Sustainability of Public Debt in Croatia

Jurica Šimurina, Dario Turkalj

***Abstract*— .**Public debt exploded in recent years as countries tried to help their economies recover from recession. Even with larger public spending many countries failed to recover and public debt crisis is looming over them. What was considered a sound anti recession policy may turn to prolonged recession and in some cases failure of state and monetary system altogether. Even though the worst case scenario is not likely, scars will remain for years to come.

***Keywords*—** Croatia, debt, government.

I. Introduction

Public debt is currently a problem in many countries. Governments on one hand want to get out of recession as soon as possible, however at the same time pitfall of inflation is lurking around the corner. In Europe, member of EMU have to keep their public debts in check as a requirement of the monetary union. Currently, many countries have gone overboard with their public debts seriously jeopardizing the monetary union, namely Greece, but others may join the club. In Croatia, even though the public debt was in check until 2007, now it has gotten even worse without any tendency of improvement in near future. This dangerous path may be the Greek path which no one wants but habits remain.

II. Background

Many discussions on public finances and public debt can shortly be summarized as follows [1] "A budget deficit is like sin. To most of the public it is morally wrong, very difficult to avoid, not always easy to identify, and susceptible to considerable bias in measurement."

Since its independence, Croatian government reached for debt financing due to several reasons. Naturally, during the War of independence, prime interest was defense which required considerable funds. After the war operations were over, there was a phase that included reconstruction along with the increasing bill for retirement and health care systems. State owned banks were an additional liability. Part of the problem was settled selling of government property through privatization of state owned enterprises (SOEs), but other liabilities were covered through debt. The problem was that government revenues increased very slowly, but expenditures rose dramatically.

Manuscript received September 30, 2010.

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The major pillar of debt was based on foreign borrowing since domestic markets were barely in existence or none existing at all. Furthermore, private savings were at low levels also, so there was no real potential for financing debt at home.

However, as pointed by Eisner [1] "Whatever the real or imagined ills of the economy, the news media, most politicians and a fair proportion of the economic profession are quick to point to the culprit: 'the budget deficit.' No matter that few appear to know or care precisely what deficit they are talking about or how it is measured. No matter that few bother to explain in terms of a relevant model just how government deficit may be expected to impact the economy. No matter that few offer any empirical data to sustain their judgment."

It is clear that budget deficits exist and that they serve a purpose, however goals of deficit financing may be very different and often political reasoning is used over economic reasoning.

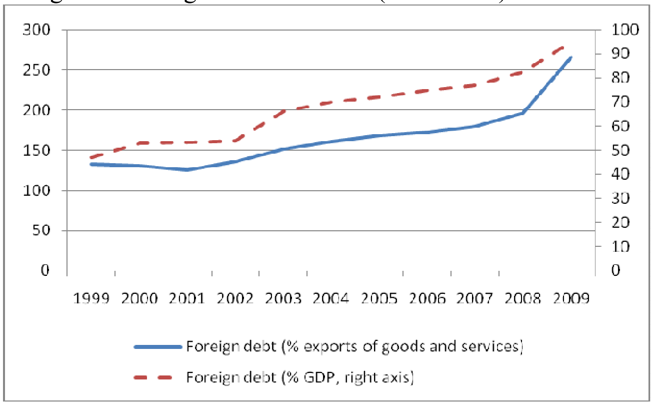
Increasing public expenditures and thus the deficit which were created in the past decade were to a large extent allocated into large infrastructure projects. However, the debt generated by the construction of freeways in the past decade is excluded from the debt figures. The framework for the debt accounting is governed by the Law on Government Budget [2] As of 2008 changes have been implemented in order to harmonize debt accounting with ESA 95 (European System of Accounts) methodology, according to which debt by HAC (Hrvatske autoceste – Croatian Motorways Ltd.) for construction of motorways is not included in the government debt.

The actual size of the public debt, which is an issue for the following sections, was created in several phases. The transition process to market economy created numerous costs with lasting future burden for the economy. The actual phases the debt can be broken to the following periods: from 1991 to 1996, 1997 to 2003 and after 2003. The first phase, which can be characterized as the early phase of public debt creation, started with the dissolution of former Yugoslavia and its debt. In 1993 Croatia acknowledged its part of the debt with the World Bank in the amount of US$135 million. Furthermore, settlement with the London and Paris clubs in 1995 and 1996, along with the World Bank debt, amounted to US$2.5 billion. In the next phase, which can be characterized as a mature phase of debt, expenditures rose at a higher pace than the revenues. The unfavorable ratio created high deficits and thus the debt was created by borrowing in domestic and largely in foreign markets. The, currently, final phase of this process was the actual lowering of growth of the public debt (consolidation) [3].

