Opportunities offered by the capital market for financing public administration

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Abstract

Nowadays, covering the financial deficit of public administration in Romania is a difficult task, taking into consideration the fact that in a continous way, this institutional sector must implement and manage investment projects, that suit the local needs of Romanian colectivity and dynamize their adaption to the social,economical and political requirements of the integration in the European Union. Therefore, the alternative of financing through the capital market is well received by the public authorities, especially because there is a lack of flexibility and variety of financing possibilities for the public administration. The interest for this type of financing has increased over the time, once with becoming familiar with the mechanisms and advantages of such a type of financing by all entities that operate on the market (issuers, investors, intermediaries).

Key words: *capital market, T-bonds, public debt management*

1. The financing need of the "Public Administration" institutional sector

The "Public Administration" area is comprised of the **central public administration** (central bodies whose competence expands all around the country, except for the administration of the social insurance systems), **local public administration (**local administrations whose competence expands only on one local administrative unit – commune, town / city, county, district, Bucharest City-, except for the territorial institutions of the social insurance systems) and **the administrations of social insurance systems** (comprise the authorities managing the social insurance systems – public pensions system and other social insurance rights, unemployment insurance system, health social insurances, insurance system for labor connected accidents and occupational conditions and other such – as well as territorial institutions subordinated to them, no matter their financing manner.)

These entities can have their necessary financing resulting from financing or co-financing the public, local or private concern projects, of the temporary treasury needs due to gaps occurring between the cashing in and payment flows, as well as to the budgetary deficit. Other reasons due to which the public administration can be in a resource deficit might be reimbursing in full or in part the loans already contracted and that reached their due date or paying the interests corresponding to the existing public debt.

During the analyzed period of time the net financing need of the public administration has encountered a dynamics showed in the figure below:

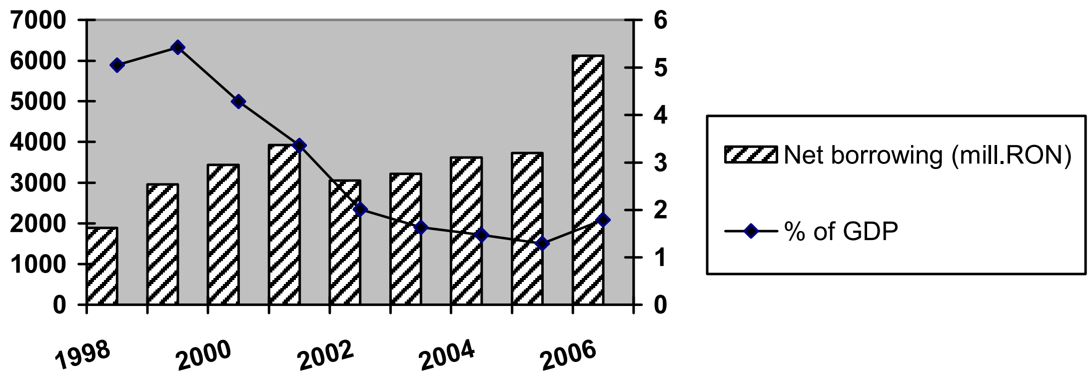

Figure 1 – Evolution of net borrowing of public administration and its weight in GDP in the period 1998-2006

Source: Dates supplied by NBR, and author calculations

In the figure it is pointed out that although the net financing need of the public administration has encountered an increase during the analyzed period of time, until 2005 this represented a percentage smaller and smaller of the GDP due to the fact GDP's increase rate was grater than that of the net financing need. Although, during 2006 the percentage of the net financing need has slightly increased up to 1.79 % of the GDP due to increasing the public debt and the amounts to be paid by the public institutions to the economic entities and to the employees.

2. Financing sources and their effects

During the analyzed period of time, 1998-2006, it is noticed that the greatest part of the financing need for the public administration is provided through loans that from RON 3687 million in 1998 reached RON 26,787 million in 2006, a significant increase. During this period of time, the long term loans have had the greatest percentage, reaching in 2006 over 99 % of the total loans. As important financing alternative there can be noticed the T-bonds, most of them being on a long term. They have also encountered an increase along the time, from RON 3358 million in 1998 to RON 13,829 million. Another financing form that mustn't be neglected, was the deposits of the economic entities in the treasury and the treasury notes, held by the population, that on their due dates have been transformed in deposits. They have increased along the time, from RON 230 million in 1998 to RON 17,428 million in 2006.

