increases the debt of the sector) and the Bank Guarantee Fund – BFG (TS held by it reduce the debt of the sector),
- differences related to liabilities, mainly matured payables, which are treated as public debt according to the domestic definition and are not included therein according to the EU definition.

Chart 2. Differences between general government debt (gg) and public debt



*) Debt consolidated within gg sector, i.e.: decreased by the nominal value of T-bonds held by Demographic Reserve Fund (FRD).

**) In compliance with Eurostat guidelines on sector classification, general government debt figures include capital expenditures of certain infrastructure projects.

***) Matured payables, debt assumption – activation of guarantee, CIRS transactions, restructured/refinanced trade credits, sale-lease-back operations.

¹ The specification of the deficit and debt for EU Member States is included in Annex 4.

The detailed description of differences related to public debt according to the Polish and EU definition is included in Annex 3.

Changes in the level of public debt in 2016 and in the first half of 2017 resulted mainly from changes in the ST debt, constituting approx. 93% of public debt and approx. 87% of the general government debt. The change in the level of the ST debt in 2016 resulted mainly from financing of the State budget borrowing requirements and the weakening of Polish zloty. In the first half of 2017, the increase in debt was mainly a result of negative borrowing requirements, strengthening of Polish zloty and gathering funds for financing borrowing requirements. In accordance with the draft Budget Act for 2018, the full-year net borrowing requirements in 2017 will be lower by PLN 23.5bn than assumed in the Budget Act for 2017. As of the end of August 2017, the level of financing gross borrowing requirements for 2017 amounted to 72% of the needs assumed in the Budget Act (i.e. 85% of the current forecast). Favourable liquidity situation of the budget and a high level of financing of the borrowing requirements enable to limit the supply of TS in the second half of the year.

Table 2. Factors affecting change in ST debt in 2016 r. and the first half of 2017 (PLN bn)

Item	2016	I-VI 2017
Change in ST debt	94,1	17,0
1. State budget borrowing requirements::	57,1	-13,1
1.1. State budget deficit	46,2	-5,9
1.2. EU funds budget deficit	12,6	0,0
1.3. Pension reform costs ¹⁾	3,2	1,7
1.4. Proceeds from privatization	0,0	0,0
1.5. Balance of deposits from public finance sector entities and court deposits	-3,1	-2,8
1.6. European funds management	-3,0	-5,8
1.7. Granted loans balance	1,4	-0,1
1.8. Other borrowing requirements ²⁾	-0,2	-0,3
2. Changes not resulting from State budget borrowing requirements::	35,3	28,5
2.1. FX rates movements	14,9	-18,8
2.2. Changes in budget accounts balance	14,7	44,0
2.3. Other factors ³⁾	5,7	3,3
3. Change in other State Treasury debt:	1,7	1,7
3.1. Deposits from public finance sector entities ⁴⁾	1,8	1,4
3.2. Court deposits ⁵⁾	0,0	0,2
3.3. Other ST debt	0,0	0,1

1) Funds transferred to Social Security Fund (FUS) as compensation for contributions transferred to open pension funds (OFE).

2) Changes in pre-financing balance (of tasks co-financed with EU funds), capital payments to international financial institutions, other domestic and foreign settlements.

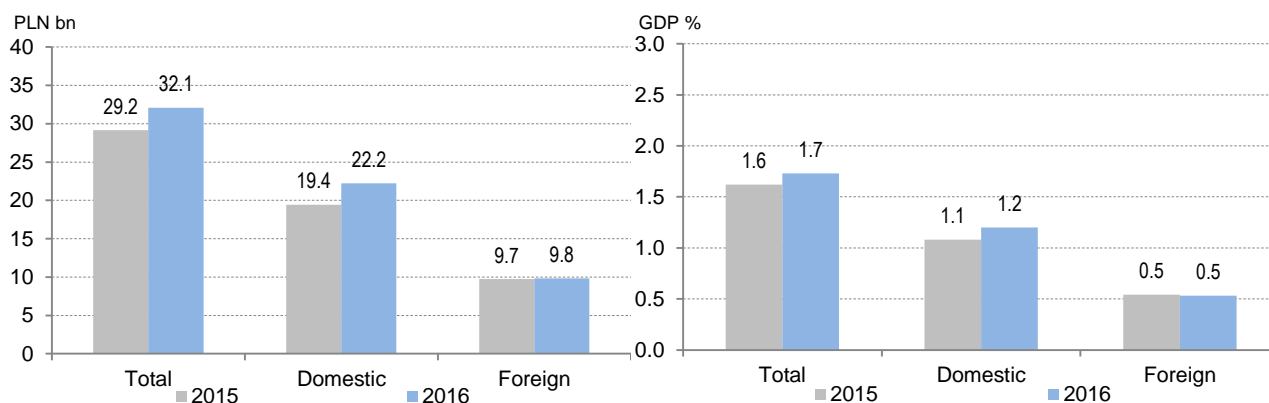
3) TS discount, TS indexation, sell-buy-back transactions.

4) Deposits from public finance sector entities with legal personality – their value does not increase public debt.

5) Court deposits from public finance sector entities with legal personality and entities outside public finance sector.

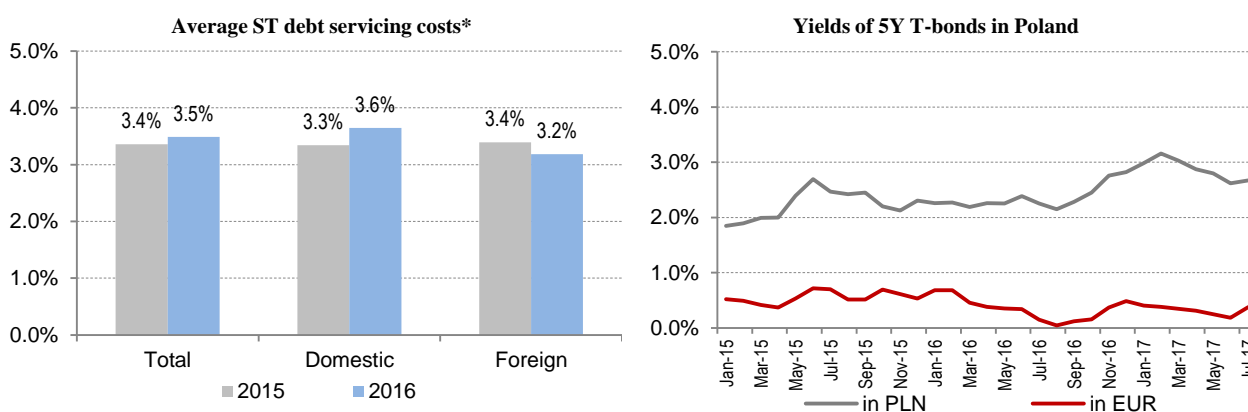
In 2016 ST debt servicing costs in nominal terms grew from PLN 29.2bn in 2015 to PLN 32.1bn, mainly as a result of operations associated with the distribution of debt servicing costs between years. The debt servicing cost-to-GDP ratio has remained at a stable level over the recent years (1.7% at the end of 2016 and 1.6% at the end of 2015). Debt servicing costs for foreign debt were lower than for domestic debt, which resulted mainly from smaller share of foreign debt in total ST debt.

Chart 3. ST debt servicing costs in years 2015-2016



The average debt servicing costs in 2016 increased slightly, from 3.4% in 2015 to 3.5%, which reflected the growth of interest rates in financial markets. The level is still higher than the current cost of market financing, which results from servicing of debt incurred in the past at higher yields.

Chart 4. Market interest rates and average ST debt servicing costs

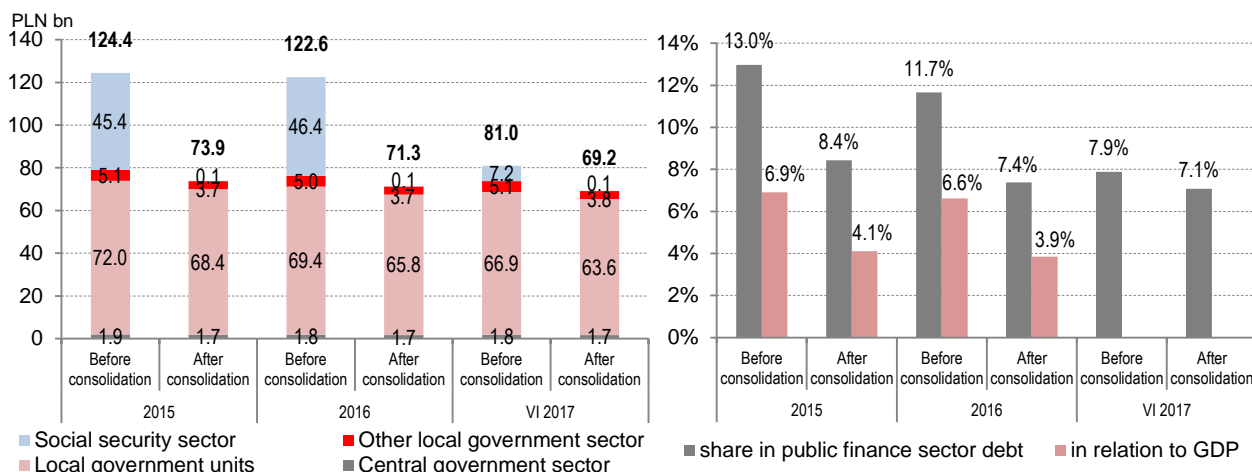


*) Average ST debt servicing costs were calculated as a ratio of the difference between debt servicing costs and revenues in a particular year to the average debt volume in this year.

At the end of 2016, debt of entities other than ST constituted 11.7% of public debt prior to consolidation (7.4% after consolidation), compared to 13.0% prior to consolidation (8.4% after the consolidation) at the end of 2015. After the first half of 2017, these values reached the levels of 7.9% and 7.1%, respectively.

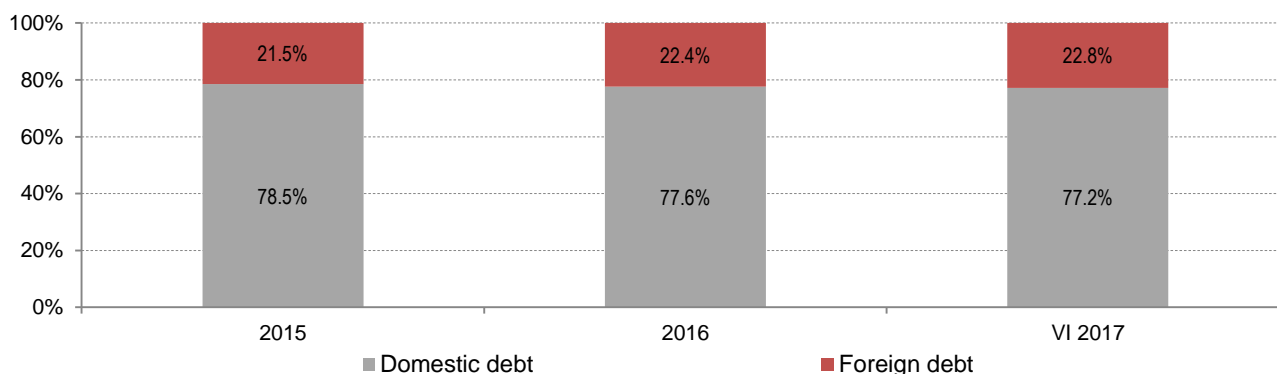
The local government sector debt, in particular that of local government units (LGUs), had the highest share in this part of the debt. Social insurance fund (FUS) liabilities constituted almost entire debt of social security sector. The difference between the level of social security sector unconsolidated and consolidated debt resulted from the past financing of a part of FUS deficit with loans from the State budget (cancellation in the first quarter of 2017 of a part of State budget loans granted to FUS reduced this difference, however, it has not affected the level of public debt).

Chart 5. Volume and structure of debt of public finance sector entities other than the ST in years 2015-2017



Over the recent years, debt of LGUs and their associations decreased. At the end of 2016, debt of this group of entities (before consolidation) amounted to PLN 69.4bn compared to PLN 72.0bn at the end of 2015. Following the first half of 2017 LGUs debt reached the level of PLN 66.9 bn.

Chart 6. Structure of debt of local government units



The structure of liabilities of LGUs and their associations is dominated by domestic debt (77.6% at the end of 2016 and 77.2% after the first half of 2017). Loans and credits prevailed in the debt of LGUs and their associations (93.7% at the end of 2016 and 93.3% after the first half of 2017).

III. EVALUATION OF IMPLEMENTATION OF THE STRATEGY'S OBJECTIVE IN 2016 AND IN THE FIRST HALF OF 2017

In 2016 and in the first half of 2017, debt management was conducted in accordance with *The Public Finance Sector Debt Management Strategy in the years 2016-2019*, adopted by the Council of Ministers in December 2015 and *The Public Finance Sector Debt Management Strategy in the years 2017-2020* adopted in September 2016.

Both documents defined the same debt management objective, i.e. long-term minimization of debt servicing costs, with the adopted constraints related to the level of risk. Risk minimization was understood in terms of two aspects: selection of instruments and ensuring effectiveness of the TS market.

III.1. Minimization of debt servicing costs – selection of instruments

In accordance with the assumptions of the Strategy, the domestic market remained the main source of financing borrowing requirements. In 2016, on the domestic market were issued TS with the face value of PLN 156.1bn, including PLN 6.5bn of T-bills used for management the State budget liquidity through a year. On the other hand, funds with the face value of PLN 33.3bn were raised on foreign markets, including PLN 4.4bn of loans from international financial institutions. In the first half of 2017, funds at a level of PLN 77.3bn were raised on the domestic market (including T-bills) and PLN 6.5bn – on foreign markets (almost exclusively, from the issue of bonds).

Table 3. Sale of Treasury securities on domestic and foreign markets and loans from IFIs

Instrument	2015		2016		January - June 2017	
	PLN bn	%	PLN bn	%	PLN bn	%
Domestic TS	110.3	80.0	156.1	82.4	77.3	92.3
Foreign TS	18.0	13.1	28.9	15.3	6.4	7.6
IFIs loans	9.5	6.9	4.4	2.3	0.1	0.1

In the structure of instruments issued on the domestic market, securities offered at auctions dominated (in 2016, they constituted 97.0% of the value of all securities sold and in the first half of 2017 – 96.1%).

In the sale structure of TS offered at auctions in 2016 and in the first half of 2017, medium- and long-term securities prevailed (with the maturity over 4 years). Since January 2016, after a three-year break, T-bills (with the maturity of 27-37 weeks) used for management of the State budget liquidity throughout a year, have been included in the sales offer. Yields earned in T-bill auctions reached their all-time lows (the average yield in auctions in 2016 amounted to 1.33%, and in the first half of 2017 – to 1.53%).

Table 4. Sale of Treasury Securities on domestic market by maturity

Instrument	2015	2016	January–June 2017
T-bills	0.0%	4.3%	8.0%
T-bonds with maturity up to 4 years (incl.)	14.5%	29.4%	12.1%
T-bonds with maturity over 4 years up to 6 years (incl.)	50.7%	35.9%	42.8%
T-bonds with maturity over 6 years	34.8%	30.3%	37.1%

Securities with a fixed interest rate maintained a predominant share in the sale structure of domestic TS in auctions, with the growing share of instruments with a floating interest rate (growth from 20.5% in 2015 to 23.5% in the first half of 2017) and decreasing share of zero-coupon bonds (after a growth to 20.3% in 2016, these instruments constituted 12.1% of the sale in the first half of 2017).

