The Government and the Money Market: Who Manages the Cash and Liquidity of the Croatian Budget

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The Government and the Money Market: Who Manages the Cash and Liquidity of the Croatian Budget?

The principal objective of this paper is to draw attention to the need for the Ministry of Finance (MF) to start managing the cash and liquidity of the Croatian Budget in order to restrain and slow down the growth in short-term public debt. For this reason in the sequel we shall put forward the basic principles and objectives, explain the problems and the institutional changes, and the existing situation in the management of cash and liquidity. The conclusion will state the main barriers, the possible problems and proposals for a high quality cash and liquidity management for the Croatian budget.

What is budget cash and liquidity management?

Cash flow management is a function of the State Treasury through which the MF secures control of cash flows via the system of the Single Account of the Treasury (SAT) in domestic and foreign currency and the centralisation of deposits of the national budget and the EBF [Extra-Budgetary Funds] in the SAT at the central bank. As part of liquidity management, the MF, via the State Treasury system, can carry out internal operations that relate to providing the most favourable terms for short-term borrowing and financing of the budget, investing budgetary surpluses in the money market, making loans to budgetary spending agencies and keeping deposits in commercial banks at the best rate of interest.

In managing cash flow, the MF controls SAT inflows and outflows, as well as collections and payments. This control does not cover only budgetary revenue and expenditure, but also outgoing and incoming payments that are performed via the EBFs. The principal aim of cash flow and liquidity management is control of overall government spending, effective implementation of the budget and minimising the costs of borrowing, investing surpluses on the money market and the orderly meeting of liabilities. For cash flow and liquidity management, the most essential thing is to make sure that government institutions operate via the SAT, to ensure that a proper payments clearing system is operated by the banks, and orderly payment of the government's liabilities.

Initial constraints and institutional changes in payments clearing

Up until 2001, the main problems in managing cash flow and liquidity in Croatia consisted of: 1. payments

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clearing that was fragmented among government accounts administered by ZAP (Institute of Payments); 2. failure of operations to be carried out via the SAT (domestic and foreign currency); 3. separate accounts of budgetary spending agencies (regular business and deposit accounts) in commercial banks; 4. payments clearing was not carried out by the banks; 5. the MF did not have any overview of the "pure" cash flows[1]; 6. the unknown balances of the (domestic and foreign currency) deposits of budgets; 7. the unknown number of budgetary accounts in commercial banks.

However, changes were made in the budgetary system, and since 2001 the situation has been improving; both the MF and the CNB [Croatian National Bank] can supervise and control cash flows in the accounts of spending agencies. Thus the Government, in cooperation with the MF and the CNB, between 2001 and 2005, took several key steps that provided the institutional premises for the management of cash flow and liquidity and made it possible for the MF to figure on the money market with surplus budgetary resources at the end of the day (table 1).

Table 1 Institutional changes in Croatia (preconditions for cash flow and liquidity management) since 2001

	Change	Year	Objective
1	Reform of the kuna payments clearing	2001	Execution of payments clearing in the banks
2	Ban on government borrowing at the CNB	2001	Making financing from primary emission impossible
3	Improvement of foreign currency payments clearing in government accounts	2003	Performance of foreign currency payments clearing in the CNB
4	Control of national budget liabilities	2001	Making sure of fiscal discipline and orderly execution of the budget
5	Single Account of the Treasury – kuna	2001	Centralisation of budget cash flows and deposits in the SAT at the CNB
6	Single Account of the Treasury – foreign currency	2003	Centralisation of foreign currency deposits of the government in the Single Foreign Currency Account of the Treasury (SFCAT)

[1] Since 2002 the Money Flows Management Department in the MF, pursuant to records of FINA revenues, has separated cash flows of pure revenue from receipts from short-term and long-term borrowing, treasury bills and foreign currency revenue and receipts. By separating out the cash flows of revenue the MF can determine what the expectations are from the so-called pure revenue (without receipts from borrowing) and the amount of borrowing necessary, or alternately the ability to invest in the event that there is a positive cash flow (i.e. a surplus).

