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The Training in Local Self Government Credit Rating

Developing a City Financing Strategy World Bank

Mechanisms of preventing macroeconomic destabilization
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DECENTRALIZATION OUR GOAL

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The Center for Economic Analyses (CEA) is a think tank of economists who share a common vision for the Republic of Macedonia as an emerging new European economy integrated in the regional and worldwide market.

The Mission of CEA is to continuously research economic development and economic policy in the Republic of Macedonia and to offer recommendations, suggestions and measures where it is deemed appropriate.

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From the editor

Dear readers,

On one side the globalization, growing pressure of the urbanization, demographic changes and the transitional forces are increasing the poverty in Macedonian municipalities and on the other side the empirical evidence in transitional countries shows that the municipalities are increasing their capital expenditures reflecting the under investment during the transition period. The situation is and will be further complicated with harmonization with EU regulations and standards.

For the big urban centers in Macedonia the globalization will not be new phenomena but soon they will face the speed, scale and complexity of global connections in the need of financing urban development. The need for capital finance will become more and more an analyses of pros and cons of alternatives among grants from budget or donors, operating surplus inflow, sale of assets and/or borrowing through loans or bond issuance.

Supporting such a complex area of borrowing will require know-how and good practices in financial management, accounting, capital investment planning, debt management, forecasting, strategic planning, solutions for asymmetrical information problems and moral hazard, bankruptcy procedures etc.

The purpose of the city financing strategies will become more important in determining how to ensure a sustainable fiscal environment at the regional and local level without undesirable consequences at the macro level.

Allowing municipalities to access capital markets is important complement to a well developed fiscal decentralization system and devolution of fiscal power to municipalities and that is why we at CEA believe that it is not early do discuss the borrowing pillar of fiscal decentralization as many believe.

Interested and viable municipalities for borrowing and/or bond issuance will not be constraint with such believe. The capable managers of those municipalities will grab the opportunity and proceed with borrowing after 2007.

In the long run, this completely new market in Macedonia will foster the development of local capital markets and possible channel long-term financing from the international markets.

However, the municipalities should be prepared for a process of examination of all available information regarding their obligation, rewards from potential investment and the risks those investments entails.

Also, municipality's borrowing is dependant on some potential problems and issues like: poor accounting, disclosure, reporting standards, lack of regulatory laws, underdeveloped financial regulatory institutions, investor reliance on central government bailouts, conflict of interests among creditors and borrowers all that contributing to potential macro fiscal instability as well.

At the outset, I would like to thank the FSVC, USAID and the trainers for their dedication to transfer knowledge to the participants of the training and finally, I express my deepest gratitude to the participants who have contributed to the event and have improved the quality of public debate on issues of municipality borrowing in Macedonia.

Best wishes,
Marjan Nikolov, MSc
Editor

Dr. Philipp Stiel

Head of Public Administration Reform Department
OSCE Spillover Monitor Mission to Skopje

The municipalities are confronted with inherited debts of around 50 Mio €. This debt is considered as one of the most important challenges for many municipalities all over the country. How can CEA in this situation edit a bulletin, which deals with municipal loans?

Fiscal decentralization is the corner -stone of every decentralized system. This is the reason why the two year probation period affects mainly and firstly the fiscal autonomy of municipalities: during this period, the units of local self-government should solidly prepare themselves for the next phase of fiscal decentralization, bringing increased competencies in the area of financial management. As of 2007, numerous municipalities will face the opportunity, temptation and risk of turning to the financial markets and borrowing money on a long-term basis.

The purpose of this publication is to contribute in the efforts to prepare local self-government units for the moment when they would be allowed to use this instrument i.e. to show how it can be used in a rational, responsible manner, as well as to demonstrate its interrelatedness with issues like good governance, citizen's participation and financial soundness - via the municipal credit-rating!

1) Thanks to the World Learning's (USAID) small grant, that CEA won in a competitive bid the web page: http://www.lsg-data.org.mk is available for all those in need of data, information and indices related to the LSG. CEA is pioneer among the NGOs in hosting database with LSG data on the Internet and making it available to the larger public with no fee.

