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The State as a Financial Market Participant

The first half of the 1970s brought two events that initiated processes of great significance for countries in the wider West. This period saw the final erosion of the Bretton Woods monetary system and the outbreak of the oil crisis. The floating of exchange rates removed barriers that had prevented the greater use of public borrowing. At the same time, a period of stagflation provided the rationale for the more active use of fiscal policy instruments to stabilize public finances. It was in the 1970s that a period of chronic budget deficits and progressive debt accumulation began.[1] Over time, it became apparent that most Western countries suffered from a phenomenon known as deficit bias. This phenomenon was induced at the interface between the process of democratic choice and the postmodern consumer society. On the one hand, political parties sought to maximize their electoral outcome. In order to do so, they sought to include wider groups of voters in their electorates, entering into the role of so-called political entrepreneurs.[2] On the other hand, voters were not sufficiently aware of the existence and role of long-term budget constraints. Consequently, they built up false perceptions about the possible options for democratic choice. The predictable result of this state of affairs was the use of public borrowing as a substitute for taxation.[3] This led to the slow transformation of tax states into debt states.[4]

The change in the financial operating model of states generated new risks, but their essence has not yet been fully identified in the literature. Increasingly, states are beginning to resemble intergenerational financial institutions, allocating funds from future generations to those currently living. The aim of this article is to identify the risks to socio-economic sustainability posed by the critical dependence of the state on the market-based financing of its borrowing needs. It is a first step in the search for a new security architecture that better serves the idea of sustainable finance.

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[1] A. Alesina, R. Perotti, *Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects*, "NBER Working Paper" 1996, no. 7530, p. 2.

[2] M. Hallerberg, J. von Hagen, *Organizacja procesu budżetowego w Polsce*, Warszawa 2006, p. 24.

[3] J.M. Buchanan, *Finanse publiczne w warunkach demokracji*, Warszawa 1997, p. 133.

[4] W. Streeck, *Buying time. The delayed crisis of democratic capitalism*, London–New York 2017, p. 72.

Scale of State Treasury activity in the financial market

An unambiguous determination of the size of the financial links between a State Treasury and the financial market is a relatively complicated task. This is largely because this entity uses a variety of instruments to perform its tasks and manage its financial resources. At the same time, some of these instruments are located outside the public finance sector. On the one hand, this circumstance affects the scope of available statistical data, on the other hand, it raises significant conceptual problems with the assessment of specific facts. An example of this is the attempt to draw demarcation lines between public and private finance. These problems arise, for example, in relation to commercial law companies, which perform the tasks of the state and do not have the ability to self-finance their activities. Nonetheless, for the purposes of the present considerations, an attempt can be made to outline to some extent the scale of State Treasury activity on the financial market.

One of the most important indicators relating to the presence of the State Treasury on the financial market is the size of its borrowing needs.[5] Pursuant to Article 76 of the Act of 27 August 2009 on Public Finance[6] (hereinafter: PFA), these needs are determined by the sum of the state budget deficit, the deficit of the EU funds budget, and repayment of debt. The Budget Act for 2023 of 15 December 2022[7] assumes that these figures will be PLN 68 billion, PLN 16.2 billion, and PLN 673.3 billion respectively. Thus, the total borrowing needs of the State Treasury for 2023 were set at PLN 757.5 billion. It is also symptomatic that the sum of forecast revenues of the state budget and the EU funds budget was PLN 713.5 billion. This means that the main source of public funds for the state budget and the EU funds budget (treated as a certain whole) is becoming public borrowing.

In fact, the analysis of the data on the size of borrowing needs included in the Budget Act did not fully reveal the scale of the State Treasury's need for repayable funds. This is because of consistent distortion of the value of Polish fiscal indicators through actions bearing the hallmarks of unstructured fiscal adjustments and, in particular, creative accounting. For example, for several years, some state budget expenditures have been recorded directly as debt. This is possible by using the transfer of treasury securities to a specific entity as a substitute for budget subsidies and grants. This reduces the reported amount of state budget expenditure and thus the budget deficit, and the treasury's borrowing needs. In 2022 alone, the total value of treasury securities transferred under this mechanism was PLN 25.8 billion.[8] These securities are,

[5] Of course, the State Treasury's borrowing needs are not entirely financed on the financial market. For example, its sources of revenue are other public finance sector entities, international financial institutions, and the European Union.