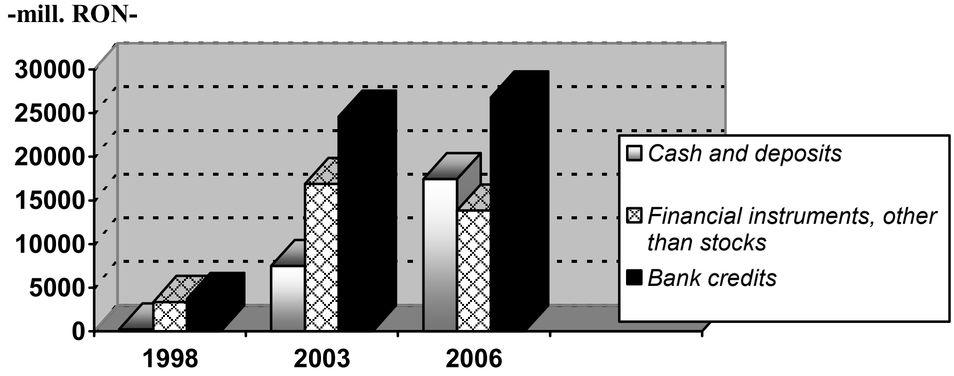

Figure 2 – Structure of financing of public administration taking in consideration the source of financing

The public administration calling to **financing through the capital market** can be made through listing the bonds or treasury notes issued on the capital market. Although the traditional manner for financing the public administrations remains using the bank type of loans, they started to perceive the capital market as a viable alternative for supporting different investment projects or for covering the budgetary deficits. **From our standpoint**, financing the necessary capital of the public administration in Romania seems today even more difficult given that this institutional sector must be able at all times to supply grounds for and to manage the investment projects that would respond to the Romanian communities' local needs and also, that would make dynamic their adaptation to the social, economic and political requirements of the European accession. **Thus, the alternative of financing through the capital market is welcomed** in the circumstances that the public administration's financing possibilities are pretty limited and little flexible. The interest for developing this type of financing grew along the time at the same time with gaining the awareness on the mechanisms and advantages of such a financing by all market actors (issuers, investors, intermediaries).

The municipalities have actively contributed to developing the capital market through issuing bonds developed in view of financing some projects at the local administration level. The low funds level the local public administration have and the impossibility to increase local taxes in order to obtain greater incomes cashed by the local budgets **imposed financing some alternative financing sources** for supporting the local investment projects. Next to the municipal bonds, **the government bonds might have a vital part on the local capital market.** The state loans are guaranteed, thus representing a standard for the remaining of bond issuing. These can be inscribed for listing and thus, they can be transacted either on a regulated market, either within an alternative transacting system. For the time being they are missing from the Romanian capital market, but there are positive perspectives that this will change soon. If in Romania these things are just in their beginning, in Poland, the country having the greatest capital market in the Central and Eastern Europe, the total value of the bonds issued inscribed in the stock market is close to EUR 100 billion and among them the greatest part is represented by bonds issued by the Polish government. This led to the existence of some bond transactions of over EUR 1.4 billion during 2006. Given that Romania has an increasing budgetary deficit and that the public debt is pretty low, approximately 12% of the gross domestic product, there are expectations for the things to change and for the state to issue more and more bonds[1].

[1] Ionuţ Dumitru, Chief of the Research Treasury Department, Raiffeisen Bank.

3. Arguments for developing a government bond market

The need to develop the bond market is felt not only in Romania, but, after the recent international crises, it has also drawn the attention of numerous decision makers at the national and international level. An intrinsic connection to this subject is provided by the governmental debt theme that has been debated on so many occasions at the IMF and World Bank level[2]. Of course that developing a government bond market represents a complex approach that depends on the developing level of the financial system existing in each country. In some countries, financing the government can depend only on some local banks which inhibits the competition and raises even more the transaction's costs. As well, the lack of an adequate market infrastructure can create difficulties for developing a bond market. The lack of institutional investors, the low saving rates at national level or the lack of interest from the institutional investors can lead to the occurrence of a small and homogenous group willing to invest in such financial bonds, as a contradiction to the heterogeneity requirements imposed by an efficient market. More, an economic instability, usually supported by high budgetary deficits or a rapid increase of the currency supply, correlated with a lower and lower exchange rate can lead to a mistrust from the investors and to increasing the risks connected to developing a government bond market. The bond markets have as role creating a connection between the issuers needing long term financing resources and the investors willing to place their available exceeding capital in interest bearing financial bonds. A mature bond market supplies a range of possibilities for timely financing the government and the private sector, thus that through developing the bond market there are usually also created enhanced possibilities for other non-governmental issuers.