III. Foreign Debt

A significant portion of public debt also represents the foreign debt. Besides the issue of the debt itself, the major attention of the monetary policy represents the exchange rate policy. Vulnerability to exchange rate exposure is significant if there are significant pressures exerted on the exchange rate. With stable exchange rate, there is not much to worry; however, the current macroeconomic situation in Croatia does not warrant such a luxury. Devaluation pressures stipulate worries of government's capability to pay its debts. If such a scenario actually materializes to a larger extent, the credit ratings, thus the interest rates on the loans may go up, rendering government incapable to pay its debt and basically default on its sovereign debt. For example, Russian Federation defaulted on its debt in 1998, and there are other examples as well, not to mention the Debt Crisis of the 1980s. Thus, the mentioned scenario is more than a theoretical consideration. Such a situation may spell disaster to public finances, especially in the light of recent events when foreign markets were virtually closed, thus the ability to refinance the public debt disappeared which made the government incapable to execute the budget.

Figure 1: Foreign debt in Croatia (1999-2009)

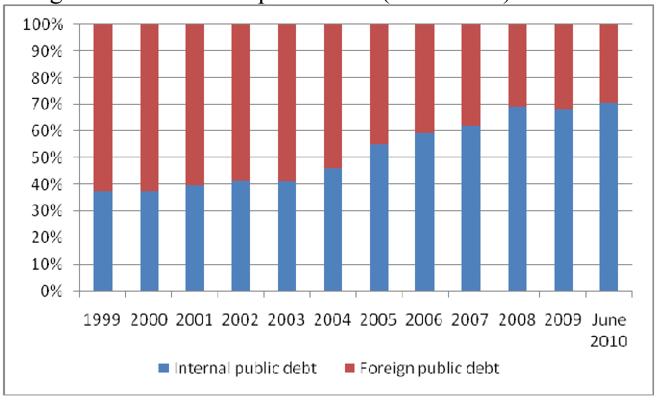


Source: [5] [6]

From figure 1 we can observe movements of foreign debt in Croatio on two accounts. First, as percentage of exports of goods and services (left axis) which indicates that exports are ever smaller proportion to our overall foreign debt. This would suggest that Croatia is not financing growth and development but to a large extent imports. This may also indicate more dificulties in the future in terms of repaying our debt. After all, we have to repay in foreign not the domestic currency. Indefinite borrowing from aboroad in order to satisfy demand for capital and for repayment of foreign debt can be exausted in time. Present financial crisis exhagerated this problem even further. Naturally, higher growth rates and lowering imports to exports ratio would make this issues less acute or even marginal. On the right axis of figure 1 we can observe percentages of our debt in GDP, and the conclusions are similar to previous analysis. Actual size of debt, relatively speaking, is not a major issue. The major issue is wheather it is sustainable or not.

In figure 2 we can observe structure of public debt in terms of foreign and domestic (internal) debt. It is clear that the focus of borrowing shifted from foreign markets to domestic markets. This also means liqudity issues generated by the government. Even though Croatian government makes the scheduled payments for foreign borrowings, domestic situation is somewhat different. Not able to pay for their domestic obligations, the solution is just to extend the payment period to ever longer periods. This in turn has devastating consequences for the entire economy, especially for small and medium enterprises which are less able to finance this debt. Furthermore, it should be noted that large enterprises in Croatia have similar tendency which exagurates the problem.

Figure 2: Structure of public debt (1999-2010)



Source: [5] [6]

IV. Public Debt

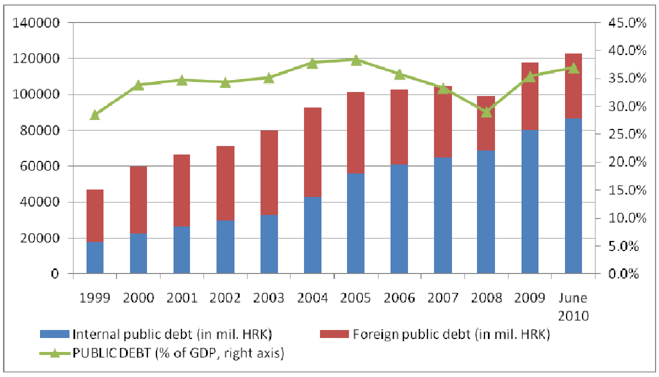
We have seen in previous section that a primary driver of foreign debt is not public domain but rather private sector, mainly through banking sector direct borrowings from abroad by companies. The absolute values of public debt in relation to foreign debt are decreasing. By 2002 the public debt was a significant portion of overall foreign debt, but situation changed in 2003 when private sector takes over in creation of foreign debt. Even though private foreign debt has significant implications on macroeconomic stability, we switch the focus entirely onto the public debt.

