# SLOVENIA: DROWNED IN DEBT AFTER TEN YEARS OF EU MEMBERSHIP

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The recently published book *Public debt: Who owes whom?* (in Slovenian: *Javni dolg: kdo komu dolguje?*), edited by Slovenian sociologists Rastko Močnik and Maja Breznik, consists of a series of analytical and critically engaged studies on the causes, structure and political aspects of current public indebtedness of Portugal, Spain, France, Greece, Slovenia and Argentina. The case of Slovenia is examined in two separate yet complementary contributions. The first article *What is the position of Slovenia in the international debt crisis?* by Maja Breznik and Sašo Furlan presents a broad economic and political context of the debt crisis in Slovenia and an inquiry into the state recapitalisations of Slovenian banking sector during the crisis. The second article *Formation of the public debt in Slovenia* by Franček Drenovec portrays the immediate causes for the eruption of public indebtedness, and scrutinises the composition of current public debt of Slovenia. What follows is a summary of these two contributions.

In the opening part of their contribution, Breznik and Furlan argue that the Slovenian public debt crisis does not originate in the public sector, but rather in the private sector. In the pre-crisis period, the growth of Slovenian economy was crucially dependent on an unprecedented inflow of credit from abroad. In the years 2005-08, when credit growth reached its peak, two basic conditions for credit expansion were in place. The first condition, on the side of supply, was a low premium of external financing (Slovenian banks had access to low interest rate credits). The second condition, on the side of demand, was the rising asset values of potential borrowers (enterprises and households), fuelled by economic growth and inflation of real estate prices. Between 2004 and 2008, Slovenian banks increased their foreign liabilities for almost 13 billion euros. Increasing indebtedness of Slovenian banks was made possible by the convergence of previously high Slovenian interest rates to lower interest rates in the Eurozone. With an enormous influx of liquidity from abroad, the lending capacity of Slovenian banks amplified. After all, this was in line with the official goal to achieve "financial deepening" of the Slovenian economy. The majority of the acquired credit was channelled to the Slovenian non-banking sector. While domestic banks were increasing their financial claims to the non-banking sector, the savings of domestic households declined. Due to lower interest rates, the wealthier households shifted a substantial part of their funds from deposits to more profitable, yet much more uncertain, investments into foreign securities. This process was mirrored in a swift growth of loans to deposits ratio of Slovenian banks.

According to the ruling politicians, various "expert" advisors and mainstream media in Slovenia, the growing provision of bank loans was a result of inefficient or corrupt corporate governance of domestic banks, supposedly a consequence of "majority state ownership". However, the data of the Bank of Slovenia clearly shows that the states' direct share in the banking sector was, by 2008, only 17.9 percent. Moreover, according to two criteria, the primary facilitators of loan provision to the Slovenian non-banking sector were banks where foreign ownership prevailed. In the pre-crisis period, the average growth rates of credit were much higher in foreign-owned than in domestic-owned banks, and the rate of indebtedness on international markets by foreign owned banks was higher as well: the credit/deposit ratio in domestic banks was considerably lower. The majority of debt funds, acquired by domestic banks on foreign markets, were directed to the mostly private owned sector of Slovenian

enterprises. Research carried out by economists Velimir Bole, Bojan Prašnikar and Domen Trobec showed that the most important source of demand for loans by enterprises came from investment in core productive activities. The second most important source was financial investment, including the notorious leveraged buyouts of Slovenian firms, and the third was investment in the real estate sector. From the point of view of demand, the credit growth in Slovenian enterprises was thus primarily driven by financing of basic productive activities. That is to say that that the causes for the pre-crisis credit expansion cannot simply be reduced to the defects of corporate governance, nor can they be attributed solely to the speculative machinations of greedy bankers or managers. The underlying causes can be traced to the core of the systemic dynamic of the Slovenian profit driven capitalist economy.