CEA expresses highest gratitude to OSCE for the support in publishing this newsletter.



THE TRAINING IN LOCAL SELF GOVERNMENT CREDIT RATING

The training was initiated by CEA and it took place 31st October - 4th November 2005.

The following goals were anticipated by CEA:

1. Where other see problem in LSG borrowing issue, CEA see opportunity;
2. LSG in Macedonia handling borrowing challenge;
3. Improve transparency of LSG actions;
4. Enhance LSG administrative capacity in handling transparent budget process;
5. Enhance LSG administrative capacity in developing firm financial management;
6. Increase the public awareness of the challenges and current progress of the fiscal decentralization;

The advisors Mr. Charles Jokey from the IGE Consulting LTD Hungary and Felix Ejgel Felixovich Associate Director, International Public Finance from Standard & Poor's Moscow delivered a five day workshop based on international best practices and illustrated with specific case studies. Each presentation included group discussions. The workshop consisted of five targeted modules that covered the following topics:

Module I: Establishing the Policy Environment to Improve Local Government Finance

Module II: Strategic Options in Financing Capital Expenditures in Local Governance

Module III: Building a Local Government Debt Market: Institutional, Policy, and Legal Priorities

Module IV: Development of a Sub-national Bond Market: Financing Priorities and Products

Module V: Developing a Credit and Borrowing Model for Local Governments

Mastering the borrowing pillar of fiscal decentralization will build further CEA's capacity, knowledge and skills related to municipality financial management, budgeting and how those processes are affecting the creditworthiness of municipalities. This training was first of that kind in Macedonia. Developing the capacity of local financial advisors and managers to understand and apply options for financing local governments will be important for the ongoing success of decentralization process in Macedonia. Enabling local consultants to rate the creditworthiness of sub-sovereign borrowers will help improve the fiscal performance and financial discipline of these borrowers as they begin to explore the possibility of issuing debt. A more complete picture of the financial performance of municipalities will help attract potentially interested domestic and foreign investors. It will also facilitate the more efficient allocation of financial resources to the most profitable investments that support economic growth.

PARTICIPANTS

Name/surname of the participants	Institution/Organization
Marjan Nikolov	President of CEA
Marija Sekulovska	CEA
Miso Nikolov	CEA
Elena Pehcevska	CEA
Aleksandar Nakovski	Centre for Research and Policy Making
Zoran Necev	Centre for Research and Policy Making
Goran Spasovski	City of Skopje
Snezana Joseska	City of Skopje
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Aleksandar Spasevski	Economic Think Tank
Gjorgji Josifov	Make Decentralization Work / USAID
Jane Vrteski	Make Decentralization Work / USAID
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Ana Stojkova	Ministry of Finance, Public Debt Dep.
Maja Subotic	OSCE
Zage Filipovski	OSCE
Violeta Madzova	EAR Technical Assistance to MoF
Bekim Imeri	World Bank
Saso Trajkov	Municipality of Gazi Baba

Participants of the training and the trainers:

Seating from left to right Marjan Nikolov-President of CEA, Felix Ejgel from S&P Moscow, Charles Jokey IGE Hungary.

