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# Press Release

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## **Models for Funding Measures for Economic Recovery and Development in Croatia**

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**Measures for economic recovery and development are currently essential for the Croatian economy. For the sake of enhancing the efficacy of the measures proposed and the funding measures, certain imprecisions in the definition of the criteria that recipients of resources must fulfill have to be obviated. It is also necessary to think about setting up additional conditions for the purpose of ensuring the desired effects, and to insist on a much greater level of transparency and consistency in the execution of the measures.**

### **Introduction**

At its 38<sup>th</sup> session, held on January 28, 2010, the Government of the Republic of Croatia decided on models of funding measures for economic recovery and development.<sup>1</sup> The objective of these measures is the creation of conditions for economic growth sustainable over the long term, i.e. for the preservation of existing and the creation of new jobs, for increasing investment and ensuring a satisfactory level of liquidity in the economy, among other things.

There are two basic models of funding:

**Model A**, in which the government actively co-finances bank loans to sustainable economic projects (via the Croatian Bank for Renovation and Development, HBOR in its Croatian abbreviation). Loans according to this model are meant for the funding of working capital. The resources necessary for model A will be provided by the coordinated actions of the Croatian National Bank, the commercial banks and the government.

**Model B**, according to which the government, via a guarantee fund, assumes part of the risks of new bank loans, primarily for the generation of investment projects that should result in positive effects for the economy, but also partially for loans for the funding of working capital and for the rescheduling of loans contracted after July 1, 2008. The guarantees will be made available through HBOR.

These measures encourage the commercial banks to make loans; the funding models lay down the criteria that users of loans must fulfil. The wish behind this is to channel funds to

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<sup>1</sup> Two documents are concerned: Measures for Economic Recovery and Development – Models of Funding and Draft Proposal of the Law for a Guarantee Fund for Economic Recovery and Development with Final Proposal of the Law. Available at: [http://www.vlada.hr/hr/naslovnica/sjednice\\_i\\_odluke\\_vlade\\_rh/2010/38\\_sjednica\\_vlade\\_republike\\_hrvatske](http://www.vlada.hr/hr/naslovnica/sjednice_i_odluke_vlade_rh/2010/38_sjednica_vlade_republike_hrvatske).

those firms that were otherwise operating successfully but got into difficulties because of the downturn in global financial and economic trends. Investment in capital projects from which positive spin-offs for the whole economy will derive is also to be stimulated. The criteria that users have to meet are to a large extent specified in the documents adopted, although some details and procedures in the allocation of funds still have to be defined by separate regulations. The documents claim that the criteria are in harmony with the regulations that govern market competition and the allocation of government aid.

This review discusses just some of the important aspects of the measures proposed, according to the writer's personal choice. Preliminarily, it should be mentioned that perfection in the definition of criteria and procedures is not to be expected, nor is it in the implementation of such economic policy measures. Some imprecisions are bound to remain, and they might confuse potential users, and perhaps enable the resources to be benefited from by those users that are not the primary target group of this kind of government intervention (or might perhaps open up a window for corruption). Such imprecisions have to be reduced to the smallest possible measure. Still, it would seem that the government is on the right road, and for a final estimate one has to await the adoption of the separate regulations and the actual results of the planned measures when they were implemented.

### **Some imprecise criteria – transparency of decisions about users as guarantee of consistent application**

The criteria used to define the circle of potential beneficiaries are in part imprecise: "The beneficiaries of these models may be companies, tradesmen and other legal persons who are registered for and carry out business activity in the Republic of Croatia, irrespective of whether they are small, medium-sized or large enterprises, and particularly enterprises that deal with a productive activity and the provisions of services related to the production sector". Is there any advantage in enterprises that deal with a productive activity? What exactly is meant by services connected with a productive activity? What about enterprises that only partially (to a greater or lesser extent) deal with a productive activity and/or related services? Later on the text explicitly excludes: "enterprises that are engaged in serving drinks, in gambling, bookmaking and similar activities". Does this mean that all other enterprises can be beneficiaries?

