



# The structure and economic significance of government guarantees in Croatia and the European Union

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Article\*\*

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## Abstract

*In the aftermath of the financial crisis, when countries are facing difficulties in raising the amounts of revenue needed to cover the expenditure side of the budget, fiscal risks can pose a significant threat to the sustainability of public finance. This became particularly evident in the case of public enterprises and their liabilities, which often increased public debt because of difficulties in meeting their financial obligations. The aim of this paper is to evaluate fiscal risks from government guarantees in Croatia and the European Union in general. Moreover, the paper aims to analyse the dynamics of the value and structure of government guarantees in Croatia in the period from 2009 to first half of 2015. Particular emphasis is placed on the impact of government guarantees on direct public debt in the context of methodological changes in the registration of public debt.*

*Keywords: fiscal risks, contingent liabilities, government guarantees, public debt, Croatia*

## 1 INTRODUCTION

Sound government finance has always been a prerequisite for competitiveness, economic development and the well-being of the population. The global financial crisis has made this imperative even more important. Public financial management has as almost never before been under the continuous surveillance of rating agencies, creditors, and other relevant institutions. This applies to all levels of government and often becomes an issue of supranational supervision as in the European Union (EU). In order to facilitate and maintain the stability of the Union, member states have signed the stability and growth pact, which implies fiscal monitoring of member states and ensures their compliance with the Maastricht criteria. This is particularly important for new EU members with weaker capacities for public financial management. In addition, those economies are mostly still undergoing the transition process, which makes their public finances even more vulnerable to the unrestrained rise in government liabilities. Besides explicit liabilities, those countries often face a sizable fiscal risk emerging from contingent government liabilities and other sources of risk.

This paper aims to analyse the importance of government guarantees in the EU, with particular reference to the Republic of Croatia. State guarantees – an important type of budgetary contingencies – tend to be partly ignored in the context of fiscal analysis. With such an approach, the assessment of the financial health of the state can result in an inaccurate impression of the real fiscal position of a country. This paper strives to highlight the importance of the appropriate treatment of government guarantees. Comparing the data for various EU countries, the paper will examine whether the stock of government guarantees in EU countries exceeds the level of their explicit direct liabilities. Moreover, the comparative analysis will show whether government guarantees in Croatia are higher than the EU average. Finally, the main part of the paper will examine the structure of government guarantees in Croatia largely building upon the previous work of Bajo and

Primorac (2011) on the size and structure of government guarantees in Croatia. Bajo and Primorac (2011) in their analyses covered the period from 1996 to 2010, whereas this paper covers the remaining period until first half of 2015, capturing the effect of the accession to the EU. This is important not only due to changes that have occurred in the size and structure of guarantees, but also in the statistical treatment (changes in the methodology of national accounts) of government guarantees in Croatia (which has gradually aligned with the EU standards).

The paper is divided into six chapters. After the introduction, we provide a theoretical background to the issue and management of guarantees and contextualize the topic in the light of the recent trends in public financial and risk management. The third chapter is devoted to government guarantees in the EU. The fourth chapter analyses the size and structure of government guarantees in Croatia, and the fifth chapter aims at discussing the fiscal implications of government guarantees, capturing their impact on public debt. The last, sixth, part is the conclusion.

## 2 THEORETICAL BACKGROUND AND POLICY CONTEXT

Fiscal risks can be broadly defined as the possibility of deviations of fiscal outcomes from what was expected at the time of preparation of the budget or other forecasts (Cebotari et al., 2009). Fiscal risks come from many sources and in many forms, which makes it difficult for governments to identify and categorize them for the purposes of analysis and disclosure. However, most can be grouped into macroeconomic and specific risks (IMF, 2014). Macroeconomic risks include unforeseen developments in real GDP growth and inflation, commodity prices, exchange rates and interest rates, external assistance flows, and so on. Specific risks relate to budgetary contingencies, asset and liability management, government guarantees, public private partnerships, financial sector exposure, as well as natural resource and environmental risks.

In the second half of 2014 the International Monetary Fund (IMF) presented its new Fiscal Transparency Code (FTC) – an international standard for disclosure of information about public finances. The Code comprises a set of principles built around four pillars: (1) fiscal reporting; (2) fiscal forecasting and budgeting; (3) fiscal risk analysis and management; and (4) resource revenue management. The fiscal risks pillar (with its 12 principles) should ensure that risks to public finances are disclosed, analysed and managed, and fiscal decision-making across the public sector effectively coordinated. As a part of its initiative, the IMF's Fiscal Affairs Department developed a comprehensive framework for evaluating fiscal risk management practices and conducted pilot fiscal transparency evaluations in several countries (e.g. Costa Rica, Ireland, Russia and Bolivia).

Fiscal risk management is relatively underdeveloped in Europe and not well reflected in EU fiscal requirements. In fact, fiscal risks in EU countries have been ignored until quite recently. At the beginning of 2015, Eurostat for the first time released information about contingent liabilities and non-performing loans of EU

member states (Eurostat, 2015). The data were collected as part of the Enhanced Economic Governance Package (the “six-pack”, Council Directive 2011/85/EU). In this classification, contingent liabilities include guarantees, liabilities related to public-private partnerships recorded off-balance sheet, and liabilities of companies that are controlled by the state, but classified outside the general government (public corporations). However, the detailed structure of those liabilities, as well as the probability of their occurrence remains unknown.

Government guarantees are part of contingent but *explicit* government liabilities, by which the guarantor (the government) undertakes to a lender that if a borrower defaults, the guarantor will make good the loss the lender would otherwise suffer (Bajo and Primorac, 2015). In case the guarantees are called (e.g. due to the occurrence of an “insured” event) the government takes on full responsibility for liabilities covered by the guarantee. International public sector accounting standards define a contingent liability as: (1) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or (2) a present obligation that arises from past events but is not recognized because: (a) it is not probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation; or (b) the amount of the obligation cannot be measured with sufficient reliability (International Federation of Accountants, 2013: International Public Sector Accounting Standard 19). The most frequent examples of government guarantees include those for liabilities incurred by lower levels of government and public enterprises, development banks and guarantee agencies, public-private partnership projects and other forms of cooperation between the government and the private sector (Bajo and Primorac, 2011).

