Public Debt and Contingent Liabilities: A Cross-Country Comparison

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1. Contingent Liabilities

1.1 What are contingent liabilities?

Contingent liabilities are obligations that arise from a particular discrete event(s) that may or may not occur. They can be explicit or implicit. Explicit contingent liabilities are defined as legal or contractual financial arrangements that give rise to conditional requirements to make payments of economic value. Implicit contingent liabilities do not arise from a legal or contractual source, but are recognised after a condition or event is realised.[1]

In practice, explicit contingencies can be confined to a variety of forms. Albeit guarantees are the most common, it should be pointed out that not all contingent liabilities are guarantees. For example, contingent liabilities in a form other than guarantees include: (a) potential legal claims; (b) indemnities, which are commitments to accept the risk of loss or damage another party might suffer; and (c) uncalled capital, which is an obligation to provide additional capital, on demand, to an entity of which Government is a shareholder.

1.2 Why measure contingent liabilities?

The ESA95 methodological framework does not record a government's explicit and contingent assets and liabilities in government balance sheets. Nevertheless if certain rights or obligations are called upon in the future, contingencies can have a substantial financial and economic impact on government in the event of the realisation of adverse uncertain events. Indeed, a high level of contingent liabilities represents an additional risk for public finances in that fiscal contingent claims can undoubtedly have an impact on potential budget deficits and financing requirements, with inherent repercussions for economic policy.

In this context it is always opportune to supplement an analysis of headline government debt with an evaluation of contingent liabilities to give a full picture of government's fiscal liabilities. The fiscal risks triggered by contingent liabilities could be inherent as there is no overt budgetary constraint unlike traditional spending. Furthermore, contingent liabilities can potentially create market distortions. These liabilities implicitly are subsidising such firms by the market value of the contingent liability over and above any present value of expected cash flow should the contingent liability be triggered. From this perspective, contingent liabilities may have moral hazard implications since recipients (government corporations or entities) are absolved from the responsibility of managing the risks in that these are transferred on to Government.

For the aforementioned reasons, an assessment on the value of consolidated gross debt that incorporates explicit contingent liabilities is important. However, an assessment of contingent liabilities requires an understanding of the probability that such situations occur, as well as the size of such liabilities under various possible scenarios.

1.3 Malta's contingent liabilities

In the In-Depth Review for Malta 2014, the European Commission outlined that

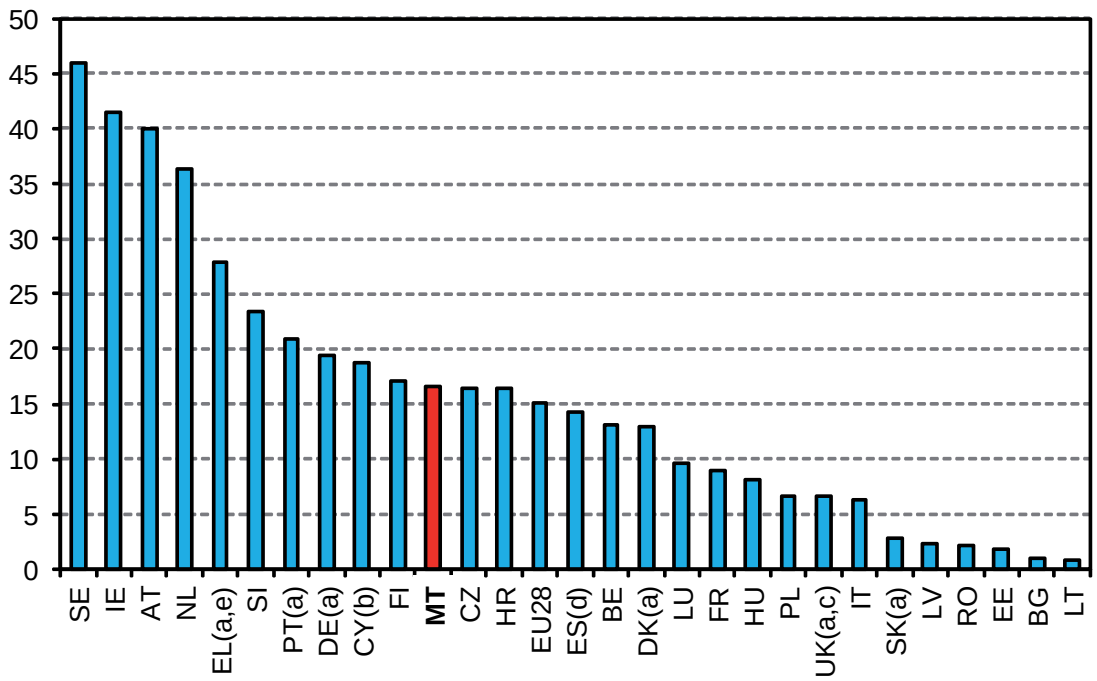
Table 1: State Guarantees by Beneficiaries, 2013

