Osnove upravljanja javnim dugom

The basics of public debt management

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When the significance of the negative effects of Croatia's public debt on public finance stability and long-term economic growth is taken into account, it is clear this research subject should more often be in the focal point of the Croatian academic community. There was thus great reason for the Institute of Public Finance to publish this volume, which will surely contribute to better understanding and generate more fruitful debates on the issues of managing public debt. Anto Bajo, Marko Primorac and Ana Andabaka Badurina constitute a young but experienced group of authors and bring new energy to the arena, which will hopefully become a stimulus for many others to join in. "The basics of public debt management" is a textbook and a guide published in Croatian intended for students, economics professors, researchers, government officials, private financial sector experts and others interested in the subject.

The book covers different aspects of public debt management in Croatia, dividing each of its eight parts into two smaller chapters. In the first chapter of each part the authors explain the general principles of a specific public debt issue, and in the second chapter they apply the theory to analyze the public finance system in Croatia. That way the authors make this matter somewhat easier to comprehend for students and less adept readers, as it immediately introduces them to numbers and real situations. At the end of each of these two parts the authors offer a list of questions and a list of recommended reading to emphasize and facilitate the use of this textbook for academic purposes. The book ends with a glossary, a handy list of regulations in Croatia related to the subject and an overview of useful web sites.

The first part sets out the basic principles – the concept and scope of public debt. Different public debt categories and classifications are explained, along with other relevant terms, such as arrears, public debt marketability, the distinctions between direct and indirect public debt, gross and net public debt, etc. After that, the public debt institutional framework in Croatia is described. The overview reveals that the deficit of Croatia's general government budget, as the result of high national budget deficit and extra-budgetary funds spending, has grown beyond acceptable levels, and the sustainability of public spending is in danger. Public debt level including guarantees in 2010 was just below the Maastricht standard of 60 percent GDP. Finally, the development and the structure of each public debt category in Croatia are thoroughly investigated. Internal and external debt values and structures are set out, after which issues of treasury bills and government bonds from 1996 to 2010 are analyzed. Finally, the authors point to the constantly high levels of high government arrears, which is mostly a result of structural inefficiencies in the health and retirement insurance sectors.

The second part deals with the fiscal risk of state guarantees and the effects that they have on the level and movement of public debt. State guarantees represent potential public debt, because of the possibility that the original debtor defaults. Since this aspect of public debt is often relatively neglected in fiscal analyses, the analysis this chapter gives us is especially valuable. It shows how unexpected financial market instabilities can, through these potential liabilities, directly influence the sustainability of a country's public finance system. First, direct and contingent public liabilities are distinguished, and the role of state guarantees as subsidies is explained. After that, the authors show categories of different related risks that can contribute to raising budget deficit and cause problems for a country's fiscal system. That is why the need for guarantee redemption risk sharing, economic restructuring and better state guarantees management is brought up. Then, state guarantee issuing in Croatia is explained, starting with the legislative framework. The distinction between performance and financial guarantees follows, after which the notions of issuing criteria, guarantee reserve and the payment of state guarantee fallen due are explained. Next, the system of state guarantee management in Croatia, along with the various offices and registers throughout history, is presented. The authors introduce a financial analysis of state guarantees issued from 1996 to 2009, and give us valuable insight into the real state of public debt developments. It is indicative that most guarantees are issued in the euro, and for covering liabilities in the sectors of transport, shipbuilding and Croatian companies constantly operating with big financial losses. Most creditors were previously domestic commercial banks, while in recent years the share of foreign commercial banks and international financial institutions grew. Between the years 2000 and 2009 as many as 5.9 billion kuna of state guarantees were invoked, and in the same period the government was reimbursed for only 12 percent of such guarantees. Active state guarantees represent a substantial level of potential public debt, and the overall level of active guarantees of 55 billion kuna in 2010 makes the general government debt amount up to 58 percent of the GDP. If the levels continue to rise, it will without a doubt be a threat to the stability of Croatia's fiscal system.