As mentioned, a perfectly precise definition of criteria (particularly of those criteria that cannot be unambiguously quantified) that leave no space for discretion in their interpretation cannot really be expected. One way that might help in ensuring consistency in the application of criteria might be an obligation that after each round of allocation of resources HBOR should promptly publish the names of firms that have secured the right to use these resources, with an appropriate explanation.<sup>2</sup> Then other enterprises would acquire an insight into the decision-making practice concerning qualified users and the criteria applied, and would have a clearer image about whether they can obtain funds from these programmes.<sup>3</sup> Government officials too would avoid any possible criticisms concerning lack of transparency and inconsistency in the application of the criteria if the decisions about the beneficiaries of the funding were promptly published; this would be particularly important because of the high perception of corruption in Croatia. A statement of reasons need not necessarily reveal information detailed enough to encroach on business confidentiality, but would put before potential users the viewpoint that if they want to have this form of aid, then they will have to agree to reveal some information crucial for the allocation of resources.

In the formulation of the prescribed purposes for benefiting from the resources, there are also some parts that are insufficiently clear. An example is the possibility of making use of

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<sup>2</sup> The statement of reasons should include information about the purpose of the funding, the interest rate and the proportion to which the state is co-financing the loan, i.e. in issuing a guarantee, the repayment periods and so on. The documents state the obligation of HBOR to prepare reports for the Finance Ministry after the implementation of every auction, but do not provide for the public being informed.

<sup>3</sup> This would create the possibility that firms control their competitors, i.e. it would avoid companies in the same industry that are competitive with each other and perhaps are in the same situation being treated differently, which would constitute a direct distortion of market competition.

guarantees for loans meant for the rescheduling of only those loans taken out after July 1, 2008. It is not clear whether a loan that was allocated after this date and that was partially or fully used for the settling of old repayment liabilities can be rescheduled from a guaranteed loan according to the proposed funding model. If it can, this might, depending on the specific circumstances of individual enterprises, encourage some enterprises firstly to reschedule loans taken on before July 1, 2008, even outside the framework of this programme, and then the rescheduling of these new loans with loans guaranteed according to the proposed funding model.

## **The expected effects**

### *In general*

The effects of the measures, according to the proposed funding measures, should primarily be considered as compared with some hypothetical scenario of government inactivity, i.e. the absence of any planned measures.<sup>4</sup> Without getting into a detailed debate about the mechanisms, it can be stated that the increase of loans to firms, and the facilitation of funding at favourable rates of interest, should in any case lead to at least a short-term improvement of the economic situation. It should be most visible through a reduction in lack of liquidity in the economy. Also in the short term, it is likely that a larger number of jobs will be kept (or a larger number of new jobs will be created) than in the alternative scenario, without the proposed measures. As for the effects of the measures over the long term, they will depend (not including external factors of course) primarily on the quality of the criteria determining the potential users of the funding as well as on how well they are applied, i.e. whether the funds will really be distributed to those enterprises and projects that will produce long-term sustainable positive economic effects.

### *Fiscal effects*

And then the question arises as to the fiscal effects of the planned funding models in conditions of high government spending that gives cause for concern in the specialised public because of its dubious sustainability. However, although HBOR will, on behalf of the government, loan some of the resources to enterprises, and will by its guarantees cover some of the loans made by the commercial banks, it is likely that the fiscal effects will be positive maybe even over the short term, as a result of the anticipated reduction of illiquidity. In addition, the measures anticipate that firms will have to settle any outstanding debts to the government they might have with the funds obtained via these programmes, if such debts are not regulated or rescheduled. On the other hand, if the measures manage to enable some promising firms to survive in this period that is so difficult for business operations, the longer-term effects on the budget should also be positive, as against the alternative scenario of government inaction. It is also anticipated that all loans should be covered by appropriate security instruments to guarantee collection of the loans, or at least the major part, even in cases when the beneficiaries do not manage to weather the economic crisis. It should also be mentioned that this form of government spending is surely much more productive in the sense of (overall macroeconomic) return on investment than many other forms, assuming well-established criteria and a high-quality implementation of the allocation of resources. Still, the fiscal authorities must not lose sight of the fact that it is necessary, at the latest at the moment of the recovery of aggregate demand from abroad and/or the private sector, to reduce the level of overall government spending.