	EUR (million)	Share
Enemalta and Vault Finance Ltd.	724.2	61%
Freeport Group Corporation	200.8	17%
Water Service Corporation	101.6	9%
Malta Industrial Parks Ltd.	90.4	8%
Transport Malta	52.0	4%
Other	23.8	2%
Total	**1192.8**	**100%**

Source: NSO

contingent liabilities represent an additional risk for Malta's public finances. This is due to the fact that following the start of the crisis, a substantial increase in the latter was registered. Contingent liabilities increased from 11.5 per cent of GDP in 2008 to 17.4 per cent of GDP in 2012. In 2013, contingent liabilities amounted to 16.6 per cent of GDP. At the end of 2013, a significant share (60.7 per cent) of the Government-guaranteed loan portfolio was in relation to the public energy utility corporation (Enemalta). Table 1 shows that 16.8 per cent of these liabilities pertained to the Malta Freeport Corporation, followed by the Water Service Corporation which accounted for 8.5 per cent of contingent liabilities. The reforms being undertaken in the energy sector can potentially reduce contingent liabilities as Government divests partially its stakes in the energy operator. The diversification of the energy mix and the potential restructuring of the energy operator can also potentially reduce risks related to energy supply, fluctuations in energy prices and operational efficiency and thus reduce the risk that these contingent liabilities are called. In this regard, the roping in of the private sector in the energy sector is a new development, which augurs well, in that it will over the longer term reduce the sector's reliance on Government.

Figure1: Central government state guarantees as a percentage of GDP, 2013



Source: Consolidated Gross Debt; Eurostat
Contingent Liabilities; Convergence/Stability Programme 2013. (a) Convergence/Stability Programme 2012; (b) IMF as at 31st March 2014; (c) Fiscal Sustainability Report; (d) as at 31st March 2014; (e) Eurostat