DEVELOPING A CITY FINANCING STRATEGY - WORLD BANK

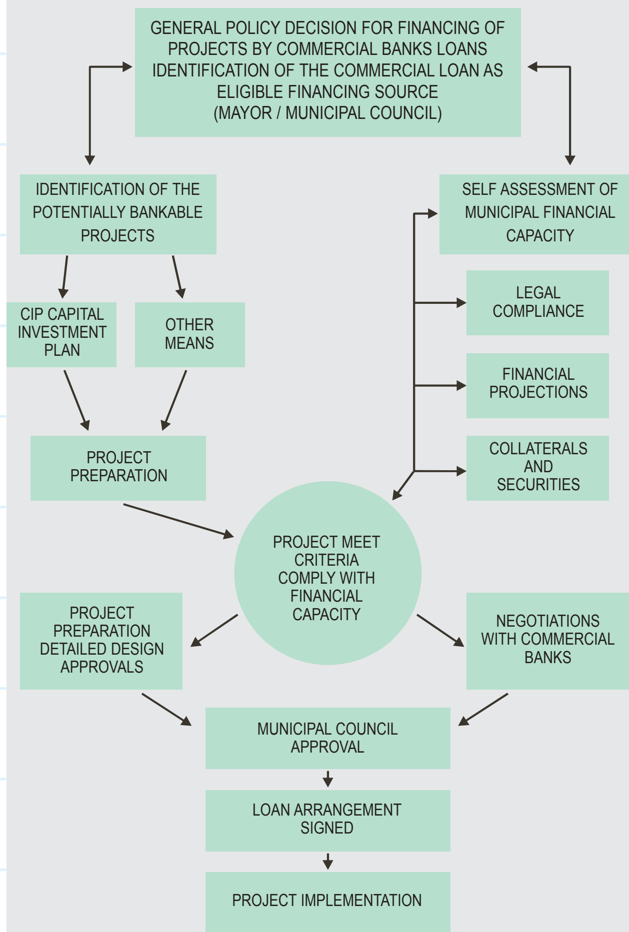
The purpose of developing a City Financing Strategy is to assist World Bank's clients in identifying their financing needs and assisting them in raising capital to meet these requirements. Accordingly, the CFS has three primary activities: financial planning, debt management (including credit rating strategy), and investment management.

1. Financial Planning includes a diagnosis of municipal structure needs (capital budgeting to determine the adequate debt structure); identification of alternative financing sources (including debt, grants, governmental transfers, and current account surpluses).

2. Debt Management includes preparation of the debt management framework oriented to risk management, to measure the costs and risks, and to determine

the proper ALM structure. It also includes preparation of funding and debt management policies and plans, plus other activities associated with the debt issuing process (such as credit rating strategy). After the first stage, the municipality may decide to issue debt. In this case, the CFS will assist the municipality in issuing bonds and developing specific debt management techniques, such as assessment of debt capacity and alternative debt structures.

MUNICIPAL BORROWER PROCESS FLOW CHART



3. Investment Management includes how to develop investment management policies and methods. The first step is to identify how the city currently manages its surplus funds. If the municipality considers issuing a bond, the CFS will assist the city in the preparation of a cash management program for the bond proceeds, and integrate this program into the treasury's overall investment management function.

THE LAW ON FINANCING LOCAL SELF GOVERNMENT

The Law on LSG states that LSG have the right to borrow in the domestic and the foreign capital markets. In addition, the new Law on Financing LSG distinguishes borrowing, short-term borrowing, long-term borrowing and government guaranties.

In practice, LSG in Macedonia can borrow in the international capital market with prior consent from the Government of Macedonia determined on the basis of the opinion issued by the Ministry of Finance. Short-term borrowing is allowed for cash flow management and must be repaid by the end of the fiscal year. The ceiling on this

type of borrowing is 20 percent of the total revenues from the so-called current-operational budget in the previous fiscal year for the accumulated annual debt service.[2]

Starting 2007 long-term borrowing will be allowed for capital investments and fixed assets financing only. The ceiling on this type of borrowing is 15 percent of the total revenues from the so-called current-operational budget in the previous fiscal year for the accumulated annual debt service. In the transitional provisions it is stipulated that a LSG can start its long term borrowing if in a period of 24 months there is favorably reviewed financial reporting from the LSG and if within two years from the law being on power the local self government do not have arrears.

The total amount of long term debt due including the guaranties cannot exceed the total revenues from the so-called current-operational budget in the previous fiscal year.

Within 10 days after the contract for long term borrowing is signed the local self government must submit the contract and the amortization plan to the Ministry of finance and more, for each installment serviced, the Ministry of finance must be informed.

LSG DEBT IN MACEDONIA

As of May 2004, the total outstanding debt of municipalities is estimated at around EUR 43 million or 1.4 % of the Macedonian GDP (the 15 EU member countries' average is 5.6 % of GDP).