[6] Consolidated text: Journal of Laws 2022, item 1634 as amended.

[7] Journal of Law 2023, item 256.

[8] Own calculations based on data from the website of the Ministry of Finance: www.gov.pl/web/finanse/dlug-publiczny [accessed: 2023.07.23].

of course, debt titles, the nominal value of which is taken into account when calculating the treasury debt.

Another way of lowering the official level of the borrowing needs of the State Treasury is the implementation of some of its tasks through entities located outside the public finance sector. The key role here is played by funds located in Bank Gospodarstwa Krajowego (hereinafter: BGK) (primarily the National Road Fund, the Covid-19 Counteracting Fund, the Armed Forces Support Fund and the Assistance Fund) and the Polish Development Fund S.A. The main source of financing for the activities of these institutions is funds from the issue of bonds guaranteed by the State Treasury. This is another activity bearing the hallmarks of creative accounting. It makes it possible to conceal part of the real debt of the State Treasury by creating potential debt, which is not included in official statistics reported to the public. It is worth noting that at the end of 2022, the debt of the aforementioned four funds located it BGK and the Polish Development Fund S.A. was PLN 300.8 billion.

The scale of the state's connection to the financial market is also evidenced by the entity structure of the debt. At the end of 2022, State Treasury debt was PLN 1.238 billion.[9] Of this amount, PLN 446.8 billion was attributable to the domestic banking sector, whose share in the entity structure of debt was 36.1%. Most of that debt was owed to commercial banks; State Treasury liabilities to the NBP were PLN 74.3 billion. The domestic non-bank sector participated in 30.7% of debt (PLN 380.2 billion). In this respect, creditors of the State Treasury included households (PLN 88 billion), insurance companies (PLN 59.6 billion), investment funds (PLN 47.1 billion), and pension funds (PLN 5.0 billion). The remaining 33.2% of the State Treasury's debt was due to non-residents, which translated into PLN 411.5 billion at the end of 2022. Of this amount, PLN 146.2 billion is debt in domestic instruments, mainly to central banks and public institutions, investment funds, pension funds, and insurance companies. On the other hand, indebtedness to non-residents in foreign instruments consisted mainly of liabilities on account of foreign bonds (PLN 175.1 billion), as well as loans and credits from international financial institutions (the World Bank, the European Investment Bank, the Council of Europe Development Bank) and the European Union (PLN 113.6 billion in total). Taking into account the above data, it is difficult to state unequivocally what the size of the strictly market-based part of the State Treasury debt was.[10] However, it seems that at the end of 2022 its value was no less than PLN 900 billion. This amount constituted more than 70% of the amount of State Treasury debt. And, at least to this extent, the entity was dependent on the course of market processes.

[9] The source of all data in this paragraph is: Ministerstwo Finansów, "Zadłużenie Skarbu Państwa. Biuletyn Miesięczny" 2022, no. 12.

[10] For the purposes of this article, this term should be understood as the state's obligations to those bondholders whose decision to purchase treasury securities was based primarily on purely economic (the desire to maximize profit at an assumed level of risk) or regulatory (the need to meet prudential requirements imposed by applicable regulations) motives.

Treasury securities as a risk factor transmission channel

Financing growing borrowing needs forces the State Treasury to have a constant presence in the financial market. Currently, the main way in which a government raises repayable funds is by issuing treasury securities. These instruments have a very long history, dating back to medieval Venice. However, after the end of the Second World War, for most countries the main means of raising repayable budgetary funds was through bank loans. This ensured a high degree of concentration of the entity structure of State Treasury debt and facilitated negotiations with a relatively narrow, homogeneous, and often capital-linked group of creditors.[11] It was not until the 1990s that the treasury securities market saw intense development. It is worth noting that, among developing countries, the rise in popularity of these instruments followed the positive experience of the so-called Brady Plan. The aim of this plan was to solve the debt crisis of some developing countries. One of its elements was the partial conversion of debts owed to commercial banks into government bonds.[12]