Table 5. Sale of TS on domestic market by the type of interest rate

Instrument	2015	2016	January–June 2017
Fixed rate bonds	66.4%	54.3%	56.4%
Zero-coupon bonds	13.2%	20.3%	12.1%
Floating rate bonds	20.5%	20.3%	23.5%
Inflation-linked bonds	0.0%	0.8%	0.0%
T-bills	0.0%	8.0%	8.0%

In the analyzed period, on foreign markets, nine issues of euro denominated bonds were carried out with the total value of EUR 6.25bn (EUR 4.75bn in 2016 and EUR 1.5bn in the first half of 2017) and one issue on the US dollar market, with the value of USD 1.75bn (in March 2016).

Moreover, in August 2016 bonds denominated in Chinese yuan, the so-called Panda bonds, with the face value of CNY 3bn, were issued for the first time in the history. Simultaneously, the proceeds were swapped into euro, hedging the future cash flows from bond servicing and redemption. After the swap transaction, the yield on the issue which was carried out in the Chinese onshore interbank bond market, reached a negative level.

In December 2016, Poland as a first sovereign ever issued 5-year euro denominated Green Bonds, with the face value of EUR 750m (a high demand reported by investors enabled to increase the issued amount from planned EUR 500m). Poland was the first sovereign in the world to issue this type of bonds where the proceeds from the transaction are to be allocated for environmental projects financing.

Table 6. Issuance of bonds on foreign markets in 2016 and in the first half of 2017

Period	Maturity (years)	Currency	Face value (in millions)	Yield
2016	10	EUR	1 000	1.542%
	20	EUR	750	2.471%
	10	USD	1 750	3.339%
	20	EUR	750	2.275%
	3	CNY	3 000	3.40%
	12	EUR	750	1.058%
	30	EUR	500	2.122%
	2	EUR	250	-0.06%
January-June 2017	5	EUR	750	0.634%
	10	EUR	1 000	1.471%
	20	EUR	500	2.198%

As far as foreign debt is concerned, other important operations included:

- drawing loans from IFIs (in 2016 and in the first half of 2017, the total of EUR 1.0bn, including EUR 0.9bn from the EIB and EUR 0.1bn from the World Bank);
- concluding market CIRS transactions: swapping FX liabilities for liabilities with lower interest rate. In 2016, transactions with the total value of USD 1.75bn (for EUR) and CNY 3.0bn (for EUR) were concluded.

Main factors which influenced the process and financing structure of borrowing requirements in 2016 and in the first half of 2017 included:

1) External factors, in particular:

- the monetary policy carried out by the main central banks in the world:

- **USA:** expectations on the continuation of monetary policy normalization, increase of interest rates by 25bp in December 2016 and the announcement of a faster pace of interest rate increase, then two increases of interest rates by 25bp each, in March and June 2017, accordingly the interest rate of federal funds ranged between 1.00-1.25%;
- **euro area:** expansion of the monthly scale of the asset purchase programme from EUR 60bn to EUR 80bn (as of April 2016) and reducing it back to EUR 60bn (as of April 2017), including relaxation of the rules for securities purchase (as of January 2017) and extension of the asset purchase programme at least until December 2017 (earlier, until March 2017), introduction of long-term refinancing operations for banks as of June 2016 (TLTRO II), reduction of interest rates (in March 2016) to the record low level, including the repo rate to 0.0% and the deposit rate to -0.4% and expectations on the continuation of expansionary monetary policy stance;
- **China:** yuan devaluation, interest rates cuts and other measures of the central bank and the government aimed at supporting Chinese economy and stabilizing situation on the financial market, as of 2017 – launching of monetary policy tightening;
- **Japan:** introduction of the negative interest rate in January 2016, maintaining the asset purchase programme with no changes (JPY 80bn per annum) and establishment of the yield curve control programme in September 2016 (a possibility to buy back government bonds in order to maintain the yield of the 10-year tenor at a level close to 0.0%);
- **Great Britain:** reduction of interest rates by 25bp, increasing the limit for the asset purchase programme to GBP 435bn for UK government bonds and to GBP 10bn for UK corporate bonds (in August 2016);
- uncertainty in financial markets associated with political developments, including:
 - victory of Brexit supporters in the referendum in June 2016 (growth of risk aversion resulting in depreciation of Polish zloty and other currencies of our region and growth in T-bond yields);
 - presidential election in the USA and the election of D. Trump as a president (a significant growth in US T-bond yields and a strong appreciation of US dollar against euro as a result of the announced expansionary fiscal policy);
 - presidential election in France in April 2017 and the victory of E. Macron – explicit strengthening on European bond markets (including the Polish bond market) and appreciation of euro against US dollar, followed by the appreciation of Polish zloty;
- euro depreciation against US dollar (by 3.2% in 2016), followed by its appreciation in the first half of 2017 (by 8.7%), including mainly in 2017 Q2 (by 7.3%);
- 2) local factors, in particular:
 - monetary policy of Monetary Policy Council (RPP) and the situation in the domestic financial market, including:
 - stabilization of interest rates at the all-time low levels (including the repo rate at a level of 1.5%), pursuing the wait-and-see policy and statements of the President of National Bank of Poland and other RPP members concerning maintaining unchanged interest rates by the first half of 2018 and, with a high probability, also in the second half of 2018;
 - ratings of credit rating agencies: S&P – downgrading Poland's rating to the BBB+ level and the outlook from positive to negative (in January 2016) followed by upgrading back the outlook to stable in December 2016; Moody's – downgrading rating outlook to negative (in

- May 2016), followed by its upgrading back to stable (in May 2017); Fitch – maintaining the rating at A- level with a stable outlook (throughout the entire analyzed period);
- changes in the flows of foreign capital on the domestic TS market (capital outflow of PLN 14.2bn in 2016, followed by its inflow of PLN 19.3bn in the first half of 2017) arising to a major extent from changes in capital flows in the global financial market);
 - strong demand from the banking sector for domestic TS (growth of exposure by PLN 64.0bn in 2016 and PLN 16.0bn in the first half of 2017), among others, as a result of introduction of the tax on certain financial institutions (including banks) and TS exemption from the tax base;
 - weakening of Polish zloty against EUR and USD in 2016 (volatility of the EUR/PLN exchange rate amounted to 7.5% against 7.2% in 2015, the average exchange rate increased to 4.36 from 4.18 in 2015; in the case of USD/PLN exchange rate the volatility reached 11.6% against 12.6% in 2015, whereas the average exchange rate increased to 3.94 from 3.77), followed by its strengthening against EUR in the first half of 2017, with a lower volatility (EUR/PLN exchange rate: volatility of 3.6%, average exchange rate: 4.27; USD/PLN exchange rate: volatility of 6.6%, average exchange rate: 3.94);
 - increase in yields of domestic T-bonds in 2016, followed by their decline in the first half of 2017 (among others, as a result of a favorable condition of the State budget);
- uneven distribution over time of the State budget borrowing requirements, arising from budget execution, including a significantly better budget balance in the first half of 2017 than assumed in the schedule, and from the redemption of large bond issues falling in January, April, July and October;
 - maintaining a safe level of state budget liquidity, through pre-financing of a significant part of gross borrowing requirements of the next year at the end of the preceding year (17.5% of the requirements for 2016 and 26% for 2017, respectively).

III.2. Minimization of debt servicing costs – ensuring the effectiveness of the TS market

The most important measures aimed at minimization of debt servicing costs include:

- issuance policy assuming creation of liquid benchmark bond series. In mid-2017, the value of 11 issues exceeded PLN 25bn, compared to 10 issues at the end of 2016 (5 issues at the end of 2015). Issues exceeding PLN 25bn constituted 57.7% of the face value of medium- and long-term bonds with fixed interest rate, against 53.9% at the end of 2016 (32.0% at the end of 2015). High value of issue is a significant factor supporting liquidity in the secondary market;
- expanding the current offer of bonds issued in the domestic market by a 30-year bond. The WS0447 bond with the redemption date falling on 25 April 2047 and a 4.0% coupon was issued at an auction in February 2017 after almost a 10-year break in the issuance of 30-year bonds. The auction sale amounted to PLN 2.1bn and the yield – to 4.27%. The purchasers of the bonds comprised domestic insurance sector (99.3% of the issue) and banks (0.7%);
- issues of bonds with the value ensuring liquidity of a given series in the euro market (6 issues with the face value of EUR 500m or higher, including three with the face value of EUR 1bn or higher) and in the USD market (one issue with the face value of USD 1.75bn);
- adjusting the level and structure of the TS supply to the current market situation and influencing this situation through information policy;

- broadening the investor base in foreign markets through the issue of so-called Panda bonds with the face value of CNY 3bn on the Chinese onshore interbank market and Green Bonds denominated in EUR (investors oriented to financing environmentally friendly projects, in accordance with the criteria set forth in the *Green Bond Framework*, prevailed among the purchasers);
- extension of the offer of saving bonds (as of October 2016) by a new product called Family Bonds. The bonds addressed to individuals eligible for benefits under the “Family 500+” programme have the maturity of 6 and 12 years and the similar construction as EDO 10-year saving bonds. The objective of the issue was to extend the investor base, increase propensity to save and promote all saving bonds;
- conducting sell-buy back (SBB) type transactions between TS primary dealers (PD) and PD candidates and BGK under special terms (the mechanism was introduced in February 2014 in order to support the clearing under the circumstances of temporary and significantly limited availability of bonds of a given issue in the secondary market). In 2016 and in the first half of 2017, transactions with the face value of PLN 11.3bn were concluded, which constituted 0.11% of all SBB transactions in the TS market;
- changes in the method of determining the supply structure of bonds offered at auctions (as of January 2017). The new model assumes, among others:
 - offering on every auction (outright and switching one) a package of 5 on-the-run T-bond issues (2, 5 and 10-year fixed rate bonds as well as floating rate bonds with shorter and longer maturity), in addition, depending on reported investors’ demand, the offer may include fixed rate bonds with maturity exceeding 10 years or inflation-linked bonds;
 - the total value of quarterly, monthly or specific auction supply remains unchanged in relation to the previous model;
 - sale of a single issue at an auction does not exceed 50% of the upper threshold of the supply range for a given auction, as long as the reported demand permits;
 - rules concerning sale of bonds at supplementary auctions remained unchanged.

The objective of introducing the new model was to limit the volatility of bond prices in the secondary market, particularly in periods before auctions, and to limit the risk of mismatch between the offer on the auction and current market conditions. The new model has met the issuer’s expectations and an indirect effect of its introduction was a significant increase in the bid-to-cover ratio as compared to previous years.

III.3. Constraints on the level of risk

Table 7. Assessment of implementation of the Strategy objective constraints related to the level of risk

Constraints of the Strategy objective						
Constraint	Level of implementation*	Implementation method	Measure	Value		
				2015	2016	June 2017
Refinancing risk	High	<ul style="list-style-type: none"> High sale of medium and long-term bonds in 2016 and in the first half of 2017 (respectively, 66.3% and 79.9% of all TS sold at outright and switching auctions); Significant role of switching auctions (31.4% of the initial value of bonds maturing in the period from January 2016 to June 2017 was bought back); Maintaining the average maturity of domestic debt at a safe level above 4 years defined in the Strategy and growth towards the targeted level of 4.5 years; Maintaining the average maturity of ST debt at a safe level above 5 years defined in the Strategy; Return to the issuance of T-bills at a limited scale in the first quarter of 2016 and the first quarter of 2017 as an instrument of State budget liquidity reserve management. 	ATM (in years)			
			<ul style="list-style-type: none"> - domestic - foreign - total 	4.27	4.36	4.43
Foreign exchange risk	High	<ul style="list-style-type: none"> Decreasing the share of foreign debt, in accordance with the Strategy assumptions; Maintaining the effective share of euro denominated debt in foreign debt above the minimum level assumed in the Strategy (70%). 	Share of foreign debt in ST debt	34.9%	34.4%	31.2%
			Share of euro denominated debt in foreign debt	73.0%	75.2%	76.3%
Interest rate risk	High	<ul style="list-style-type: none"> Increasing ATR of domestic debt and maintaining it in the range of 2.8-3.8 years, set in the Strategy; Maintaining interest rate risk of foreign debt at a safe level, not posing a constraint to cost minimization. 	ATR (in years)			
			<ul style="list-style-type: none"> - domestic - foreign - total 	3.24	3.35	3.42
			Duration (in years)			
			<ul style="list-style-type: none"> - domestic - foreign - total 	3.04	3.07	3.10
				4.54	4.71	4.74
				3.61	3.70	3.67

Constraints of the objective - cont.		
Constraint	Level of implementation*	Implementation method
Liquidity risk	High	<p>The main instruments used in liquidity risk management included:</p> <ul style="list-style-type: none"> • switching auctions (in 2016, bonds of the face value of PLN 28.9bn were bought back, while in the first half of 2017, the value amounted to PLN 12.9bn); • interest-bearing PLN denominated deposits at the NBP – deposits of the total value of PLN 91.4bn were made in 2016, while those made in the first half of 2017 amounted to PLN 47.7bn; • PLN denominated deposits where BGK acted as an intermediary – in 2016 transactions with the total value of PLN 1,607.1bn were concluded, whereas those concluded in the first half of 2017 amounted to PLN 1,021.9bn; • FX deposits – deposits made in 2016 amounted to EUR 26.5bn and those made in the first half of 2017 – to EUR 7.3bn; • loans in the interbank market – in 2016, a transaction with the value of PLN 2.0bn was concluded; • sale of a part of FX funds from the EU budget and those associated with debt management operations directly on the market (in 2016, foreign currencies equivalent to EUR 2.2bn were sold) and in the NBP (EUR 6.4bn in 2016); • deposits of liquid funds of public finance sector units on the accounts of the Minister Development and Finance in BGK as a part of the liquidity management consolidation – at the end of 2016, the accumulated funds amounted to PLN 39.8bn and the end of June 2017 – to PLN 42.6bn. <p>The level of State budget liquid assets in 2016 and in the first half of 2017 provided for smooth execution of budgetary flows.</p>
Credit risk	High	<ul style="list-style-type: none"> • Deposits in BGK, secured with TS, did not generate credit risk; • For unsecured deposits in BGK, a system of credit limits is in place; • Credit risk connected with derivatives is limited by the selection of counterparties with high credit rating; • A collateral system related to transactions in derivatives in the form of blocking TS in the National Depository Securities (KDPW) is in force. Secured transactions do not generate credit risk; • The credit risk generated by unsecured transactions is diversified through limits imposed on the total value of transactions made with individual counterparties. Creditworthiness of potential partners is monitored on an on-going basis.
Operational risk	High	<ul style="list-style-type: none"> • Debt management conducted in one department in the Ministry of Finance; • Technical infrastructure adequate to the requirements of conducting market transactions; • Security of information related to debt management; • Integrated database of the ST debt.
Distribution of debt servicing costs over time	High	<ul style="list-style-type: none"> • Coupons of new issues were set at a level slightly below their forecasted yields. Yields of both domestic and foreign bonds remained at levels allowing to issue new debt with coupons lower than those for bought-back instruments, what had a positive impact on the debt servicing costs; • Switching auctions on domestic market and USD denominated bond buy-back auctions contributed to smoothing distribution of costs. <p>The level of debt servicing costs in 2016 was affected by swap transactions (with the face value of PLN 27.0bn) with the aim of distribution of debt servicing costs over time. Consequently, in 2016 costs increased by PLN 1.39bn (cost reduction by PLN 1.40bn in 2017). The purpose of those transactions was to use savings in debt servicing costs in 2016, to simultaneously reduce debt servicing costs in 2017.</p>

*) In accordance with the scale: high, satisfactory, moderate and low.

