CROATIAN NATIONAL BANK

Comments on

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Sovereign Debt Structure for Crisis Prevention

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*Disclaimer: All remarks are author's and do not represent those of the CNB

Main points of the paper

- could the sovereign debt be used for crisis prevention

1. Discusses how the structure of existing sovereign debt could propagate/prevent a possible crisis
2. Explores whether existing debt instruments could be used for crisis prevention

- NEW PROPOSALS

3. Explicit seniority in privately held sovereign debt
4. Indexation to real variables to ameliorate the effects of crisis

- survey of investors about use of new instruments

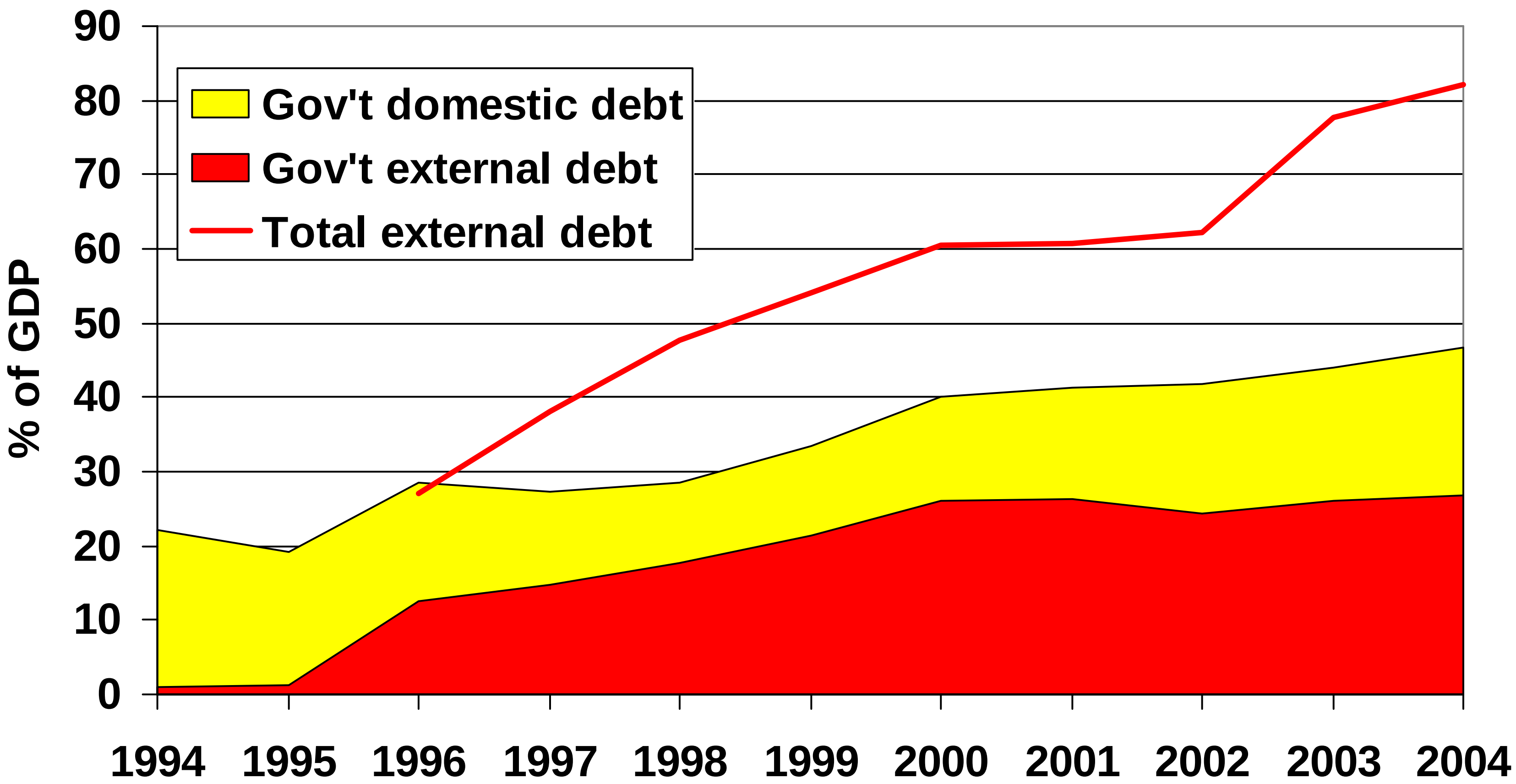
Few points

- "Paper not strictly academic"
- Aims to initiate discussion

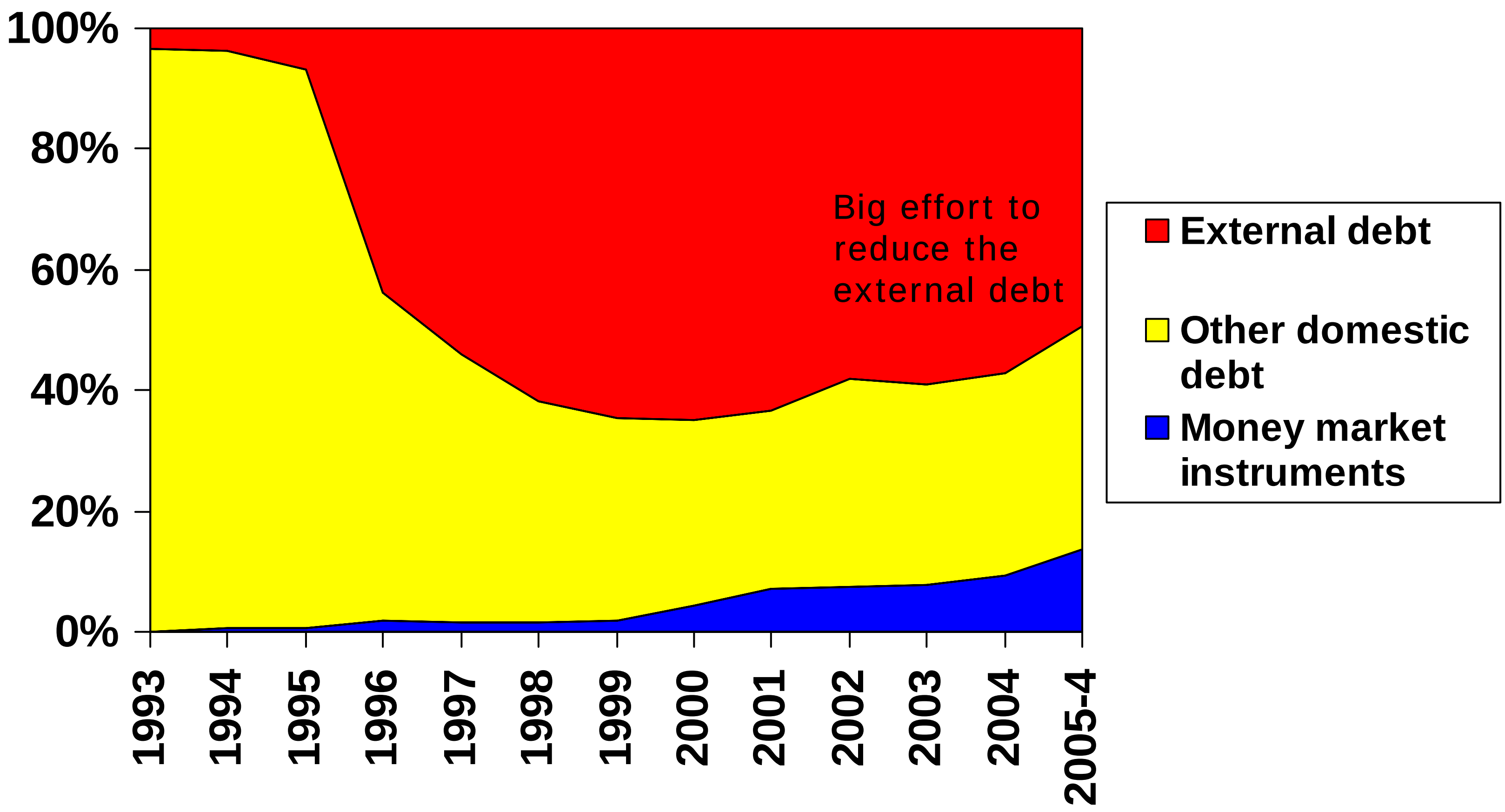
=> How does it apply to Croatia?