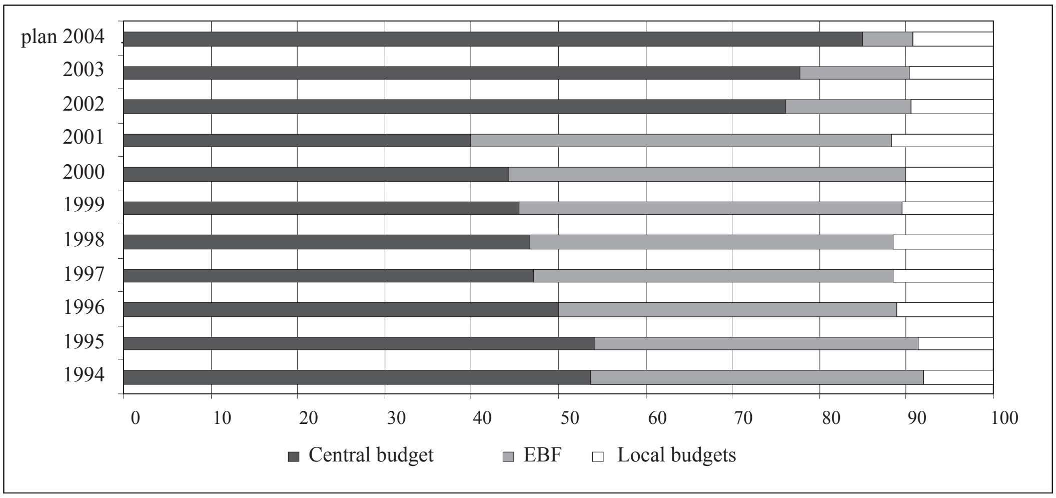
Thanks to these institutional changes, since 2001 the MF has been able, for the first time, to control the financial operations of institutions that it finances from the national budget, for incoming payments and outgoing payments are made via the Single Account of the Treasury (domestic and foreign currency) at the CNB. Payments clearing has been handled by the commercial banks since 2001, and in addition, in 2003 the CNB took over the foreign currency payments for government accounts clearing from the commercial banks.

Payments clearing for government accounts (incoming and outgoing payments)

FINA (Financial Agency, the former ZAP) went on performing kuna payments clearing even after 2001 on behalf and at the expense of the government and went on charging the government a fee for the jobs it did. From 2001 on, the main change in the government finances has been in the way contributions (for pensions and health insurance) have been paid and the majority of own revenues that spending agencies could independently dispose of in the SAT. But within the incoming payment of own revenues there were still exceptions[2]. Still, from 2003, the MF for the first time had the capacity to keep daily watch on the dynamics of the inflow of most of the revenue into the SAT. In parallel with the centralisation of incoming payments the MF centrally performs most outgoing payments from the SAT. Thus the MF (central Treasury) can effectively restrict cash flows from the SAT up to the moment when they are required. In the new operational system via the SAT spending agencies remit requirements for payment to their own ministry (local treasury), the ministries (the local treasuries) prepare serial payments and apply for bulk settlement from the central Treasury in the MF. After that the MF transfers funds from the SAT to the accounts of spending agencies in the Croatian Postal Bank (CPB) or (most frequently) from the SAT directly to the commercial banks pursuant to invoices received and authorised. Some of the payments (material costs and wages bills of the spending agencies) are carried

[2] Although the size of transactions via the SAT has increased, individual cash transactions are still carried out from accounts managed by spending agencies in commercial banks. According to the Law on Central Government Budget Execution for 2005 (the Paragraph 35, Official Gazette No. 171/04), although they meet material costs and wages bill from the SAT, outside of the treasury are spending agencies from science, higher education, health, justice, social securities, culture, diplomat-consular representative, state inventories, system of penitentiary institutions and Ministry of Justice. These institutions are included in operations via the SAT only for their revenue and expenditure, which are financed from the central budget. The spending agencies spend their own revenues to cover expenditure, and their deposits are kept in accounts at commercial banks. (Naturally, the balance of deposits from their own revenues is in the sphere of the commercial banks, and is not inside the SAT system of collection and payment.)

Graph 1 Expenditure of the national budget as proportion of expenditure of the budget of general government between 1994 and 2004 (in %)



Source: MF Republic of Croatia, 2005

out by the MF via accounts in the CPB that are transaction accounts, the balance held in the accounts being zero. Potential surpluses are transferred to deposit accounts in the CPB. The account and balance on deposit in the CPB belong to the SAT in the CNB and are an integral part of it.

Because of the improvements and the enlargement of the coverage of financial transactions via the SAT, the MF has an overview of and control of most of the financial transactions of general government (which consist of the national budget, the EBFs and the local units). Thus the first premise for the management of cash flow and liquidity has been provided for within the MF – the financial operations of spending agencies take place within the system of the domestic and foreign currency SAT in the CNB.

Consolidation of budgets

Thanks to the consolidation of the budgets, in which the biggest EBFs (the pensions and the healthcare) were included in the national budget, the MF has been able since 2002 to monitor and manage the revenue and expenditure of the national budget centrally (graph 1).

Up to 2001 the MF directly controlled about 40% of the expenditure of general government, but from 2002 the Government and the MF have increased the scope of financial transactions within the national budget to about 80% of the expenditures of general government. Thus the MF has achieved the second premise for the management of cash flow and liquidity – the centralization of the financial operations of most of the institutions of government within the national government.

Outstanding liabilities

Only since 2000 has the MF controlled outstanding liabilities of budgetary spending agencies (table 2). Not, it is true, completely, for institutions from the healthcare system do not meet their liabilities in the anticipated periods and the MF is obliged to provide collateral by the issue of long-term bonds, which thus increases the public debt.