IV. ASSUMPTIONS OF THE STRATEGY

The following subchapters present the main macroeconomic assumptions of the *Strategy* and the market conditions that affect debt management. The issues discussed include the role of domestic and foreign investors in the domestic TS market as well as the potential developments in the major international markets.

IV.1. Macroeconomic assumptions of the *Strategy*

The assessment of the macroeconomic situation and directions of the fiscal policy is presented in the justification to the draft Budget Act for 2018. Table 8. contains the macroeconomic assumptions of the *Strategy*, compliant with the assumption of the draft budget.

Table 8. *Macroeconomic assumptions of the Strategy*

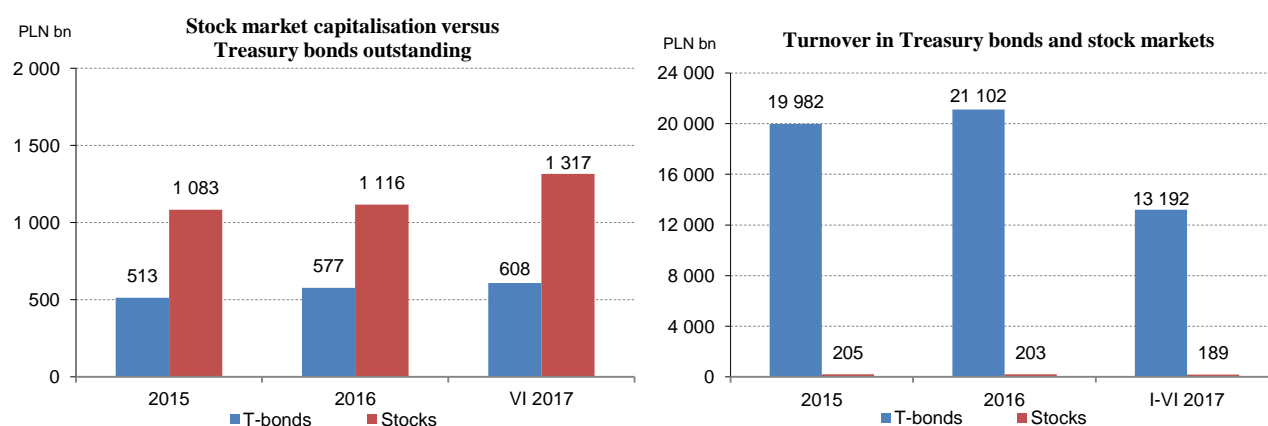
Item	2016	2017	2018	2019	2020	2021
Real GDP growth (%)	2.7	3.6	3.8	3.8	3.8	3.6
GDP at current prices (PLN bn)	1,851.2	1,938.3	2,057.2	2,185.3	2,325.7	2,469.5
Average CPI (%)	-0.6	1.8	2.3	2.3	2.5	2.5
USD/PLN - end of period	4.18	3.99	3.99	3.99	3.99	3.99
EUR/PLN - end of period	4.42	4.25	4.25	4.25	4.25	4.25

IV.2. Domestic TS market

The level of development of the domestic financial market, including the domestic investor base, as well as the role of foreign investors in this market are significant determinants of debt management. Under the conditions of free capital flow, a well-developed and deep domestic market allows for absorption of external shocks and outflows of foreign capital.

In terms of the value of traded securities, the value of the domestic T-bonds market at the end of June 2017 corresponded to 46% of stock market capitalization. However, this market demonstrates a definitely higher liquidity – turnover in T-bonds exceeded trade in the stock market by approximately hundred-fold.

Chart 7. *Comparison between Treasury bonds and stock markets*



Entities investing in the domestic TS market can be divided into three main groups: domestic banking sector, domestic non-banking sector and foreign investors. In 2016 and in the first half of 2017, the following changes in the holders' structure of domestic TS debt were observed:

- a significant increase in domestic banks' holdings (by PLN 80.0bn in total) translated into their prevailing share in the holders' debt structure (40.1%);

- following the decrease in the portfolio in 2016, in the first half of 2017 foreign investors systematically increased their domestic TS holdings, exceeding the remaining groups of investors with the scale of purchases;
- domestic non-banking investors increased their TS portfolios by PLN 18.7bn in total, mainly as a result of a growth in holdings of insurance companies, so-called other entities (including mainly BFG and FRD), investment funds, as well as individuals who significantly increased their investments in TS in the first half of 2017.

Chart 8. Structure of domestic TS portfolios held by main groups of investors

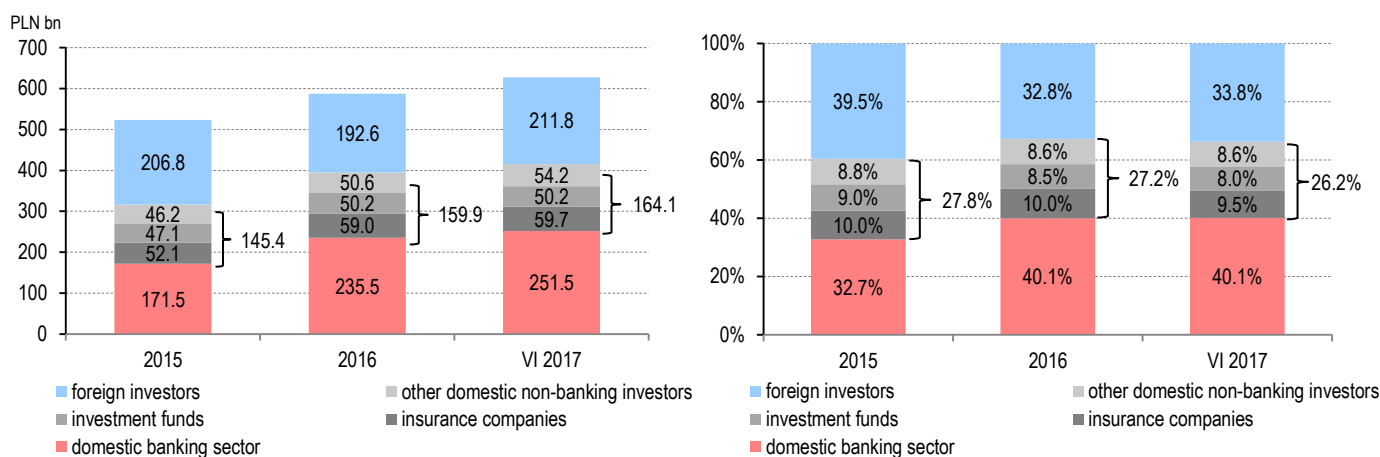
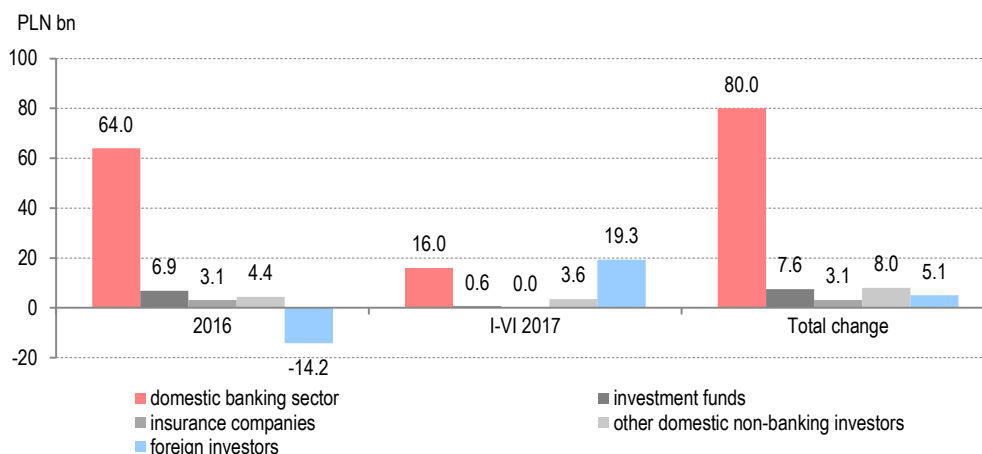


Chart 9. Changes in domestic TS portfolios held by main groups of investors



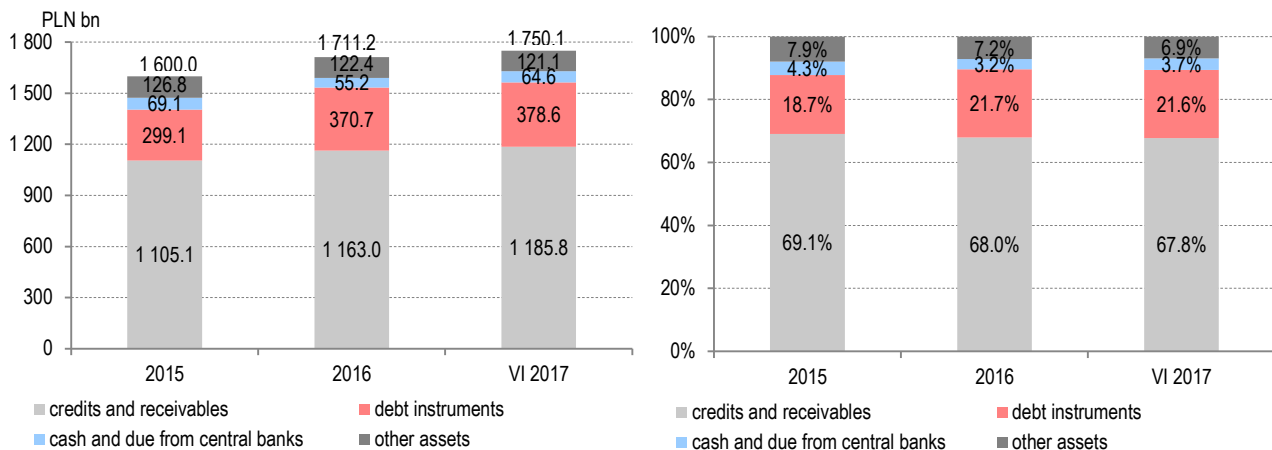
As at the end of June 2017 domestic investors held 66.2% of domestic TS debt, an increase by 5.7 pp compared to the end of 2015 that resulted mainly from a high increase in the banks' portfolio.

IV.2.1. Domestic banks

At the end of June 2017 assets of domestic banks amounted to PLN 1.8tn (an increase by 9.4% compared to the end of 2015), with the dominant share of credits and receivables (ca. 68%). Debt instruments represented the second largest component of assets, simultaneously constituting the largest group of instruments in banks' financial assets. Their share increased from ca. 19% at the end of 2015 to ca. 22% at the end of June 2017. The prevailing share in the structure of debt instruments had TS, mainly Polish ones, as well as instruments of central banks, mainly NBP money bills. In the recent years, an increase in banks' TS holdings has been observed, with the simultaneous reduction in the portfolio of money bills, which has been fostered by the low interest rate environment.

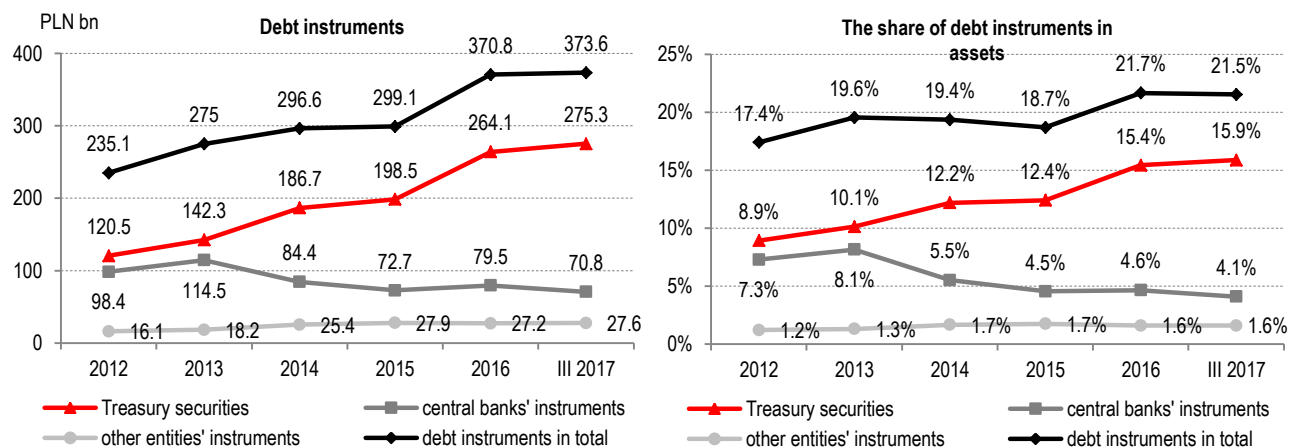
In 2016, the introduction of the tax on certain financial institutions as of February 1st, 2016, comprising mainly banks and insurance companies, was a factor contributing to a significant increase in banks' demand for TS. Assets decreased by, inter alia, own funds and Polish TS, make banks' tax base. Such construction of the tax encouraged banks to optimise their structure of assets through a significant increase in the share of Treasury instruments. At the same time, the value of the banks' credits and receivables portfolio was also increasing.

Chart 10. Structure of domestic banks' assets



Source: data of Polish Financial Supervision Authority

Chart 11. Debt instruments in domestic banks' assets



Source: data of Polish Financial Supervision Authority

The most significant factors to affect banks' demand for domestic TS in the timeframe of the Strategy include:

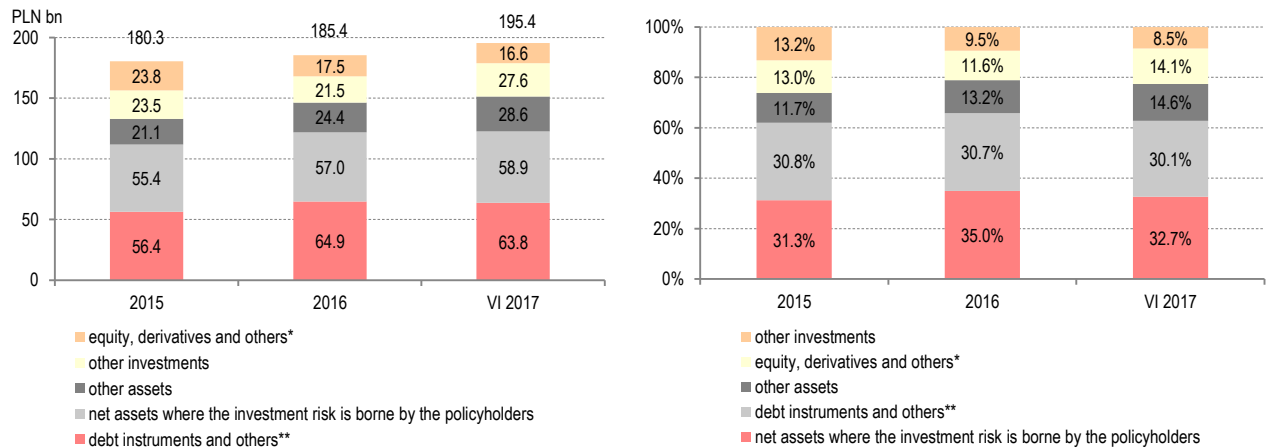
- development of economic situation affecting the size and structure of banks' assets, inter alia, the scale of credits granted and development of the level of deposits;
- the level of over liquidity of the banking sector;
- persisting low interest rates;
- tax on certain financial institutions.

