ARDAL

Practical experience of the Debt and Liquidity Management Agency in applying the Fiscal Responsibility Act

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The Constitutional Act on Fiscal Responsibility (hereinafter referred to as the ”Act“) has been in force since 2012. Its draft was created in a turbulent period of the culminating debt crisis in Europe and the political environment of the forthcoming early national elections in Slovakia. The initial philosophy of this Act was to avoid uncontrolled indebtedness of the state by politicians and to put pressure on securing long-term, sustainable, and responsible budgetary policies for future governments.

Several years of the practical application of the Act at the operational level of debt management have also revealed its practical shortcomings. The Act inadvertently linked the formation of a new debt, which arises under the decisions of political leaders, with its financing. A key issue at the operational level of debt management is the setup of this Act to ***gross debt****, which limits, for example, frontloading the state with cheaper cash if market conditions are favorable. The current wording of the Act has greatly reduced flexibility in the management of state debt and liquidity bearing greater financial risks and, as a rule, higher related costs.*

The simplest technical solution and improvement of this Act is the recommended transition to ***net debt*** *(gross debt minus the financial assets of the state), thereby ensuring the separation of real debt creation from its financing.*

The Act was passed in response to the global financial and economic crisis, which subsequently gradually transformed into a debt crisis. The adoption of the Act was preceded by a 'storm' in European financial markets when in autumn 2011, even the most reliable borrowers (e.g. AAA-rated Germany) had a problem financing their current needs and refinancing their debt. Slovakia was in a similar situation when it had to cancel the announced benchmark issue of government bonds due to limited demand from investors and the unexpected fall of the government. Subsequently, there was almost zero demand in government bond auctions, and the ARDAL executed the state budget financing, repayment of state liabilities and assurance of liquidity of the State Treasury for several months exclusively from the cash reserve.

In this economic and political climate, the Act was adopted, the main aim of which was to reduce uncontrolled indebtedness of the state, improve its credibility and gradually reduce the public debt with the aim of sustainable public finances.

The purpose of the adoption of the Act was in the area of state debt management, in particular:

- to put long-term pressure on politicians to implement a responsible budgetary policy, which will result in a gradual reduction in the size of public debt and sustainable public finances;
- through budget ceilings, to ensure that politicians do not misuse economic growth in good times for unjustified debt growth;
- to strengthen the fiscal credibility of the state, which increases the confidence and reliance of financial markets and international institutions towards the long-term sustainability of Slovakia's public finances;
- to ensure the transparency and comprehensibility of communicated data on the state and development of public debt.

The Act entered into force in March 2012 and was adopted without prior public discussion. It introduced an internationally used indicator of total public debt concerning the size of GDP, its upper limit, and at the same time the limits below the upper limit, the exceedance of which is penalized, into the Slovak financial legislation. The breach of any of these limits as of 31 December of the current year means the launch of the appropriate sanction mechanism. Government gross debt as of 31 December is published in April and confirmed in October of the following year by Eurostat.

The gross debt ratio relative to GDP is based on the Maastricht rules according to Eurostat methodology (60% threshold), which monitors and compares the gross government debt of individual countries. According to Article 5, par. 2 of this Act "The amount of debt is the amount of debt of the Slovak Republic, currently published by the European Commission (Eurostat), expressed as a percentage of gross domestic product."

The law inadvertently linked two relatively independent processes - **debt creation** and **debt financing**. These processes interact, but their nature is different.

Debt creation results from the decisions of political leaders. Simply, debt creation can be described as a negative difference between state revenues and expenditures. The aim of the Act should be to regulate and limit the creation of debt as much as possible. The wording of the Act, which has been in force without change since 2012, does not allow this objective to be fulfilled without any negative effects on debt financing.

On the contrary, **debt financing** is a process that is triggered by the creation of new debt. In addition to financing the newly created debt, the existing debt due must also be refinanced. This process is the responsibility of ARDAL. However, Eurostat's methodology considers debt to be state liabilities resulting from its financing. This implies that the Act regulates debt financing more than debt formation. Because of its dependence on financial market conditions, debt financing needs to be sufficiently flexible and should be time-independent and separated from debt creation.

In particular, the key issue is to set up a philosophy of the Act that specifies public debt as gross government debt for regulatory purposes.

Gross debt, as compared to net debt, does not take into account the state's liquid financial assets, such as the cash reserve. This means that any state borrowing operation on the liabilities side of the state increases its gross public debt, even if the funds received have not been spent. This operation causes the increase of the financial assets of the state and the net debt will not change.

Examples of government financial operations that incur a liability and the financial assets increase at the same time (account balance):

- *the sale of government securities to investors,*
- *loan disbursement,*
- *short-term loan on money market,*
- *increase in the State Treasury resources of clients outside of public sector,*
- *receiving of collateral related to operations that hedge the debt portfolio against exchange rate or other risks.*

In all these operations, in addition to increasing gross debt, the cash reserve also increases and thus there is no real increase in government debt. Debt financing should be separated from debt creation and real expenditures and, in particular, time-independent.