After defining the basic terms and main issues of the public debt system, part three introduces the reader to the book's main theme – the public debt market and the basics of public debt management. Recent developments in the world's financial markets have revealed the importance of an efficient and vigilant institutional framework and of modern public debt management techniques. Improving the public debt management processes, with the assumption of their coherence with a sound macroeconomic strategy, can reduce the risk of controlling public debt levels and minimize the cost of borrowing money. The third part starts by determining the roles of different government offices and the objectives different countries define regarding public debt management. After that, the focus turns to risk management and setting the desirable levels of public debt portfolio with the acceptable levels of risk in different countries. The authors recommend the institution of a relatively independent debt management office as the best way of handling public debt efficiently and professionally. It can be a part of a ministry of finance, a central bank or, in the best-case scenario, a separate agency. Then, a functional organization of proper public debt management is described. As for the

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situation in Croatia, the authors feel that the IMF and the World Bank have shown far more interest in managing public debt reforms than the Croatian Parliament, the Government or the Ministry of Finance. The system is gradually improving, but it is far from developed, as reforms are uncoordinated and lacking in concept. After that, the authors give us an overview of expected state borrowing, due payments, annual budget deficit, redemption costs and interest rate costs in Croatia – they are all on the rise. Finally, strategic targets, practices and organization of public debt management in Croatia are presented. Although there have been improvements in terms of technical infrastructure in recent years, the authors point to a lack of transparency and predictability in the borrowing system because of the government's practice of not publishing detailed annual government borrowing plans.

Part four focuses on the primary market and state gilt issuing techniques. It starts by explaining the basic issuing methods and their pros and cons. Multiple and uniform price auctions are explained, along with an overview of their use in different countries. Then, the focus turns to syndicate, tap sale and private placement methods. Finally, the role of primary dealers is explained. Next, the process and characteristics of gilt issuing on the primary market in Croatia is illustrated. First, issuing of short-term treasury bills using the Bloomberg Auction System is presented, and the role of the Central Depository & Clearing Company is explained. After that, the system of issuing government bonds using the syndicate method is clarified, along with the Memorandum of Understanding and the role of leading banks as underwriting patrons and arrangers for the bond issuing process. The authors emphasize the need for forming a referent domestic yield curve for bonds, which would facilitate price setting for all other instruments in the financial market. At the end of the chapter, the international market and two kinds of bonds – external bonds and eurobonds, are explained.

The fifth part describes the secondary market for government gilts, trading techniques and the financial instruments traders use. The authors notice the key role of the secondary market in minimizing borrowing costs and improving investor confidence in the public finance sector. Then, they define the conditions under which the development of the government gilt market is possible, such as a safe banking system and fiscal and monetary stability. Order-match, market maker, spot transactions and repurchase agreement trading techniques are identified, after which the focus turns to explaining financial derivatives. The authors then unfold the ways clearing and depositary institutions execute the actions of clearing and settlement, and illustrate their organizational and ownership structures in a list of benchmark countries. A preview of the Croatian public debt market follows. The authors feel that the secondary short-term and long-term public debt market is not sufficiently developed, mostly because of the negative motivational effects of large rated price spreads and an excessive buying activity of treasury bills on the primary market. Other negative trends include *underdeveloped money market, li-*

mited liquidity, lacking of standardized government gilts and the absence of the primary dealer system. Then the authors' attention turns to investors on the public debt market. Secondary public debt market investors in Croatia include commercial banks, insurance companies, housing saving banks and investment funds, while the household sector is unjustifiably ignored, especially when it comes to bond trading. After the 2002 pension reform, pension funds become the biggest institutional investors, especially in government bonds, raising their asset level from 2 billion kuna in 2002 to 36 billion kuna in 2010. The authors then explain the role of the Zagreb Money Market and emphasize the fact that it is underdeveloped, as it hosts only 30 percent of financial transactions. It serves as an overnight trading market for money in excess of the obligatory reserve, rather than a short-term gilt market. After that, government gilt trading on the Zagreb Stock Exchange is analyzed, with its structure and interest rates. The authors feel that primary dealers should be introduced to make the trading system more efficient and liquid. Next, profiles of government bond investors are shown and the relation of money market interest rates, stock prices and government bond yields is explained. After that, government borrowing on the international market is put into focus. Since borrowing on the domestic market tends to crowd out private investment, to maintain liquidity, the government can borrow money abroad. Croatia had five bond issues on the international market. The interest rate level is mainly dependant on credit ratings assessed by the agencies Moody's, Standard & Poor's and Fitch. Their ratings for Croatia for the period from 1997 to 2010 are explained and listed. Next, yields on Croatian eurobonds are analyzed and compared with the German ones and bonds issued by other transitional countries. The conclusion is they are too high, partly because public debt is not managed properly. The authors offer solutions to fix the problem, such as broadening the investor base, developing domestic borrowing instruments, issuing larger quantities of bonds with lower nominal values, publishing issuing calendars and introducing the primary dealer system. They also stress the need for Croatia to attune public debt management and structure with the EU supranational benchmark. At the end, the automatic clearing and settlement Bloomberg system implementation in Croatia is described.