IV.2.2. Domestic non-banking investors

Insurance companies and investment funds represent two the largest groups of domestic non-banking sector investors. As at the end of June 2017, these entities held 9.5% (a decrease by 0.4 pp compared to the end of 2015) and 8.0% (a decrease by 1.0 pp compared to the end of 2015) of domestic TS, respectively. The main factors affecting the value of TS portfolio held by insurance companies and investment funds include the value of assets and the investment policy of those entities.

In case of insurance companies, as at the end of June 2017, an increase in assets compared to the end of 2015 was observed – by PLN 15.1bn (i.e. by 8.4%), up to the level of PLN 195.4bn. Within the structure of assets, the portfolio of debt instruments and other fixed income securities in which Treasury instruments prevail, increased by PLN 7.4bn, i.e. by 13.4%.

Chart 12. Structure of insurance companies' assets



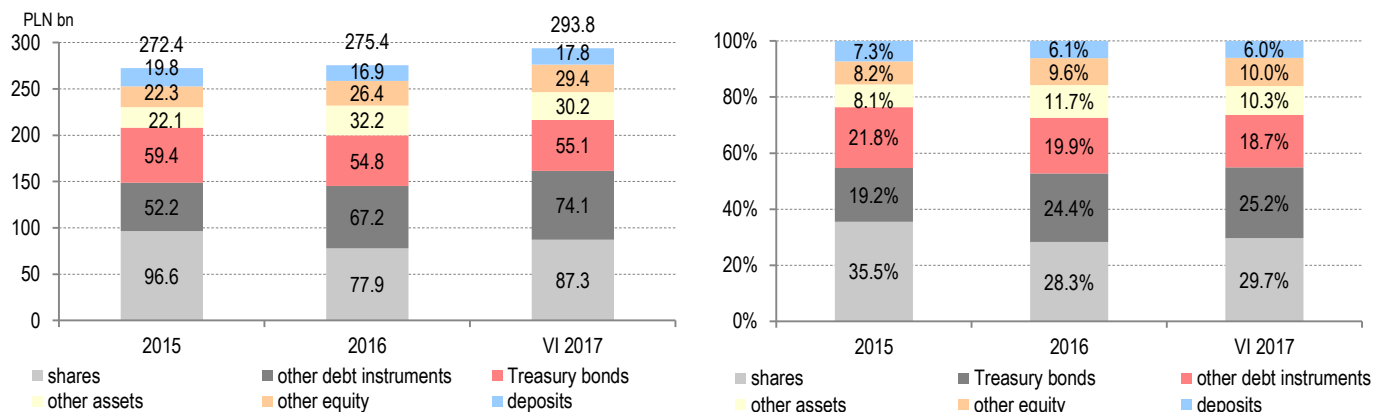
Source: data of the Polish Financial Supervision Authority.

*) Other floating income securities, and units and investment certificates in investment funds

**) Other fixed income securities

As at the end of June 2017, net assets of investment funds amounted to PLN 293.8bn, which meant an increase by PLN 21.5bn, i.e. by 7.9% compared to the end of 2015. The largest increase in assets referred to debt instruments other than T-bonds (by PLN 21.9bn). The value of T-bonds held by investment funds decreased slightly, whereas their share in assets remained significant (at the level of ca. 19%).

Chart 13. Structure of investment funds' net assets*



Source: data of National Bank of Poland

*) Excluding money market funds and funds in liquidation as defined in the ECB methodology

The main factors to determine the value of TS portfolio in assets under management of non-banking financial institutions in the forthcoming years include:

- further development of the insurance and investment funds markets;
- developments in the level of domestic savings, including, as a result of the Capital Accumulation Programme implementation, assuming an increase in the scale of savings in the economy, inter alia, through Individual Retirement Security Accounts and Employee Equity Schemes managed by investment fund management companies, as well as building the culture of households' long-term saving;
- situation in the stock market, which is one of the factors determining households' decisions on savings allocation;
- persisting low interest rates, encouraging households to search for capital investment opportunities, alternative to bank deposits.

Besides the aforementioned factors, the developments of the share of domestic investors in the holder's structure of domestic TS debt in the forthcoming years will also depend, to a major extent, on the level of borrowing requirements, determining the level of TS supply offered to investors.

IV.2.3. Role of foreign investors

Foreign investors play a significant role in financing the State budget borrowing requirements on the domestic market – as at the end of June 2017, their share in domestic TS debt amounted to 33.8% and decreased by 5.7 pp compared to the end of 2015. The decline in the share of non-residents resulted mainly from the reduction in the TS portfolio in 2016, as well as from a significant increase in the demand of domestic banks. In the first half of 2017, a gradual increase in foreign investors' holdings of domestic TS, particularly those with longer maturity, was observed.

The foreign investors' demand depends, to a large extent, on international situation and, as a consequence, is highly volatile. However, the risk of a sudden outflow of foreign capital from Poland is limited due to high diversification, both institutional and geographical, of the non-residents structure. The structure of debt held by non-residents is dominated by stable institutional investors, in particular, central banks and public institutions constitute over 1/4 of the total debt.² The geographical structure of domestic TS holders also demonstrates high diversification – as at the end of June 2017 TS were held by investors from 61 countries.

The most significant factors to affect non-residents' demand for Polish TS in the timeframe of the *Strategy* include:

- actions undertaken by central banks;
- Poland's strong economic foundations;
- assessment of Poland's credit risk;
- persisting disparity in interest rates;
- functioning of a large and liquid financial market in Poland (in particular, the TS market) and its adequate infrastructure;
- highly diversified structure, both institutional and geographical, of foreign investors holding domestic TS;

² The structure does not include omnibus accounts.

- access of Poland to the flexible credit line of the International Monetary Fund, playing a stabilising role under the circumstances of increased volatility in international financial markets.

Due to free flow of foreign capital, non-residents' investment in domestic TS, as well as raising funds in international markets, may pose exchange rate risk for ST debt, considering the impact on the level of Polish zloty exchange rate. Therefore, this factor determines a flexible approach to shaping the financing structure in terms of selection of the market and currency.

IV.3. International conditions

The most important international conditions from the perspective of ST debt management include:

- the situation on the interest rate markets for the currencies in which liabilities will be incurred, predominantly in the EUR and USD markets, and actions undertaken by central banks:
 - declared gradual normalisation of the monetary policy by Fed – increases of interest rates and reducing the bank's balance sheet;
 - continuation of expansionary monetary policy announced by the ECB – maintaining interest rates at lower level over a longer period of time and continuation of the asset purchase programme so that a sustainable recovery of the inflation path towards the inflation target is guaranteed;
 - continuation of the asset purchase programme by the Bank of Japan and maintaining the reference interest rate at a negative level as long as required to reach the inflation target;
 - maintaining the negative deposit rate and the negative fluctuation band for the three-month LIBOR CHF rate by the Swiss National Bank and the readiness to undertake intervention in the foreign currency market, if required to counteract excessive CHF appreciation;
 - tightening of the monetary policy by the People's Bank of China;
- the perception of Poland's credit risk and liquidity preferences of buyers of Polish T-bonds operating in global markets, which affect the level of the premium in relation to core markets.

V. OBJECTIVE OF THE STRATEGY

The objective of the *Strategy* will remain **the minimization of the long-term debt servicing costs subject to the constraints at the level of:**

- 1) refinancing risk,
- 2) exchange rate risk,
- 3) interest rate risk,
- 4) State budget liquidity risk,
- 5) other risks, in particular credit risk and operational risk,
- 6) distribution of debt servicing costs over time

This objective, determining the debt management, is understood in terms of two aspects, as:

- **selection of instruments**, aimed at cost minimization within the timeframe defined by maturity of the longest instruments and a significant share in debt, through the adequate selection of markets, debt management instruments, structure of financing borrowing requirements and issuance dates;
- **ensuring the efficiency of the TS market**, contributing to the lowering of TS yields. It means striving to eliminate or limit potential unfavorable factors in market organization and infrastructure.

The approach to accomplishment of the objective of minimization of debt servicing costs has not changed in relation to the previous year's *Strategy*. This means the possibility of a flexible financing structure in terms of selection of the market, currency and type of instruments, including with the use of derivative instruments. The choice of this structure should result from an assessment of market conditions (level of demand, interest rates and the shape of the yield curve in individual markets, as well as the expected levels of exchange rates) and the financing cost in the long term, taking into consideration constraints resulting from the acceptable risk levels.

Experience in debt management indicates a significant role of flexibility and diversification of sources of financing borrowing requirements, subject to market situation. It contributes both to ensuring the security of financing the State budget borrowing requirements as well as to the reduction of its cost, which is particularly important in the period of disruptions in financial markets.

The domestic market shall remain the main source of financing the State budget borrowing requirements. The supply of instruments in this market will be developed in a flexible manner, adapted to the current market situation, i.e. the reported structure and level of demand, so that the TS supply impact on the yields can be minimized. Financing in international markets will supplement domestic financing and its level should:

- take into account the borrowing requirements of the budget in foreign currency as well as inflow of EU funds;
- ensure diversification of funding sources through the access of Poland to the investor base in major financial markets;
- maintain the position of Poland in the euro market;

- stabilize the domestic market through ensuring the security of financing the State budget borrowing requirements in case of temporary disturbances in the domestic market;
- utilize the access to attractive financing in international financial institutions;
- allow for selling currencies on the financial market or in the NBP as a financing instrument of foreign currency borrowing requirements and managing the foreign currency funds, while taking into account monetary and economic policy considerations as well as financial rationale.

Minimization of long-term debt servicing costs will be subject to constraints related to the debt structure. Therefore, the following assumptions have been made in the scope of:

1) refinancing risk

- maintaining of the dominant role of medium and long-term instruments in the State budget borrowing requirements financing in the domestic market subject to market situation;
- reaching and maintaining of the ATM of domestic debt at the level close to 4.5 years, subject to market conditions
- maintaining the average maturity of ST debt at a level close to 5 years;
- aiming at an even distribution of redemption in the following years;

2) exchange rate risk

- decrease in the share of foreign currency debt within the timeframe of the *Strategy* below 30%;
- possibility to use derivative instruments in order to shape an desired currency structure of debt;
- maintaining, within the timeframe of the *Strategy*, the effective (i.e. taking into account derivative transactions) share of euro in foreign currency debt at a level of at least 70%, with possible temporary deviations in case of unfavorable market situation;

3) interest rate risk

- keeping ATR of the domestic debt in the range of 2.8-3.8 years;
- separating the management of the interest rate risk from the management of the refinancing risk by using floating-rate bonds and inflation-linked bonds, and a possibility to use derivatives;
- the current level of foreign debt interest rate risk does not restrain cost minimization;

4) State budget liquidity risk

- maintaining the safe level of State budget liquidity while managing liquid assets in an effective way. Their level will be determined on the basis of current and forecasted budgetary and market situation, including budget seasonality and smoothing of TS supply over the year;
- a possibility to use FX funds and derivative transactions in managing the currency structure of liquid assets;

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

- concluding derivative transactions with entities of high creditworthiness;
- using solutions that mitigate credit risk, including collateral agreements, and allowing for its diversification while concluding derivative transactions. In the timeframe of the *Strategy* concluding new collateral agreements is planned that would be in line with current best

practices in the market and what would enable to conclude transactions on more favorable terms without bearing credit risk;

- diversification of credit risk generated by uncollateralized transactions;

6) distribution of debt servicing costs over time

- aiming at an even distribution of debt servicing costs in subsequent years, including the use of derivative instruments;
- setting bond coupons at a level slightly below their forecasted yield in the period of sales.

VI. TASKS OF THE STRATEGY

The following tasks have been recognized as essential for implementing the objective of the *Strategy*:

- 1) ensuring liquidity of the TS market,
- 2) ensuring efficiency of the TS market,
- 3) ensuring transparency of the TS market,
- 4) effective State budget liquidity management.

The tasks assumed in the Strategy connected with TS market development are long-term and cover measures implemented on a continuous basis. These tasks are to a large extent interdependent, i.e. individual measures may contribute to the implementation of more than one task at a time. Accordingly, the measures undertaken should be mainly aimed at maintaining the proper functioning of the market or its further improvement, in order to contribute to the better implementation of the Strategy objective.

The measures aimed at effective management of the State budget liquidity have been distinguished as an independent task.

VI.1. Ensuring liquidity of the TS market

This task relates to liquidity of both the entire TS market and individual issues, and it is associated with striving to eliminate the premium for inadequate liquidity (and the associated high costs of disinvestment) as well as to the increase in demand from investors interested only in liquid issues. Both of these factors contribute to decreasing TS yields and, accordingly, to the minimization of ST debt servicing costs. In the timeframe of the *Strategy*, continuation of the former policy is planned, i.e.:

- building large issues of bonds (benchmarks) in the domestic market – in case of medium- and long-term bonds with fixed interest rate their value should amount to at least PLN 25 bn, taking into account smooth distribution of redemptions over time;
- large liquid bond issues in the euro market and, depending on market conditions, also on the US dollar market;
- adapting the issuance policy, including sale, switching and buy-back auctions to market circumstances, including the demand in particular segments of the TS market.

VI.2. Ensuring efficiency of the TS market

This task is aimed at minimizing debt servicing costs under the second out of two aspects of implementation of this objective, discussed in Chapter V and covers measures both in the primary and in the secondary market:

- adjusting the issuance timing in the domestic and foreign market to the market and budgetary conditions;
- increasing the role of participants of the PD system in the development of the TS market and in debt management operations - in the areas where participants of the PD system are at least as competitive as other financial market participants, conclusion of transactions and selection of partners will be carried out taking into account preferences resulting from their participation in the system;
- sustaining relations with domestic and foreign investors, including through:
 - regular meetings with banks participating in the PD system,

- meetings with non-banking sector entities;
- meetings with foreign investors and foreign banks;
- ongoing meetings and phone consultations with investors;
- broadening of the investor base, including regular meetings with foreign investors on key foreign markets in order to promote TS issued on both domestic and foreign markets;
- active participation in conferences and seminars with investors.

VI.3. Ensuring transparency of the TS market

This task is aimed at limiting the uncertainty connected with TS market functioning and enables its participants to receive reliable information on current market prices and to formulate expectations concerning the developments in future market prices. Both predictability of the issuance policy and transparent functioning of the secondary market contribute to the transparency of the market as a whole. In this scope, the following activities will be undertaken:

- maintaining transparent issuance policy, including TS issuance calendars covering current year, quarter and month;
- promoting the electronic market through:
 - the adequate regulations in PD system that ensure competitiveness and transparency, in particular with regard to PD duties related to TS quotations, sustaining adequate spread levels and the share in TS fixing;
 - adjusting the organizational status of the electronic market to the current needs of the TS market while taking into account the regulatory environment.