### *Liquidity of the economy*

One of the objectives of the measures is to ensure an adequate level of liquidity in the economy, which should be the natural consequence of freeing resources to the banks for them to make more loans available to enterprises. In order to ensure the full effect of the measures in this context in some way there should be an attempt to prevent situations in which some enterprise that has a great market power over its suppliers (because of its size for example) does not pay its debts to suppliers in time, although it might have enough

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<sup>4</sup> Naturally, in principle the effects can be observed as against some other hypothetical scenario in which the government takes some other steps to help the economy.

liquidity available.<sup>5</sup> Small suppliers often do not dare to take the step of forcible collection in the fear of losing an important customer. If such a (usually large) firm meets the criteria and becomes a user of a loan for the funding of working capital from the planned measures, perhaps it might be possible to prescribe the condition that it has to use an exactly defined part of the funds for the immediate payment of outstanding debts to suppliers and/or to prescribe the obligation of not prolonging (and indeed of having to shorten) the average periods in which suppliers are paid during the time in which the allocated funds are being used.<sup>6</sup> This kind of condition can, for easier monitoring, be imposed only on those major firms that can be important generators of illiquidity. And some penalty has to be provided in case they do not abide by these conditions, for example in the form of subsequently calculated higher interest rates on the resources allocated.

#### *Avoiding certain undesirable effects*

In the context of the expected effects one should mention the possibility that the Government might via these measures contribute to the maintenance of certain undesirable economic anomalies. It is often said that for the construction industry for example, special aid measures will be drawn up. However, construction firms are not explicitly excluded from making use of the proposed funding models.<sup>7</sup> Although it is clear that this branch of the economy too needs aid, it is important to make sure that the conditions are not created for investors in residential construction (construction firms on the whole) to keep up prices of dwellings in Croatia that are beyond the level that members of the public are able on the whole to afford.<sup>8</sup> This kind of thing cannot possibly be the objective of a responsible economic and social policy.

*It can be concluded that the initiative of the Government in the form of the proposed measures and forms of funding is extremely necessary and that it is a pity it was not launched earlier. The Government, however, must persevere in the removal of certain unclaritys, in establishing additional conditions for the purpose of obtaining the desired effects, and insist on as great as possible a level of transparency and consistency in the implementation of the measures.*

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<sup>5</sup> Such large enterprises might use such resources for other purposes, for example for expansion abroad and/or taking over other companies. This in itself need not be bad, in fact can be excellent, but suppliers must not be allowed to go under for the sake of this purpose.

<sup>6</sup> Although the established models of funding allow for control of the use of funds according to their purposes, so far no mention has been made of deadlines, so that some firm can drag out the use of resources for working capital for a longer period of time – paying its suppliers, but not at the speed that would be desirable from the perspective of economic policy. Also, if the beneficiary of the funding is a member of a group of firms, account should be taken that it at least even-handedly meets its obligations to suppliers that are not members of the group. At the same time in the case of the possible monitoring of the average periods for the payment of the suppliers of the firm, payments to enterprises in the same group should be excluded.

<sup>7</sup> Here one should mention that the explicit exclusion of some economic branches (or the allocation of aids to some branches only) might be attended by certain problems with respect to alignment with the rules of the EU concerning allocation of aid.

<sup>8</sup> See Vizek, M. (2009). "The Affordability of Housing in Croatia and in Selected European Countries". *Revija za socijalnu politiku*, 16(3), pp. 281-297.