The indebtedness of the Slovenian state was not crucial for the credit expansion. The public debt even steadily decreased in the pre-crisis period. However, Breznik and Furlan argue that the state, including the Bank of Slovenia (BS), helped to facilitate the proliferation of debt in the private sector, and effectively decreased the inflow of income into the state budget. The consequences of such pro-cyclical measures were seen in a rapid rise of public debt after the crisis. After 2005, several tax measures were adopted, resulting in tax cuts for the owners of capital and top income earners. The state ran a pro-cyclical policy on the side of expenses as well. When the economic growth was at a historical high, it substantially increased the expenses for investment. The credit expansion was further amplified by the changes in monetary policy in the time of Slovenia's accession to the European exchange rate mechanism in 2005 and the Eurozone in 2007. Namely, the BS had to abandon its previous sterilisation policies, which led to a decrease of investment into BS securities, and simultaneously, to an increase in bank loans. Finally yet importantly, the credit expansion was accentuated by the adoption of "International Financial Reporting Standards" (IFRS), which were, in comparison to the previous domestic standards, considerably less strict about bank reserves requirements. The embrace of IFRS resulted in a decline in bank reserves, and in an upsurge in bank capital. It is thus safe to say that the integration of the Slovenian economy to the European markets helped to facilitate the credit boost.

In the second part of their contribution, Breznik and Furlan depict the detrimental consequences of the crisis. When the crisis struck in 2008, the domestic banks were unable to meet their obligations to foreign banks. The process of deleveraging followed. During the crisis, domestic banks decreased their loans for 11.5 billion euros: their debt obligations to foreign banks dropped from 16 billion euros in 2008 to only 4.5 billion in 2014. A generous part of the difference was covered by the Slovenian state. Bank recapitalisations in 2008-2014 alone costed the state 5.2 billion euros, while the transfer of nonperforming bank assets to the state backed "bad bank" (The Bank Asset Management Company - BAMC) costed the state an additional 1.5 billion euros. The banks had to scoop the rest up from the economy, which was under severe pressure of the crisis. The banks reprogramed the enterprises' loans under much worse conditions than in other European countries. The debts to foreign banks were also repaid by fire sales of assets, used as collateral for unpaid loans. Since there was no financial means to purchase these assets in Slovenia, they had to be sought for abroad. Consequentially, the banks helped to complete the process of privatisation, initiated by domestic capitalists, and concluded by international capital.

After the eruption of the crisis, a new government, led by Borut Pahor, the leader of the Slovenian Social Democratic Party, was established. The government immediately enacted several measures, including liquidity funds for banks, credit guarantee schemes for banks and enterprises as well as subsidies for the export sector. The public debt of Slovenia, which,

before the crisis in 2008, stood at merely 22 percent of GDP, started to escalate. Simultaneously, the government launched a reform program aimed at reducing the public deficit, including labour market and pension reforms. The declared goal of the succeeding right wing government, led by Janez Janša, the leader of Slovenian Democratic Party, which came to power in February 2012, was to cut public spending, withdraw the state from the economy, and to create a "tax friendly environment" for investment. The results of the enacted "Fiscal Balance Act", faithful to these three goals, was a sharp decrease in public benefits and a harsh decline in public sector wages. Despite the temporary decrease in the government deficit, a new recession struck the Slovenian economy, making the pressure on public finance even more severe. While the least well off were suffering the consequences of the governments' robust curtailment of social rights and benefits, the owners of capital were generously awarded with a new decrease on capital income tax. In March 2013, the newly appointed government of Alenka Bratušek announced the end of austerity and previously launched structural reforms. In only one week, the interest rate on 10 year government bonds increased from 5 percent to 6.73 percent. The interest rates only decreased when the government denounced its plans and decided to continue with the policies of previous governments. With the "National Reform Programme 2013-2014", the government embraced the policy of privatisation of public goods, by formulating a list of fifteen state-owned enterprises to be privatised as soon as possible. When the government of Alenka Bratušek was deposed, the current centre government, led by Miro Cerar, was elected. It continues with the policies of privatisation and austerity up to this day.

