State financialization in Croatia:

preliminary findings of an interview-based case study

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The financialization of the state

a) The state as an actor (subject) of financialization

- financial liberalization, active support for new financial markets (Braun 2016; Engelen et al. 2011; Gabor and Braun 2016; Helleiner 1994; Krippner 2011)
- financialization of state investment policies: sovereign wealth funds (Cumming et al. 2017; Fini 2011), financial techniques in state asset and risk management (Munoz Martinez; Wang 2016)

b) The state as an object of financialization

- financialization of public sectors and services: pension systems (Biondi and Sierra 2018; Dixon and Sorsa 2009), education (Beverungen et al. 2014; Eaton et al. 2016; Engelen et al. 2014), health care (Mulligan 2016; Vural 2017), housing (Aalbers 2016; Fernandez and Aalbers 2016; Fields and Uffer 2016) and utilities (Bayliss 2014; Bresnihan 2016; Løding 2018)

Public debt

- Some accounts emphasize its special importance for state financialization, especially visible in crisis contexts (Bieling 2013; Lapavitsas et al. 2012; Overbeek 2012; Streeck 2013, 2014)
- Debt as a mechanisms of “market discipline” (Hardie 2011; Rommerskirchen 2015)
- Streeck: tax state -> debt state -> consolidation state
- financialization of sovereign debt management (Fastenrath et al. 2017; Lagna 2016; Preunkert 2017).

Peripheral financialization

- Becker et al.’s (2010) model of peripheral financialization:
    - Extraverted (with a cyclical dynamics of capital inflows/outflows)
    - Based on interest-bearing capital
    - Supported by monetary policies of the target countries
    - Resulting in external asymmetries
    - Volatile, crisis-prone
    - In ECE, led by foreign-owned banks (see also Gabor 2010)
- Gabor (2010, 2011): capital flows and carry trade in ECE

State financialization in Croatia: comparative statistical analysis

- Large financial account and current account deficits before the global financial crisis, reduction and eventually switch to surpluses after the crisis
- Official international reserves: highest GDP share in the CEE region by 2015
- Indicators of high levels and risky forms of public debt: the highest debt/GDP share in the region since 2013; high shares of short-term and foreign-currency debt; high GDP share of debt service due; but below-average and declining share of external debt
- Highest GDP share of the assets of pension funds in the region, which are associated with the financialization of pension system

State financialization in Croatia: literature analysis

- **Pre-crisis:** capital inflows (profiting from interest-rate differentials)
- crediting households and investments in non-tradables (construction, telecom etc.) rather than export-oriented production and businesses in general
- Procyclical central bank policy
- Growth of external debt
- Financial account and current account deficits
- Growth model based on imports, debt, consumption and real estate bubble, leading to the loss of competitiveness and deindustrialization
- Growth of public debt despite economic growth

State financialization in Croatia: literature analysis

- Crisis: reduced capital inflows, end of credit boom
- Crisis revealed the accumulated macroeconomic imbalances and the small maneuvering space for monetary policy
- Procyclical policies of the central bank (defending the exchange rate, this time from depreciation) and the government (wage deflation, more broadly austerity)
- Recession, reduced public revenues and insufficient fiscal consolidation resulted in a major expansion of public debt, debt servicing costs, and the share of short-term and foreign-currency debt in public debt in 2009-14

Interview-based case study

- Conducted over several weeks in May and June 2019
- 17 interviews with 19 individuals, all but one interview were recorded and then transcribed; one interview was conducted over Skype
- Of the 19 individuals, there were 12 men and 7 women
- 5 economists (including one member of the Fiscal Policy Committee)
- 4 officials and economists of the Croatian National Bank (incl. one former fixed-income analyst in a private bank and one former Ministry of Finance official)
- 3 pension fund managers
- 2 private bankers, incl. one engaged with primary emissions of government bonds
- 2 Ministry of Finance officials, incl. one engaged with debt management
- 1 business journalist
- 1 official of the financial regulator HANFA, engaged with capital market supervision
- 1 pension system expert

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Assessment of public debt

- General admission that Croatia’s public debt is **the highest or one of the highest in ECE-11**
- At the same time, many interlocutors made one or more **relativizing arguments**: 1. debt reduction since 2015; 2. methodological changes since 2014 (implementation of ESA 2010); 3. pension system

“Well, [Croatia’s public debt] is higher than in all remaining countries of Central and Eastern Europe but while the methodology for calculating public debt is the same for all countries, causes of public debt are somewhat different. I would say that its scope is somewhat larger in the Croatian case.” (a CNB official)

“*For much of the [2009 –15] period, Croatia’s borrowing was much more expensive than the borrowing of many other countries, especially since Croatia was paying a high risk premium and for a long time it was being assessed without considering that it did not intervene in the second pillar [of the pension system], which is a big difference from other countries, for example Poland and Hungary that succeeded in stabilizing their debt by seizing much or all the funds of the pension system, so the assessment by the rating agencies perhaps wasn’t most fair from that perspective.”* (a CNB official)