From the structure of the public debt we can now see clearly that the debt shifted from foreign to internal public debt. Overall, there was a significant growth in public debt during the observed period. After 2004, major portion of the public debt is actually concentrated within the country, no longer abroad. However, even though this means lower exchange rate exposure of the debt, we cannot be at peace with such a structure. The debt was not generated abroad to a larger extent; however, internal debt is rising alarmingly. Furthermore, by prolonging payment periods, the government is making havoc on small and medium enterprises. Even though the public debt is close to Maastricht criteria, it is not the Maastricht criterion that is important. The sustainability of the debt is. The accession process to the EU is still at bay, and the prospects of entering the EMU, especially in the light of

ISBN: 978-960-474-253-0

recent events in Greece, remain distant. Keeping public debt in check is a major issue for public policy. If the debt spirals out of control it would have devastating consequences on overall public finances. By looking at the data for the observed period, there is absolutely no reason to worry. Public debt in terms of GDP is falling. However, given the situation after 2008 and large negative growth rates with increasing debt, one should think twice before making a final conclusion. As stipulated by Mihaljek [4], there are many aspects of debt sustainability. Namely, assessment of financial obligations and resources of the debtor in the medium run, assessment of influence of shocks on variation of liabilities and resources, and assessment of scenarios given the "vulnerability thresholds" and problems with repayment of debt. Within the same analysis, Croatian budget deficit was largely unsustainable in the observed period (1997-2003). With current prospects of the budget deficits, it is likely that deficits are again unsustainable and subject to political balancing of powers, not subject to clear economic reasoning.

Figure 5: Domestic (internal) and foreign public debt in Croatia 1999-2010



Source: [5] [6]

In comaprison to other countries position of Croatia is somewhere in the middle. On one side of the spectrum we have Estonia with extremely modest debt below 10% of GDP. On the other side of the spectrum we have Hungary with extremely high ratio ranging largely form 60-70% and recently even above those figures [7]. Generaly speaking, countries of Central and Eastern Euorpe are still struggling with health care reforms and pension reforms that drain a lot of resources. It is visible that most countries put in an effort to curb the debt, however some countries with greater success than others.

V. POLICY OPTIONS

Croatia is a candidate country for the EU. Croatia will not have a choice on EMU. According to agreements Croatia, and other recently admitted countries, signed convergence in term of Maastricht criteria is unavoidable. One of the issues is public debt.

Besides the convergence criteria, there are other short, medium and long run aspects of decisions being made today. If the policy option is to blindly go ahead and continue with the policy that brought the problems it is possible that Croatia may be a candidate for the worst case scenario. This would be all out failure of public finances. Currently, Croatian bonds sell at rates near to junk bonds, thus present perception of Croatian fiscal policy is bleak at best. According to this option, in the short run, the unions, the government and general population would be happy because the wages do not go down and political elites and their patrons get what they want. In the medium run, it turns that putting a blind fold eventually gets you nowhere. Payment of debts amount to more and more as a percentage of the central government budget and pension and health care systems get to the point of failure. Solution would be similar to Greece, unpopular but necessary.

The other option would be to cut on the over blown budget which is unsustainable for Croatian economy. This is painful, does not pay in the short run, but pays in the medium run. We have a problem here. Decision makers are mostly elected on perception of short run events, thus they may fall into populist trap, and in the end not do the right thing. The right thing would certainly pay in the medium and long run.

Most extreme option would be to cut budget considerably, which would include at least 20% cut in wages, most subsidies cut fully, and healthcare and pension systems would have to considerably lean toward market solutions. In the short run this would be a tremendous blow to everyone, thus cutting down on expectations and making future very uncertain. However, medium and long run effects would be definitely positive. Again we have the same problem, medium run effects might take years to come through, and decision makers do not have support for deep cuts.

VI. CONCLUSION

In the analysis of the public debt in Croatia we have come to a conclusion that in the observed period of 10 years, even though there was a rise of debt, general situation is relatively stable. However, sustainability of the debt in the medium run is something different. As presented above, there are many aspects of debt sustainability, and given the past performance of Croatia we cannot be entirely satisfied with the debt management.

It is true that figures presented show improvement in very important aspect of the debt as percentage of GDP, however, it is also evident that the burden of the debt is put more on domestic markets which in the end means increase of illiquidity in the economy.

In the light of recent events and a huge drop in GDP growth rates, debt that seemed rather sustainable is increasingly moving towards unsustainable position. Future will show weather public policy can move away from political reasoning and move more closely to economic reasoning. Even though elections are every four years, economic success of a country is decided by more long term decisions which run beyond four year periods.

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ISBN: 978-960-474-253-0