

# Where is your borrowing and public debt management strategy, gentlemen?

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*Source / Izvornik:* **Press releases, 2014, 7, 1 - 2**

**Journal article, Published version**

**Rad u časopisu, Objavljena verzija rada (izdavačev PDF)**

<https://doi.org/10.3326/pr.2014.63>

*Permanent link / Trajna poveznica:* <https://um.nsk.hr/um:nbn:hr:242:417243>

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*Download date / Datum preuzimanja:* **2024-07-12**



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# PRESS RELEASES

## Where is your borrowing and public debt management strategy, gentlemen?

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**The last week of a year and the month of July have often been perfect points of time for Croatian Governments to change the legislation or enact decisions that have a major impact on government finance. This is corroborated by the last two Government phone sessions held on December 24, 2013 (Christmas Eve) and December 27, 2013. As a result of four decisions adopted, the Government increased public debt by about HRK 4bn. in only one week.**

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**Decisions leading to public debt growth.** The agenda of the phone session held on December 24, 2013 included a Draft Decision on giving approval to the minister of finance for the borrowing of EUR 200m on behalf of the Republic of Croatia and a Decision on giving approval to the Restructuring and Sale Center (RSC) for a loan of HRK 606.4m. Three days later, the Government adopted a Decision on giving approval to the company Croatian Roads Ltd for taking out a loan and a Decision on giving approval for assuming the debt of the company Croatian Railway Infrastructure Ltd. Thus, in only one week and as a result of the four Government decisions, public debt rose by about HRK 4bn. The contributions of the Croatian Roads Ltd, the Croatian Railways, the government (by direct short-term borrowing) and the Restructuring and Sale Center to debt growth were HRK 0.4bn, HRK 1.4bn, HRK 1.5bn and HRK 0.6bn respectively.

**Instead of T-bills - unfavourable short-term borrowing from Goldman Sachs.** The Republic of Croatia has made a short-term debt of EUR 200 million (about HRK 1.5bn) with the Goldman Sachs Bank. Specified in the relevant Government's Decision is a fixed interest coupon at an annual rate of 2.5% and a repayment deadline of end-March 2014. Given such a short maturity of the debt, the only reasonable conclusion is that the debt instrument used has been a short-term loan. With such a short maturity, the Government and the Ministry of Finance could have issued a T-bill with no coupon interest (such bills are usually sold at a discount and are not interest-bearing due to short maturity). Assuming that the borrowing costs for the three-month period amount to one fourth of 2.5% (i.e. 0.625%) and due to exceptionally short maturity this loan can be assessed as unfavourable. For comparison's sake, at the auction held on December 10, 2013, the Ministry of Finance's euro-denominated T-bills with a maturity of 91 days (which corresponds with the maturity of the loan taken from Goldman Sachs) were sold at a price of EUR 99.888 and with a YTM of 0.45%. Borrowing in the form of T-bills seems to be much more favourable than borrowing on external markets. Why has the Government opted for borrowing under less favourable conditions abroad, despite the relatively good liquidity of the domestic financial system and the demand for short-term government securities?

**Borrowing by the Restructuring and Sale Center.** At its phone session, the Government gave its approval to the RSC for taking out a loan worth over HRK 606.4m for the purchase of 24.5% of ordinary shares of JANAF Plc from a budget user - the Croatian Compulsory Oil Stocks Agency (CGOSA), with a

bill of exchange guarantee of the Republic of Croatia. Unlike with other loans, the information on creditors and on the terms and methods of realisation of this loan has not been disclosed. The loan is particularly interesting, if not peculiar, given that both the RSC and HANDA were established by the Government. As the Republic of Croatia, in its capacity as owner, has the legal authority to dispose of the GCOSA's property, and as the RSC manages the business interests and shares held by the Republic of Croatia in companies, the whole transaction seems highly unusual. A potential net effect of this transaction is disguised borrowing, because, thanks to the GCOSA (a budget user), the amount of HRK 606.4m from the loan taken by the RSC (an extrabudgetary user) will be paid into the budget, which is an important source of fiscal risk and public debt growth.

**Approval to the borrowing by Croatian Roads Ltd is a permit for raising budget deficit and public debt.** The government has given its approval to Croatian Roads Ltd for the borrowing of EUR 56.5m (ca. HRK 431m)<sup>1</sup>, including interest and borrowing costs, from a consortium of domestic banks consisting of the following banks: Croatia banka, Hypo Alpe-Adria, Istarska kreditna banka Umag and PBZ. The loan to be repaid in 7 years (with a grace period of 2 years) will be used to finance the construction and maintenance of state roads and to settle the company's loan liabilities in 2013. The interest rate is variable and is equal to the six-month EURIBOR rate plus 5.6%. The six-month EURIBOR as at the date of the decision (27 December 2013) was 0.392%, so that the total interest rate was 5.992%. The borrowing costs are further increased by an arrangement fee of 1.25% (EUR 706,250 or ca. HRK 5,387,049). This is increased by an additional annual cost of EUR 10,000 in agent's commission (a total of EUR 70,000 or ca. HRK 534,000). The effective interest rate is 6.39%, and total costs are estimated at almost EUR 16 million. The Government has issued a guarantee for this loan, thus enhancing the fiscal risk. Moreover, given higher likelihood that the Government guarantees to the Croatian Roads company will come due, it is reasonable to believe that public debt will go up. We are talking about unfavourable borrowing due to high credit risk, which is why banks raise the price of capital.

**The debt of Croatian Railways (CR Infrastructure Ltd) directly increases public debt.** In order to deleverage and achieve financial consolidation, the Government has granted its approval to the Ministry of Finance for the assumption of the debt of CR Infrastructure Ltd, by issuing guarantees worth HRK 1.3 bn. Pursuant to the Decision on the debt assumption, the capital of the public good CR Infrastructure has been increased by HRK 1.33bn in principal and by additional amounts of HRK 76.7m and HRK 8.9m in interest and default interest respectively. The debt, HRK 1.4bn in total, relates to the company's liabilities to two domestic banks (PBZ and ZABA). By assuming these liabilities, the Government has directly increased total public debt and further weakened the country's fiscal position. This debt affects the level of public debt to be taken into account by the European Commission in setting the final annual limits on government deficit and debt within the Excessive Deficit Procedure for Croatia.

**Where is a borrowing and public debt management strategy?** The total amount of recent borrowing exceeds HRK 4bn and is directly reflected in public debt growth. The borrowing costs are fairly high and the creative financial transactions through which the Government tries to find sources of funding will certainly not go unnoticed by the Commission and will be recorded within the EDP. While the government has no public debt management strategy, the unfavourable current borrowing calls for an urgent fiscal risk management strategy. Contingent liabilities the Government is about to face in the next period are increasing, and they arise from growing debts of extrabudgetary users - public companies which have been given government guarantees. Instead of improving the borrowing conditions, the Government tries to develop new modalities of borrowing (on unfavourable terms). Inadequate public debt management results in extremely high borrowing costs which offset the effects of the modest fiscal reforms on the expenditure side of the budget. The Government should urgently adopt a Public Debt Management Strategy and a Public Debt Act, as well as establish an office or agency outside the Ministry of Finance to manage public debt. Such a unit should also include a department of public sector risk management, as fiscal risks are becoming increasingly important in Croatia and pose a threat to the sustainability of public finance. The Government should take this issue with the utmost seriousness and give it its due attention, given the unfavourable borrowing conditions and the loss of control over borrowing costs.

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<sup>1</sup> The analyses were based on a monthly average of the Croatian National Bank's middle exchange rate in November 2013, of HRK 7.627680/EUR.