VI.4. Effective State budget liquidity management

This task includes, on the one hand, acquiring and maintaining funds at a level ensuring timely implementation of the State's tasks as well as budget resilience to the changing market situation and, on the other hand, in their investing, so that the net cost of their maintaining is as low as possible, taking into consideration the budgetary and market conditions, and constraints related to risk, including credit and operational risk.

Maintaining an adequate level of liquidity triggers direct cost resulting from higher yields of TS sold on the auctions in relation to the income earned on short-term deposits. However, maintaining the adequate level of liquid funds allows for indirect savings arising from the fact that the issuer has a possibility to sell TS in periods adapted to the market situation and at a level adjusted to the demand.

The following instruments will support the implementation of the task:

- depositing PLN and FX funds in NBP or in the financial market via BGK (the state-owned bank)
- concluding buy-sell-back transactions directly in the financial market, as a new instrument for depositing budgetary funds without bearing a credit risk;
- sales of a part of FX funds on the market or in NBP;
- utilizing liquid funds of public finance sector entities and court deposits placed on the account of the Minister of Development and Finance in BGK;
- FX swap transactions allowing to shape the currency structure of liquid funds;
- short-term loans on the interbank market.

VII. IMPACT ON THE PUBLIC FINANCE SECTOR DEBT

Pursuant to Article 74 of the Public Finance Act of August 27, 2009, the Minister of Development and Finance is in charge of the public finance sector as regards the rule which states that the public debt must not exceed 60% of the annual GDP.

In the case of public finance sector debt, including the debt of units other than the State Treasury, which are autonomous in incurring liabilities, the influence on their level of debt is indirect and is derived from the regulations of the Public Finance Act. Above all, they include constraints imposed on the way of incurring liabilities by LGUs as well as the prudential and remedial procedures, which apply to the public finance sector entities when both the public debt-to-GDP ratio and at the same time the ratio to GDP of the amount of public debt recalculated using for the foreign currency denominated debt the yearly average of the NBP foreign currency exchange rates for the year concerned and reduced by the value of the funds used for pre-financing of borrowing requirements in the preceding budget year (Article 38a), exceeds 55%.

Moreover, the stabilizing expenditure rule included in the Public Finance Act sets the thresholds for the relation to GDP of the amount specified in article 38a(3) of the Act at the levels of 43% and 48%. Exceeding the thresholds and fulfilment of additional conditions defined in the Act triggers an automatic correction mechanism, that limits the growth rate of expenditure amount for the specific budgetary year.

Annex 3 presents constraints related to incurring public debt, provided in the Public Finance Act (arising from prudential and remedial procedures and rules of incurring liabilities by LGUs), as well as the correction mechanism of the expenditure rule.

VII.1. Changes in the regulations relating to local government units

At present, works on the amendment of the Public Finance Act aimed at changing the regulations on incurring liabilities by local government units are in progress. The purpose of the planned changes is to rationalize incurring of debt by LGUs, make their financial management more flexible and to strengthen legal mechanisms intended to increase the financial security.

VII.2. Medium-term budgetary framework

On 26 July 2016, the Council of Ministers adopted *The assumptions of the budget system reform* which define the conceptual framework of the new budget system. In the timeframe of this *Strategy*, the following activities are foreseen in particular: introduction of a medium-term budgetary framework and integration of multiannual and annual planning processes, introduction of homogenous and multi-dimensional budget classification as well as streamlining the data collection systems, i.e. budgetary reporting and financial reporting.

Within the first stage of the reform, works on the draft Act amending the Public Finance Act and some other acts are carried out to introduce changes supplementing the current budgetary system, facilitating subsequent works related to the implementation of target comprehensive system solutions.

In particular, introduction of a medium-term budgetary framework is foreseen, to be adopted jointly with the draft Budget Act and to comprise forecasts of revenue and expenditure for the consecutive two years, including forecasts of debt servicing costs. Those forecasts, developed according to the unchanged policy scenario, will provide the basis for consecutive budget planning cycles. In consequence the timeframe of the public finance sector debt management strategy will be adjusted to the horizon of the medium-term budgetary framework.

The proposed changes may generate significant benefits arising from extending of the planning timeframe and enhancing the reliability of budget forecasts, thus contributing positively to ST debt management and possibilities to influence public debt.

VIII. EXPECTED EFFECTS OF IMPLEMENTING THE STRATEGY

The expected effects of the *Strategy* implementation include forecasts of:

- the volume of public debt and the costs of its servicing,
- changes in the scope of risk related to public debt,
- the level of debt of public finance sector entities other than ST.

These are the expected results of the implementation of the *Strategy* objectives under the adopted macroeconomic, budgetary and market assumptions. Moreover, the most important threats to the implementation of the *Strategy* objectives are indicated in subchapter VIII.4.

VIII.1. Debt volume and its servicing costs

Under the adopted assumptions, in 2017 the public debt-to-GDP ratio shall decrease to 51.7% and stabilize at that level in 2018; in the subsequent years, it will gradually fall to 46.2% in 2021. The ratio of the amount specified in Article 38a (3) of the Public Finance Act to GDP shall reach the level of 50.4% in 2017 and 50.6% in 2018, to decrease gradually to 44.8% in 2021.

The general government debt-to-GDP ratio will amount to 53.8% in 2017 and 54.2% in 2018, to be followed by its subsequent decrease to reach the level of 48.9% in the timeframe of the *Strategy*.

In nominal terms, the limit of ST debt servicing costs set in the draft Budget Act for 2018 will be close to the limit for 2017 (PLN 30.7 bn against PLN 30.4 bn). In relation to GDP, debt servicing costs will decrease from 1.57% in 2017 to 1.49% in 2018. It is assumed that in the timeframe of the *Strategy*, the debt servicing cost-to-GDP ratio will decrease to the level of 1.44% - 1.47%.

Table 9. Forecasts of the level of debt and debt servicing costs

Item	2016	2017	2018	2019	2020	2021
1. State Treasury debt						
a) PLN bn	928.7	968.7	1,029.8	1,086.1	1,108.6	1,108.5
- domestic	609.2	662.0	722.6	774.3	798.7	805.4
- foreign	319.5	306.7	307.2	311.8	310.0	303.1
b) in relation to GDP	50.2%	50.0%	50.1%	49.7%	47.7%	44.9%
2. Public debt						
a) PLN bn	965.2	1,002.7	1,064.3	1,120.9	1,142.8	1,140.7
b) in relation to GDP	52.1%	51.7%	51.7%	51.3%	49.1%	46.2%
3. The amount specified in Article 38a (3) of the Public Finance Act *						
a) PLN bn	918.7	976.6	1,041.1	1,092.7	1,110.9	1,107.1
b) in relation to GDP	49.6%	50.4%	50.6%	50.0%	47.8%	44.8%
4. General government debt						
a) PLN bn	1,006.3	1,043.6	1,116.0	1,180.7	1,205.2	1,208.4
b) in relation to GDP	54.4%	53.8%	54.2%	54.0%	51.8%	48.9%
5. State Treasury debt servicing costs (cash basis)**						
a) PLN bn	32.1	30.4	30.7	32.0 - 32.8	33.4 - 34.1	35.5 - 36.3
- domestic	22.2	20.0	21.1	23.5	24.9	27.2
- foreign	9.8	10.4	9.6	8.5 - 9.2	8.4 - 9.2	8.3 - 9.1
b) in relation to GDP	1.73%	1.57%	1.49%	1.47% - 1.50%	1.44% - 1.47%	1.44% - 1.47%

*) The amount of public debt recalculated using the yearly average of foreign currency exchange rates for the year concerned and reduced by the value of State budget liquid funds raised to finance the borrowing requirements for the following budget year.

***) Forecasts of the debt servicing costs for the years 2019-2021 account for the exchange rate risk provisions.

Chart 14. Debt-to-GDP ratio

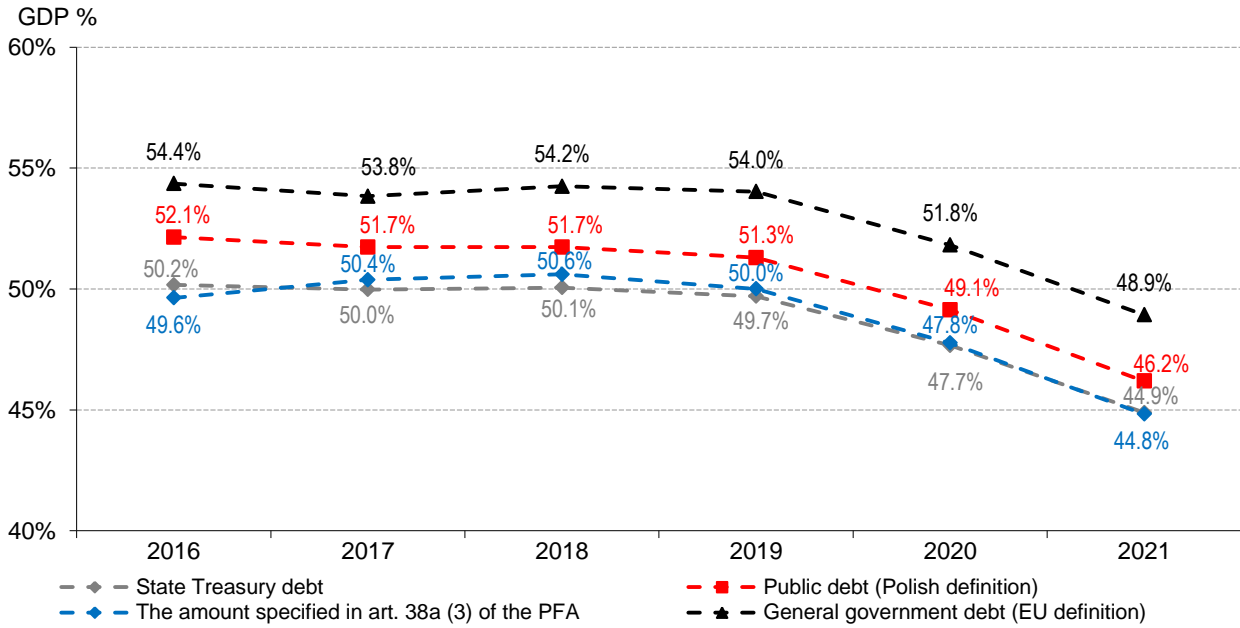


Chart 15. ST debt servicing costs-to-GDP ratio

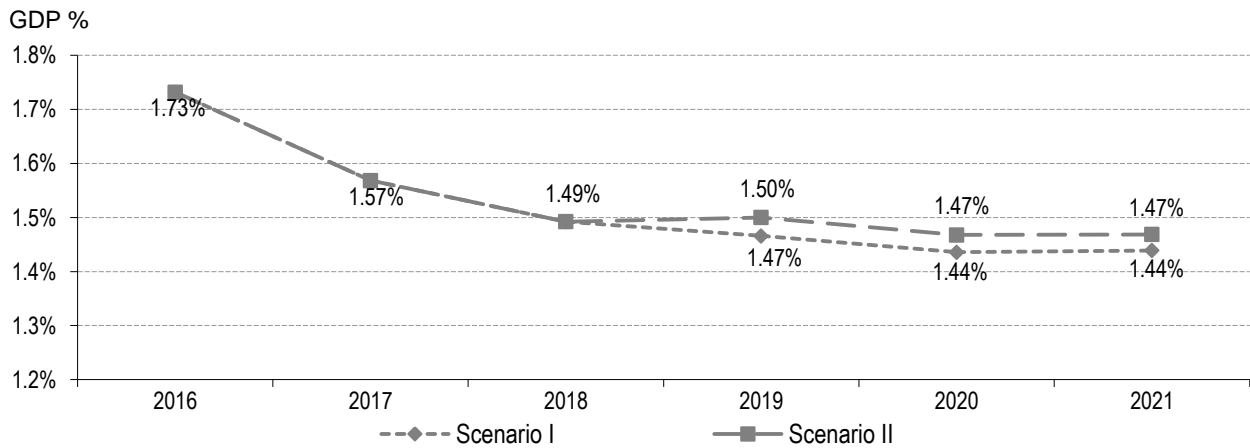
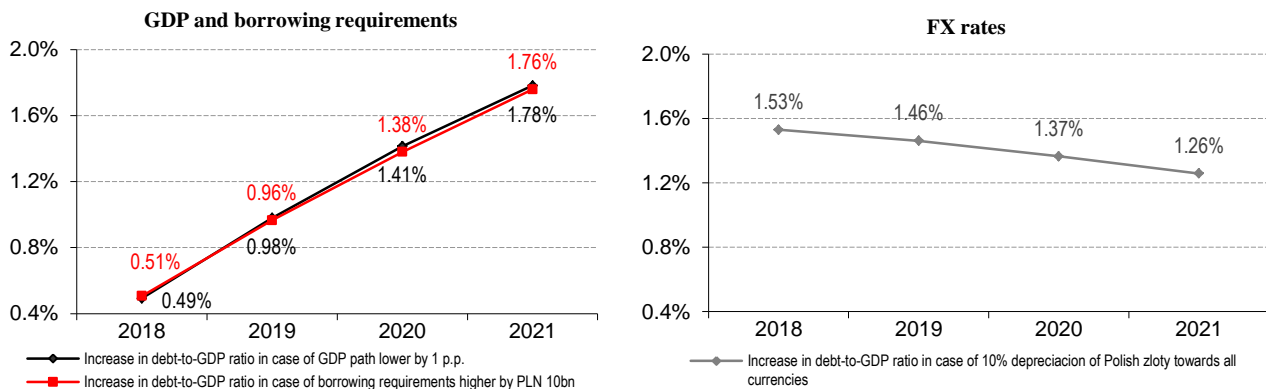
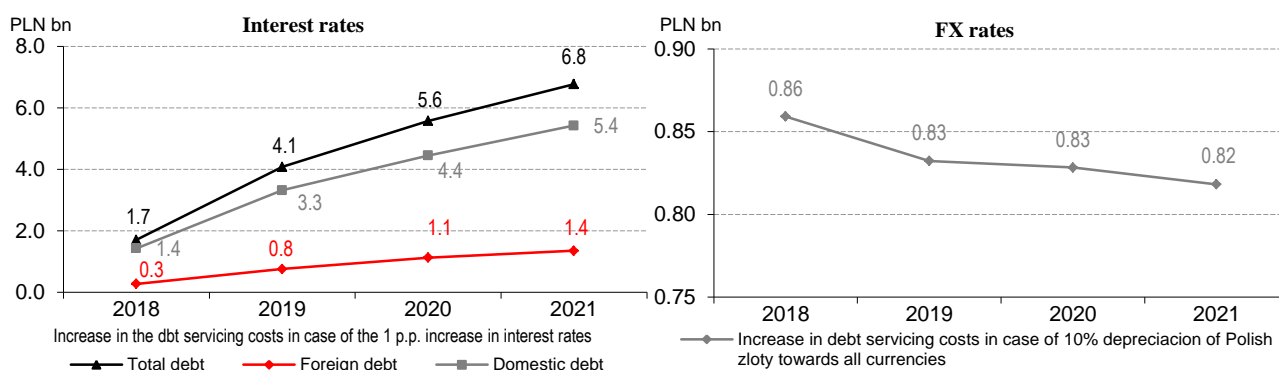


Chart 16. Sensitivity of public debt-to-GDP ratio to changes in assumptions *



*) Assuming the change of paths since 2018.