With a properly chosen issuance strategy, treasury securities are proving to be the most effective form of public borrowing. Their great advantage is the ability to reach a wide range of investors. This translates into both greater certainty of financing a treasury's borrowing needs and minimizing debt servicing costs.[13] Moreover, there are a number of national and supranational legislative solutions that increase investor interest in treasury securities. Excellent examples of this include the provisions of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012[14] and Commission Delegated Regulation (EU) No 2015/35 of 10 October 2014 supplementing Directive 2019/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).[15] In a nutshell, these regulations introduce prudential standards to which credit institutions and insurance undertakings are subject. In doing so, both acts give preferential treatment to the claims of these entities on the central governments of the Member States of the European Union, provided that these claims are denominated and funded in the national currency of the government concerned. When calculating the risk exposure amounts of individual assets of credit institutions and insurance companies, these claims are assigned a weight of zero. Exposures to public sector entities are treated in a similar manner, provided they benefit

[11] W. Mark, C. Weidemaier, M. Gulati, *A People's History of Collective Action Clauses*, UNC Legal Studies Research Paper, no. 2172302, Chapel Hill 2012, p. 6.

[12] M. Dynus, *Obligacje Brady'ego sposobem na rozwiązanie kryzysu zadłużeniowego krajów rozwijających się*, "Toruńskie Studia Międzynarodowe" 2010, no. 1(3), p. 41.

[13] M. Mosionek-Schweda, P. Panfil, *Klauzule wspólnego działania w strefie euro* [in:] *Instytucje prawno-finansowe w warunkach kryzysu gospodarczego*, eds. W. Miemiec, K. Sawicka, Warszawa 2014, p. 629.

[14] OJ L 176, 27.6.2013, p. 1 as amended.

[15] OJ L 012, 17.1.2015, p. 1 as amended.

from adequate central government guarantees (Articles 114[4] and 116[4] of Regulation 575/2013 and Article 180[2] of Regulation 2015/35).

Solutions favoring sovereign debt at the level of prudential norms seem to go too far. As the experience of the euro area debt crisis shows, even liabilities denominated and financed in domestic currency are not without risk. This would only be the case if the central bank acted as lender of last resort to the State Treasury. However, in the European Union, this possibility is, at least in theory, excluded by Article 123 of the Treaty on the Functioning of the European Union[16] (hereinafter: TFEU). According to this provision, the ECB and the central banks of the Member States may not grant loans to EU institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, or to other national public institutions or undertakings. This prohibition is also articulated in a slightly different way by Article 220(2) of the Constitution of the Republic of Poland of 2 April 1997.[17] According to it, the Budget Act may not provide for covering the budget deficit by incurring a liability in the central bank of the State. Consequently, the zero risk attributed to, inter alia, treasury securities at the level of prudential norms is in systemic contradiction with the prohibition on financing the State Treasury's borrowing needs by the central bank. It would therefore seem necessary to make these norms more realistic by attributing to State Treasury claims the actual risk that these claims generate. Alternatively, the central bank should be allowed to perform the function of lender of last resort to the State Treasury. However, the exercise of this function should only take place in times of serious threat to fiscal sustainability.

Given the legislative arrangements in place, EU Member States may not increase the attractiveness of treasury securities through the use of tax preferences. According to Article 124 TFEU, any measure not based on considerations of a prudential nature establishing privileged access by the institutions, bodies, offices or agencies of the EU, central governments, and regional, local, or other public authorities to financial institutions is prohibited. This prohibition also extends to other institutions or public undertakings of the Member States. Article 124 TFEU thus ensures transparency and, to a large extent, the equivalence of relations between the public and private sectors. By contrast, the purpose of this provision is to prevent public authorities of EU Member States from using their power (or the emanation of that power in relation to public undertakings) to force any decision on financial sector institutions.[18]

The provisions of Article 124 TFEU are clarified by Council Regulation (EC) No 3604/93 of 13 December 1993 laying down definitions for the application of the prohibition of privileged access listed in Article 104a of the Treaty.[19] According to Article 1 of this Regulation, "any measure establishing privileged access" shall mean, inter

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16 Consolidated version OJ EU C202, 7.6.2016, p. 47 as amended.

17 Journal of Laws, No. 78, item 483 as amended.

18 A. Nowak-Far [in:] *Traktat o funkcjonowaniu Unii Europejskiej. Komentarz. Tom II*, eds. K. Kowalik-Bańczyk, M. Szwarc-Kuczer, A. Wróbel, Warszawa 2012, pp. 709–710.