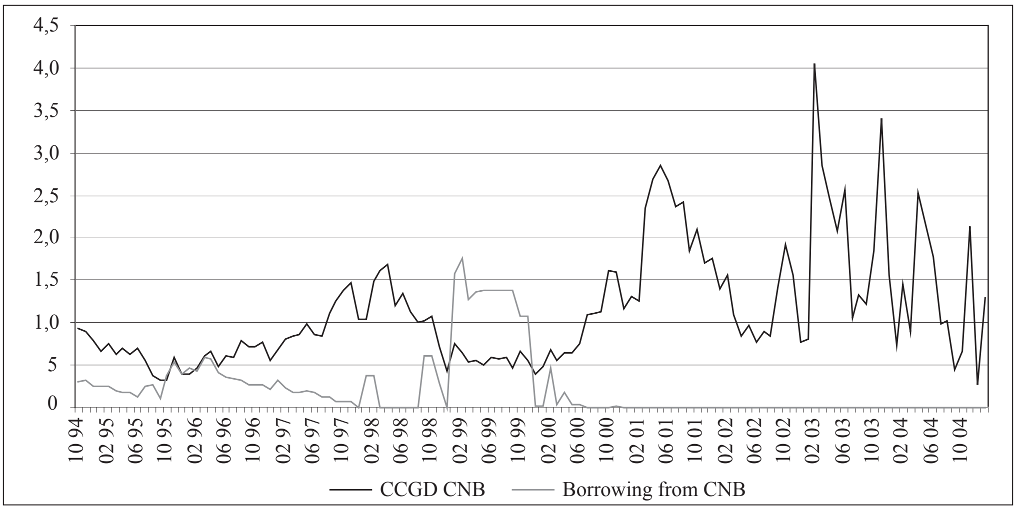
Table 2 Outstanding liabilities of the national budget, situation as of the end of the period (in million kuna)

	1999	2000	2001	2002	2003	2004
1. Brought forward from previous year	–	1,236	147	123	101	–
2. New liabilities in the current year:	–	2,043	359	442	313	1,290
a) HZZO [Health Fund] liabilities				316	500	1,062
b) HZMO [Pension Fund] liabilities				126	42	1
c) other spending agencies' liabilities						227
3. Total outstanding liabilities (1+2)	9,586	3,279	506	565	956	1,290

Source: IMF and MF Republic of Croatia 2005

It can be seen that of the 9.5 billion of outstanding liabilities at the end of 1999, 506 million kuna remained in 2001. However, when the EBFs, for healthcare and pensions, were included in the budgetary system, outstanding liabilities of the national budget increased to 956 million kuna in 2003 and 1.3 billion kuna in 2004. It sho-

Graph 2 Deposits and short-term loans of the national budget in the CNB, 1994-2005 (in billion kuna)



NB: CCGD – Consolidated Central government deposits in the CNB.
Source: CNB, 2005

uld be pointed out that since 2001 the MF, at first quarterly and then monthly, has controlled the outstanding liabilities of all spending agencies and has thus attained the third precondition for cash flow and liquidity management – supervision and control of liabilities. Of course, the issue of the orderly settlement of outstanding liabilities of spending agencies, mainly the institutions from the healthcare system, still remains.

Playing with government deposits

A key issue is whether the MF can manage the short-term liquid funds of the budget. In order to establish this, we should look at the balance of deposits of central government (the national budget and the EBFs) in the CNB and the amount of short-term loans of the CNB to government (graph 2).

Deposits of the national budget in the CNB have increased from 930 million kuna in 1995 to 1.2 billion kuna in 2005. The state has occasionally borrowed from the CNB, mainly in 1999. Interestingly enough, in spite of the existence of available short-term liquid funds and deposits, because of the lack of any cash and liquidity management, up to 2001 the MF on the whole took loans for the purposes of liquidity from the CNB, and from government institutions as well[3]. The prohibition of borrowing at the CNB from 2001[4] gave the MF the opportunity independently to manage deposits and liquidity and to participate in the money market with budgetary surpluses or to borrow by direct loans from commercial banks, clearly an unpropitious option.

Thanks to the operations in and consolidation of funds in the SAT, from 2001 the available deposits of the government budget in the CNB have increased. Since April 2003 the balance of deposits has increased thanks to the move of foreign currency payments and deposits to the single foreign currency account of the treasury (SFCAT) at the CNB. However, still, most of the financial assets of central government (mainly deposits) are immobilised in commercial banks. This is shown by the figures in the graph 3.