The structure of local debt is as illustrated in the next tables. It should be noted that these figures are arrears and not traditional debt in their nature. However, the law on financing LSG says in article 18 that all arrears due more than 90 days will be counted as debt.

	Principal	Interest	Total
Total:	2,006,692,797	1,142,836,906	3,149,529,703

Financial structure	
By type of debt	**Structure**
Administrative	0.37%
Construction	62.36%
Electricity	8.50%
Expropriation of land	3.51%
Other	25.27%
Total:	**3.149.529.703**

EXCERPTS FROM THE TRAINING PROGRAM (COURTESY FROM MR. JOKEY)

Design issues relating to the legal framework for municipal insolvency

- Early Warning System
- Maintain Municipal Services
- Create procedures for financial discipline without extra burden on central government
- Reduce potential financial obligations of central govt.
- Maintain municipal autonomy
- Debt adjustment that is fair to creditors and preserves market conditions
- Support cooperation among municipalities, Ministries, other stakeholders

Debt control mechanisms used elsewhere in Europe

- Restrictions on volume of borrowing and debt service ratios
- UK: credit approval
- Denmark: no municipal borrowing is allowed at all with a few exceptions.
- Germany: each Bundesland has its own volume of borrowing limits and explicit approval is needed from the Land
- Poland and Czech Republic: 15% of revenues may be used to fund debt service
- Croatia: 20% of own resources may be used for debt service and the MOF needs to approve each loan
- Ireland: each municipal borrowing must be approved by the Minister who determines whether they need the loan and whether they can pay it back
- Austria: each Land has a different set of criteria for debt needing higher level approval, and differing absolute or relative limits

- **Restrictions on municipal guarantees**
- Guarantees to third parties are allowed and NOT counted against debt limits: UK, Sweden, Czech Republic, Finland.
- Municipal guarantees are restricted to public purpose organizations, non-profit organizations, communal enterprises, or enterprises and institutions with municipal

2) The current operational budget is defined as the total revenues excluding grants from the budget of Macedonia and budgets of funds earmarked for financing capital investments, revenue from self-contributions, and funds received in the form of loans. This will leave the own revenues from taxes on property, fees, and charges and retained part of the PIT as the basis for calculating the ceiling for short-term borrowing. This arrangement may give additional incentives to LSG for increasing the collection rate of those revenues.

majority ownership: Belgium, Norway, Denmark, Croatia.
- Guarantees to third parties are counted as municipal debt and included in the limits on debt volumes: Croatia, Denmark, France, Austria.
- **Restrictions on collateral**
- No municipal asset may be used to guarantee debt, only cash flow: UK
- Property may be used to guarantee municipal loans: Ireland, Norway, Finland, Denmark. (by Bundesland permission only in Germany)
- Public sector assets may not be used as collateral: Belgium, France, Italy, Spain, Portugal
- No restrictions on the use of municipal assets as collateral: Czech Republic, Poland, Croatia

Why are municipal defaults and excessive borrowing risky?

LSG:
- Inability to make timely payment, penalties and sanctions imposed
- Strain on operational budget
- Halted or partially finished investment projects don't pay returns
- Assets and collateral lost
- Disruption of essential public services
- Risk of losing next election
- Sanctions from national government (eligibility for other grants, criminal prosecution etc)
- Repayment of other debts endangered
- Blacklisting by financial institutions
- Ultimate dissolution of local government, forced merger and state supervision

Central governemnt:
- Guarantees called, stress on national budget
- International obligations on gross state debt (Maastricht, IMF etc.)
- Bad precedents set in case of repeated bailouts
- Lose value of grants and investments already made if projects are halted midstream
- Service provision obligation may revert to national level (safe drinking water)
- "bad publicity" for entire local government system
- need for policy reform and incipient debate

Creditor/bond holder:
- balance sheet losses (value of loans made or bonds held, or accounts receivable written off)
- provisioning and regulatory problems
- cost of managing bad assets
- negative publicity for banks "pressuring" municipalities
- risk of losing entire asset/loan in a workout agreement or liquidation procedure
- lost future business with municipal sector

SOME RULES FOR THE USE OF CREDIT BY MACEDONIA'S LOCAL GOVERNMENTS

E-Interview with Prof. Jorge Martinez-Vazquez, Georgia State University

The international experience offers several approaches to the management of local government debt from which Macedonia might profit when designing its own model. The most common approaches include: (i) leaving financial market discipline to operate freely; (ii) establishing strict administrative, case-by-case control; and (iii) establishing explicit, preemptive and legally binding general rules to prevent crises and encourage good market behavior. A combination of these options may prove more advantageous for the Macedonia.