19 OJ L 332, 31.12.1993, p. 30.

alia, a law, regulation or other binding act adopted in the exercise of public authority granting:

1. tax breaks that can only benefit financial institutions,
2. financial facilities that are not in line with market economy principles,

- to encourage these institutions to acquire or hold the liabilities of central government institutions and bodies.

In Poland, Article 124 TFEU is not fully complied with. The most important breakthrough in this respect was created by Article 5(9) of the Act of 15 January 2016 on tax on certain financial institutions[20] (hereinafter: TFIA). This provision introduces a tax credit that can be used by domestic banks, branches of foreign banks, branches of credit institutions and cooperative savings and credit unions. Its essence is the deduction from the tax base[21] of the value of assets in the form of treasury securities and securities statutorily guaranteed by the State Treasury. The latter include, for example, bonds issued for the benefit of certain funds placed with BGK (e.g., the Armed Forces Support Fund). Undoubtedly, Article 5(9) of the TFIA increases the competitiveness of securities issued or statutorily guaranteed by the State Treasury against other instruments characterized by low profitability and risk. In this respect, the construction of the tax on financial institutions distorts the market mechanism and forces taxpayers to make decisions that are beneficial from the point of view of the fiscal interests of the state.[22]

Another factor building up commercial bank demand for treasury securities is the practice of central banks. These securities are, inter alia, the subject of activities carried out under market-based monetary policy instruments. In Poland, it is possible to distinguish at least four, partly interrelated areas of NBP activity that relate to treasury securities. First, these instruments serve as collateral during the refinancing of commercial banks. Second, they are used during open market operations. Third, the share of treasury securities in the bank's own portfolio is taken into account during competition for the function of money market dealers. Fourth, these instruments are used during operations that are part of the concept of quantitative monetary easing. Within the framework of the latter, debt securities guaranteed by the State Treasury also play a similar role to treasury securities (e.g., bonds issued by BGK for the benefit of KFD and FPC-19, or bonds of PFR S.A.). However, the scale of operations implemented as part of NBP's quantitative easing of monetary policy in 2020–2021 is evidenced by changes in the central bank's balance sheet. While at the end of 2019 the Polish central bank was not involved in debt securities denominated in the domestic currency,[23] at the end of 2021 their involvement reached PLN 149.3 billion. (almost PLN 87 bil-

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[20] Consolidated text: Journal of Laws 2022, item 1685 as amended.

[21] In some simplification, this basis is the excess of the taxpayer's total assets over the amount of PLN 4 billion.

[22] P. Panfil, *Podatek od niektórych instytucji finansowych w świetle art. 124 Traktatu o funkcjonowaniu Unii Europejskiej*, GSP 2017, vol. 38, p. 398.

[23] NBP, *Raport Roczny 2019*, Warszawa 2020, p. 182.

lion in treasury securities and PLN 62.4 billion in securities guaranteed by the State Treasury).[24]

Twin debt crises

The dependence of modern states on market financing for their borrowing needs creates a two-way crisis transmission mechanism between the public finance sector and the financial sector. This mechanism is one of several reasons for the occurrence of so-called twin debt crises. Research shows that the spread of foreign government bonds shows a strong correlation with the spread of domestic loans to private borrowers. Episodes of sovereign bankruptcy in the international market, on the other hand, show a strong correlation with episodes of large-scale bankruptcies of private domestic entities.[25]

From the point of view of the financial sector, the danger of the loss of fiscal sustainability by a state can be treated as so-called systemic risk. This concept is defined in Article 4(15) of the Act of 5 August 2015 on the macroprudential supervision of the financial system and crisis management in the financial system.[26] According to this provision, systemic risk is the risk of disruption in the functioning of the financial system which, if it materializes, disrupts the operation of the financial system and the national economy as a whole. In particular, its source can be trends related to excessive credit or debt dynamics and related asset price imbalances, unstable funding patterns, risk distribution in the financial system, linkages between financial institutions, and macroeconomic and sectoral imbalances. Undoubtedly, the deteriorating state of public finances is a manifestation of macroeconomic imbalances resulting from excessive debt. At the same time, it leads to volatility in the prices of treasury securities and disrupts the financial sector.[27] A fall in the value of these instruments obviously aggravates the situation of their holders, particularly banks.[28] Paradoxically, entities are sometimes forced to refinance maturing sovereign debt. This is because this behavior can protect them from the possible bankruptcy of the issuer of treasury securities.[29] However, sovereign bankruptcy itself means that financial institutions have to update the value of their asset portfolios. Historically, such bankruptcies have meant a reduction in claims by holders of treasury securities in the range of 13–73%.[30] Undoubtedly, this type of situation can lead to the bankruptcy of some bondholders.