The sixth part is about the models of establishing functional and organizational features of state treasury institutions, based on good international practices, and the State Treasury in Croatia, as a separate unit within the Ministry of Finance. The State Treasury system with a unified government budget account represents a quality way to manage the country's cash and liquidity. It also enables the management of public debt and facilitates a number of other important tasks, such as planning, payment control and budget accounting. The operations and structure of a Unique Treasury Account are introduced, and the methods of transaction and cash flow centralization are explained. Unified treasury accounts also facilitate access to resources for fiscal spending and they reduce transaction costs. Next, financial planning, which includes the cash plan, budget execution plan and revenue/expenditure projections, is identified as the basic element for producing a state

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borrowing plan. Since it is imperative for the government to ensure that there are sufficient liquid funds to cover all of the daily liabilities, the authors explain the main borrowing rules and good cash management principles. Then, government budget liquidity management in Croatia is presented, connecting the functions of the Ministry of Finance, Croatian National Bank, State Treasury and the Financial Agency. An overview of changes in the practice of payment operations and institutional liquidity management reforms with their main goals in Croatia is presented, and all of the offices within the Departments for Budget Execution, along with their main activities and duties are listed. Then, the authors analyze the possibilities and limitations of quality cash and liquidity management in the Ministry of Finance by looking into activities that make the process possible: payments, budget consolidation, budgetary users' outstanding liabilities and state deposits. To complete the picture, the authors give the reader an insight into the average liquid balance and the assets the government receives by operating on the money market and in the form of short-term credits from commercial banks. They emphasize the fact that commercial banks' interest rates on short-term credits the government received in the period from 2003 to 2005 were practically the same as the rates those banks charged when crediting the business and household sectors. Hence, in the opinion of the financial market, there was no difference in public and private sector creditworthiness and risk assessment. The authors argue that since the government failed to obtain a lower interest rate, financing short-term public debt is a problem. Finally, the authors set out key lessons and recommend ways of improving cash and liquidity management. They include consolidation of extra-budgetary users' deposits, improving the cooperation between the Ministry of Finance and the Croatian National Bank and increasing the placement of budgetary surplus assets on the money market.

Part seven gives the reader an insight into the relationship of and coordination between monetary authorities and public debt policy makers, i.e. central banks and ministries of finance. Since those institutions have different operational goals, the authors explain the most common conflict points – interest rates, state borrowing growth rate and the similarity of short-term debt instruments. In that sense, it is important that both sides fully understand and accept each other's objectives. The authors explain the role and functions of the central bank regarding the issues of public debt. Institutional conditions crucial for achieving cooperation are listed and examples of different ways of cooperation with respectful consequences are described. Next, cooperation scenarios for the primary market are set out, after which the authors explain why operations on the open market became the most important and most efficient monetary policy instrument of the developed economies. After that, the authors illustrate how the central bank can use direct gilt buying and selling and repo contracts as ways to enforce regular, fine adjustment or structural operations of conducting an expansive or restrictive monetary policy. Next, the coordination of managing the public debt, monetary policy and fiscal policy in Croatia is analyzed, along with possible reasons for occasional conflicts.