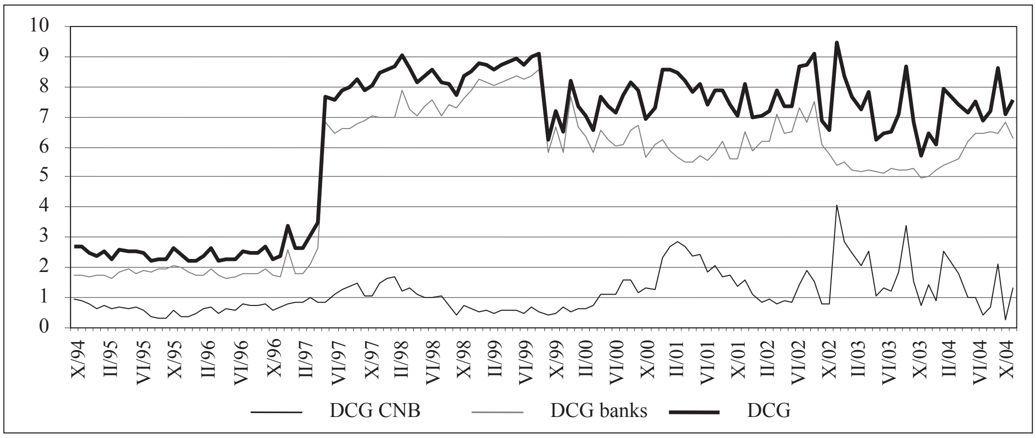
Total deposits of central government increased from 2.9 billion kuna in 1995 to 8.3 billion kuna in 2005. Thus the MF, in collaboration with the CNB, centralised or increased the amount of deposits of the national budget in the SAT (foreign and domestic currency) from 396 million kuna in 1995 to 1.5 billion kuna in 2005. However, the largest part of central government deposits are in the commercial banks, increasing from 1.8 billion in 1995 to as much as 6.8 billion kuna in 2005. This refers primarily to EBF deposits, which when the two largest EBFs were moved into the national budget did not reduce but were actually increased. Still, for a more detailed insight into the inability of the MF to control deposits of the government in the commercial banks and to manage them, one should look at the table 3 concerning the amount and structure of general government deposits.

General government deposits thus increased from 8.7 billion in 2000 to 10.3 billion kuna in 2005. Most of these government deposits, which increased from 2.7 billion in 2000 to as much as 5.2 billion in 2005, are pla-

[3] For example, with ZAP, shipbuilding, the Tax Aministration and the City of Zagreb.

[4] The Croatian National Bank Law, OG 36/01

Graph 3 Central government deposits (of the national budget and the EBFs) in the CNB and in commercial banks from 1993 to 2005 (in billion kuna)



DCG CNB – deposits of central government in the CNB
DCG banks – deposits of central government in the commercial banks
DCG – total deposits of central government
Source: CNB 2005

Table 3 Amount and structure of general government deposits from 2000 to 2005 (in million kuna)

	2000	2001	2002	2003	2004	01 2005
1. Central budget deposits	5,033	4,136	3,143	2,007	1,564	2,505
Short term	2,380	1,970	1,312	992	795	1,823
Time deposits	2,654	2,166	1,831	1,015	769	682
2. EBF	2,706	3,251	3,560	3,716	5,592	5,231
Short term	185	436	706	413	531	526
Time deposits	2,521	2,815	2,854	3,303	5,060	4,704
3. Local units	967	1,381	2,430	2,591	2,592	2,587
Short term	728	1,039	1,937	2,035	2,041	1,963
Time deposits	239	342	492	555	551	625
4. General government (1+2+3)	8,706	8,768	9,133	8,313	9,748	10,322
Short term	3,293	3,444	3,956	3,440	3,367	4,312
Time deposits	5,413	5,324	5,177	4,873	6,380	6,011
Deposits in financial institutions (a + b)	8,706	8,768	9,133	8,313	9,748	10,322
a) CNB	1,009	1,752	608	440	334	1,456
b) Banks	7,697	7,016	8,525	7,874	9,414	8,867

NB: for 2005, the figures relate to the situation as of January 31
Source: CNB, 2005

ced in commercial banks, mainly the time deposits of the EBFs that the MF cannot use in the way of financial potential to be invested on the money market, nor can it affect, by the supply of these funds, the amount of interest rates that are formed on the money market according to supply and demand (daily and overnight). Unfortunately, like the EBFs', local government unit deposits (which increased from 967 billion in 2000 to about 2.6 billion in 2005) are outside the SAT system (and outside the governmental financial information system) in the commercial banks, and the MF cannot affect them or make objective decisions about the amount of grants to allocate to local units from the government budget.[5]

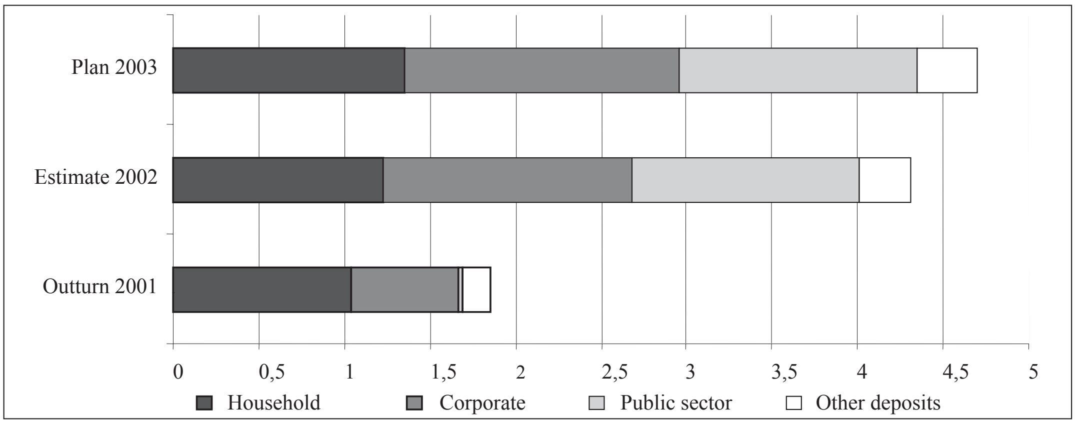
Thus there are some available financial potentials that the MF, in collaboration with the CNB, could use, primarily in the way of investing budgetary surpluses on the money market, as well as a resource for making short-term loans to budgetary and extra-budgetary spending agencies, which, instead of the banks, would be authorised by the Treasury of the MF, naturally, with lower rates of interest, and could use them as an instrument for the introduction of fiscal discipline.