Although government guarantees might be convenient in terms of reaching the desired outcome (supporting beneficiaries) without incurring expenditure, this is at the same time the most dangerous disadvantage of guarantees. Potential obligations from government guarantees are not budgeted and accounted for, nor are they considered in conventional fiscal analysis (Polackova, 1999). They can be used as a means to bypass the government’s fiscal constraints on central and local government borrowing, which is why they can produce a hidden and adverse effect on fiscal policy (Bajo and Primorac, 2011). Guarantees can often have potentially significant fiscal consequences. This is clearly the case where countries have issued guarantees extensively, as happened in many countries in transition that sought to shift the costs of structural reforms to the future through guarantees (Ter-Minassian, 2005).

Managing fiscal risk at the national level is particularly important in the European Union as a way of maintaining fiscal and general economic stability. However, very few member states have the institutional frameworks and capacities to effectively control and manage contingent liabilities (Polackova and Brix, 2004). For instance, fiscal costs can be significant in federal countries where there is an assumption that the central government will bail out sub-national governments that get into financial difficulties, as well as in transition countries where governments are generally ex-

pected to stand behind privatised firms and financial institutions once they get exposed to competition (Ter-Minassian, 2005). In the EU context, new member states have been perhaps most prone to the accumulation of contingent liabilities and related fiscal risk (Polackova and Brixi, 2004). A further concern is that the fiscal costs of guarantees and other contingent liabilities are often exposed precisely during crises (Ter-Minassian, 2005). One way to reduce the risk of such surprises and improve the measurement and budgeting of guarantees is to promote transparency about fiscal risks and their potential costs (Thobani, 1999; Ter-Minassian, 2005).

### 3 GOVERNMENT GUARANTEES IN THE EU

According to the EU law, contingent liabilities are not included in the scope of the general government debt.<sup>1</sup> The value and structure of government guarantees for most EU countries have been publicly available for some time. However, data on other contingent liabilities of EU member states were first made publicly available in January 2015. This was the outcome of a process that started in November 2011, when the European Parliament and the Council adopted an Enhanced Economic Governance package – the so-called “six pack”, which required collection and publication of relevant information on contingent liabilities of all general government sub-sectors with a potentially large impact on the state budget, including guarantees, non-performing loans and liabilities of public enterprises. The new questionnaire (“Supplement on contingent liabilities and potential obligations to the excessive deficit procedure related questionnaire”) was added to an existing group of questionnaires on the excessive deficit procedure. Thus, national statistical offices submit data from the new questionnaire annually (by December 31) for the previous year, including data on standardised and one-off guarantees, off-balance sheet public-private partnerships and non-performing loans (Eurostat, 2014).

*Standardised guarantees* are typically issued in large numbers, each usually backing a small loan (e.g. export credits and guarantees for student loans). They are issued for the benefit of financial institutions granting loans under specific lending programmes approved by national authorities. *One-off guarantees* are awarded on a case-by-case basis, usually for individual high-value contracts (e.g. big infrastructure projects, guarantees for loans of public enterprises). These guarantees are typically subject to close monitoring, because they could potentially provide unfair competitive advantage to the particular firms whose loans are guaranteed. Therefore, the issuance of such guarantees is monitored by EU competition authorities or even the WTO.

Data on guarantees in the EU do not include those issued under the Framework Agreement of the European Financial Stability Facility<sup>2</sup>, derivative-type guaran-

<sup>1</sup> See Council Regulation (EC) No 479/2009 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community.

<sup>2</sup> The European Financial Stability Facility (EFSF) is a company agreed to by the countries that share the euro in 2010 and incorporated in Luxembourg. The EFSF's objective is to preserve financial stability of Europe's monetary union by providing temporary financial assistance to euro area member states if needed. The assistance is financed by the EFSF through the issuance of bonds and other debt instruments backed by guarantees given by the euro area member states in accordance with their share in the paid-up capital of the European Central Bank (for more information see: <http://www.efsf.europa.eu/about/index.htm>).

tees (e.g. credit default swaps)<sup>3</sup>, deposit insurance guarantees and comparable schemes and government guarantees issued for natural disasters (earthquakes, large scale flooding), the occurrence of which is very difficult to cover via commercial insurance (Eurostat, 2015).

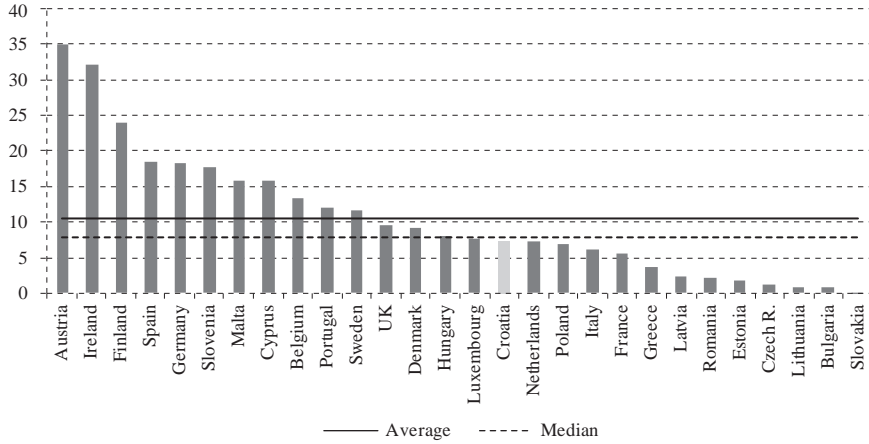
The global financial crisis has had a significant effect on the accumulation of government guarantees in EU countries. Since the consequences of the crisis were most severe in the financial sector, governments have often called for state intervention in order to safeguard the collapsing financial systems. Therefore, a significant amount of government guarantees arose in the past due to securities issued under liquidity schemes (e.g. in Greece and the United Kingdom). Some member states even created special purpose vehicles to tackle the emerging problems faced by the financial sector. In Denmark – a state guarantee was issued to cover losses in Roskilde Bank, in Ireland – a special purpose vehicle related to the National Asset Management Agency (NAMA), in Spain – Sociedad de Gestión de Activos procedentes de la Reestructuración Bancaria (SAREB), in France – Société de Financement de l’Economie Française (SFEF), and in Austria – guarantees were issued for the activities of Clearingbank (Eurostat, 2014b). However, countries have also issued guarantees to support other sectors and causes. For example, Finland has used government guarantees to promote its exports (particularly to United States and Germany), as well as for domestic operations of SMEs through Finnvera (a state-owned financing company that is the official export credit agency for Finland). Guarantees were also issued for the long-term loans of Finavia – a state-owned corporation responsible for maintaining and developing its 25 airports and Finland’s air navigation system. In general, the structure and intensity of issuing guarantees in EU countries depend on national particularities including the strategic objectives, the structure of the economy (dominant economic sectors and those of strategic importance), state ownership and many other factors.