Chart 17. Sensitivity of ST debt servicing costs-to- GDP ratio to changes in assumptions



VIII.2. Structure of the State Treasury debt

It is expected that in the timeframe of the *Strategy*:

- regarding the refinancing risk – the direction of changes in the ATM of the ST domestic marketable debt will depend on market conditions, so that the average maturity in 2021 may reach the value in the range from 4.1 to 4.8, and for the total ST debt, 4.8-5.4 years against, respectively, 4.4 and 5.1 years at the end of 2017;
- the interest rate risk will remain within the range set in the *Strategy*, depending on the adopted financing structure, the ATR of the domestic marketable debt will remain within the range of ca. 3.1-3.6 years compared to 3.4 at the end of 2017, and for the total debt – ca. 3.7-4.0 years, whereas the duration of the domestic marketable debt will remain in the range of ca. 2.9-3.2 years compared to ca. 3.1 at the end of 2017, while that of the total debt will range from ca. 3.3-3.6 years;
- the share of foreign currency debt will be reduced and in the timeframe of the *Strategy* it will fall below 30% (in the base scenario in 2018).

Chart 18. ATM of the ST debt

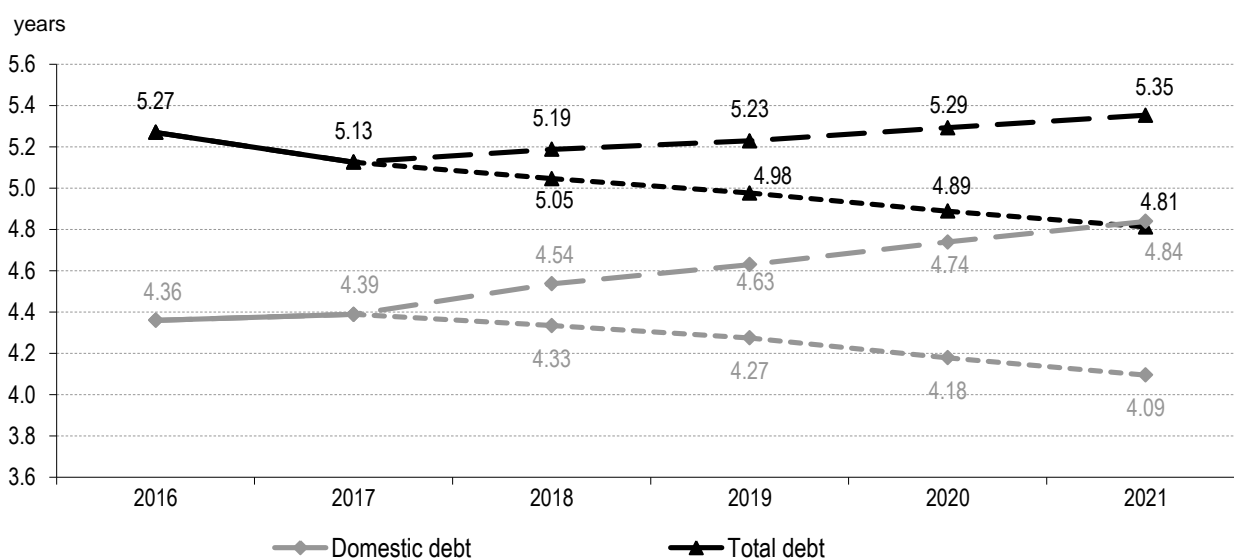


Chart 19. ATR of the ST debt

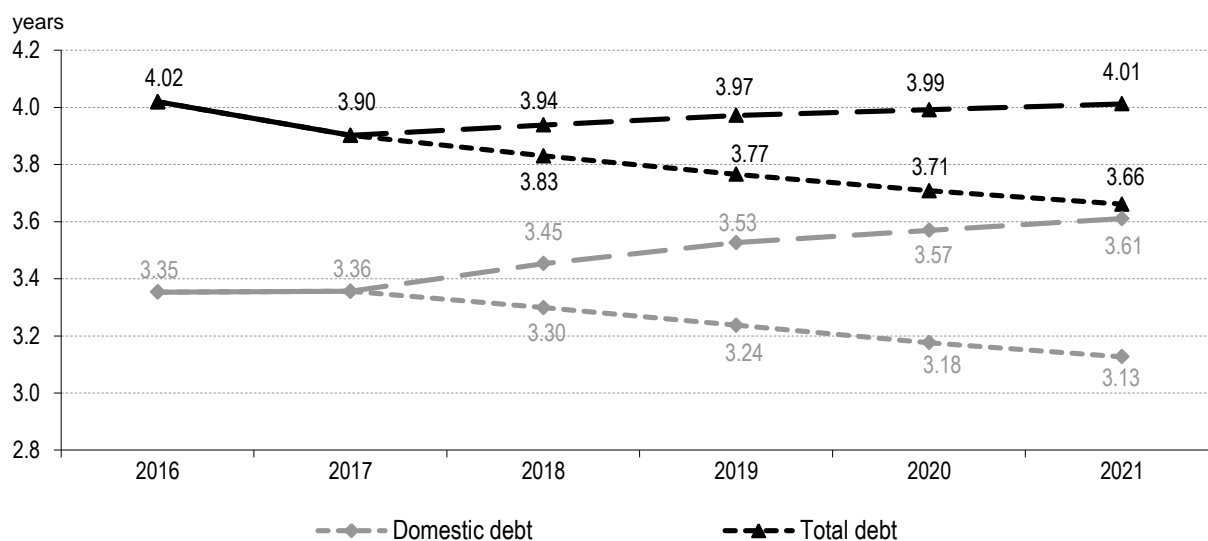


Chart 20. Duration of the ST debt

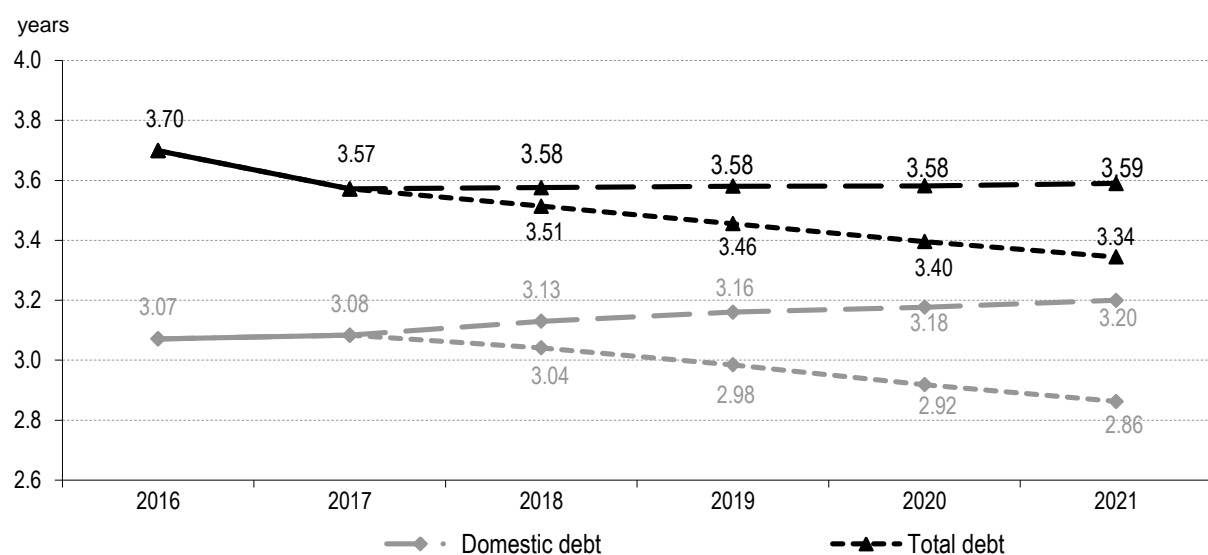
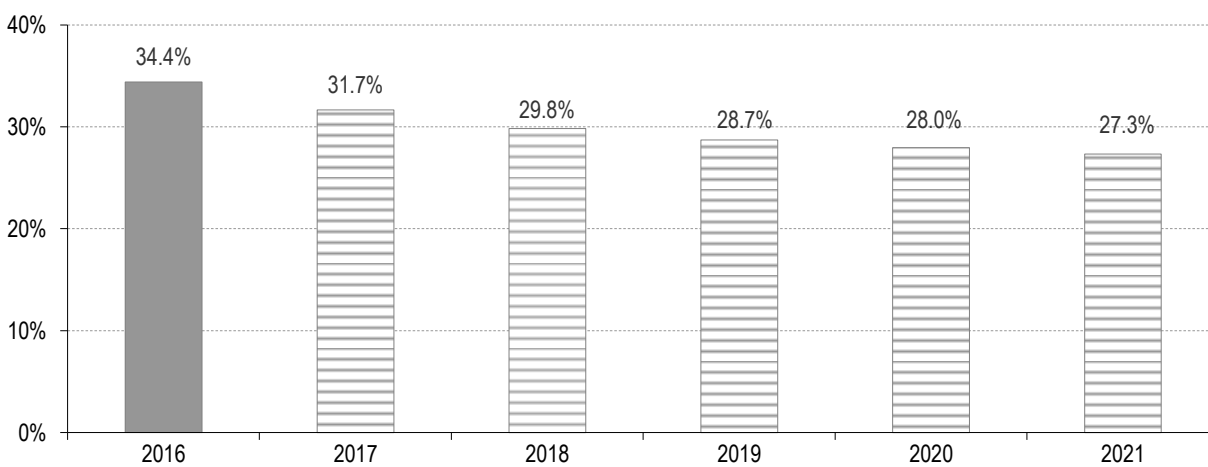


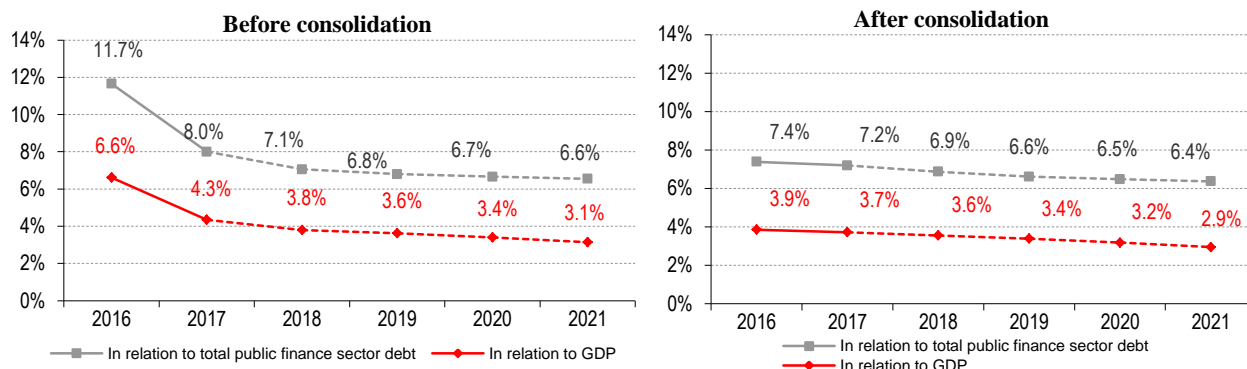
Chart 21. The share of foreign currency debt in total ST debt



VIII.3. Debt of public finance sector entities other than the State Treasury

Under the adopted assumptions, in the timeframe of the *Strategy*, the before consolidation debt-to-GDP ratio of the remaining public finance sector entities will decrease from 4.3% to 3.1%, whereas the debt after consolidation will fall from 3.7% to 2.9%. The share of this group of entities in the public finance sector debt before consolidation will decline from 8.0% to 6.6%, and after consolidation – from 7.2% to 6.4%.

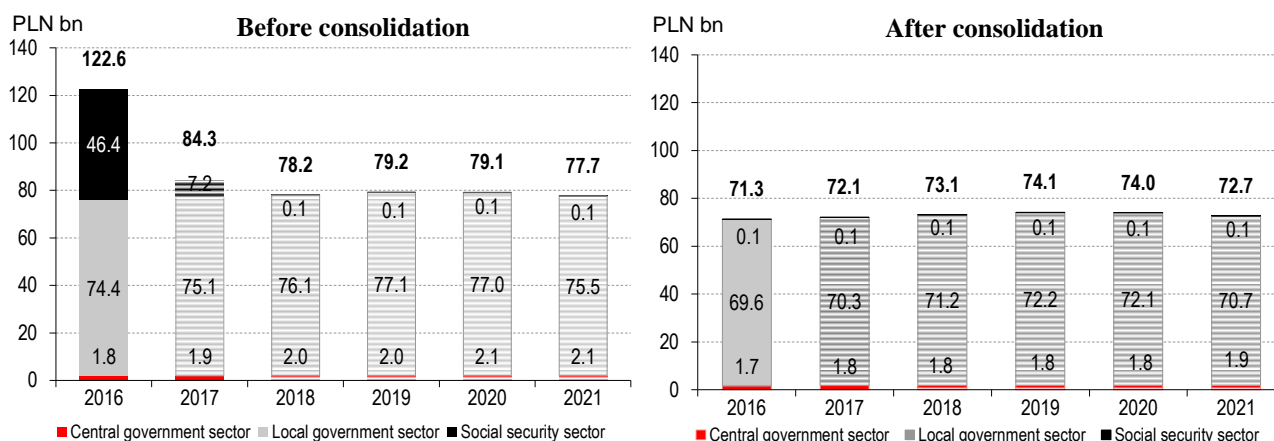
Chart 22. Debt of public finance entities other than the State Treasury before and after consolidation – in relations to GDP and as a share of total public finance sector debt



In the timeframe of the *Strategy*, the nominal debt of public finance sector entities other than ST will drop from PLN 84.3 bn to PLN 77.7 bn before consolidation, mainly as a result of scheduled in 2018 cancellation of loans from the State budget granted to FUS, with the repayment deadline falling in 2019. The cancellation of loans from the State budget granted to FUS will not affect the level of debt after consolidation which, in the timeframe of the *Strategy*, will slightly increase from PLN 72.1 bn to PLN 72.7 bn.

The *Strategy* assumes that the debt of the LGUs and their associations will remain at a relatively stable level: it will increase in the years 2017-2019 and subsequently gradually decrease as a result of projected budgetary surpluses. The level of debt of the LGUs will be also affected by the rules regarding incurring liabilities by those entities, including the individual debt ratio.