The Croatian Postal Bank – from fiscal agent of the government to a genuine commercial bank

Another problem for the government finances consists of government deposits at the CPB instead of their being consolidated in the SAT at the CNB. For since 2001 the CPB has become a fiscal agent of the government, via which outgoing payments are made from the transaction accounts of government institutions to end users. Nevertheless, deposits are also to be found in the government accounts in the CPB. Although we do not have up-to-date information about the balance of government deposits in the CPB, the figures from the graph 4 are indicative enough.

[5] It is possible, for example, for the government to allocate grants to local units that have enough unused monetary resources in their own accounts already (see Bajo, A., 2004).

Graph 4 Structure of deposits in the CPB from 2001 to 2003 (in billion kuna)



Source: CPB, 2003

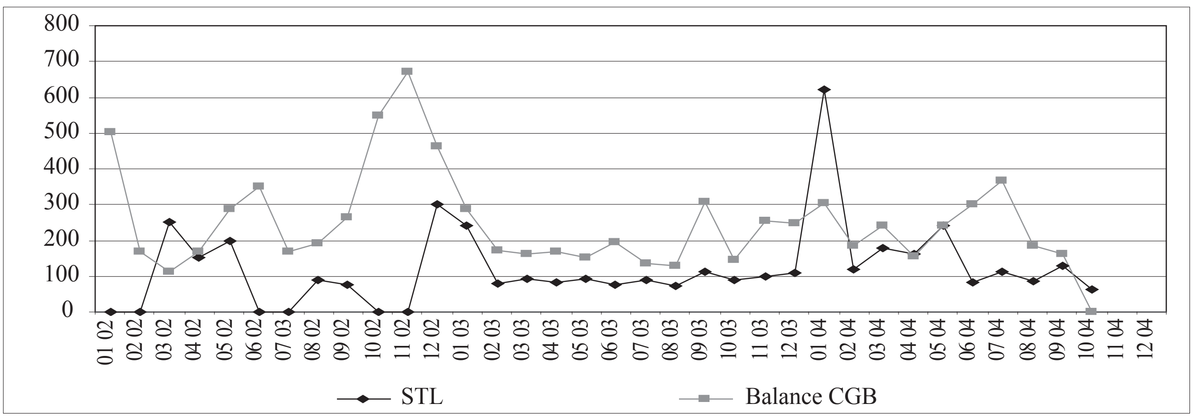
Government deposits in the CPB increased from 26 million in 2001 to about 1.3 billion in 2002. The CPB planned for government deposits in 2003 of approximately 1.2 billion kuna. It should be pointed out that deposits in the CPB are an integral part of the government deposits in the SAT at the CNB, but only on paper, and not in reality. Because cash flow and liquidity are not managed, the MF uses CPB deposits as a loan potential for the short-term financing of the government in conjunction with market conditions, that is, at market rates of interest.

Central budget short-term borrowing

For a complete overview of the situation of the liquidity of the central budget, it is necessary to determine the average balance of liquid resources, and of short-term loans for the sake of liquidity that the MF takes directly from the commercial banks and to a smaller degree on the money market (graph 5).