In principle, market discipline would set the most desirable benchmarks. However, governments realize at times that market discipline alone cannot be as effective as desired, because of prevailing market failures, including restricted access to financial markets, lack of transparency, soft budget constraints and moral hazard incentives or insensitivity to market signals. The international evidence is that even in mature financial markets sole reliance on market discipline may not be satisfactory for controlling excessive indebtedness of sub-national governments.

Most countries have opted for the use rules to regulate access to credit markets by sub-national governments. Rules for access to capital markets can be effective only if they are legally binding, simple to follow, transparent, and applied across-the-board. Such rules should comprise clear quantitative limits and procedural norms, which respect and imitate, to the extent possible, good practices of financial market discipline and creditworthiness indicators.



Rules for access to capital markets:

(i) Obey the "golden rule" - i.e., never borrow to finance recurrent expenditures and restrict loans to high-return investment expenditures in infrastructure and social services.
(ii) Limit the debt service ratio of local governments to a fixed conservative maximum of sub-national government revenues.
(iii) Limit the total indebtedness indicator of local government (i.e., the ratio of debt stock outstanding-including indirect and contingent liabilities-to the flow of total annual revenue excluding conditional grants) to a maximum.
(iv) Limit financial institutions' portfolio exposure to local credit to a certain maximum dictated by recommended banking prudential rules, enforced on a bank-by-bank assets basis, for each local government.
(v) Adopt and implement a financial emergency or bankruptcy law for local governments that could clearly define debt workout procedures in case of local government default.
(vi) Adopt a Law on Fiscal Responsibility aiming at limiting reiterated, excessive deficits and the imprudent buildup of (local) public debt.
(vii) Encourage the dissemination of risk and credit rating analyses of local governments to improve transparency, and impel the financial system to operate as closely as possible to market discipline, and promote the practice of creditworthiness analysis.
(viii) Establish an official monitoring agency, possibly under the Ministry of Finance, to keep records and monitor the overall development of local government indebtedness, including all kinds of contingent liabilities.

MECHANISMS OF PREVENTING MACROECONOMIC DESTABILIZATION

Marjan Nikolov, MSc

In Macedonia the needs for local infrastructure investment have been traditionally covered by the central government, mainly through the off-budget Road Fund (under specific criteria), the BUR and the Ministry of transportation, which approves funds for construction, modernization and reconstruction of local roads, the power supply network, local water supply systems, sewage network, and so on.

There is some international donor funding of local investments but the allocation of donor funding often reflects the initiative of individual municipalities, which results in some arbitrariness in the local incidence of these projects. This system results in an allocation mismatch of LSG priorities compared to priorities of the national government regional policy (if any).

As long as local investments are funded by the national government or by international donors through capital grants, the risk of macroeconomic instability is reduced. However, uncontrolled access of municipalities to domestic or international capital markets could jeopardize macroeconomic and fiscal sustainability in principle.

In the next figure one can see how the economic growth affects the debt to GDP ratio and the fiscal sustainability in Macedonia[3]. The following assumptions were taken into account:

- Previous debt is on the level of the IMF's 40 % debt rule;
- Primary deficit up to 2004;
- GG deficit from 2005 as agreed with the IMF;
- US $ LIBOR up to 2006;
- US $ interest rate of 3 % from 2006;
- Macedonian interest rate of 5 % for repayment of previous debt;
- Share of foreign currency denominated debt of 0.640;
- GDP deflator 3 %;
- GDP real growth rate of 4 % in 2005 and 4.5 % for 2006, 2007, 2008 and 2009 as agreed with the IMF
- Nominal MKD exchange rate depreciation against US $ dynamics for: 2006=50 MKD, 2007=55 MKD, 2008=61 MKD. After 2009 1 US $ = 1 EUR.