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24 NBP, *Raport Roczny 2021*, Warszawa 2022, p. 192.
25 D. Tymoczko, *Operacje banków centralnych w okresach kryzysu* [in:] *Polityka pieniężna*, ed. A. Sławiński, Warszawa 2011, p. 219.
26 Consolidated text: Journal of Laws 2022, item 2536 as amended.
27 P. Panfil, *Reguły i iluzje fiskalne w Polsce. Ujęcie prawnofinansowe*, Gdańsk 2021, p. 62.
28 S. Pawłowski, *Nowe zadania Europejskiego Banku Centralnego a kryzys zadłużeniowy*, “Analizy Natolińskie” 2013, no. 10, p. 28.
29 Z. Grocholski, *Banki i rynki finansowe. Od zaufania publicznego do kasyna?*, Warszawa 2016, p. 168.
30 K. Oosterlinck, *Sovereign debt defaults: Insights from history*, “Oxford Review of Economic Policy” 2013, vol. 29, no. 4, p. 700.

As an aside, attention should also be drawn to the modern view of fiscal sustainability. This notion implies avoiding the excessive growth of government liabilities, which burdens future generations, while at the same time being able to provide necessary public services to society, including adequate security in difficult times, and the possibility of changing policies pursued in response to new challenges.[31] One of the attributes of fiscal sustainability thus becomes the ability of the state to respond adequately to emerging crisis phenomena, and thus to fulfil the stabilizing function of public finances. At the same time, in an era of chronic budget deficits, this capacity depends on the creditworthiness of the state and the confidence it enjoys in the financial market. These factors determine the ability to provide market-based financing for the government's surging borrowing needs. It is worth noting here that the costs of supporting financial institutions in times of crisis are usually very high. The example of Ireland, which guaranteed the liabilities of its largest banks on 30 September 2008, can be cited here. At the end of 2010, this resulted in state disbursements of EUR 50 billion and a public finance crisis.[32] This amount was equivalent to almost a third of Ireland's GDP. The disbursements associated with the guarantees caused the general government deficit to reach an astronomical 31.2% of GDP in 2010 and the general government debt to rise to 92.5% of GDP.[33] Impressively, Ireland was able to finance this expenditure and regain the confidence of financial market participants after a relatively short period of disruption. The fact that Ireland entered the global financial crisis with very sound public finances appears to have been a key factor in this. In 2007, this manifested itself in a small general government surplus and a debt of only 25.0% of GDP,[34] which created space for the extensive use of fiscal policy instruments in response to extraordinary challenges.

Undoubtedly, the need to support financial institutions at risk of bankruptcy is becoming a serious challenge for public finances, potentially leading to a spike in public debt. However, this is not the only mechanism for the transmission of crisis phenomena. Growing risk aversion and the deteriorating situation of financial market participants affect their behavior. The result is changes in the volume and structure of demand for treasury securities. Due to the herd behavior of investors, such processes are often highly dynamic. The decisions taken by participants in the market game are not always rational, balanced, or right, but are often irrational, unfair, and even hysterical.[35] Moreover, at high levels of debt, investor reactions become highly non-linear.[36] Some phenomena and processes are also self-fulfilling prophecies. This issue is related to the so-

[31] European Commission, *Fiscal Sustainability Report 2012*, "European Economy" 2012, no. 8, pp. 1–2.
[32] P. Bagus, *Tragedia euro*, Warszawa 2011, p. 117.
[33] European Commission, *European Economic Forecast. Spring 2012*, "European Economy" 2012, no. 1, p. 70.
[34] European Commission, *European Economic Forecast. Spring 2010*, "European Economy" 2010, no. 2, p. 87.
[35] A. Wernik, *Finanse publiczne*, Warszawa 2011, p. 102.
[36] J. Escolano, *A practical guide to public debt dynamics, fiscal sustainability, and cyclical adjustment of budgetary aggregates*, "IMF Technical Notes and Manuals", January 2010, p. 11.

called collective action problem. Creditors might realize that the best solution would be to continue refinancing the country; however, they refuse to do so assuming that other lenders will behave in the same way. Consequently, rational individual decisions lead to a disastrous collective outcome.[37] At the public-private association level, this type of creditor behavior generates a phenomenon similar to a bank run.[38] As a result, state bankruptcy can occur not only because of insolvency but also a loss of liquidity.