In 2013, guarantees as a share of GDP were highest in Austria (35%), followed by Ireland, Finland, Spain, Germany and Slovenia, whereas the lowest shares were recorded in the new member states from Central and Eastern Europe (Slovakia, Bulgaria, the Baltic States, the Czech Republic, Romania) but also in Greece (figure 1). The Croatian government had issued guarantees amounting to 7.25% of GDP, which is lower than the EU average of 10.5%. However, the average is a biased statistic given the wide dispersion of data: in terms of the median, which is a more accurate measure of the central tendency of data in this sample, Croatia was positioned just slightly below the median observation, which was 7.9%.

<sup>3</sup> Derivative-type guarantees are those that are actively traded on financial markets and fall under the usual treatment of derivatives, which do not require specific provisions for government transactions in the EU markets. The derivative is based on the risk of default and generally not actually linked to an individual loan or bond (Eurostat, 2013).

FIGURE 1

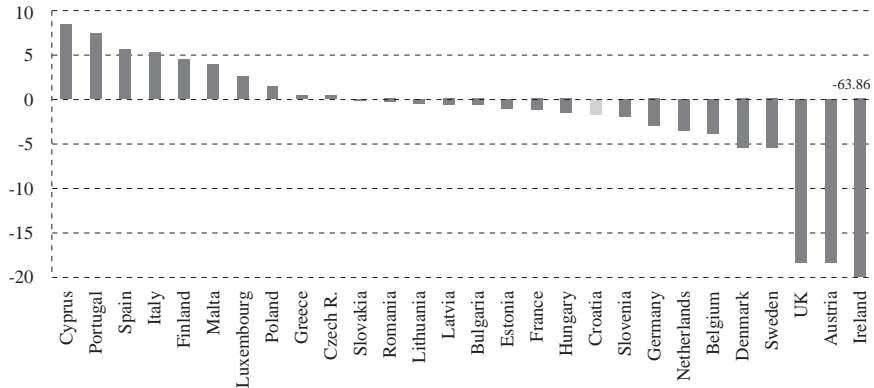
General government guarantees of EU countries in 2013 (% of GDP)



Source: Eurostat.

FIGURE 2

The increase in the amount of guarantees of EU countries from 2010 to 2013 (% of GDP)



Source: Eurostat.

It is quite surprising that the old EU members in general have higher relative amounts of guarantees than the new members. The old members tend to take a leading role in promoting transparency, accountability and implementing good practices in public financial management. Nonetheless, they seem to use off-balance sheet liabilities more frequently than the new members, which are still in different phases of transition and would therefore be expected to rely more heavily on government guarantees. Whether the old EU members really have more experience in utilising the benefits of guarantees or some other factors have determined their particularly high exposure to guarantees remains an open question. One should however note that in several countries guarantees were issued within the framework of broader policies aimed at bailing out financial institutions

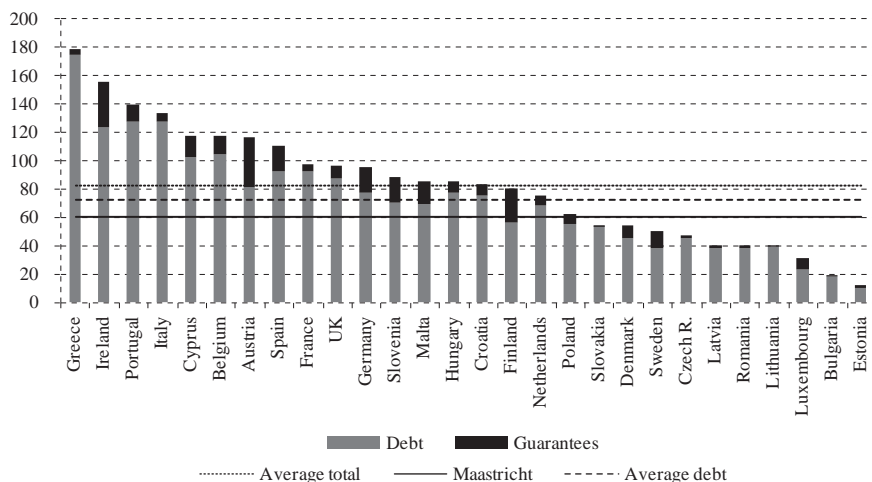


affected by the crisis. Moreover, the coverage of guarantees is incomplete in most countries (Eurostat, 2015). In Croatia, for instance, data are not available for standardised guarantees and guarantees of the local government subsector.

In any case, the recent crisis indubitably plays an important role in explaining how the size of government guarantees changed over time. Government guarantees in Cyprus, Portugal, Spain and Italy increased from 2010 to 2013 by more than 5% of GDP mainly due to new issues of guarantees provided to financial institutions. On the other hand, guarantees in the United Kingdom, Austria, and especially Ireland decreased significantly, mostly due to setting aside the rescue measures related to state interventions in the financial system during the crisis. In the United Kingdom, the guarantees issued under the liquidity schemes ceased to exist in 2013. Austrian Clearingbank, which served as an intermediary on the interbank market by borrowing funds (backed up by state guarantees) and lending to credit institutions and insurance undertakings, wound up in 2011. Irish NAMA was set up with the aim of addressing the problem of impaired assets in the banking system. Assets (primarily land and development loans) were transferred from banks to NAMA to strengthen their balance sheets and ensure that uncertainty over bad assets is reduced. In addition, the Eligible Liabilities Guarantee (ELG) scheme was introduced to provide the participating institutions (mainly systemically important and solvent credit institutions incorporated in Ireland) with access to medium-term state-guaranteed funding (with maturities of up to five years). Since the ELG scheme was abolished and the NAMA's task was to bring the balance sheet down to zero as soon as commercially practicable, government guarantees in Ireland decreased from 2010 to 2013 by almost 65% of GDP.