The government bonds are the "back bone", a reference item for most financial bonds with fixed income in the developed countries, but also in the countries in progress of developing, as we will point out in the next paragraph. Through these benchmark type of bonds it is supplied a reference yield curve for the other loan financial instruments having similar traits. As well, the mortgage financing can depend in full or in part of the mortgage bonds. The development of a government bond market provides a number of important benefits, if the prerequisites to a sound development are in place. At a macroeconomic policy level, a government bond market provides an avenue for domestic funding of a budget deficit other than the central bank, and thereby can reduce the need for direct and potentially damaging monetary financing of deficits and avoid a buildup of foreign-currency denominated debt. A bond market can also strengthen the transmission and implementation of monetary policy, including the achievement of monetary targets or inflation objectives; and can enable the use of market-based indirect monetary policy instruments. The existence of such a market not only can enable authorities to smooth consumption and investment in response to shocks, but can, if coupled with sound debt management, also help governments reduce their exposure to interest rate, currency, and other risks. Finally, a shift toward market-oriented domestic funding will reduce debt service costs over the medium to long term through development of a deep and liquid market.

4. Bonds issued on the Romanian capital market and comparisons at regional and European Union levels

At the level of the Romanian capital market there has been registered a growth pace from one year to another as regards the bond transactions, but they are still far from the potential the market gives to such instruments. This was due, mainly, **from our point of view,** to the fact that the first

[2] Concerning this, please make reference to *Draft Guidelines for Public Debt Management*, IBRD SEC M2000-376 and *Sound Practices in Sovereign Debt Management*, drafted by the World Bank in collaboration with IMF.

bond operations took place only in the autumn of 2001, in other words these fixed income instruments are relatively new on the market. The law that decentralized the local authorities' finance and that allowed the issuing of municipal bonds was applied beginning on January 1, 1999. After this date the structure of local budgets has been significantly changed, the following two years being transition characterized. For analyzing the local finance status, absolutely mandatory for issuing bonds, there was needed similar financial reporting for a 2 or 3 year period of time. 2001 was the year when there were produced reporting starting on the same basis, the one stipulated by the local public finance law applied since 1999. But, the issuers have been from the beginning very open to approaching the financing through bonds due to the fact the in those years the bank loans for local authorities were difficult to obtain, for most of them being requested real estate guarantees, difficult or impossible to be granted by the town or city halls. The bonds took their logical path of guaranteeing the loan with the budgetary execution and they had the major advantage of low interests than the bank ones and of being transparently calculated.

The first municipal bonds issued having an 18 month due date was launched on October 8, 2001 by the Predeal Town Hall. It was followed by Mangalia Town Hall and by other towns and cities: Zalău, Alba-Iulia, Cluj-Napoca, Breaza, Bacău, Sebeş, Târgu-Mureş and Slobozia. There was expected for the European Union accession to truly bring a reanimation on the bond market, thing which actually happened. The actual number of bonds transacted doubled in 2007. Thus, BVB (Bucharest Stock Exchange) strengthened its position of main local stock market and came closer to the goal of becoming a regional reference market through the novelties promoted. Thus, from 2001 and until 2007 the number of bonds newly listed in each year grew from 2 to 11, the number of issuers increasing also from 2 to 22 and the volume of transacted bonds doubled from 2006 and until 2007, reaching 6,652,467[3]. If we take into account just the **municipal operations,** until 2007 have been performed over 40 issuing for such bonds. In 2007 were being transacted on the market 16 municipal bond issuing having a value of RON 182 million of which seven were new to the stock market in that year as against 6 in 2006. The year for accessing the European Union also represented a record as regards bond issuing (Bacău City Hall), having a value of RON 35 million. This proves that these instruments are believed by the issuers as being more and more an efficient manner for financing the investment projects, and by the investors as an instrument supplying higher interests as against the ones existing on the banking market and having a low risk degree as against the shares on the capital market.

From our standpoint, 2008 is forecasted to be a year with even more bond issuing given that BVB went through tremendous efforts in order to make the city and town halls aware of the advantages of such a financing and of the positive examples supplied by the other successfully made bond issuing. It is expected for in the near future the number of municipal bond issuers to increase but at a lower rate than the ones of increasing issuing taking into account that some city and town halls came back to this financing manner, developing now two or three bond issuing. As the local authorities will be developed from a financing standpoint and the economic conditions will allow it, the municipal bonds will increase as maturity and value.