2. Main Statistical Findings

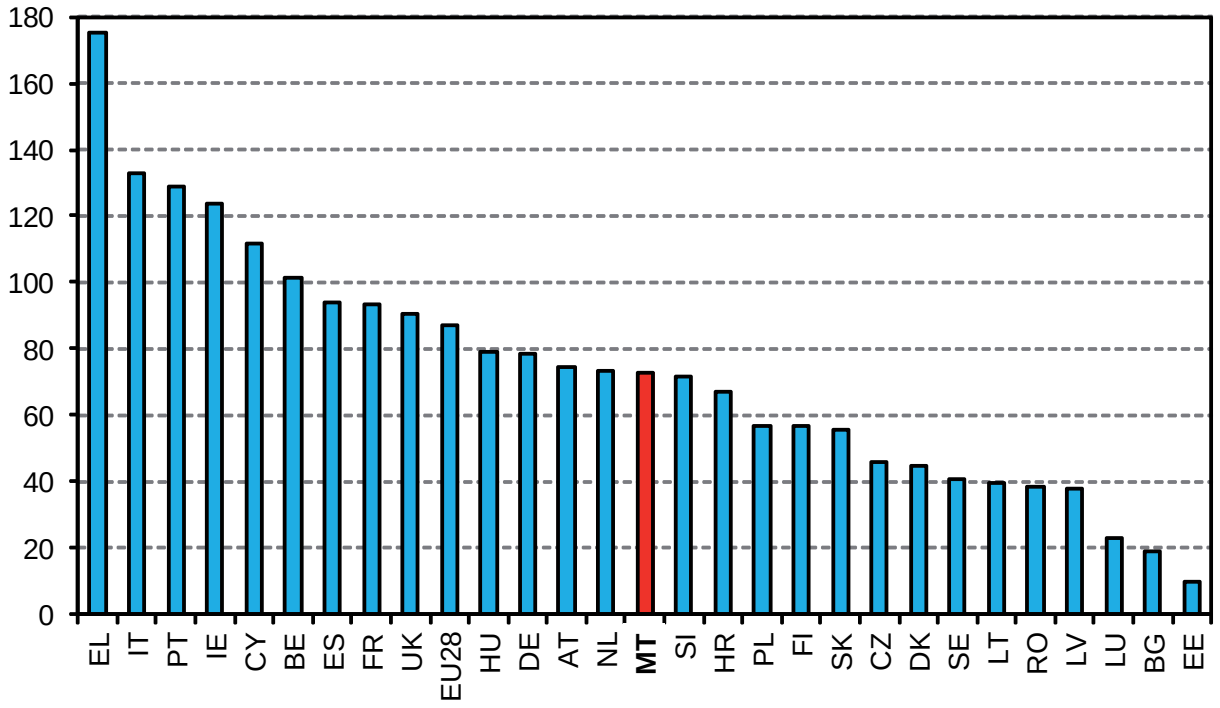
2.1 State guarantees as a percentage of GDP

Based on the Stability Programme and Convergence Programme from EU Member States, the ratio of state guarantees in relation to the underlying debt of non-government units, as a percentage of GDP, is shown in Figure 1. In 2013, the amount of state guarantees as a percentage of GDP did not exceed 10 per cent for 12 countries. A share of less than 4.0 per cent was recorded in Lithuania (0.8 per cent), Bulgaria (1.0 per cent), Estonia (1.8 per cent), Romania (2.2 per cent), Latvia (2.3 per cent), and Slovakia (2.9 per cent). State guarantees ranged between 10.0 per cent and 20.0 per cent in Denmark (12.9 per cent), Belgium (13.1 per cent), Spain (14.3 per cent), Croatia (16.4 per cent), Czech Republic (16.5 per cent), Malta (16.6 per cent), Finland (17.1 per cent), Cyprus (18.8 per cent), and Germany (19.4 per cent). The highest value was registered in Sweden (45.9 per cent), followed by Ireland (45.3 per cent), Austria (39.9 per cent), Netherlands (36.3 per cent), Greece (27.9 per cent), and Slovenia (23.4 per cent). The weighted EU28 average is estimated to be 15.1 per cent of GDP in 2013.

2.2 Government debt as a percentage of GDP

Government debt in the euro area countries, usually referred to as the Maastricht debt, is defined as the gross debt of general government at nominal value outstanding at the end of the year. Government liabilities compromise currency along with deposits, loans and securities other than shares. Government debt excludes certain financial instruments, such as financial derivatives and trade credits. This concept of government debt is applied within the European fiscal framework of the Excessive Deficit Procedure (EDP). It is particularly relevant for procedural purposes in that it is used for fiscal surveillance, under the SGP, to assess whether the criterion of a government debt ratio below the "60.0 per

Figure 2: Gross Consolidated Debt as a % to GDP, 2013



Source: Eurostat

cent of GDP" reference value is met.