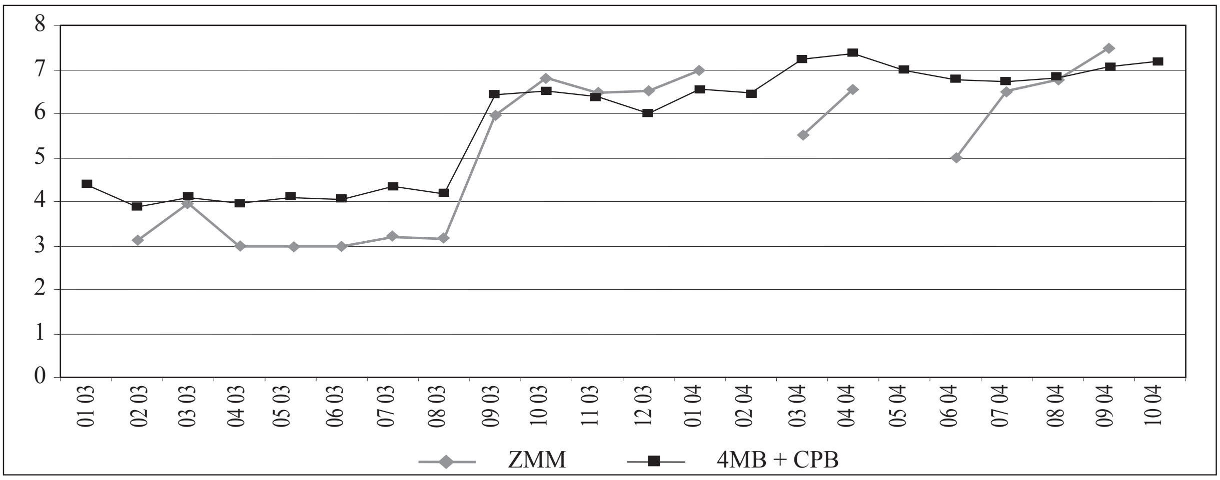
Interestingly enough, the MF (central budget) in 2002 had at the monthly level about 324 million kuna daily at its disposal, which it could use as a surplus of liquid funds and lay them out on the money market. However, in spite of the liquid funds, the MF directly borrowed from the commercial banks, by an average of 89 million kuna. In 2003 the MF had 196 million kuna at its disposal and yet at the same time took on loans at commercial banks of 103 million kuna. In 2004 the average daily balance on the government account was 214 million kuna, and yet the MF took on loans to the tune of 173 million kuna. In other words, short term loans that the state takes on from the banks are smaller than the available monetary resources of the government. In such conditions it can be expected that the MF, apart

Graph 5 Short term government borrowing versus the balance of the central budget (daily average at the monthly level) from January 1 2002 to November 1 2004 (in million kuna)



Note: STL – the average amount of short-term loans of commercial banks; Balance CGB – the average balance of the central government budget.
Source: MF Republic of Croatia 2005

Graph 6 Interest rates on direct bank loans and interest rates on the Zagreb Money Market (in %)



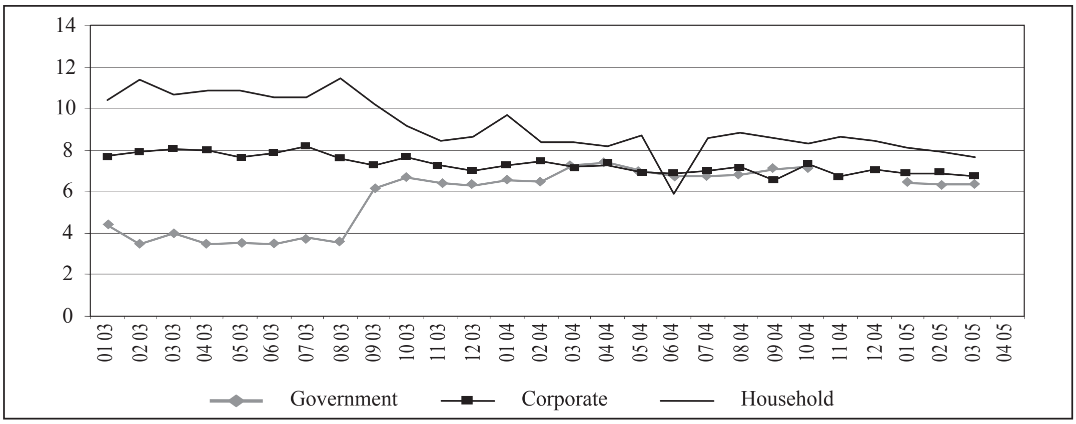
NB: ZMM – interest rates at the Zagreb Money Market; 4 MB+CPB – interest rates at the four major banks and the Croatian Postal Bank
Source: ZMM and MF Republic of Croatia 2005

from borrowing on the Zagreb money market, will borrow greater amounts at the commercial banks as well, mainly from the largest. Still, let us look at the amount of interest on short-term budget borrowings on the money market and directly (for larger amounts) at the commercial banks (graph 6).

And indeed, the interest rates on the short-term loans that the MF takes directly from the four major banks and the state-owned CPB are larger than those on the Zagreb Money Market. The difference in these interests in 2003 came to about 1%, in favour of direct loans from the commercial banks, with the proviso that in 2004 the government on the whole took out short-term loans only from commercial banks at an average interest rate of 7%. However, this perhaps would not be a problem if the interest rates on the short term loans of government and of other institutional sectors, primarily the retail and corporate sectors, were not practically identical (graph 7).