It is also worth noting the contagion effect, which is the transmission of a crisis among actors seeking financing on the financial market. This phenomenon can occur, inter alia, between financial institutions and states and between states. In the latter case, the source of the disruption can be, for example, investors automatically closing their positions in countries belonging to the same group.[39] An excellent example of the contagion phenomenon is the events that took place during the Eurozone debt crisis. Interestingly, this effect was induced by the problems experienced by the financial holding company Dubai World in 2009. This institution managed a large portfolio of Dubai government investments and projects. As a result, investors assumed that Dubai World's liabilities were guaranteed by the emirate. However, a representative of the Dubai government officially denied this assumption on 30 November 2009.[40] Investors realized that any assumptions about implicit or informal guarantees of liabilities could prove to be wrong.[41] This situation coincided with Greece's mounting fiscal problems. In the case of this country, investors also made the erroneous assumption that it had an informal guarantee of support from the richer members of the eurozone. This goes some way to explaining the spectacular fall in interest rates on Greek government securities issued after the country joined the single currency area.[42] However, the assumption of informal guarantees given to euro area members by countries such as Germany and France has never had a strong basis, especially in the context of the wording of Article 125 TFEU. This provision explicitly prohibits the EU and its members from incurring or assuming responsibility for the liabilities of other Member States. When investors realized their mistake, a sell-off of Greek government securities began, which ultimately put the country in a very difficult position. In doing so, they began to compare the consequences of a possible Greek bankruptcy with the situation that occurred in the financial market after the collapse of Lehman Brothers. Banks holding debt securities issued by the country and issuers of credit default swaps (hereafter: CDS) insuring Greek debt became the focus of particular attention.[43]

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[37] T.F. Geithner, *Stress Test. Reflections on Financial Crises*, New York 2014, p. 61.

[38] C. Arellano, N. Kocherlakota, *Internal debt crises and sovereign defaults*, "NBER Working Paper" 2008, no. 13794, p. 4.

[39] M. Kiedrowska, P. Marszałek, *Stabilność finansowa – pojęcie, cechy i sposoby jej zapewniania (II)*, "Bank i Kredyt" 2002, no. 4, p. 20.

[40] A. Abocar, *Dubai govt won't back Dubai World debts*, "Reuter" 2009, November 30.

[41] R. Petru, *Koniec wolnego rynku? Geneza kryzysu*, Warszawa 2015, p. 129.

[42] J. Peet, A. la Guardia, *Unhappy union. How the euro crisis – and Europe – can be fixed*, London 2014, p. 37.

[43] K. Whelan, *Sovereign default and the euro*, "Oxford Review of Economic Policy" 2013, vol. 29, no. 2, p. 493.

Various financial market malfunctions or pathologies also prove to be a certain threat to fiscal sustainability. It should be borne in mind that the financial health of the state is continuously assessed by financial market participants. The results of this assessment influence the demand for treasury securities and the risk premium demanded. In this context, three market indicators for assessing the fiscal sustainability of the state are of key importance. These are: 1) ratings; 2) the spread between domestic government bond yields and the benchmark;[44] and 3) the premium in CDS contracts. In each of these cases, problems can be found that require the intervention of the legislator.

At the heart of the rating services market problem is an over-reliance on the ratings provided by the credit rating agencies (hereinafter: CRAs). Its manifestation is the widespread use of ratings in, among other things, the process of estimating capital requirements and liquidity standards, or for constructing investment strategies.[45] This phenomenon is largely stimulated by legislators who force financial market participants to use ratings for so-called regulatory purposes. Such solutions have contributed to the creation of the oligopolistic structure of the market for rating services and exacerbate the conflicts of interest that exist in it.[46] The scale of the problem is exacerbated by the high barriers to entry into the market for rating services, the funding model adopted for rating agencies, and the petrification of business relationships resulting, inter alia, from the so-called lock-in effect.[47] This situation adversely affects the independence, objectivity, and quality of the ratings provided by CRAs. Legislative action should therefore aim to reduce the use of ratings for regulatory purposes and to increase competition in the rating services market.[48] In the EU, the solutions contained in Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies[49] were generally intended to achieve this result. However, the big three CRAs (Fitch, Moody's, and Standard & Poor's) continue to hold a dominant share of the ratings issued on request. In the case of treasury securities issued by European Economic Area sovereigns, it was around 95% at the end of 2022.[50] Undoubtedly, therefore, the problem of the oligopolistic structure of the rating services market remains unresolved.