  - current debt structure
  - attractivenes of indexation (CPI vs. real indexation)
  - debt seniority not discussed

Croatian Sovereign and Foreign Debt



Structure of Croatian Government Debt - domestic vs external



Currency structure of Croatian government debt (as of April 2004) - estimate

- mostly in foreign currency (or indexed to fx) ~ 80%
  - almost entire external debt (~ 50% of total debt)
  - most domestically issued bonds (indexed to fx ~ 22% of total debt)
  - domestic banks credits - (fx 6%, indexed ~ 3% of total debt)
- some domestic currency ~ 20%
  - two bonds (5 year maturity ~ 4% of total)
  - domestic banks credits (2% of total debt; 2/3 under 1 year)
  - money market instruments (short term - 14% of total debt)

Structure of Croatian government debt – some conclusions

- large currency exposure (eurisation of Croatian economy)
- domestic debt small
  - only 40% of which in domestic currency
  - mostly short term 80%
- current effort of switching from external to internal debt only partially prevents crisis
  - \+ less dependence on foreign capital (?)
  - \+ repayment in kuna
  - \- but debt burden grows with depreciation (indexation to Fx)
  - \- domestic currency debt mostly short term

=> how to encourage long term debt in domestic currency

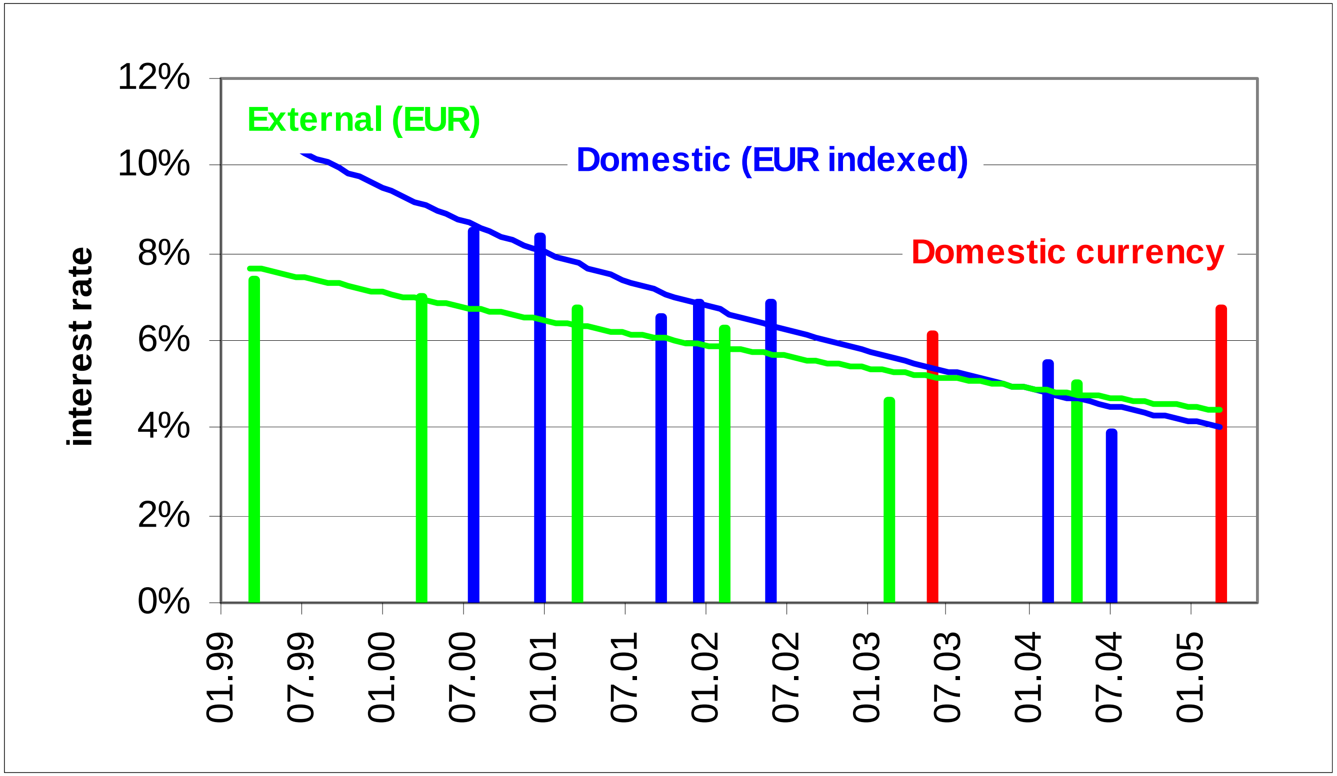
Indexation to CPI ?