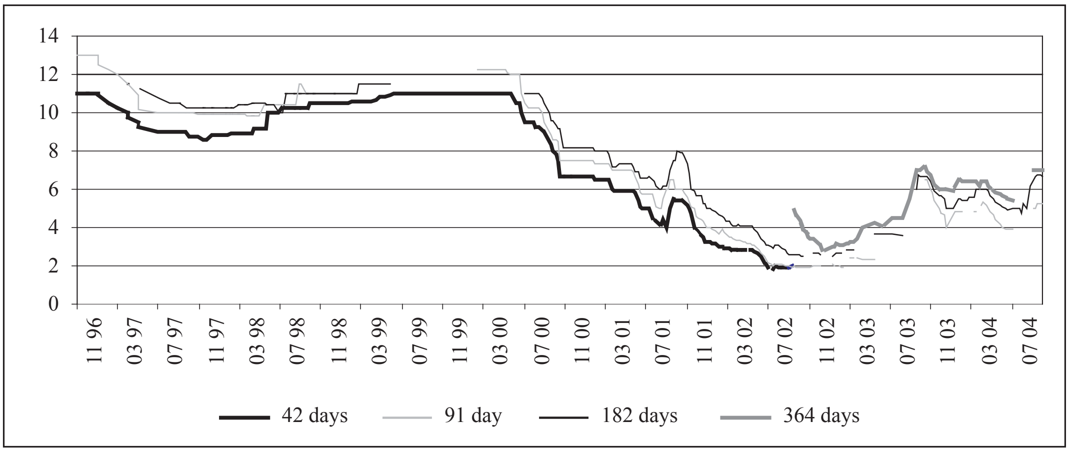
Although up to June 2003 there were differences, from that date the interest rates in conjunction with the foreign currency clause on short-term loans and the interest rates on government short-term loans with no currency clause (our point of departure being the naïve assumption that a short term loan to the government is attended with the lowest risk) are almost identical. In 2004 and 2005 there were on average about 7%. This shows that the financial market does not recognise differences in the qualities of individual debtors, classifying them more or less all the same, with identical degrees of risk. But clearly there is a problem for the government in the financing of short-term loans, and so a little more should be said about the nature of the short-term public debt.

Graph 7 Interest rates on short-term loans per institutional sector – foreign currency clause (in %)



NB: Interest rates on short-term loans of commercial banks to the government do not contain the foreign currency clause
Source: CNB and MF Republic of Croatia, 2005

Graph 8 Interest rates on MF treasury bills from 1996 to 2005 (in %)



Source: MF Republic of Croatia 2005

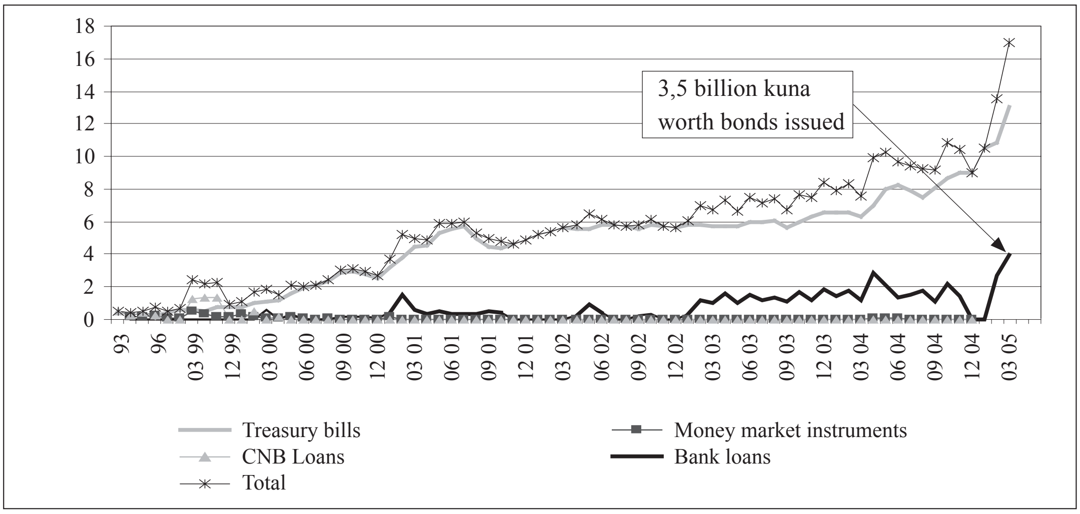
The nature of the short-term public debt

Particularly since 2001, the government has taken on short-term debt in two ways[6]. By the issue of treasury bills and by direct loans from commercial banks. It is a fact that the largest part of the short-term debt has been created by the issue of treasury bills. Thus we should look at the amount of interest on treasury bills according to maturity dates (graph 8).

The MF is lengthening the periods for the redemption of treasury bills. From 1996, when it first issued treasury bills, the MF borrowed at 42, 91 and 182 day periods and in 2002 went over to a period of 364 days. At the same time, the average rate of interest on treasury bills was reduced from a high 11% in 1996 to about 6% in 2005. The reduction of interest rates led to more favourable terms of short-term borrowing, as well as a large increase in the short-term debt created by the issue of treasury bills. The overall short-term debt of the government has markedly increased since 1993, as shown by the graph 9.

