Public Debt Policies

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Government liabilities

Debt developments

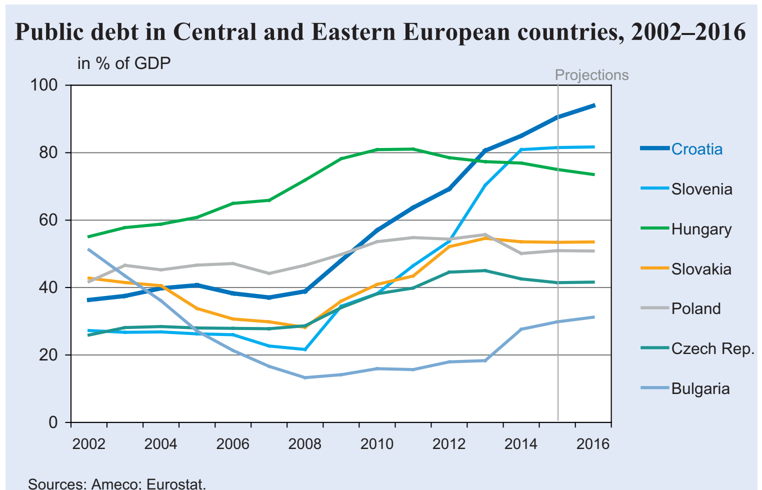
Public debt is an important indicator for assessing the sustainability of a country's fiscal policy: high and rising debt levels (usually expressed as a share of GDP) jeopardize fiscal sustainability. Fiscal risks can result from the currency denomination of public debt, the creditor structure, the maturity structure, and interest rate developments. Liabilities not recorded in the budgetary system ('hidden debt') also impair fiscal sustainability. Comprehensively assessing a country's fiscal sustainability requires considering obligations the government has assumed both inside as well as outside the budgetary system, such as government guarantees on borrowing by public and private entities and liabilities of state-owned enterprises.

In 2014, Croatia's general government debt-to-GDP ratio was 85.0 percent[1] Croatia's debt-to-GDP ratio was still below the EU28 average (86.8 percent), but compared to central and eastern European peer group countries Croatia exhibits the highest debt-to-GDP ratio (see Figure 1). The Croatian debt-to-GDP ratio is expected to rise further to 93.9 percent in 2016 (European Commission 2015).

The central government holds 98.1 percent of general government debt. Central government debt under the Eurostat definition includes guarantees to the state-owned road transport companies[2] (about 9.8 percent of GDP) and the Croatian Bank for Reconstruction and Development (about 4.5 percent of GDP). Excluding guarantees, general government debt amounts to about 70.7 percent of GDP (CNB 2014). Additionally, the government has issued guarantees of about 2.4 percent of GDP to units classified outside the general government that are not included in the Eurostat definition (see Figure 2).

After a moderate decline between 2002 and 2007, general government debt started to increase strongly after the outbreak of the financial crisis in 2008 and during the following years of recession. The unfavorable developments of the government budget, combined with decreasing nominal GDP, raised the government debt-to-GDP ratio by about 46 percentage points between 2008 and 2014. Between 2008 and 2011, the primary deficit (net lending excluding interest payments) as a share of GDP increased from 1.0 percent to 4.5 percent. After a decline between 2011 and 2013, the primary deficit increased to 2.2 percent of GDP in 2014; it is projected to reach 1.9 percent and 2.0 percent in 2015 and 2016, respectively. Interest payments as a share of GDP increased from 1.6 percent in 2002 to 3.5 percent in 2014 and will increase further in the next years.

Figure 1



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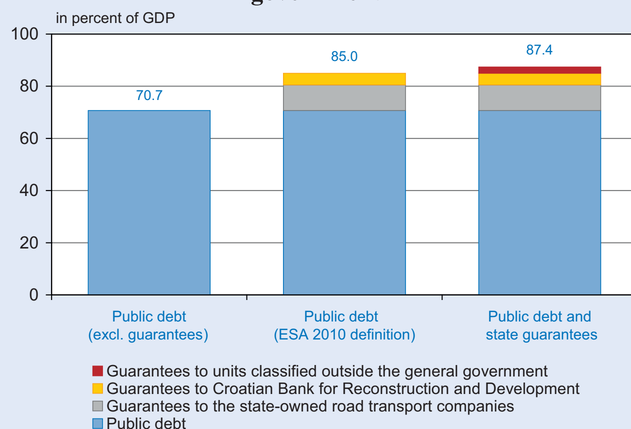
[1] The debt level in absolute terms amounted to about 36.5 billion euros.

[2] Croatian Motorways, Croatian Roads, and Rijeka-Zagreb Motorway.

Figure 2

Contingent and non-contingent liabilities of the Croatian general government



Sources: Ameco; Eurostat; own calulations.

In April 2015, Croatia faced the second-highest interest rate among its peer countries, after Hungary, on long-term government bonds denominated in national currency. Credit default swaps (CDS), which insure investors against the default of the bond-issuing sovereign, are higher in Croatia than in all peer group countries. CDS spreads are an indicator of the market's current perception of the sovereign's risk of default. At the beginning of 2015, Standard & Poor's cut Croatia's credit rating from BBB to BB, two levels below investment grade, because the government did not manage to reduce the budget deficit and the economy remains in recession (Bloomberg 2015).

Debt structure

The currency structure of Croatian public debt poses risks to fiscal sustainability because the government has largely issued bonds denominated in foreign currencies. In 2013, only 23.3 percent of government debt was denominated in kunas, while 72.2 percent was denominated in euros, 4.3 percent in US dollars and 0.1 percent in Swiss francs. At about 58.1 percent of GDP, debt denominated in foreign currency is very large and makes Croatia vulnerable to external shocks and exchange rate risks.