The roles of the Croatian National Bank and the Ministry of Finance in various areas of managing the public debt are analyzed. Those areas include keeping public debt records, the development of the primary market, and cooperation on the money market. The authors argue that there have been some positive legislative changes for an efficient coordination, but mostly because *Ministry of Finance was not able to produce a borrowing strategy or introduce annual borrowing plans... the cooperation is formalized but not fully functional.* Also, a system of primary dealers does not exist, nor does an up-to-date state gilt-issuing calendar, the financial market is underdeveloped and the Ministry of Finance is sometimes late in informing the National Bank about expenditures and public debt. Then, the ways that the central bank helped the government to reach certain borrowing goals using monetary measures, by lowering the required reserve rate and lowering the minimum coverage rate for foreign currency liabilities are described. The next section explains open market operations. It starts with clarifying the processes of concluding repo contracts, and the ways in which they are settled. Then, the practice of managing repo auctions in Croatia since the introduction of open market operations in 2005 is illustrated. Repo auctions have had some positive effects on money market interest rate stability and the stability of interest rates on treasury bids and government bonds. Finally, the advantages of the central bank's open market operations are summarized. The most important feature is the fact that those operations enable more favorable domestic state borrowing. It is solely up to the central bank to keep prices and exchange rate stable and manage trading with government gilts in its portfolio, and the job of the Ministry of Finance is to manage public debt.

In the final chapter the authors analyze local and regional government borrowing, used mostly for financing capital investments. Long-term borrowing is a good way for financing local capital investments without crowding out private investments. Municipal bonds are divided into general obligations bonds and revenue bonds, after which the advantages and reasons in favor of long-term municipal borrowing are listed. Next, the processes of determining local government's credit rating and its possible improvement are described. The authors highlight the conditions to efficiency in local government borrowing – quality leadership, a separate capital budget, balanced multi-annual capital financing programs, developed financial market and a strong fiscal capacity. After that, the system of local units' borrowing in Croatia is described. Strong institutional boundaries and obligatory state guarantees limiting financing local authorities' debt make them dependant on discretionary governmental decisions. First, a preview of legislation framework is set out, and the process of drawing credits and municipal bond issuing is explained. Annual and additional borrowing limitations and conditions form 1996 to 2010 are listed, after which actual amounts of direct borrowing are compared with budget limitation values. The authors explain the conditions and regulations local authorities have to satisfy in order to get central government's approval and the guarantee they need. Local units' extra-budgetary users can also get short-term

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loans from banks that keep their accounts or long-term loans and issue corporate bonds, which hold a higher level of risk. Communal companies can issue bonds with the consent of the local authorities, without the approval of the central government. Since in Croatia there is no structured information about communal companies' financial performance, thorough analyses of the structure of their assets, revenues and expenditure are usually not carried out. The guarantees companies receive from local authorities can serve as hidden local unit's borrowing, so in this way local governments can bypass central government limitations. The authors number the risks of local institution borrowing and possible improvements to the system in order to create quality credit capability assessment. An overview of local units' budgets from 2002 to 2009 reveals stable budget growth and primary surplus until 2009. Then, the practice of local unit borrowing, with its structure and interest rates from 1997 to 2009 in Croatia, is analyzed, based on the levels of gross and net debt. Some points about municipal bonds in Croatia are brought up. Since they have a high risk premium and interest rate level, investors tend to hold on to them until the end, so they do not have a high market capitalization. That is why private placement of such bonds would be a more convenient way of selling them. The authors then analyze the structure and values of gross debt, with a special insight into direct debt, guarantees handed out to extra-budgetary users and utility companies, arrears and total gross debt in the period from 1997 to 2009. Values for net debt follow, comparing local units' liquid financial assets to financial liabilities. Finally, utility companies are pinpointed as potential dangers for local units' financial stability, because of the lack of systemized information about their financial operations. The authors recommend stronger borrowing regulations for all government levels, consolidation of local units' and companies' financial reports and a stronger credit rating system.

In summary, it can be argued that this textbook represents one of the most comprehensive recent readings on the issues of the Croatian public debt. The authors offer an examination of government borrowing processes, trying to incorporate all of the aspects of the modern public finance management, including monetary policy as well. More than a few times the authors emphasize the necessity of more professional and foresighted governance and cooperation among institutions. In the authors' own words, *this book should fill in the gap in literature, contribute to better understanding of the public debt, and be useful as a guide and manual for strengthening the responsibility of government institutions*. Its purpose is to point to the negative effects that poor public finance leadership and untidy public records can have on the sustainability of public finance. Since structural economic problems in Croatia have not been abolished, and are even magnified as a result of the global crisis, we cannot afford to waste any more resources and time. But the authors' main goal is not to complain but to encourage further research and offer solutions – the routes that lead to good practice and efficiency.