Total government short-term debt increased from 517 million kuna in 1993 to as much as 17 billion kuna in 2005, and this can in all honesty be called long-term. The government creates the major part of its short-term debt by the issue of treasury bills, which increased from 272 million in 1996 to as much as 13

Graph 9 Short-term central budget debt from 1993 to 2005 (in billion kuna)



Source: CNB, 2005

[6] A third category could be due and still outstanding liabilities of spending agencies.

billion kuna in 2005. However, the growth in the overall short-term debt is partially the consequence of the increased amounts of loans for liquidity (mainly for pensions) that the MF takes on from the commercial banks. Liquidity loans increased from 620 million kuna in 2000 to 3.9 billion kuna in 2005. The explosion in short-term borrowing because the MF does not manage its liquidity and cash flow brought the MF to the point at which it ultimately had to turn double short-term debts into one long-term debt, because of which it sells bonds on the domestic and foreign market. Thus in April 2005, in order to settle its short-term debts to the banks, the government issued bonds in the amount of 3.5 billion kuna, which is about 90% of the direct short-term debt (loans) of the state to domestic commercial banks. The Government and the MF adduced as reasons for these new borrowings "financing of the orderly execution of the budget", which is really nothing else but borrowing to finance current budgetary expenditures, on the whole for pensions. In such conditions the question arises as to who in the MF is managing, as well as cash flow and liquidity, the public debt. Unfortunately, there is no point in writing at the present moment of public debt management. The situation is just the same as liquidity and cash flow management – it does not exist at all.

Who manages cash flow and liquidity of the central budget?

In few countries that are aspiring to enter the EU is there no collaboration between central bank and the MF in the management of fiscal and monetary policy, particularly in that part that relates to the control of cash flows in the government accounts and to the daily, weekly and monthly management of the money potential of the government. In Croatia, in May 2005, the CNB, without involving the MF, made a decision to increase the rate of mandatory reserves, although such a decision can have a direct impact on the conditions under which the government has to borrow (the interest rates). Why do the chief financial institutions charged with the stability of the government or state finances not collaborate, maintaining an appropriate level of budgetary deficit and public debt, as well as price and exchange rate stability? The main problem is that the management of government cash flows and liquidity is not in the hands of the MF or the CNB but has been surrendered to the (on the whole the biggest) commercial banks, in which the major parts of the government deposits are kept, particularly those of the EBFs.

The MF and the Government, since 2001 at least (when short-term borrowing at the CNB was forbidden) should have become quite aware that the functions of the execution of the budget and the management of cash flows and liquidity are at the heart of the budgetary system and that improvements in them can lead to a slow-down in the growth of the public debt, even of public spending. Unfortunately, since the MF still does not manage the deposits (of the EBFs and the local government units, principally) and liquidity of the government budget and because as a result there is no collaboration between the CNB and the FM, control of cash flows has been resigned to the commercial banks. In such conditions, the MF, instead of being a player on the money market with its budgetary surpluses, is still borrowing directly from the commercial banks, even from its own state-controlled bank, but on market conditions.

Conclusion

For the MF to be able to control cash flow and liquidity of the central budget, it is necessary for:

- the MF and the CNB to set up a system of collaboration in the management of the monetary potential of the budget
- the MF to set up and improve its cash flow and liquidity management and, as well as recording, actually to start managing the available financial potential. This means above all:
  a) investing budgetary surpluses on the money market
  b) making loans to spending agencies and the EBFs (internal operations of the Treasury)
  c) in agreement with the banks, the selection of the most favourable financial services provider, by for example the opening of transaction accounts
- the Government to privatise the CPB
- the Government and the MF to centralised foreign currency deposits in the SAT in the CNB, and for the MF to consolidate EBF deposits and start managing them
- local government units to start operating via their own SATs that they have to open at the CNB.

Perhaps the key issue in Croatia is to develop an awareness of the nature and value of public money.

Potential problems in the realisation of these proposals are to be found in the resistance of the banks to consolidation of deposits in the SAT at the CNB, the dubious technical competence of the MF for the management of cash flow and liquidity, and to collaborate with the CNB, the resistance of spending agencies and EBFs to operating via their SATs and centralised government deposit management in the MF, the resistance of local government units to operating via their SATs in the CNB, and the absence of any political will for the privatisation of the CPB.

Key conclusions

- Cash flow and liquidity management can serve the MF as a means for the introduction of fiscal discipline.
- If the government figures on the Zagreb Money Market through coordinated action of the MF and the CNB, direct short-term borrowing at banks might be done away with, and more transparent short-term financing of the central budget with treasury bills alone ensured, in conjunction with lower costs.
- Privatisation of the banks does not mean a loss of sovereignty in the management of fiscal and monetary policy.
- If the MF figures on the Zagreb Money Market with surplus funds, it will not (with good management) undermine monetary stability.
- With good cash flow and liquidity management the MF can help the CNB to run monetary policy, particularly in making sure of effective control of the credit potential of commercial banks and in management of the exchange rate.
- Opening SATs of local units in the CNB would give the MF the capacity to define better criteria for the allocation of grants from the central budget.

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