In contrast, the other two market-based indicators for assessing fiscal sustainability – the spread on the yield of treasury securities and the premium in CDS contracts – are sensitive to speculative activities aimed at lowering the market value of treasury secu-

[44] From a Polish perspective, this benchmark is the yield on German government bonds.

[45] P. Niedziółka, *Agencje ratingowe – instytucje wczesnego ostrzegania przed kryzysem czy podmioty destabilizujące rynki finansowe?*, „Zarządzanie i Finanse" 2013, vol. 2, no. 1, p. 397.

[46] Opinion of the European Economic and Social Committee on Credit Rating Agencies, COM(2008) 704 final – 2008/0217 (OJ C 277, 17.11.2009, p. 117).

[47] The effect is that the issuer refrains from changing rating agency for fear that such a step will be interpreted by financial market participants as an expression of creditworthiness problems.

[48] *Report of the High-Level Group on Financial Supervision in the EU*, chaired by J. de Larosière, Brussels, 25 February 2009, pp. 19–20.

[49] OJ L 302, 17.11.2009, p. 1 as amended.

[50] ESMA, *Market Report on the EU Credit Ratings market 2023*, Paris 2023, p. 45.

rities. Investment strategies such as short selling and so-called naked CDS contracts are used for this purpose. In general, short selling consists of two steps. In the first, the investor borrows treasury securities and sells them at the current market price, while in the second step, which is carried out at a specific point in the future, they purchase instruments of the same type and repay the borrowing. In the case of this strategy, the investor's profit is hidden in the difference between the higher selling price of the treasury securities and the lower buying price of them. Meanwhile, the name naked CDS contracts refers to contracts in which the purchaser of the credit protection insures themself against the risk of a credit event, even though its occurrence does not involve any damage to it. An example would be the purchase of CDS contracts against the risk of bankruptcy of a particular sovereign by an investor who does not hold treasury securities issued by that sovereign.

The investment strategies described pose a significant challenge to the smooth functioning of the market for treasury securities, especially when implemented on a large scale. Short selling means an increase in the supply of these instruments on the secondary market and generates downward pressure on their price. The consequence of this situation can be an increase in the yield of treasury securities and the cost of financing a treasury's borrowing needs. Meanwhile, the high demand for CDS contracts leads to an increase in the premium demanded by their issuers, thereby worsening the conditions under which holders of treasury securities insure themselves against the risk of a credit event. At the same time, financial market participants perceive such a situation as an increase in the probability of sovereign default. The effect can be both an increase in the risk premium demanded by investors and a decrease in demand for treasury securities. It seems, therefore, that the possibility of using investment strategies based on short selling and naked CDS contracts should at least be limited. Given the global nature of today's financial market, however, such restrictions should be set at a supranational level. In this respect, it is worth highlighting the efforts of the EU legislator, which has, in principle, introduced a ban on naked CDS contracts in the European Union and partially restricted the use of strategies based on short selling. This has been achieved through the solutions contained in Regulation (EU) No 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps.[51] However, it should be highlighted that there has been a trend in recent years of some EU Member States introducing more far-reaching restrictions on short selling. It is therefore possible to consider whether such solutions should be transferred to the EU level. In addition, it would be worthwhile making efforts to harmonize the rules on naked CDS contracts and short selling in the major global financial markets.

A separate problem that countries can face in the financial market is the activity of vulture funds. These entities appear on the secondary market for treasury securities of countries experiencing serious fiscal difficulties, buying up the instruments they have issued at a large discount to face value. Then, rejecting restructuring proposals,

[51] OJ L 86, 24.03.2012, p. 1 as amended.