**FIGURE 3**

*Total general government debt (gross debt plus guarantees) of EU countries in 2013 (% of GDP)*



Source: Eurostat.



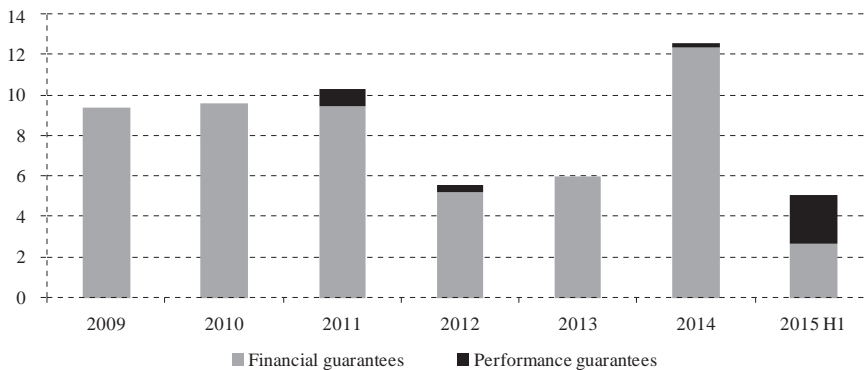
To get a clear perspective on the significance of government guarantees in EU countries, it is also useful to compare the size of government guarantees with the size of public debt. The share of general government debt in GDP in 2013 was lowest in Estonia (10%) and highest in Greece (175%) (figure 3). The debt/GDP ratio in Croatia was 76%, which was above the EU average of 72%. With government guarantees included, the overall picture of relatively high public sector indebtedness does not change much: in addition to Greece, Ireland, Portugal, Italy Cyprus and Belgium, two more countries – Austria and Spain – would have a total government debt exceeding 100% of GDP, and three more – France, the United Kingdom and Germany – would be close to that benchmark. Only 10 out of 28 countries would satisfy the 60% benchmark Maastricht criterion, as against the 12 when government guarantees are not included in public debt.

#### 4 SIZE AND STRUCTURE OF GOVERNMENT GUARANTEES IN CROATIA

The Croatian Government and Ministry of Finance have been issuing financial guarantees since 1995 and performance guarantees since 1998 (Bajo et al., 2011). With financial guarantees, the government warrants that an original debtor's financial liabilities will be settled if the debtor is unable to settle them fully and on time. Performance guarantees are issued against a pledge of movable property to guarantee the fulfilment of a contract to deliver/return goods or services. Figure 4 shows the amounts of financial and performance guarantees issued in the period from 2009 to the first half of 2015.

**FIGURE 4**

*Financial and performance guarantees issued from 2009 to first half of 2015 (in billion HRK)*



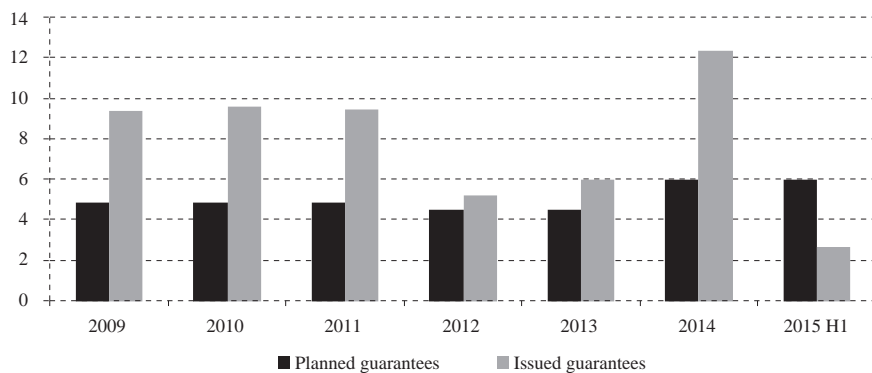
*Source: Authors based on Ministry of Finance (2009, 2010, 2011, 2012, 2013, 2014a and 2015a).*

The total amount of guarantees issued ranged from HRK 5.6bn in 2012 to HRK 12.6bn in 2014. Financial guarantees are prevalent in the reported period, whereas a significant amount of performance guarantees appears only in the first half of 2015 and relates to the shipbuilding sector, which – after a while – again seems to have become a significant (if not the dominant) beneficiary of government guarantees.

The Law on the Execution of Government Budget, which is passed for each year, stipulates the annual value of the new government guarantees (planned), as well as conditions of their issuance. Figure 5 shows a comparison of planned and issued guarantees: the amount of financial guarantees actually issued exceeded the limit set forth by the budget law through the entire period. This is because guarantees issued pursuant to the decisions of the Parliament, which account for a large share of the total, are not counted towards the annual limit in the budget law (Bajo and Petrušić, 2014). In 2012 and 2013, this gap was somewhat smaller because the Parliament was less active in issuing guarantees, so the limit set out by the budget law was largely adhered to. However, the trend reversed in 2014, when the amount of guarantees issued was more than double the maximum amount of guarantees prescribed in the budget law.

**FIGURE 5**

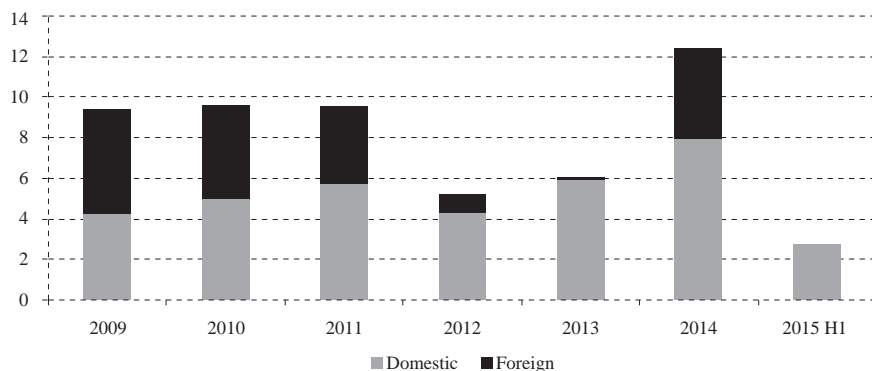
*Planned and issued financial guarantees from 2009 to the first half of 2015 (in billion HRK)*



Source: Authors based on Ministry of Finance (2009, 2010, 2011, 2012, 2013, 2014a and 2015a).