At a time when the ratio of public debt to GDP is close to limits, when the appropriate sanction mechanisms are triggered (which was throughout the entire period of validity of the Act), the wording of the Act causes problems in managing and financing state debt, especially in following contexts:

Pressure on debt management at the end of the year. The current wording of the Act decisively complicates debt financing, especially at the end of the year, when politicians, regardless of party affiliation, strive to optimize (reduce) the size of gross debt. Instead of reducing budget expenditures, the way to reduce the cash reserve (larger expenditures are not covered by debt growth but rather by a fall in the cash reserve) is chosen at the exchange of higher liquidity and refinancing risk.

It is not possible to prepare for the redemptions of liabilities gradually. Debt funding and liquidity management are activities that arise from the cash flows of the state and the State treasury. Maturing liabilities cannot be postponed, reduced or transferred to another entity; the state must be able to fulfill its liabilities every day. State has liabilities from issuing bonds within the state debt portfolio, whereas the largest liabilities payable on a single day may exceed EUR 3 billion. The cash reserve of the state (which politicians try to keep naturally as low as possible) is usually not enough to repay liabilities of a similar size. It is, therefore, necessary to gradually raise and accumulate funds well in advance, in particular from the sale of government bonds. This process usually takes several months.

Accurate data on government debt and GDP are known with a significant time delay. As Eurostat's methodology is rather complicated and ambiguous, the Ministry of Finance will never know exactly the size of gross public debt at the end of the year. It is not clear which items will be recognized as public debt and which will not. The data on indebtedness of some other public administration entities (e.g. municipalities) are not exactly known either. Notification of gross debt is known only in April (4 months from the decisive date of 31 December, on which it is necessary to manage the debt position) and its specification is usually issued in October. This contributes to creating unnatural pressure to minimize bond issuance and fundraising, especially at the end of the year, thus offsetting the potential risks arising from uncertainty about the size of public gross debt. This worsens the risk of state refinancing and does not limit the interest rate risk of future costs of new government bonds. At the same time, it brings non-standard and less predictable behavior of the state as an issuer on the market, which is negatively assessed by investors and rating agencies.

The impossibility of frontloading cash reduces the flexibility in debt and liquidity management. Prior to the effectiveness of the Act, the issue of bonds was not restricted and the coverage of state debt and the state budget deficit could be optimized, for example by issuing bonds in advance in good market conditions. Frontloading (the size of the cash reserve) is also an object of interest of rating agencies in the country's assessment. In times of market failures and with limited access to the market, the state was able to fulfill its liabilities from the created reserves without risk before the effective date of this Act. In this way, the cost of state debt could also be significantly saved in case of expected interest rate increases. It is the usual method of debt portfolio management used in all countries with modern public finance management.

In order to offset the growth of gross debt at the end of the year, the state repurchases (buys back) issued government bonds before maturity from investors. Since 2012, ARDAL has bought back more than EUR 5 billion of government bonds at market prices. Given the considerable fall in interest rates, investors' interest in the buybacks is declining significantly, and the government is increasingly having problems optimizing the size of gross debt at the end of the year. Purchasing government bonds can also be costly and organizationally demanding. In addition, if investors know the position of the state, this increases the pressure on the yield and price of the purchased bond.

The impossibility of frontloading increases the risks. The Act puts pressure on ARDAL to issue bonds just before the maturity of the currently maturing bonds, thereby worsening – increasing - the refinancing and interest rate risks. This also causes problems with the implementation of the State Debt Strategy, as the Act indirectly determines which bonds and when to offer to investors. This leads to the use of the cash reserve for current financing. In the event of a sudden rise in interest rates, debt service and the state budget can generate further losses and increase risks, as it will have to accept increased interest rates and finance current payables at any price. Also, the position of the state is not secure as there may be a situation where the liabilities that are due will not be financially covered. It may cause the state to be insolvent, with consequences for its credibility and rating.

Insufficient diversification of investors and failure to use special financial instruments. Slovakia has a specific undeveloped domestic financial market, which is mainly influenced by its size. At present and in the coming years, the domestic market is not and will not be able to meet the financial needs of the state. Given the possibility of market failures and financial crises, it is necessary to gradually diversify the investor base by the presence in other financial markets outside the euro area and to use special financial instruments (private placement, green bonds, etc.). The current set-up of the Act limits the use of these additional financing options due to their time-consuming nature, which is an obstacle to managing the gross debt position, especially at the end of the current year.

ARDAL proposes to change the monitoring and evaluation of gross debt to the monitoring and evaluation of net debt *(net debt = gross debt less state financial assets). This will ensure the separation of real debt creation from its financing. This means that bonds can be issued - sold - optimally as needed (good market conditions, the fulfillment of the State Debt Strategy, etc.), without increasing the actual debt (the funds will end up in the cash reserve account), and will not be spent in the form of expenses. The value of the issued bonds in stock will be deducted from the gross debt as these funds will be part of the state's financial assets - cash reserves.*

Such a solution will eliminate the vast majority of problems caused by the current wording of the Act. Debt management will be much more efficient, with more flexibility in timing when and what instruments to use. More flexible management will also contribute to lower portfolio risk and reduce debt service costs.

Note: This material reflects the opinion of the Debt and Liquidity Management Agency on the issues of the Budget Responsibility Act and its implications for practical debt management. The aim of this paper is to provide an opinion of ARDAL as a key player in debt management and thereby contribute to a community-wide professional debate on the potential change of the Act to eliminate the problems this Act brings while retaining its benefits. The paper or parts thereof may be freely distributed, indicating the source.