Causes of public debt

- **historical (pre-crisis):** assumption of generous social entitlements; accumulation of debts by road companies and the development bank due to highway construction; issuing of government guarantees of loss-making companies (shipyards, railways etc.), leading to "one-off" events with major detrimental impact on public finance
- **2009-14:** large government budget deficits due to insufficient austerity; increased debt service costs; and the methodological changes

"[T]he crisis has had a significant influence on the growth of public debt in Croatia. And that was actually a mixture, when one looks at the decomposition of public debt … it was roughly 50/50 contribution of the snowball effect, that is a negative relationship between [GDP] growth rate and interest rates, and of [government budget] deficits that were constant in Croatia from 2009 all the way to 2015. … It should be considered also that methodological chances also had some influence on public debt dynamics…"
(an economist)

Has Croatia got a problem with its public debt?

- Divided opinions
- Two economists said they could imagine Croatia defaulting

"Unlike Greece at the time of its integration to the EU, Croatia is also geostrategically insignificant, it has less than four million inhabits, so I would say that Croatia will default in silence, it cannot even expect the level of help that Greece received. Croatia has a zero coalition potential in the EU, it cannot join forces with anybody." (an economist)

- Several interlocutors said debt was not a problem now but will likely re-emerge as a problem again in the future due to the next economic shock (considering weak economy and insufficient austerity) or due to the ongoing demographic changes
- however, a comparable number of interlocutors argued that it was not a problem, pointing to: the debt reduction; a supposed social consensus about the dangers of reckless borrowing; or a combination of improved fiscal policy, public debt portfolio and real economy

Debt service costs / credit ratings / risk premia

- Many interlocutors questioned **the objectivity of credit rating agencies and investors** on the negative side – ignoring the impact of the pension reform; "perceptions" influenced by the 1990s war and ongoing disagreements in the region; ideological and political agendas of the agencies

"Ratings consist of two components, one is measurable and the other is less measurable or qualitative and this is where Croatia has been, so to say, damaged by its rating and perceptions, in our opinion the perception was not necessarily correct. It was about, I don't know, the fact that [Croatia] has come out of war or political relationships in the region which created a perception of possible risk…" (a Ministry of Finance official)

- **Causes of high debt service costs in 2009-15:** long recession; the one-off events with negative impact on public finance; the publication of the 2013 government budget, leading to the loss of investment grade rating (not parallel by Croatia's peers); the blanket approach of large international investors to their CEE portfolios; agency credit ratings specifically – agencies slow to change ratings, follow rather than lead markets

Debt service costs / credit ratings / risk premia

- **Causes of the more recent fall of debt service costs:** end of recession; fiscal consolidation and debt reduction; the expected return to the investment grade; broader market trends: negative yields on the German bund, increasing demand for CEE bonds; high and growing domestic demand for Croatia’s bonds; insufficient supply; sudden renewal of investors’ interest in Croatia’s debt after “years of neglect” – large purchases that possibly pushed the risk premium even below the level warranted by economic fundamentals

“The playground is very crowded, a lot of investors, it seems that their number is growing and appetite is growing as well, but there are fewer and fewer [bond] emissions.” (a private banker)

Debt management policy

- **Praise of debt management policy:** debt reduction in recent years; refinancing – reducing the cost of debt; using derivatives to hedge against FX risk; development of the Debt Management Directorate (DMD) at the Ministry of Finance; relaunch of Debt Management Strategies; reduction of external debt
- **Critiques of debt management policy:** debt reduction depends on GDP growth and current economic and market conditions; limited human resources at the DMD; a lack of debt management agency; a lack of transparency vis-à-vis investors; weak secondary markets in bonds; limited competition between investors due to a lack of opening to households and businesses as investors and the technique of sales of bonds (syndication rather than auctions); insufficient emphasis on kuna bonds

Fiscal policy

- **Praise of fiscal policy:** budget planning now starts from revenues and adjusts expenditures accordingly; Ministry of Finance acts as a “fiscal board”; its macro projections became more precise; public investments increasingly funded from EU funds
- **Critiques of fiscal policy:** more cuts in expenditures needed, especially “current spending” (public sector wage bill, pensions…); instead, public investments have been cut – “austerity in wrong places”; cuts should be more selective

Preliminary conclusions

- Public debt has been and is an important channel of state financialization in Croatia
- It has a significant impact on public policy: austerity, though criticized as insufficiently radical –> neoliberalization
- Debt management policy appears to have become more important and professionalized, though capacities are still seen as inadequate and particular measures are questioned or seen as lacking – calls for more transparency, competition, investor orientation, better management of debt as a portfolio, professionalization of debt management –> more financialized debt management (Fastenrath et al. 2017)
- While recent debt reduction is considerable, there are doubts about it sustainability and expectation that public debt might re-emerge as a serious issue when current economic and market conditions end