**FIGURE 6**

*Domestic and foreign financial guarantees issued from 2009 to the first half of 2015 (in billion HRK)*



Source: Authors based on Ministry of Finance (2009, 2010, 2011, 2012, 2013, 2014a and 2015a).

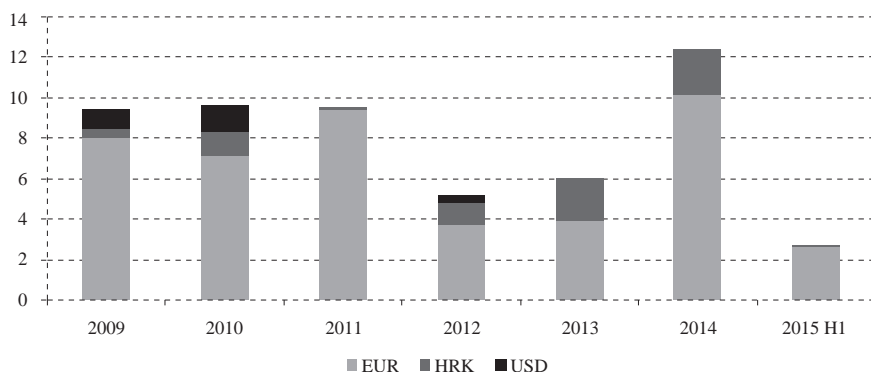
Several other breakdowns provide interesting information on the structure of government guarantees and how it has evolved over time.

Among financial guarantees there has been a steady increase in the share of guarantees on loans provided by domestic financial institutions (figure 6). In 2013, the share of such guarantees reached 98% of the total. However, this increase did not reflect greater reliance of public enterprises on borrowings from domestic banks, but rather a sharp fall in foreign bank lending and, as a result, guarantees on such loans. This trend reversed in 2014, with HRK 4.5bn of guarantees issued for the loans that Croatian Highways took from foreign financial institutions.

Most of the guarantees back bank loans denominated in euros (figure 7). Guarantees for bank loans denominated in HRK increased steadily between 2009 and 2014, but disappeared in the first half of 2015.

**FIGURE 7**

*Currency structure of financial guarantees issued from 2009 to the first half of 2015 (in billion HRK)*



Source: Authors based on Ministry of Finance (2009, 2010, 2011, 2012, 2013, 2014a and 2015a).

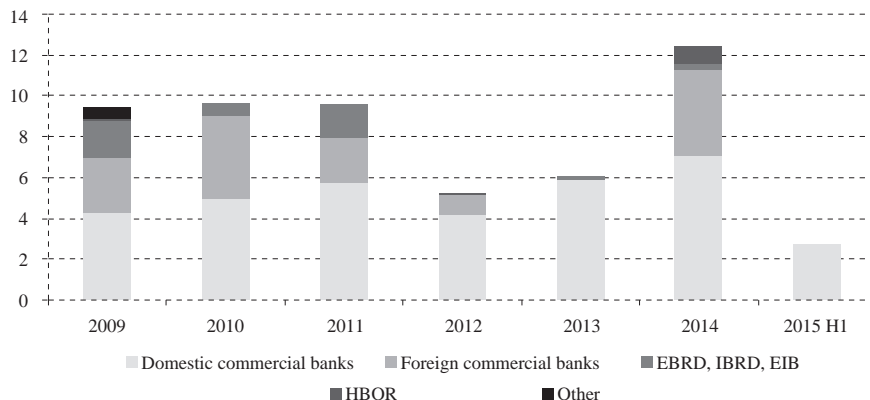
Most of the government guarantees back loans provided by domestic commercial banks (figure 8). The share of financial guarantees backing up loans provided by foreign financial institutions decreased significantly between 2010 and 2013, but jumped in 2014 to the highest level ever. This reflected mainly the guarantee for the Deutsche Bank London loan to Croatian Highways to refinance existing loans. In 2009-11, some guarantees were also issued to back up the loans provided by EBRD, IBRD and EIB for infrastructure projects (highways, roads and ports); and in 2014 for a HRK 0.8bn loan provided by the Croatian Bank for Reconstruction and Development (CBRD) to Croatian Railways Passenger Transport for the purchase of trains.

Turning to sectoral breakdown, between 2009 and 2013 financial guarantees were mostly issued for the transport and manufacturing sectors (figure 9). Within the transport sector, most guarantees were issued for loans granted to Croatian Roads,

Croatian Highways, Croatian Railways, and port authorities in Rijeka, Split and Zadar. In 2009 and 2010, a large part of financial guarantees was issued to firms in the manufacturing sector, more specifically to shipbuilders.<sup>4</sup> As shipyards were restructured and privatised in 2011 the government no longer had to issue guarantees for their loans. However, financial difficulties of highway companies intensified, so almost all guarantees issued since 2011 have backed up loans to the transportation sector. In sum, government guarantees before 2010 were used almost exclusively for propping up the loss-making shipbuilding industry, and since 2011 the loss-making highway companies.

**FIGURE 8**

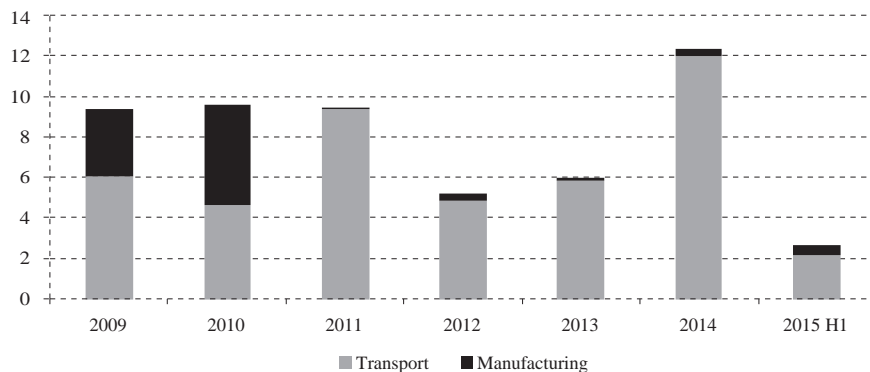
*The structure of financial guarantees issued by type of creditor from 2009 to first half of 2015 (in billion HRK)*



Source: Authors based on Ministry of Finance (2009, 2010, 2011, 2012, 2013, 2014a and 2015a).