Chart 23. Debt of public finance entities other than the State Treasury before and after consolidation by sector



VIII.4. Threats to the Strategy implementation

The main threats to the implementation of the presented *Strategy* are mainly associated with:

- a macroeconomic situation in Poland varying from the assumed scenario, in particular, a slower GDP growth, higher interest rates, as well as volatility in foreign exchange rates;
- conditions in the international market, including:
 - a slower than expected growth rate in the global economy, in particular in Europe,
 - consequences of leaving EU by the United Kingdom,
 - monetary policy of major central banks, including the ECB and Fed,
 - capital outflow towards core markets or other markets as a result of, inter alia, geopolitical situation;
- the risk of excessive growth of public debt-to-the-GDP ratio, in connection with:
 - higher State budget borrowing requirements depending, among others, on the trends in the Polish economy,
 - depreciation of Polish zloty as compared to the assumptions of the *Strategy*,
 - considerable increase in debt of public finance sector entities other than ST,
 - the necessity to execute sureties or guarantees granted by public finance sector entities.

IX. GUARANTEES AND SURETIES GRANTED BY PUBLIC FINANCE SECTOR ENTITIES

IX.1. Assumptions of the strategy of granting guarantees and sureties

In order to limit the risk associated with granting ST guarantees and sureties while preserving the advantages of using them as an instrument of the State economic policy, the following principles should be maintained:

- granting sureties and guarantees mainly to support development-oriented projects, in particular, in the scope of infrastructure, environmental protection, creating new jobs and regional development, financed i.a. with the EU funds as well as to support other investment tasks arising from potential new support programmes stipulating granting sureties and guarantees;
- sureties and guarantees may be also used to support possible measures undertaken in case of potential deterioration in the Polish financial system.

The value of new sureties and guarantees granted in a given year is limited through the Budget Act. Pursuant to Article 31 of the *Act of May 8, 1997 on sureties and guarantees granted by the State Treasury and certain other legal persons*, each year the Budget Act stipulates the total amount to which guarantees and securities can be granted by the ST. The limit for 2018 in the draft Budget Act was determined at a level of PLN 200bn. The extent of the use of ST sureties and guarantees will result mainly from the continuation of infrastructural investments. Moreover, a substantial part of the limit has been prearranged to secure potential measures that may be undertaken in case of deterioration of the Polish financial system. An increase in contingent liabilities resulting from sureties and guarantees granted by the ST will be affected to a large extent by sureties and guarantees granted to the following entities:

- BGK for bonds issuance and repayment of loans incurred for the KFD in order to co-finance the construction of road infrastructure;
- PKP Polskie Linie Kolejowe S.A. for the repayment of loans incurred in order to co-finance the investment in railway infrastructure.

IX.2. Analysis and forecasts of the level of guarantees and sureties

Contingent (undue) liabilities arising from guarantees and sureties granted by public sector entities at the end of the first half of 2017 amounted to PLN 123.4 bn, compared to PLN 128.2 bn (6.9% of GDP) in 2016 and PLN 116.9 bn (6.5% of GDP) in 2015.

Liabilities due to guarantees and sureties granted by the ST had a dominant share in the contingent liabilities. At the end of the first half of 2017 they amounted to PLN 119.8 bn, as compared to PLN 124.5 bn (6.7% of GDP) in 2016 and PLN 113.2 bn (6.3% of GDP) in 2015. The increase in contingent liabilities until the end of 2016 resulted mainly from new guarantees granted to support the development of infrastructure. The hitherto ST operations do not pose significant risks to public finance and at the end of 2016, c.a. 85% of contingent liabilities due to guarantees granted by the ST belonged to the low-risk group.

The biggest amounts of ST contingent liabilities (status as at 30 June 2017) resulted from:

- | | |
|---|------------|
| • guarantees granted for BGK | PLN 85.2bn |
| including, for the support of KFD | PLN 83.8bn |
| • guarantees granted for PKP Polskie Linie Kolejowe S.A. | PLN 13.4bn |
| • guarantees of payments from KFD for Gdańsk Transport Company S.A. | PLN 8.0bn |
| • guarantees of payments from KFD for Autostrada Wielkopolska II S.A. | PLN 6.3bn |

- guarantees granted for Autostrada Wielkopolska S.A. PLN 3.4bn
- guarantees granted for PKP Intercity S.A. PLN 1.9bn

It is expected that the relation of potential ST liabilities due to sureties and guarantees granted to GDP will amount to approx. 7.6% at the end of 2017, and then grow subsequently, however, in the consecutive periods of forecast it will remain at a level below 10%.

Table 10. Contingent liabilities under guaranties and sureties granted by the ST and the public finance sector units

	2015	2016	2017	2018	2019	2020	2021
Contingent liabilities under guaranties and sureties granted by:							
a) Public finance sector							
- PLN bn	116.9	128.2	150.3	159.4	174.0	191.0	209.3
- in relation to GDP	6.5%	6.9%	7.8%	7.7%	8.0%	8.2%	8.5%
b) State Treasury							
- PLN bn	113.2	124.5	146.7	155.9	170.5	187.4	206.0
- in relation to GDP	6.3%	6.7%	7.6%	7.6%	7.8%	8.1%	8.3%

Annex 1. Abbreviations and glossary

A. Abbreviations used in the Strategy

ATM – average time to maturity
ATR – average time to refixing
CIRS – currency interest swap
ECB – European Central Bank
Fed – the Federal Reserve System in the USA
FUS – Social Security Fund
IFIs – international financial institutions
KFD – National Road Fund
LGUs – local government units
NBP – National Bank of Poland
PD – Primary Dealers
PFS – Public Finance Sector
SPZOZ – independent public health care units
ST – State Treasury
TS – Treasury securities

B. Glossary

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 would be redeemed. The further the maturity dates, the lower the refinancing risk and the higher the average maturity. Average maturity of domestic marketable TS is calculated according to the following formula:

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

where:

t – maturity date,

T – set of all maturity dates,

N_t – face value paid at time t ,

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

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*. The *ATR* of domestic marketable TS is calculated according to the following formula:

$$ATR = \frac{\sum_{r \in R} r N Z_r + \sum_{t \in T} t N S_t + \sum_{j \in J} \frac{1}{12} N I_j I_0}{\sum_{r \in R} N Z_r + \sum_{t \in T} N S_t + \sum_{j \in J} N I_j I_0}$$

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.

Benchmark

1. (*issue*) the large amount of TS issue with a liquid secondary market. Yield of benchmark bond is the reference point for yields in a given maturity segment. Benchmark issues subject to trading on the electronic market Treasury BondSpot Poland are TS issues defined by the Minister of Development and Finance, in particular fixed rate bonds, with maturity of at least one year and total face value of at least PLN 10bn or on-the-run issues with total face value of at least PLN 2bn. When setting benchmarks on the Polish yield curve in Reuters and Bloomberg the criterion of time to maturity is applied.
2. (*portfolio*) target characteristics of the public debt portfolio, which constitutes a reference portfolio for the existing portfolio and determines 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.

Buy-sell-back – transaction which consists of two agreements: spot purchase and forward sale of securities at a price set upfront at the day of the transaction.

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 with receivables. For the debt management unit such a situation occurs with financial transactions on derivatives. Credit risk also occurs in management of liquid assets, e.g. through making deposits with banks and purchase of securities. Credit risk is managed mainly by choosing partners with high creditworthiness (measured by their ratings) and by setting limits for total transaction size for partners, dependent on their credit credibility and type of transaction.

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 (expressed in years) of debt servicing costs adjustment to the change of interest rate levels. 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.

$$Duration = \frac{\sum_{r \in R} \left[r \sum_{s \in S_r} \frac{CFZ_s}{(1+i_s)^s} \right] + \sum_{s \in S} \frac{sCFS_s}{(1+i_s)^s}}{\sum_{s \in S} \frac{CFZ_s}{(1+i_s)^s} + \sum_{s \in S} \frac{CFS_s}{(1+i_s)^s}}$$

where:

- s – payment date (of interest or face value),
- S – set of all payment dates (of interest or face value),
- r – payment date of the nearest fixed coupon for floating rate instruments,
- R – set of all payment dates of the nearest fixed coupons for floating rate instruments,
- S_r – set of all payment dates for these floating rate securities which the nearest fixed maturity is r ,

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 .

Duration of total debt of ST is a weighted average of appropriate duration coefficients for every currency, where weights are market value of debt in particular currency.

Exchange rate risk – arises from the vulnerability of the foreign currency denominated debt level and its servicing costs to exchange rate fluctuations. The Polish zloty appreciation or depreciation against a given foreign currency results in a proportional increase or decrease (in the Polish zloty terms) of debt volume and debt servicing costs denominated in this currency.

Interest rate risk – risk that payments related 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 the 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 to the level of other types of risk will increase due to infrastructure, organization and supervision of the debt management, that is inadequate to the scope of tasks. Operational risk the most difficult risk to be measured. Limiting the operational risk can be achieved by integration of public debt management procedures in one organizational entity, having its structure, infrastructure and procedures adjusted to efficient operations in the environments of government administration and financial markets.

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.

Potential debt – liabilities that are not public debt, but which can become public debt once after a specific event takes place. Guaranties and sureties granted by the public finance sector units are a classical example of potential debt. In case of execution of a guaranty or surety, the liabilities become due and increase expenditures of an entity that granted them, thus increasing its borrowing requirements and public debt.

Primary Dealers – a group of institutions (banks) 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 investor or group of investors.

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. Refinancing risk is influenced by the level of outstanding debt and its maturity profile. An extension of the debt maturity and an even distribution of debt redemption over time contribute to the reduction of refinancing risk.

Residency criterion - the criterion of the division of public debt into domestic and 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).

Spread – the difference between yields of two debt securities. In narrower sense credit spread (also credit margin) – the difference between yields of two securities with all the characteristics (especially maturity date) except for issuer identical (or almost identical). Spread is often understood as a difference between yields of credit risk-burdened and credit risk free (or characterized by the lowest risk in the class) security.

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 expenditures. 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 disruptions which prevent or make difficult financing borrowing needs on the financial market at rational cost.

State budget liquidity risk is managed, on one hand, by keeping safe reserve of funds at the lowest possible level (by improving the process of state budget liquidity planning and monitoring) and on the other hand, by the management of liquid assets in a way that they generate budget revenues which in the highest possible extent compensate for costs of keeping a given level of liquidity.

Swap – a derivative contract through which two parties exchange cash flows based on a notional principal amount with rules of calculating their value specified in advance. Swap may be a separate financial instrument or it may accompany other instruments.

Annex 2. Cyclical publications of the Ministry of Finance regarding public debt and TS market

- Annual reports:
<http://www.finanse.mf.gov.pl/en/web/wp/public-debt/publications/annual-reports>
- State Treasury debt, monthly bulletin:
<http://www.finanse.mf.gov.pl/en/public-debt/outstanding-debt/state-treasury-debt>
- Public debt, quarterly bulletin:
<http://www.finanse.mf.gov.pl/en/web/wp/public-debt/outstanding-debt/public-debt1>
- Monthly information on TS supply and its background
<http://www.finanse.mf.gov.pl/en/web/wp/public-debt/publications/monthly-bulletin>
- Monthly information on investors structure on domestic TS market:
<http://www.finanse.mf.gov.pl/en/public-debt/secondary-market/structure-of-investors>
- Monthly information on transaction on secondary TS market:
<http://www.finanse.mf.gov.pl/en/public-debt/secondary-market/secondary-market-statistics>

Annex 3. Legal regulations applied to public debt in Poland and the EU

Table 1. Public debt – basic legal regulations

Polish regulations	EU regulations
<p>1. Constitution of the Republic of Poland</p> <ul style="list-style-type: none"> ban on incurring loans and granting guaranties and sureties resulting in the public debt exceeding 3/5 of GDP (Article 216(5)); 	<p>1. Treaty on the functioning of the European Union</p> <ul style="list-style-type: none"> level of general government debt and restrictions applied to general government deficit constitute the criterion on the basis of which the Commission examines the compliance with budgetary discipline in Member States (Article 126) – specifies the Excessive Deficit Procedure (EDP);
<p>2. Public Finance Act</p> <ul style="list-style-type: none"> regulations on public debt: definitions, basic principles of issuing public debt and debt management, prudential and remedial procedures applied to public debt levels; definition of the scope of the public finance sector. 	<p>2. Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community and the Treaty on the functioning of the European Union</p> <ul style="list-style-type: none"> definition of general government debt and reference value of debt to GDP ratio at 60%;
	<p>3. Council Regulation (EC) No 479/2009 of 25 May 2009 on the application of the Protocol on the Excessive Deficit Procedure annexed to the Treaty establishing the European Community</p> <ul style="list-style-type: none"> definition of general government debt with specification of categories of liabilities which constitute it;
	<p>4. Regulation (EU) No 549/2013 of the European Parliament and of the Council of 21 May 2013 on the European system of national and regional accounts in the European Union (ESA 2010)</p> <ul style="list-style-type: none"> definition of categories of financial liabilities; definition of general government sector.

Table 2. Limits on the public debt to GDP ratio in Public Finance Act

Public Finance Act
<p>I. Legal procedures regarding limits on public debt to GDP ratio</p> <p>1) the ratio in year x is greater than 55% and lower than 60%:</p> <p>a) it is assumed the lack of deficit or the difference between state budget revenues and expenditures in draft budget act adopted by the Council of Ministers for the year $x+2$ must ensure the decrease in State Treasury debt to GDP ratio as compared to the ratio announced for the year x;</p> <p>b) budget deficit of local government unit diminished by cumulated budgetary surplus from previous years and liquid funds in budget resolution for the year $x+2$ can only derive from expenditures for current tasks co-financed from EU funds or non-returnable financial aid provided by EFTA member countries;</p> <p>c) in draft budget act adopted by the Council of Ministers for the year $x+2$:</p> <ul style="list-style-type: none"> no increase in salaries of public sector employees is assumed, revaluation of pensions must not exceed the CPI level in the budgetary year $x+1$, ban on granting new loans and credits from the State budget is introduced, the increase in expenditures of the Sejm (lower house of Polish Parliament), the Senate (upper house of Polish Parliament), Presidential Chamber of the Republic of Poland, Constitutional Tribunal, Supreme Audit Office (NIK), Supreme Court, Primary Administration Court, common courts of law and provincial administration courts, Spokesman of Citizen Rights, Spokesman of Child Rights, National Board of Radio and Television, General Inspector for the Security of Personal Data, The Institute of National Remembrance – Commission for the Prosecution of Crimes against the Polish Nation, National Electoral Office, National Labor Inspection must not be higher than expenditures in the government administration; <p>d) the Council of Ministers make a review of:</p> <ul style="list-style-type: none"> State budget expenditures financed by foreign credits, long- term programs; <p>e) the Council of Ministers presents a remedial program ensuring the fall in public debt to GDP ratio;</p>