- way to promote long term debt in domestic currency
  - domestic pension funds (long term liabilities in domestic currency) -
    - currently have large currency exposure (many assets in Fx)
- good examples exists
- "minor" problems:
  - encouraging price indexation - superior to present indexation to Fx
  - nominal convergence ?
- good idea to encourage borrowing in domestic currency

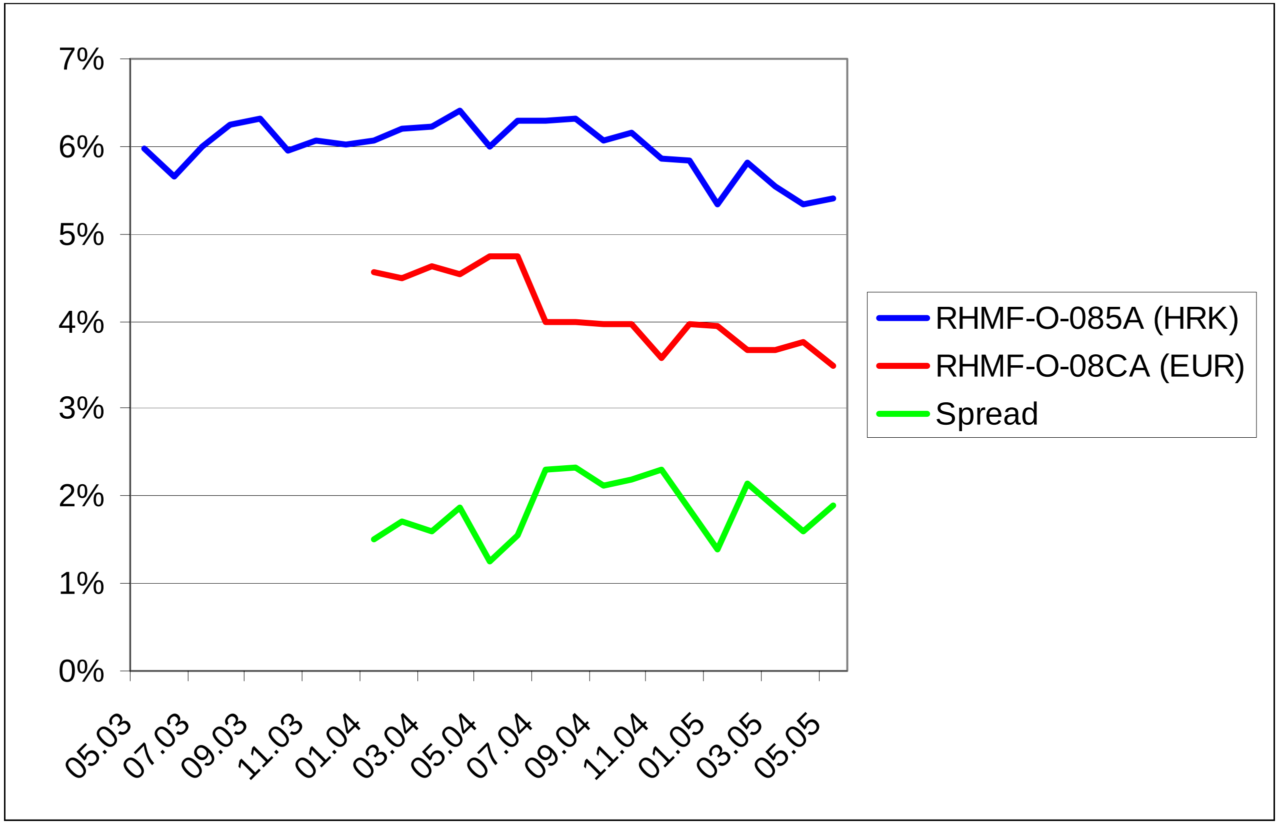
… and reduce price premium

Price of Croatian government bonds

(at issuance date)