**FIGURE 9**

*Structure of the value of financial guarantees issued by sectors from 2009 to the first half of 2015 (in billion HRK)*



Source: Authors based on Ministry of Finance (2009, 2010, 2011, 2012, 2013, 2014a and 2015a).

<sup>4</sup> For a detailed discussion on fiscal risks emerging from guarantees issued to the shipbuilding sector, see Bajo and Primorac (2011a).

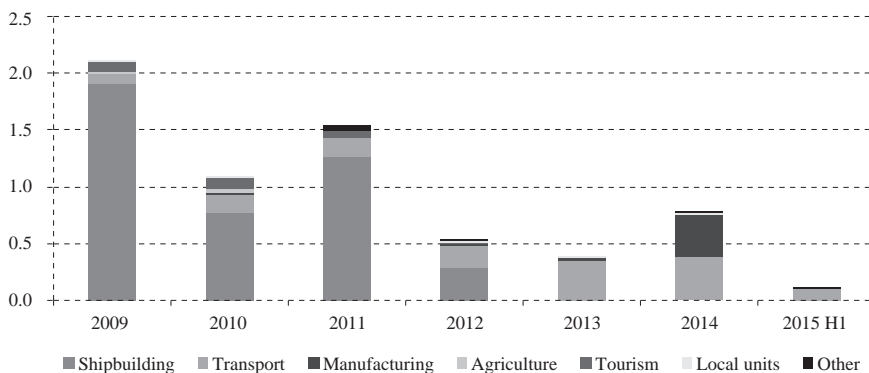
## 5 FISCAL IMPLICATIONS OF GOVERNMENT GUARANTEES

If guarantees are called on, they become direct government debt. A portion of loans for which guarantees are called on has to be repaid by the government. The Government and the Ministry of Finance normally attempt to recover part of the amount they had to pay for defaulted loans from guarantee reserves. Unfortunately, the amounts recovered and transferred to the budget are low, as the original debtors typically have longstanding financial difficulties and are not able to meet their obligations.

The majority of guarantees were called in 2009, 2010 and 2011, primarily in the shipbuilding sector (in 2009 by as much as HRK 1.9bn), but also in the transport sector, tourism and agriculture. In 2012, the amount of called guarantees decreased by 65.4%, primarily due to the fact that the payments for the liabilities of shipyards were, as of March 2012, recorded under expenses for the repayment of the principal and interest – and not as withdrawals from the guarantee reserves. This change was caused by the administrative manoeuvre by which the Government in 2011 converted the shipyards' contingent liabilities – totalling HRK 11.3bn – into explicit public debt (Bajo and Primorac, 2011a).

**FIGURE 10**

*Called financial guarantees by sector from 2009 to the first half of 2015 (in billion HRK)*

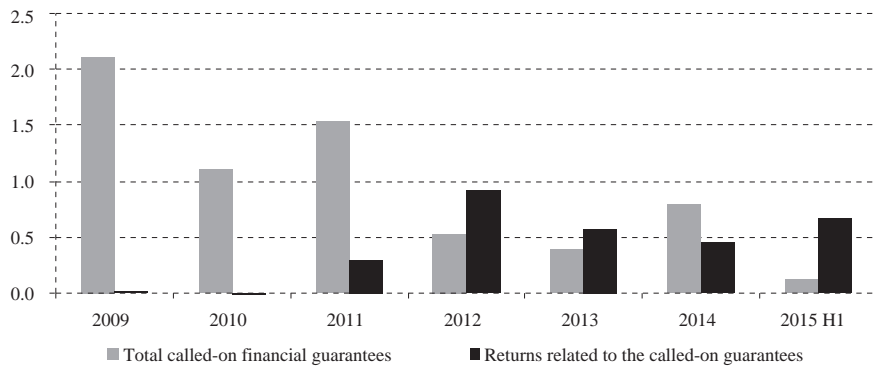


*Source: Authors based on Ministry of Finance (2009, 2010, 2011, 2012, 2013, 2014a and 2015a).*

In 2009 and 2010, the total amount of called financial guarantees was far greater than returns to the government budget. The original debtors, based on direct deposit or otherwise, repaid only 1% of the total amount of guarantees called in those years. However, the situation improved in 2011. In addition to direct payments to the budget of only HRK 26m, the state also collected claims for paid guarantees by acquiring company shares worth HRK 257m and assets worth HRK 25m.

FIGURE 11

Called guarantees and refunds from 2009 to first half of 2015 (in billion HRK)



Source: Authors based on Ministry of Finance (2009, 2010, 2011, 2012, 2013, 2014a and 2015a).

Since 2012, things have drastically changed. Recovery related to guarantees called in 2012 was nearly double the total amount of guarantees called in that year. This is a direct result of the transformation of claims based on called guarantees issued to Croatia Airlines into shares amounting to almost HRK 900m and the acquisition of the debtor's real estate worth HRK 3m. In the same way the government acquired shares in Croatian Railways Cargo – in the first half of 2015 – amounting to HRK 454m. This is *de facto* hidden financing through increasing the shareholders' equity, although the Republic of Croatia is already the only shareholder (holding 100% of the equity). Therefore, there is not much economic reason behind these operations – they are, in effect, state subsidies with a delayed effect and a different accounting treatment.