The concluding part of Breznik's and Furlan's contribution comprises a detailed account of the state led bank recapitalisation programmes. We will sum up just a few of their findings, which indicate a lack of transparency and legally questionable implementation of the programmes contributing to the sharp increase of Slovenian public debt during the crisis. Between 2007 and 2012, the state enacted several recapitalisations of the two biggest Slovenian banks, NLB and NKBM. Recapitalisations of both banks, which cost the state above 1 billion euros, were based on purchases of overpriced shares (in some cases the prices were multiples of the book share values). In this way, the recapitalisations of NLB *de facto* included substantial financial support for the private Belgian bank KBC, a former co-owner of NLB.

In 2012 the formation of the bad bank (BAMC) was announced (enacted in March 2013). According to the original 2012 plan for the transfer of non-performing bank loans to the bad bank, the transfer was to be finished till June 2013, and should include an additional 0.9 billion euros recapitalisations of the three biggest Slovenian Banks (NLB, NKBM and Abanka). However, the representatives of the Directorate for Competitiveness, ECOFIN and the ECB were supposedly not convinced with these calculations. Based on a new cataclysmic scenario, set up by the European Commission (EC) and the European central bank (ECB), the banks were to be recapitalised for more than 3 billion euros after the transfer of assets. It should be stressed that private companies Oliver Wyman and Roland Berger made two stress tests, which varied significantly. The state however did not hesitate to hold on to the results of the test that implied the highest recapitalisation costs. Furthermore, another two private companies which had charge of the valuation of banks assets, Delloite and Ernst & Young, admitted that they used valuation methods not in line with international accounting standards.

The state formed the bad bank, despite the warning of several economists, that the transfer of bad loans to the bad bank is one of the most costly solutions for the recovery of banks and the rest of the economy. Yet, since the establishment of the bad bank, its directives clearly

indicate that its primary goal is not the recovery of the companies, but rather a fire sale of the assets under their management. According to the law, it is obliged to sell at least 10 percent of their assets. Since the portfolio of the bad bank includes not only non-performing loans, but also performing loans (the ratio was half-half at the establishment of the bad bank), including company shares. The bad bank thus literally creates bad loans out of "good ones". Last but not least, Breznik and Furlan emphasise that the conditions for the recapitalisation of the Slovenian banks that were set by the EC mirror the asymmetrical treatment by the European institutions of core and peripheral EU countries. In the early stage of the crisis, immediately after August 2007 when the banks of core countries, such as Germany, Britain and France, were in needed of recapitalisation, the State aid rules were not yet adopted. It was only when the bank crisis spread to the peripheral countries that they were enforced. The peripheral states were thus forced to recapitalise their banks under much stricter conditions than the core states.

In the second article *Formation of the public debt in Slovenia* Franček Drenovec first provides a general picture of the Slovenian public debt. At the end of 2014, the public debt of Slovenia amounted to 30.313 billion euros or 80.9 percent of GDP. Despite the fact that it remains below the average of the EU and Eurozone countries, it seriously strains the Slovenian public finances with exceptionally high interest costs (more than 3.3 percent of GDP in 2014) and, even more importantly, holds the Slovenian state in constant dependence from international financial markets. The borrowing of the state primarily comprises issuances of long term securities, i.e. bonds. Until 2006, domestic holders of debt were favoured. In 2007 however the structure of the debt shifted in favour of foreign bondholders. In the end of 2014 the latter were in possession of approximately four fifths of the Slovenian public debt.