Premium for borrowing in domestic currency: Yield to maturity on domestic market

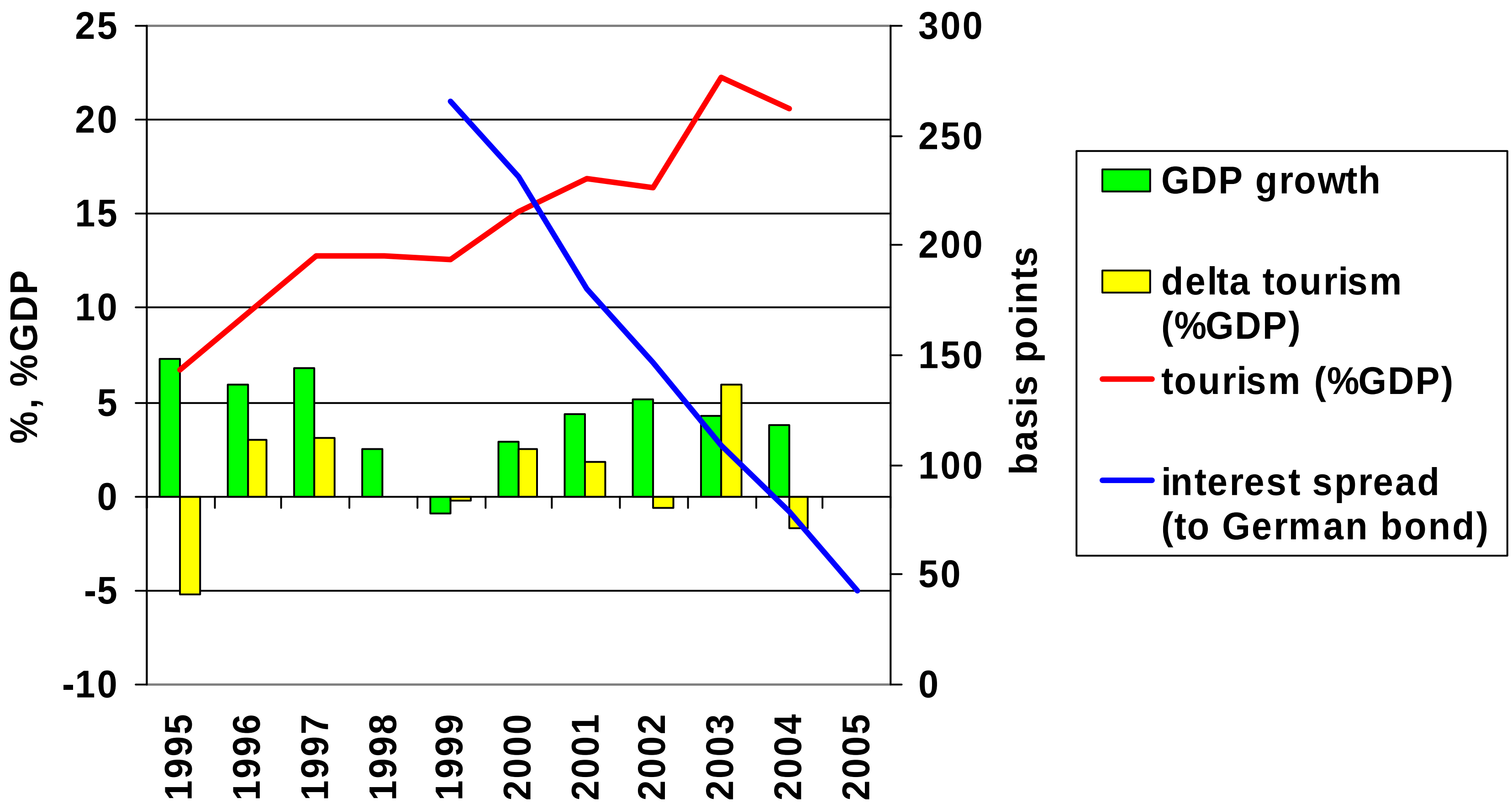


Real indexation ?

- insurance against "bad times“ and procyclicality (due to debt eurisation)
- interest in investing in emerging markets (gaind from real convergence)
- which variable best for Croatia ?
  - GDP
  - tourism exports - major Croatian export (inflow of Fx)
- bigger problems than with CPI indexation
  - incentive to misreport/bias data – even in advanced countries (creative accounting)

    … but current circumstances also create perverse incentives ? ("cosmetics“)
  - short history – difficult to estimate potential growth (4,2%?, postwar period?)
    - (what is the cost of making a mistake ?)
  - willingness to pay insurance premium and risk aversion ? – political cycle?
  - more international experience / explicit demand

Tourism exports and GDP vs. interest spread



Conclusion

- structure of Croatian government debt could improved
- growing interest in long term debt in domestic currency
- CPI indexation coud suport borrowing in domestic currency and make it cheaper

… but insurance premium? – size & acceptance

- Real indexation – to GDP despite strong tourism sector

  … interesting but less than CPI indexation

  - more experience needed /investors demand