TABLE 1

Guarantee reserves and called financial guarantees from 2009 to first half of 2015

Year	Guarantee reserves (HRK bn)	Called guarantees (HRK bn)	Potential maturity (HRK bn)	Reserves/ Maturity (%)	Reserves/ Called (%)	Called/ Maturity (%)
2009	0.7	2.1	3.8	18	32	56
2010	1.0	1.1	3.2	31	91	34
2011	1.0	1.5	7.7	13	65	20
2012	1.0	0.5	5.1	20	187	10
2013	0.5	0.4	4.3	11	121	9
2014	0.8	0.8	5.6	15	106	14
2015 H1	0.5	0.1	4.5	12	464	3

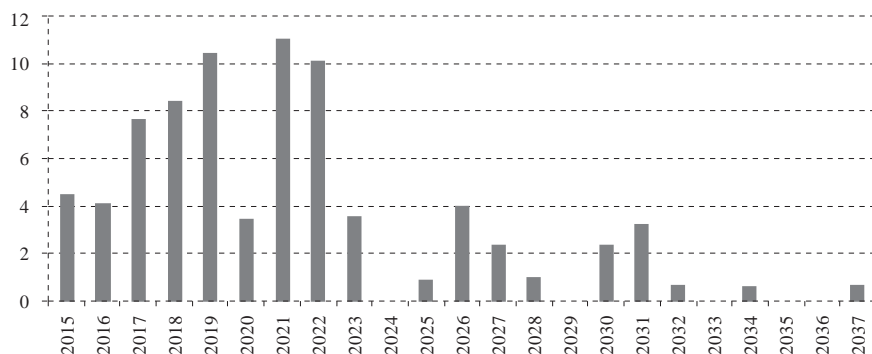
Source: Authors based on Ministry of Finance (2009, 2010, 2011, 2012, 2013, 2014a and 2015a).

Between 2009 and 2011 the guarantee reserve funds were not sufficient to cover the guarantees called – additional funds had to be provided from alternative sources. In the remainder of the observed period, there was an excess of guarantee reserve. This is mainly due to changes in the record-keeping of shipyards' debt

secured by government guarantees in 2011. Throughout the period, guarantee reserves covered less than 20% of outstanding guarantees (with the exception of 2010 – 31%). The ratio of called and outstanding guarantees gradually decreased from as much as 56% in 2009 to only 3% in the first half of 2015, which is also largely a result of the change in the national statistics and record-keeping.

**FIGURE 12**

*Value and potential maturity of financial guarantees active at the end of the first half of 2015 (in billion HRK)*



Source: Authors based on Ministry of Finance (2009, 2010, 2011, 2012, 2013, 2014a and 2015a).

The beneficiaries of government guarantees have created obligations for the repayment of debts and interest until as far as 2037. The amount and maturities of financial guarantees vary. In 2015 and 2016 approximately HRK 8bn of loans backed up by government guarantees will become due. From 2017 to 2019, and also in 2022, the state budget will be under significant pressure from potential “activation” of issued financial guarantees and their conversion into direct public debt.

The uncertainty created by government guarantees is a significant source of risks from the debt sustainability perspective. If the extent of guarantees called surpasses the expected level, it could undermine the sustainability of the debt, increase the likelihood of fiscal problems, and ultimately lead to a crisis (IMF, 2005).

Although often misinterpreted in the public, an increase in the value of Croatian public debt in the last couple of years cannot be attributed solely to the increase of government net-borrowing, but also to a “statistical increase” due to changes in the methodological frameworks for debt statistics. These changes mostly relate to the increase of the scope of public debt by increasing the scope of the general government. The methodological frameworks mostly evolve so as to include institutions formally outside the general government in the scope of general government, if it is likely that general government will take on their liabilities. The inclusion of liabilities of such institutions in direct public debt decreases the amount of government guarantees granted to those institutions to avoid double inclusion of the same amount in the debt statistics (first as a direct and then also as an indirect liability).



From 2009 to 2013 the amount of debt to GDP in Croatia increased by 73%. However, the transition of methodological frameworks – from GFS (Government Finance Statistics) to ESA (European System of National and Regional Accounts) 95 and finally to ESA 2010 – created the public perception of the public debt to GDP ratio in 2013 as double the value of 2009 (76% of GDP in 2013 according to ESA 2010 related to 36% of GDP in 2009 according to GFS).

TABLE 2

*General government debt and government guarantees from 2009 to 2013, according to different methodologies (in billion HRK and % of GDP)*

Methodology	2009		2010		2011		2012		2013	
	Bn HRK	% GDP	Bn HRK	% GDP	Bn HRK	% GDP	Bn HRK	% GDP	Bn HRK	% GDP
BDP (ESA 2010) <sup>(c)</sup>	331.0	100	328.0	100	332.6	100	330.5	100	330.1	100
<b>General government debt</b>										
GFS 2001 <sup>(a)</sup>	117.7	36	138.0	42	156.0	47	177.3	54	n/a	n/a
ESA 95 <sup>(b)</sup>	120.8	36	145.7	44	170.9	51	183.7	56	220.2	67
ESA 2010 <sup>(c)</sup>	158.9	48	186.9	57	211.9	64	228.8	69	266.1	81
ESA 2010-95	38.1	12	41.2	13	41.0	12	45.1	14	45.9	14
<b>Government guarantees</b>										
GFS 2001 <sup>(a)</sup>	50.9	15	59.4	18	59.9	18	55.1	17	n/a	n/a
ESA 95 <sup>(b)</sup>	51.9	16	56.9	17	51.0	15	54.3	16	53.7	16
ESA 2010 <sup>(c)</sup>	13.1	4	14.9	4	8.4	3	8.6	2	8.0	2
ESA 2010-95	-38.8	-12	-42.0	-13	-42.6	-12	-45.7	-14	-45.7	-14

Sources: <sup>(a)</sup> MOF (2014), <sup>(b)</sup> CNB (2014), <sup>(c)</sup> CNB (2015), and MOF (2015).

Since September 2014, all EU countries are obliged to apply the ESA 2010, which is the European version of the UN's methodological framework System of National Accounts (SNA 2008). Due to the new way of expressing certain parts of the national economy, the scope of economic sectors changed significantly. In addition to changes in the calculation of GDP, the changes are also reflected in the scope and size of the deficit and general government debt.