The composition of creditors of the general government has changed over time, depending more strongly on domestic borrowing in 2013 than a decade ago. The share of external debt has decreased by about 21.3 percentage points between 2001 and 2013, and amounted to about 39.0 percent of total debt in 2013. Public debt has thus become less vulnerable to sudden capital outflows, but is still exposed to external shocks. The share of external debt is lower than the share of debt denominated in foreign currencies, indicating that also domestic creditors lend to the government in foreign currencies.

The main domestic creditors of the general government are deposit credit institutions, which held about 34.2 percent of government bonds in 2013. 68.9 percent of the credit institutions' claims on the central government are denominated in a foreign currency. Given the owner structure of the banking sector (16 out of the 35 credit institutions in Croatia are foreign-owned banks) a large part of borrowing from credit institutions could also be considered *de facto* as external debt. The second-largest domestic creditors are pension funds, which held about 16.7 percent of government bonds in 2013. Pension funds started buying government bonds only in 2002, after the introduction of the second pillar of the pension system. Since 2002 the share of government bonds held by pension funds has steadily increased, reaching about 71.5 percent of total net assets in pension funds in 2014.

Guarantees and liabilities of state-owned enterprises

The Croatian central government issues debt guarantees to ensure favorable borrowing conditions for enterprises that are predominantly in state ownership (particularly the state-owned road transport companies), local government units, extra-budgetary funds and the Croatian Bank for Reconstruction and Development (see Bajo and Primorac 2011). Guarantees are mainly issued for development and construction projects. The tourism sector, the agriculture sector and shipbuilding projects also received government guarantees. In 2014, government guarantees amounted to about 16.7 percent of GDP. Government guarantees may become actual liabilities if corporations receiving guarantees are privatized or face financial difficulties.

In 2014, the state owned shares in about 641 companies, holding more than 50 percent of the stock in 79 of them. According to the State Office for State Property Management (2014), the state holds shares

in companies worth about 14.2 percent of GDP, including financial and insurance services, manufacturing, transportation and storage, construction, and agriculture, forestry and fishing. In 2014, the liabilities of 49 state-owned non-financial companies amounted to about 26.8 percent of GDP (State Office for State Property Management 2014; Bajo and Primorac 2014). The companies with the largest amount of total liabilities were Croatian Motorways, Croatian Roads, HEP and INA. Total liabilities of the road transport companies amounted to about 12.5 percent of GDP. Total liabilities of the state-owned financial companies amounted to about 11.3 percent of GDP.

Policy recommendations

To slow down the accumulation of public debt, Croatia must implement structural reforms to reduce the primary deficit. Additionally, privatization receipts should be used to reduce the stock of debt. Privatization should proceed in two stages: In the first stage, it should start with the sale of state-owned enterprises (SOE) in the competitive and purely commercial sectors of the economy, such as manufacturing, banking, hospitality and food services sectors. The sale of infrastructure assets, such as transport (railways, highways and roads), telecommunications, energy, and sewage, should only be considered in later stages of privatization. The sale of assets in the infrastructure sectors embodies public policy considerations such as universal access and consumer protection from abuse of monopoly pricing, and thus poses complex regulatory and competition issues. International experience shows that governments have sought to build credibility for privatization programs concentrating on competitive sectors in the first stage of privatization, and only later addressing infrastructure assets. Additionally, establishing market and regulatory frameworks is essential to the success of the transactions (OECD 2003). Certain firms with public goods characteristics, such as water and forest lands, require special regulations and protection. The list of companies of strategic interest that are not planned to be privatized should be carefully reviewed.

The state-owned enterprises that are not privatized in the first stage and the companies of strategic interest need to be restructured. The large liabilities of several SOEs constitute an obstacle to the privatization process. Restructuring should also include a professionalization of the management, i.e. (i) depoliticizing the SOE management and increasing managerial autonomy and accountability; (ii) setting clear objectives, performance evaluation and incentive structures; and (iii) instituting transparent disclosure. The SOEs should be encouraged to obtain a credit rating and seek funding from private lenders, which can reduce the government's influence and foster corporate discipline.

Debt policies and accounting and reporting standards should address implicit as well as explicit, and contingent as well as non-contingent fiscal risks. To better control contingent liabilities, government guarantees should be reduced. This requires publicly recognizing and communicating the limits of the state's responsibilities. Privatizing and restructuring (troubled) state-owned enterprises reduces contingent liabilities and future government expenditures, such as subsidies or recapitalization costs, thereby strengthening the sustainability of public finances. In the absence of more ambitious restructuring efforts in the railway and road infrastructure companies, the main recipients of state guarantees, the risk of additional public debt increases remain significant (see also European Commission 2014).

Sound fiscal institutions should be developed to evaluate, regulate, control, and prevent financial risks. A debt management strategy is crucial to reducing vulnerabilities in the public sector, and should address the following issues:

a) The share of bonds issued in foreign currencies should be reduced to lessen the risks stemming from exchange rate fluctuations, concentrating more on domestic currency financing of public debt.
b) The share of short-term debt should be kept at the current low level and even reduced in the coming years.
c) All guarantees to public and private entities and liabilities of public companies should be included in a comprehensive debt report.
d) The creditor structure should be closely monitored. The share of debt held by external creditors should be reduced to lower risks stemming from external shocks.

A debt management agency could be established to ensure optimal financing conditions for the central government. A main task of the debt management agency would be taking loans on the money and credit

markets to repay maturing debts and to ensure that all government expenditures are financed. The agency's responsibilities could also include supporting bond emissions, and portfolio optimization using derivative financial instruments. Additionally, the agency could carry out market analyses, develop models for an optimal borrowing strategy, and be responsible for liquidity management and risk monitoring.

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