they demand payment of the face value of the securities acquired plus matured interest. This type of operating strategy is fraught with high risk. Obtaining a favorable court judgment and its subsequent enforcement are both problematic. Consequently, a relatively small group of specialized entities [IMF 2012], usually operating in the form of hedging funds (e.g., Elliott Associates, NML Capital Ltd.), opt for this profile of activity. From the point of view of the activities of vulture funds, it is crucial that there is no bankruptcy law designed for states at the international level. Thus, public-law associations that become illiquid or insolvent do not benefit from any form of additional legal protection.[52] In this context, the use of collective action clauses in treasury securities issuance contracts is extremely important. This term refers to a set of contractual provisions that simplify the debt restructuring process, thereby contributing to the orderly resolution of debt crises. In simple terms, collective action clauses allow a specific group of treasury security holders to accept restructuring proposals in a manner that is binding on all creditors.[53]

Conclusions

One of the conditions for the realization of the idea of sustainable finance is an appropriate legal architecture, which should take into account the complexity of the financial system. This complexity is revealed, inter alia, in the multifaceted interrelationships that exist among the various elements of this system. The applicable rules should seek to limit the scale of the transmission of risk factors between these elements. Indeed, a crisis occurring in a single segment of the financial system should not have a destructive impact on the functioning of the entire system. One area of particular concern for national and EU legislators should be market-based financing of treasury borrowing needs. Of course, it is reasonable to limit the size of these needs and build a restrictive budgetary framework. Indeed, countries with a low level of public debt have a greater capacity to absorb various shocks to public finances, as well as to provide support to financial institutions in times of crisis. In addition, a lower debt level means less State Treasury involvement in the financial market.

Regardless of the solutions relating directly to public finance, national and EU legislators cannot depreciate the importance of solutions directly affecting the way a State Treasury operates on the financial market. In this respect, it is postulated that this entity should be subject to fully market-based mechanisms of operation. In particular, a State Treasury should not enjoy any preferences with regard to its presence on the financial market. This postulate concerns both tax issues and the assessment of the risks associated with treasury securities. At the same time, the legislator should strive to eliminate the financial market inefficiencies that affect the situation of the state

52 P. Panfil, *Ograniczenie działalności sępich funduszy w strefie euro – wnioski de lege lata*, "Prace Naukowe Uniwersytetu Ekonomicznego we Wrocławiu" 2018, no. 531, p. 352.

53 M. Mosionek-Schweda, P. Panfil, *Klauzule wspólnego działania…*, p. 631.

treasury. These include, for example, the oligopolistic nature of the market for rating services, the activities of vulture funds, and the use of certain investment strategies such as short selling and naked CDS contracts. However, the effective elimination of such inefficiencies requires coordinated action at the supranational level.

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Summary

Przemysław Panfil

The State as a Financial Market Participant

High levels of public debt and chronic budget deficits force states to be constantly present on the financial market. This leads to the slow transformation from tax states into debt states. The change in the financial operating model generates new risks, the essence of which the literature has yet to fully identify. Increasingly, states are beginning to resemble intergenerational financial institutions, allocating funds from future generations to those currently living. The aim of this article is to identify the risks to socio-economic sustainability posed by the critical dependence of the state on market-based financing of its borrowing needs. This is a first step in the search for a new security architecture that better serves the idea of sustainable finance.

Keywords: public debt, borrowing needs, treasury securities, financial market, fiscal sustainability.

Streszczenie

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Państwo jako uczestnik rynku finansowego

Wysoki poziom długu publicznego i chroniczny deficyt budżetowy zmuszają związki publicznoprawne do stałej obecności na rynku finansowym. Prowadzi to do powolnej transformacji państw opartych na podatkach w państwa oparte na długu. Zmiana modelu działania państw na płaszczyźnie finansowej generuje nowe zagrożenia. Wydaje się, że ich istota nie została jeszcze w pełni zidentyfikowana w literaturze przedmiotu. W coraz większym stopniu państwa zaczynają przypominać międzypokoleniowe instytucje finansowe, dokonujące alokacji środków finansowych od przyszłych pokoleń na rzecz pokoleń obecnie żyjących. Celem artykułu jest identyfikacja zagrożeń, jakie dla zrównoważonego rozwoju społeczno-gospodarczego niesie ze sobą krytyczne uzależnienie państwa od rynkowego finansowania jego potrzeb pożyczkowych. Jest to pierwszy krok na drodze do poszukiwania nowej architektury bezpieczeństwa, która lepiej służyłaby idei zrównoważonych finansów.

Słowa kluczowe: dług publiczny, potrzeby pożyczkowe, skarbowe papiery wartościowe, rynek finansowy, stabilność fiskalna.