The primary reason for the change in the level of general government debt and government guarantees by switching from ESA 95 to ESA 2010 was the reclassification of the liabilities of Croatian Highways and Rijeka-Zagreb Highway, Croatian Railways Infrastructure, Croatian Radio and Television, together with the Croatian Bank for Reconstruction and Development, State Agency for Deposit Insurance and Bank Resolution and the Croatian Energy Market Operator into the consolidated central government sector (CBS, 2015). This retroactively increased the general government debt, and consequently reduced the amount of guarantees throughout the entire period. In 2013, the difference between the amount of guarantees according to the old (ESA 95) and the new (ESA 2010) methodology was almost HRK 46bn. In relative terms, the guarantees amounted to 16% of GDP

according to ESA 95 and 2% of GDP according to ESA 2010. At the same time, the general government debt expressed according to these two methodologies differed by an almost identical amount – reaching 67% of GDP according to ESA 95 and 81% of GDP according to ESA 2010. The total public debt (general government debt plus guarantees) amounted to 83% of GDP in both cases, only the structure of the debt (direct vs. indirect) being different. This proves that an increase in the general government debt in 2013 was – to a large extent – offset by a corresponding decrease in the amount of guarantees, i.e. indirect was transformed into direct debt (due to methodological changes) causing a “statistical increase” of the public debt. A similar conclusion can be reached for the remainder of the observed period (see table 2 and compare the difference ESA 2010-95 for general government debt and government guarantees).

## 6 CONCLUSION

Government guarantees are a significant source of fiscal risk and threaten the stability of public finance in both developing and developed economies. This points to the need for the implementation of a well-developed policy for issuing and managing government guarantees. Good practices in contingent liabilities management include the provision of comprehensive and transparent databases, introduction of certain limitations to exposure to fiscal risks, the establishment of contingencies reserve funds and the existence of separate legislation and institution(s) responsible for management of fiscal risks.

The financial crisis has hit EU economies hard and destabilized their financial sectors. In order to maintain the financial stability, the governments have implemented various emergency measures often relying on government guarantees. Accordingly, the amount of guarantees in certain countries (e.g. Ireland, Austria, Finland, and Slovenia) reached significant amounts. On the other hand, Slovakia, the Czech Republic, Bulgaria and the Baltic countries have had relatively low levels of guarantees. Although Croatia has had a moderate level of guarantees as a percentage of GDP compared to other member states, it has to be pointed out that guarantees in Croatia proved to be an extremely significant risk source. Namely, the adoption of a broader European framework of national statistics (ESA, 2010) has provided a more comprehensive picture of government finances by converting indirect liabilities (guarantees) amounting to about 14% of GDP into direct liabilities (general government debt). Therefore, the lower-than-average level of guarantees in Croatia is not the result of a prudent (restrictive) issuing policy, but rather the fact that the majority of issued guarantees qualified for conversion into direct general government debt, leaving only a small portion of issued guarantees being recognized as contingent liabilities.

Two types of guarantees appear in Croatia – financial and performance guarantees. They may be approved by the Government or the Parliament. Croatia has mainly issued financial guarantees and mostly in amounts higher than planned. Guarantees were predominantly issued for borrowing in the domestic market and

denominated in euros. The structure of creditors is constantly dominated by domestic commercial banks, whereas the structure of beneficiaries has changed significantly throughout the observed period. The share of the transport sector increased because of the restructuring and privatization of shipyards, which caused a decrease in the share of guarantees issued to the manufacturing sector. In the structure of the called financial guarantees, the most significant liabilities occurred between 2009 and 2011 in the shipbuilding sector, whereas from 2012 the amount of called guarantees decreased significantly. Refunds related to guarantees called from 2009 to 2011 were extremely low, while afterwards they even exceeded the amount of the called guarantees. However, this is mainly the result of the conversion of government claims into shares through accounting operations without any real cash inflow into the budget.

The policy of issuing government guarantees mainly to public companies with major financial problems has led to undesirable consequences for the Croatian public debt. Instead of supporting prosperous and healthy economic sectors to induce growth and employment, government guarantees in Croatia have actually served as a support to loss-making sectors (shipbuilding, transport and the like) until their restructuring or privatization. The country should have found appropriate solutions for such sectors through much earlier privatisation or concessioning.

Adequate management of government guarantees can significantly reduce the associated fiscal risks. However, the prerequisite for implementing the quality strategic objectives is the availability of reliable information on the size and structure of government guarantees. In Croatia, the existence of comprehensive and transparent databases on the size and structure of government guarantees would help formulate strategic objectives. The administrative framework for issuing and managing guarantees should also be improved. The legislative framework could be enhanced by adopting a single act regulating the area of public debt and fiscal risks, whereas gathering all functions related to the management of public debt and fiscal risks in one institution (agency) would certainly upgrade the institutional framework, which is currently organized around a few employees of the Ministry of Finance. An appropriate administrative infrastructure is a precondition for the compilation of relevant and reliable fiscal risk reports and the adoption of the public debt and fiscal risks management strategies.

TABLE A1

*Total stock of government guarantees in EU countries from 2010-2013 (% of GDP)*

	2010	2011	2012	2013	Average 10/13
Belgium	17.17	14.30	17.08	13.29	15.46
Bulgaria	1.33	1.15	0.98	0.75	1.05
Czech Republic	0.82	0.72	1.10	1.19	0.96
Denmark	14.62	12.77	7.15	9.18	10.93
Germany	21.23	19.66	18.81	18.22	19.48
Estonia	2.64	2.19	1.95	1.71	2.12
Ireland	96.00	83.89	66.89	32.14	69.73
Greece	3.23	3.85	3.86	3.67	3.65
Spain	12.74	14.84	20.68	18.41	16.67
France	6.65	5.57	4.55	5.53	5.58
Croatia	8.97	6.76	7.55	7.25	7.63
Italy	0.81	3.53	6.16	6.10	4.15
Cyprus	7.47	7.81	14.46	15.85	11.40
Latvia	2.88	3.03	2.91	2.31	2.78
Lithuania	1.36	0.99	0.84	0.82	1.00
Luxembourg	5.12	5.03	7.66	7.72	6.38
Hungary	9.48	8.82	8.74	8.03	8.77
Malta	11.80	12.53	16.52	15.88	14.18
Netherlands	10.77	9.95	7.95	7.22	8.97
Austria	53.35	47.13	41.16	35.01	44.16
Poland	5.28	6.28	6.25	6.80	6.15
Portugal	4.63	10.93	12.22	11.97	9.94
Romania	2.36	1.75	2.08	2.15	2.09
Slovenia	19.73	17.89	16.10	17.82	17.89
Slovakia	0.06	0.05	0.04	0.03	0.05
Finland	19.62	20.72	21.83	24.08	21.56
Sweden	17.05	14.15	12.13	11.56	13.72
United Kingdom	27.76	15.42	10.36	9.47	15.75

*Source: Eurostat.*

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