The most important elements provided by the evolution of the municipal bonds in the period of time taken into account for the analysis and that represent also the future trends are **increasing the maturity period (over 10 years) and increasing the issuing value.** Although it is expected that the number of issuing to increase, we can notice that during the analyzed period it was diminished which did not lead to also diminishing the value of issuing made because that town and city halls started to issue bonds to a higher value and having a higher maturity period. If we analyze the value of bonds issued we can notice that if in 2001 there was a value of RON 1.5

[3] Calculations made by the authors on dates supplied by BSE, kmarket.ro

million of the bond issuing and a number of 2 such issuing, at the end of 2007 the bond issuing amounted to 3 and they accounted for RON 63.7 million, a significant increase showing the increased interest for such financing type[4]. Another important element that encouraged the municipalities for issuing bonds is the so-called "bridge loan". Due to the fact that the town and city halls have encountered difficulties in spending all moneys, as they come following the bond offer, there appeared this type of credit contracted on 1 to 3 years after which they are reimbursed with the money obtained for issuing bonds. Most times, it is created a consortium between one bank and the intermediary of the bond offer. Today most issuing are preceded by a **bridge loan**. A significant element for developing the bond market and the capital market in general is the existence of powerful and long term investors, such as the **private pensions funds**. According to the regulations in the area that have in view diminishing the risks incurred by the savings of the persons making deposits in these funds, these funds must place an important percentage of their contributions in **T-bonds.** But, right now the newly issued T-bond transactions, but also the ones on the secondary market, take place only on the interbank market managed by the National Bank of Romania. Due to the fact that in Romania the first contributions to the privately managed funds will begin in April 2008, these funds' managers are putting additional pressure on the Romanian capital market in order to make possible listing these financial instruments within the stock market. On the contrary, they will have to make short term investments in T-bonds belonging to the European Union member states and to accept lower yields.

If we take into account the structure of the domestic bond markets, and thus the importance held by issuing different bonds, there can be seen that at the level of well developed states (Japan, Great Britain, Germany, France), but also as regards the less developed countries (Argentina, Brazil, Turkey, Poland, Czech Republic) the registered level of the public sector's issuing is very high with values from 50% and above, reaching even 99% in the case of Turkey[5]. As a comparison, at the end of 2006 Romania had a transacted value of the bonds of USD 55.06 million, of which 83% belonged to the private area and just 17% to the public sector[6].

5. Final conclusions

The public administration can perceive the capital market as a **viable alternative** for financing the financial resources needed. The year 2008 is forecasted to be one with many bond issuing given that BVB went through tremendous efforts in order to make the city and town halls aware of the advantages of such a financing and of the positive examples supplied by the other successfully made bond issuing. It is expected for in the near future the number of municipal bond issuers to increase but at a lower rate than the ones of increasing issuing taking into account that some city and town halls came back to this financing manner, developing now tow or three bond issuing. Next to the municipal bonds, **the government bonds might have a vital part on the local capital market.** The state loans are guaranteed, thus representing a standard for the remaining of bond issuing. These can be inscribed for listing and thus, they can be transacted either on a regulated market, either within an alternative transaction system. For the time being they are missing from the Romanian capital market, but there are positive perspectives that this will change soon and that capitalizing the bond sector will significantly increase.

[4] Calculations made by the authors on dates supplied by BSE, kmarket.ro
[5] See Appendix 1
[6] Data supplied by BVB and processed by the authors.

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[3]Corduneanu C. – *Pieţe de capital. Teorie şi practică*, Ed.Mirton, 2006
[4] www.bvb.ro
[5] www.bis.org
[6] www.bnro.ro

Appendix nr.1

Structure of domestic bond market in different developed and developing countries Comparative analysis september 1999 - september 2007

	All issuers		**Public sector**		**Financial institutions**		**Private sector**	
	Bil.USD		**%**					
	1999	**2007**	**1999**	**2007**	**1999**	**2007**	**1999**	**2007**
USA	14.938,0	23.899,5	55	27	28	60	18	13
Japan	5.938,0	8.706,7	74	81	14	11	12	8
Germany	1.921,7	2.457,8	42	53	57	40	1	7
Italy	1.485,6	2.942,0	77	60	23	29	1	11
France	1.164,5	2.652,6	60	52	32	37	9	11
UK	906,1	1.354,2	52	67	32	32	16	1
Spain	347,8	1.532,3	84	32	9	38	8	30
Brazil	271,3	900,2	81	73	18	26	1	1
China	196,5	1.528,7	65	68	33	26	2	6
Argentina	76,6	79,8	31	82	69	6	0	12
Mexico	47,7	330,2	82	56	6	36	12	8
Turkey	44,1	217,0	100	99	0	0	0	1
Czech Republic	19,5	89,7	75	83	12	13	13	4
Poland	26,9	144,9	100	100	0	0	0	0

Source: Dates supplied by BIS, and authors calculations