Public Finance Act	
f)	the Council of the Ministers make a review of regulations in force to propose possible legal solutions which influence state budget revenues, including VAT rates,
g)	State Fund for the Rehabilitation of Disabled Persons receives earmarked subsidies from the state budget for co-financing of disabled workers salaries at the level of 30% of planned funds for that year,
h)	new liabilities can be incurred by government administration if the investments are co-financed from EU funds or non-returnable financial aid provided by EFTA member countries at the maximum level, set in the rules or procedures for particular type of investment, not lower than 50% of the total costs, however these restrictions do not apply to state road rebuilding or repairs required for road traffic hazard removal, anti-flood infrastructure investments, electronic toll service and compensations for properties taken over for public roads investments;
2) the ratio in year x is equal to or greater than 60%:	
a)	procedures provided in point 1, letters a, c, d, f, g and h in case of the ratio greater than 55%, and lower than 60% are in force;
b)	budgets of local government units for the year x+2 must at least be balanced;
c)	a ban on granting new sureties and guarantees by public finance sector entities is introduced;
d)	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%;
Procedures provided in point 1 are not applicable if the amount of debt determined by recalculating public debt using for the foreign currency denominated debt yearly average of NBP exchange rates and reducing it by the value of State budget liquid funds raised to finance borrowing requirements of the following year does not exceed the threshold of 55%.	
II. Principles and limits on incurring liabilities by local government units	
a)	planned and executed current expenditures must not exceed planned and executed current revenues including liquid funds and budgetary surpluses from previous years;
b)	executed current expenditures can be higher than executed current revenues including liquid funds and budgetary surpluses from previous years only by amounts linked to the current tasks co-financed from EU funds or non-returnable financial aid provided by EFTA member countries if these funds were not forwarded in specified year;
c)	Local government units can incur loans and issue securities for: <ul style="list-style-type: none"> • repayment of previously incurred liabilities resulting from securities and loans, • covering transitional budget deficit of local government within the fiscal year, • financing of planned budget deficits; • financing in advance of the tasks co-financed from UE funds;
d)	Loans incurred and securities issued for covering temporary budget deficit of local government have to be paid off or redeemed in the same year as they were incurred or issued;
e)	Local government can only incur liabilities of which servicing costs are borne at least once a year, while: <ul style="list-style-type: none"> • discount of securities issued by local government cannot exceed 5% of their face value, • capitalization of interest is forbidden;
f)	For a local government unit, the total ratio of: <ul style="list-style-type: none"> • instalments of loans and interest payable in this fiscal year, • redemption of securities and interest (including discount) payable on them, • potential payments resulting from sureties and guarantees granted, to planned revenues cannot exceed in the budgetary year and any other year following the budgetary year the arithmetical average for last three years of current revenues including proceeds from privatization minus current expenditures to total revenues ratio;
g)	Limitations on debt repayments of local government do not apply to: <ul style="list-style-type: none"> • instalments and interest payable on loans drawn in connection with a programme, project or task co-financed with the EU funds; • redemption and interest (including discount) payable on securities issued in connection with a programme, project or task co-financed with the EU funds; - but no later than 90 days after the end of the programme, project or task and receiving a refund; this cut-off date does not apply to liabilities incurred for national contribution; <ul style="list-style-type: none"> • instalment of loans and redemption of securities, and interest (including discount) payable on them, incurred or issued to finance national contribution of a programme, project or task with the EU co-financing level exceeding 60%.

Table 3. Correction mechanism of the stabilising expenditure rule.

Public Finance Act
The correction amounts of the stabilizing expenditure rule pursuant to Article 112aa(4):
<p>1) – 2 percentage points:</p> <ul style="list-style-type: none"> • the general government deficit in year x-2 exceeds GDP 3% (including costs of pension system reform) or • the amount specified in article 38a point 3 of the Public Finance Act (the amount of public debt recalculated using the yearly average of foreign currency exchange rates for the year concerned and reduced by the value of State budget liquid funds raised to finance the borrowing requirements for the following budget year) exceeds in year x-2 GDP 48%.
<p>2) – 1.5 percentage points:</p> <ul style="list-style-type: none"> • the general government deficit in year x-2 does not exceed GDP 3% (including costs of pension system reform) and the amount specified in article 38a point 3 of the Public Finance Act exceeds in year x-2 GDP 43% but is not higher than GDP 48% and • the forecasted dynamics of the real GDP for year x (assumed in the draft budget act for the year x) is not lower than the medium term average by over 2 percentage points;
<ul style="list-style-type: none"> • the general government deficit in year x-2 does not exceed GDP 3% (including costs of pension system reform) and • the amount specified in article 38a point 3 of the Public Finance Act in year x-2 is lower or equal to GDP 43% and • the sum of the differences between the general government nominal balance and the medium-term budgetary objective (MTO) exceeds in year x-2 GDP 6% and • the forecasted dynamics of the real GDP for year x (assumed in the draft budget act for the year x) is not lower than the medium term average by over 2 percentage points;
<p>3) + 1.5 percentage points:</p> <ul style="list-style-type: none"> • the general government deficit in year x-2 does not exceed GDP 3% (including costs of pension system reform) and • the amount specified in article 38a point 3 of the Public Finance Act in year x-2 is not higher than GDP 43% and • the sum of the differences between the general government nominal balance and the MTO exceeds in year x-2 GDP 6% and • the forecasted dynamics of the real GDP for year x (assumed in the draft budget act for the year x) is not higher than the medium term average by over 2 percentage points
4) in other cases there is no correction element

Table 4. Differences between public debt (Polish definition) and general government debt (EU definition).

Polish regulations	EU regulations
public debt	general government debt
1) scope of the public finance sector	
<ul style="list-style-type: none"> • Public Finance Act defines limited catalogue of units included in the public finance sector, i.e.: <ul style="list-style-type: none"> – bodies of public authority, including bodies of government administration, bodies of state control and legal protection, courts and tribunals; – local government units and their associations; – budgetary units; – local government budgetary entities; – executive agencies; – institutions of budgetary management; – state special-purpose funds; – Social Security Institution and funds under its management; – Agricultural Social Insurance Fund (KRUS) and funds under management of the President of KRUS; – National Health Fund; – independent public health care units; – public universities; – Polish Academy of Sciences and organizational units founded by it; – state and local government cultural institutions; – other state or local government legal persons founded under separated acts in order to execute public tasks, excluding enterprises, research institutes, banks and commercial companies. 	<ul style="list-style-type: none"> • scope of <i>general government</i>¹⁾ sector is defined in ESA2010²⁾; no limited catalogue of units is defined;
<i>differences in the scope of sector depending on regulations</i>	
<p>a) funds formed within Bank Gospodarstwa Krajowego (BGK), f. ex. : the National Road Fund (KFD), the Railway Fund (FK)</p> <ul style="list-style-type: none"> • are excluded from the public finance sector; 	<ul style="list-style-type: none"> • are included in the general government sector³⁾;
<p>b) public corporations that are deemed non-marketable (f. ex. PKP PLK S.A., Port Lotniczy Łódź, health care institutions)</p> <ul style="list-style-type: none"> • are excluded from the public finance sector; 	<ul style="list-style-type: none"> • are included in the general government sector;
2) liabilities which constitute public debt	
<ul style="list-style-type: none"> • securities (excluding shares); • loans (including securities whose disposal is limited); • deposits; • matured payables (i.e. liabilities due but not settled, which have not been lagged nor cancelled); 	<ul style="list-style-type: none"> • securities; • loans; • cash and deposits;
<i>differences in liabilities depending on regulations</i>	
<ul style="list-style-type: none"> • matured payables; 	<ul style="list-style-type: none"> • ⁴⁾ • restructured or refinanced trade credits (including those with original maturity of one year or less) are included in loan category⁵⁾
3) valuation of liabilities denominated in foreign currencies	
<ul style="list-style-type: none"> • liabilities denominated in a foreign currency shall be converted into the national currency on the basis of the middle exchange rate applicable on the last working day of each period. 	<ul style="list-style-type: none"> • liabilities denominated in a foreign currency, or exchanged from one foreign currency through contractual agreements to one or more other foreign currencies shall be converted into the other foreign currencies at the rate agreed on in those contracts and shall be converted into the national currency on the basis of the representative market exchange rate prevailing on the last working day of each year.

Polish regulations	EU regulations
public debt	general government debt
4) contingent liabilities	
<i>differences in treatment of contingent liabilities in debt-to-GDP ratio</i>	
<ul style="list-style-type: none"> is not included; 	<ul style="list-style-type: none"> EU limitations do not take directly into account contingent liabilities generated by issued sureties and guarantees; when specific criteria are met contingent liabilities should be treated as debt assumed by the entity which issued surety or guarantee;

- Polish Central Statistical Office (GUS) is responsible for the scope of general government sector (in line with EU regulations). The list of general government sector entities is available on the internet website of GUS: http://stat.gov.pl/download/gfx/portalinformacyjny/pl/defaultaktualnosci/5483/6/6/1/lista_jednostek_sektora_instytucji_rzadowy_ch_i_samorzadowych_s13_zgodnie_z_esa2010_stan_na_31_grudnia_2016.xlsx
- ESA2010 (Regulation (EU) No 549/2013 of the European Parliament and of the Council of May 21, 2013 on the European system of national and regional accounts in the European Union) states that an entity is classified to the general government sector if it is not a separate institutional unit from government or is a separate institutional unit controlled by general government and it is non-market. The ability to undertake market activity is checked notably through the usual quantitative criterion, i.e. if the ratio of sales revenues to production costs is above 50% , the unit is in principle deemed market. However, in order to decide whether a producer that operates under the control of government is a market unit some qualitative criteria must also be taken into account.
- In compliance with Eurostat guidelines on sector classification of some infrastructure projects, general government debt figures may, under specified conditions, include capital expenditures of the projects in question (imputed loan)
- Matured payables are expenditure on accrual basis and thus are included in net borrowing/net lending calculated (balance of general government) in accordance with EU methodology.
- Pursuant to decision of Eurostat of 31 July 2012 on *The statistical recording of some operations related to trade credits incurred by government units*

Annex 4. Selected statistical data concerning public finance and credit rating in Poland and EU

Table 5. General government deficit, debt¹⁾ and yields on 10-year bonds²⁾ in the EU countries in 2015-2016

	2015			2016		
	GG balance	GG debt	10Y interest rate	GG balance	GG debt	10Y interest rate
	% PKB	% PKB	%	% PKB	% PKB	%
Greece	-5.9	177.4	9.67	0.7	179.0	8.36
Italy	-2.7	132.1	1.71	-2.4	132.6	1.49
Portugal	-4.4	129.0	2.42	-2.0	130.4	3.17
Cyprus	-1.2	107.5	4.54	0.4	107.8	3.77
Belgium	-2.5	106.0	0.84	-2.6	105.9	0.48
Spain	-5.1	99.8	1.73	-4.5	99.4	1.39
France	-3.6	95.6	0.84	-3.4	96.0	0.47
United Kingdom	-4.3	89.0	1.79	-3.0	89.3	1.22
Euro area	-2.1	90.3	1.22	-1.5	89.2	0.86
Austria	-1.1	85.5	0.75	-1.6	84.6	0.38
Croatia	-3.4	86.7	3.55	-0.8	84.2	3.49
European Union	-2.4	84.9	1.44	-1.7	83.5	1.11
Slovenia	-2.9	83.1	1.71	-1.8	79.7	1.15
Ireland	-2.0	78.7	1.18	-0.6	75.4	0.74
Hungary	-1.6	74.7	3.43	-1.8	74.1	3.14
Germany	0.7	71.2	0.50	0.8	68.3	0.09
Finland	-2.7	63.7	0.72	-1.9	63.6	0.37
Netherlands	-2.1	65.2	0.69	0.4	62.3	0.29
Malta	-1.3	60.6	1.49	1.0	58.3	0.89
Poland	-2.6	51.1	2.70	-2.4	54.4	3.04
Slovakia	-2.7	52.5	0.89	-1.7	51.9	0.54
Sweden	0.3	43.9	0.72	0.9	41.6	0.54
Lithuania	-0.2	42.7	1.38	0.3	40.2	0.90
Latvia	-1.3	36.5	0.96	0.0	40.1	0.53
Denmark	-1.3	39.6	0.69	-0.9	37.8	0.32
Romania	-0.8	38.0	3.47	-3.0	37.6	3.32
Czech Republic	-0.6	40.3	0.58	0.6	37.2	0.43
Bulgaria	-1.6	26.0	2.49	0.0	29.5	2.27
Luxembourg	1.4	21.6	0.37	1.6	20.0	0.25
Estonia	0.1	10.1	:	0.3	9.5	:

¹⁾ Data on general government balance and debt – Eurostat. Data on Poland – MF.

²⁾ 10-year interest rate – average of average monthly 10-year T-bond yields from last twelve months, from January to December; Eurostat.

Table 6. Long-term government debt rating in foreign currency of EU Member States as of September 18, 2017

	Standard&Poor's	Fitch	Moody's
Austria	AA+	AA+	Aa1
Belgium	AA	AA-	Aa3
Bulgaria	BB+	BBB-	Baa2
Croatia	BB	BB	Ba2
Cyprus	BB+	BB-	Ba3
Czech Republic	AA-	A+	A1
Denmark	AAA	AAA	Aaa
Estonia	AA-	A+	A1
Finland	AA+	AA+	Aa1
France	AA	AA	Aa2
Greece	B-	B-	Caa3
Spain	BBB+	BBB+	Baa2
Netherlands	AAA	AAA	Aaa
Ireland	A+	A	A2
Lithuania	A-	A-	Baa1
Luxembourg	AAA	AAA	Aaa
Latvia	A-	A-	A3
Malta	A-	A+	A3
Germany	AAA	AAA	Aaa
Poland	BBB+	A-	A2
Portugal	BBB-	BB+	Ba1
Romania	BBB-	BBB-	Baa3
Slovakia	A+	A+	A2
Slovenia	A+	A-	Baa1
Sweden	AAA	AAA	Aaa
Hungary	BBB-	BBB-	Baa3
United Kingdom	AA	AA	Aa1
Italy	BBB-	BBB	Baa2

Source: Reuters

Table 7. Public debt in Poland in 2006 – June 2017

Item	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	June 2017
1. State Treasury debt												
a) PLN bn	478.5	501.5	569.9	631.5	701.9	771.1	793.9	838.0	779.9	834.6	928.7	945.7
domestic *	352.3	380.4	420.2	462.7	507.0	524.7	543.0	584.3	503.1	543.3	609.2	650.2
foreign *	126.2	121.1	149.7	168.8	194.8	246.4	250.9	253.8	276.9	291.3	319.5	295.5
b) GDP %	44.7%	42.2%	44.3%	46.0%	48.6%	49.2%	48.7%	50.6%	45.4%	46.4%	50.2%	-
2. Public debt (domestic definition)												
a) PLN bn	506.3	527.4	597.8	669.9	747.9	815.3	840.5	882.3	826.8	877.3	965.2	977.2
b) GDP %	47.3%	44.4%	46.5%	48.8%	51.7%	52.0%	51.6%	53.3%	48.1%	48.8%	52.1%	-
3. General government debt (EU definition)												
a) PLN bn	502.3	524.4	595.4	678.3	767.8	847.7	875.3	922.8	863.9	919.6	1,006.3	1,016.0
b) GDP %	46.9%	44.2%	46.3%	49.4%	53.1%	54.1%	53.7%	55.7%	50.2%	51.1%	54.4%	-

*) place of issue criterion

Table 8. GDP and exchange rates in 2006 – June 2017

Item	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	June 2017
1. Gross Domestic Product												
PLN bn	1,069.8	1,187.6	1,286.1	1,372.2	1,445.3	1,566.8	1,629.4	1,656.8	1,719.7	1,799.3	1,851.2	-
2. Exchange rate (end of period)												
a) EUR	3.8312	3.5820	4.1724	4.1082	3.9603	4.4168	4.0882	4.1472	4.2623	4.2615	4.4240	4.2265
b) USD	2.9105	2.4350	2.9618	2.8503	2.9641	3.4174	3.0996	3.0120	3.5072	3.9011	4.1793	3.7062