Drenovec stresses that until 2008 the Slovenian debt was very small and only rose sluggishly, to barely 8 billion euros in 2008. The public debt as percentage of GDP was only 18 percent in 1994, and only 22 percent in 2008. In 1994-2005 the debt rose by 6.1 billion euros, but this increase was compensated with an equally substantial increase of Slovenian official foreign exchange reserves. Up to 2005 the Bank of Slovenia curtailed foreign borrowing and "sterilised" the remaining capital inflows by directing them into reserves. Immediately before the crisis, the Slovenian state ran one percent general government surplus. But, as soon as the crisis struck in late 2008, the surplus shifted to a deficit, amounting to 6 percent of GDP. The public deficit roughly remained on the same level for the next couple of years, and then decreased to 4 percent of GDP. This sudden hike of public deficits, alongside with accumulated minor deficits from previous years, contributed the most to the current state of the public debt.

In the first year of the crisis, fiscal revenues shrank by about 6 percent, roughly in accordance with the decline in nominal GDP. Meanwhile, expenditures increased by 12 percent. Since revenues are directly linked to economic activity and because economic slumps activate "automatic stabilisations" in social expenditure, the outburst of deficit was, at least to some extent, imminent. Yet, Drenovec emphasises that the majority of the outburst was caused by a rather crude fiscal policy. Namely, in the pre-crisis period, when economic activity and enterprise profits were the highest, the government systematically deteriorated its income base with excessive tax cuts for capital owners and high income earners. Up until 2008 the consequences of these tax measures were seen in a downfall of fiscal revenues, amounting to 650 million euros annually or around 1.7 percent of GDP. In the following years, previous measures caused the trend to accelerate further, reaching 2.5 percent of GDP annually.

According to Drenovec, the second decisive cause for the collapse of public finance was the decision of Janez Janša's government, made in 2008, to raise the salaries in the public sector. This measure resulted in an additional 500 million euros government costs per year. In the end of 2008 several others public expenditures also amplified. The fiscal imbalance, which erupted in the beginning of the crisis, was therefore already created before the crisis. The increase in public sector expenditure indeed helped to restrain the collapse of demand until 2011 and mitigated the effects of the crisis. The tax cuts however did not have such positive effects. The ensuing balancing of the state budget, which was primarily a consequence of these cuts, included an increase in revenues in 2010, decrease in investment, as well as cuts in public sector wages and social transfers in 2012, resulting in an additional 4 percent decline in GDP and employment.

Drenovec continues by analysing the effects of the breakdown in the Slovenian banking sector on the public debt. The processes of bank rehabilitation between 2011 and 2014 directly contributed to a 6 billion euro increase in the state debt. At the end of 2014, the accumulated debt of these operations equalled 15.8 percent of GDP. To some extent, the banks already rehabilitated themselves before the financial aid of the state, by large scale formation of reserves and provisions. From 2009 to 2014, the banks thus acquired 3.6 billion euros (10 percent of one annual GDP) from the domestic market. The immediate burden of state rehabilitation of the banks was lesser accordingly. Yet, the effect of the banks' "self-rehabilitation" on economic activity should not be underestimated. It surely contributed to the pressure on the public budget. The public costs for bank rescues were therefore much higher than 6 billion euros. The data, showing that after 2008 a large amount of foreign debt of the banks was converted into the state's foreign debt, further supports this thesis.

To sum up, Drenovec underlines two crucial factors that contributed to an unprecedented increase in public debt, without having positive effects on economic growth or welfare: the cumulative pressure of tax cuts, amounting to a loss of 5.1 billion euros or 14 percent of GDP; and the collapse of the banking sector, contributing to a loss of 5.9 billion euros or 16 percent of GDP. The later official number does not include the aforementioned indirect costs of bank rehabilitation. If one were to add these additional expenses into the equation, the final costs would be even higher. Note that the costs of bank rehabilitation are a one-time expenditure: they only persist in the public debt, but not in the public deficits. The other budget changes however are permanent. Eventually, the latter part of the deficit had to be covered by the government. It was covered by an increase of indirect taxes, such as value added tax and consumption taxes on fuel, cigarettes and alcohol, as well as with cuts in social benefits and public sector salaries. By means of this mechanism, the costs of tax cuts and other expenses, produced by the economic elites, were shifted to the rest of the citizens, often directly to the most vulnerable and disadvantaged ones.