Figure 2 shows that 15 out of 28 EU Member States reported debt-to-GDP ratios over the reference value of 60.0 per cent. Greece recorded the highest debt ratio at 175.1 per cent, followed by Italy at 132.6 per cent. The lowest debt-to-GDP ratio was registered by Estonia at 10.0 per cent. The debt-to-GDP ratio for Malta was 73.0 per cent, which is below the EU28 average of 87.1 per cent of GDP.

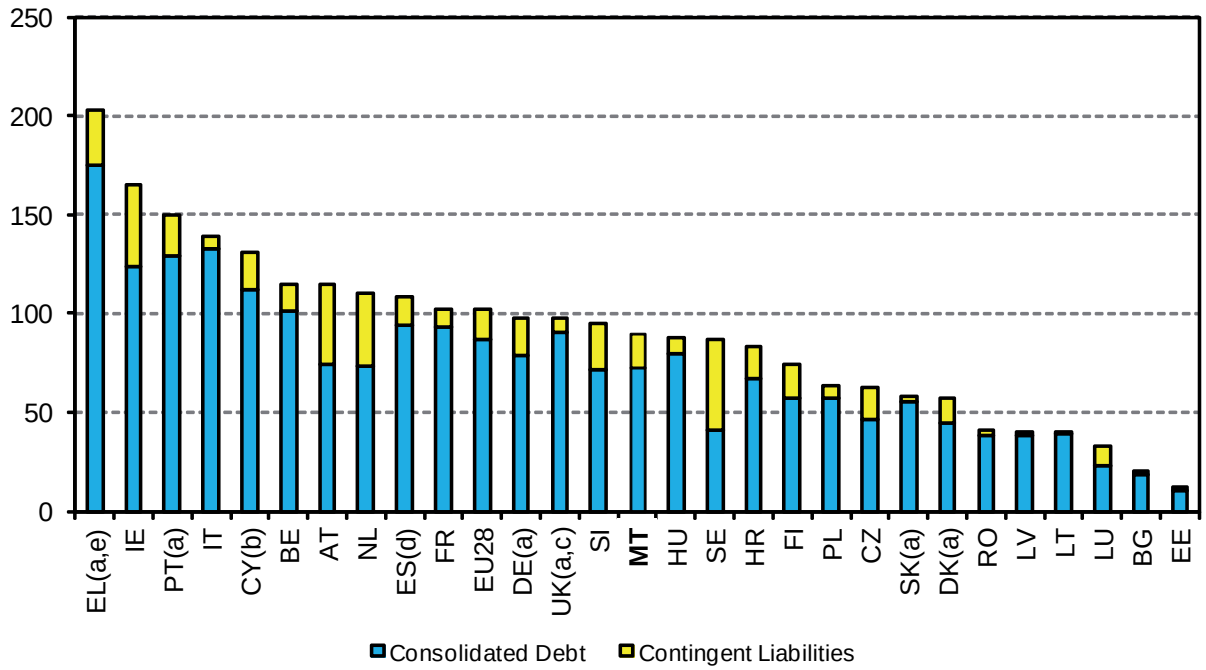
2.3 Contingent liabilities incorporated in the debt-to-GDP Ratio

Figure 3 of this note presents the results of the calculations that seek to assess what would be the impact on the debt-to-GDP ratio if contingent liabilities were to be entirely included in the debt-to-GDP ratio in the worst case scenario where all MSs face a situation in which all their guarantees are called upon. In this scenario we are assuming that all countries share the same probability that such liabilities occur.

In such an event, the debt-to-GDP would deteriorate substantially and the EU28 average would increase from 87.1 per cent to 102.2 per cent of GDP with cross country variations ranging from an increase of 45.9 percentage points for Sweden to a 0.8 percentage points for Lithuania reflecting the range of contingent liabilities.

Given the uneven distribution among Member States this may have a considerable effect on the ranking of countries. Indeed this is demonstrated in Table 2, which compares the rank-order of countries with contingent liabilities incorporated in debt-to-GDP ratio. Greece would remain the most indebted country at approximately 203.0 per cent to

Figure 3: Central government state guarantees as a percentage of GDP, 2013



Source: Consolidated Gross Debt; Eurostat
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Table 2: Comparing Implied Debt-to-GDP ratio with Gross Consolidated Debt as a % to GDP, in 2013

	Gross Consolidated Debt	Contingent Liabilities	Implied Debt-to-GDP Ratio
Greece	175.1 (1)	27.9 (5)	203.0 (1)
Ireland	123.7 (4)	41.4 (2)	165.1 (2)
Portugal	129.0 (3)	20.9 (7)	149.9 (3)
Italy	132.6 (2)	6.3 (22)	138.9 (4)
Cyprus	111.7 (5)	18.8 (9)	130.5 (5)
Belgium	101.5 (6)	13.1 (15)	114.6 (6)
Austria	74.5 (12)	39.9 (3)	114.4 (7)
Netherlands	73.5 (13)	36.3 (4)	109.8 (8)
Spain	93.9 (7)	14.3 (14)	108.2 (9)
France	93.5 (8)	8.9 (18)	102.4 (10)
Germany	78.4 (11)	19.4 (8)	97.8 (11)
United Kingdom	90.6 (9)	6.6 (21)	97.2 (12)
Slovenia	71.7 (15)	23.4 (6)	95.1 (13)
Malta	73.0 (14)	16.6 (11)	89.6 (14)
Hungary	79.2 (10)	8.2 (19)	87.4 (15)
Sweden	40.6 (22)	45.9 (1)	86.5 (16)
Croatia	67.1 (16)	16.4 (13)	83.5 (17)
Finland	57.0 (17)	17.1 (10)	74.1 (18)
Poland	57.0 (17)	6.7 (20)	63.7 (19)
Czech Republic	46.0 (20)	16.5 (12)	62.5 (20)
Slovakia	55.4 (19)	2.9 (23)	58.3 (21)
Denmark	44.5 (21)	12.9 (16)	57.4 (22)
Romania	38.4 (24)	2.2 (25)	40.6 (23)
Latvia	38.1 (25)	2.3 (24)	40.4 (24)
Lithuania	39.4 (23)	0.8 (28)	40.2 (25)
Luxembourg	23.1 (26)	9.7 (17)	32.8 (26)
Bulgaria	18.9 (27)	1.0 (27)	19.9 (27)
Estonia	10.0 (28)	1.8 (26)	11.8 (28)
EU28	87.1	15.1	102.2

Note: Rank in parenthesis

GDP, followed by Ireland (165.1 per cent), Portugal (149.9 per cent), Italy (138.9 per cent), and Cyprus (130.5 per cent). In contrast to this, Bulgaria and Estonia would have no significant changes in their respective implied debt-to-GDP ratio. It is interesting to note that the ranking of Sweden, Austria and Netherlands deteriorates significantly by 5 rankings or more whilst that of Hungary improves by five rankings when account is taken of contingent liabilities. Malta's ranking remains unchanged.

3. Conclusion

This note shows to what extent the implied debt-to-GDP ratio increases if all state guarantees had to be called-upon and compares the relative debt-to-GDP positions

of each country in 2013. The analysis shows that the incorporation of guarantees leads to notable changes in the overall implied debt-to-GDP ratio of a number of countries. Moreover, the relative debt rankings across the EU change notably once guarantees are factor in. Nevertheless, Malta's debt position relative to other Member States is not altered if one were to incorporate the entire stock of guarantees in Government debt.

Endnotes:

[*] The views expressed in this research article are those of the authors and do not necessarily reflect those of the Economic Policy Department, Ministry for Finance. The authors are grateful to Kevin Vella and staff of the Economic Policy Department for helpful comments and suggestions.

[1] For the purpose of this note we are not considering implicit obligations in our calculations.