I will use the accounting approach (used by IMF as well) for fiscal sustainability estimation in which economic indicators as a percent of GDP are used to assess debt sustainability. Under this approach, pre-defined macroeconomic targets are specified for the rate of inflation, the real growth rate of output in the economy, and the interest rate.

The stress test for public debt to GDP ratio is illustrated in the next Table for the baseline scenario of 4 % GDP

3) This simulation was done by Marjan Nikolov for the purpose of the final paper request upon the "Public Debt Management Training" October 14-November 26, 2005 Skopje, Macedonia conducted by University of Pittsburgh, Graduate Center for Public Policy and Management-Skopje.

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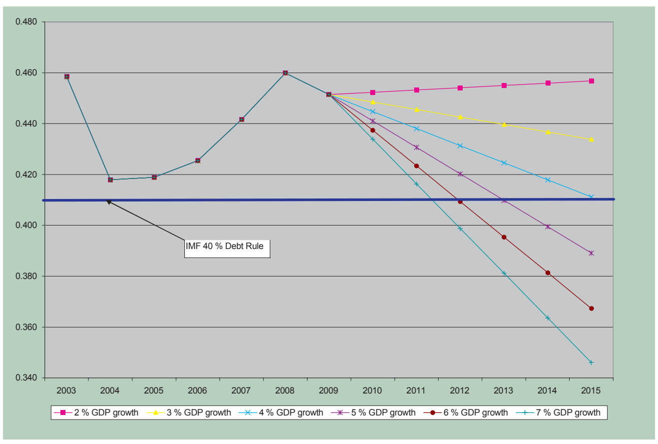
growth rate after 2010. Unfortunately the subsovereign debt was not counted for.

Stress test for public debt ratio

Time, *t*	Change in public sector debt	Auto debt dynamics	Primary deficit	Public debt ratio
2003	-0.046	-0.047	0.000	0.458
2004	-0.040	-0.031	0.009	0.418
2005	0.001	-0.003	-0.004	0.419
2006	0.007	0.001	-0.006	0.425
2007	0.016	0.010	-0.006	0.442
2008	0.018	0.012	-0.006	0.460
2009	-0.009	-0.015	-0.006	0.451
2010	-0.007	-0.013	-0.006	0.445
2011	-0.007	-0.013	-0.006	0.438
2012	-0.007	-0.013	-0.006	0.431
2013	-0.007	-0.013	-0.006	0.425
2014	-0.007	-0.013	-0.006	0.418
2015	-0.007	-0.013	-0.006	0.411

The results from the sensitivity analyses for different growth rates of GDP are illustrated in the next figure.



What we can conclude from the graph is that all else equal the economic growth has impact on how much a government can borrow. For Macedonia after 2009 (if all macro indicators are on line with what is agreed with IMF) growth rates lower than 2 % will lead to unsustainable debt to GDP ratio. That is why the central government should create the ambient for higher economic growth rates than the experienced so far in these 15 years of transition.

This model can also give answer to the question of how much additional borrowing can be allowed for given GDP growth up to the moment when the targeted debt is on the 40 % debt to GDP line.

The new public debt law should be amended to include provisions for debt management on subsovereign level as well. Refereeing only to the law on financing local self government is not enough. A possible impact assessment of amending a new municipality bankruptcy law could prove very beneficial for prevention and regulation in this area as well.

The Public Debt Department within the ministry of finance can also make some simulations as of how much additional borrowing can be allowed for given GDP growth up to the moment when the targeted debt is on the IMF's rule of 40 % debt to GDP for different sovereign and sub-sovereign borrowing portfolios. They should also start to develop a system for registering subsovereign debt and data collection and analyses.

Capital markets in Macedonia are still narrow, which limits access of municipal governments to capital market. This makes local borrowing difficult in an environment of no stable and predictable revenue stream. Prevailing high interest rates will limit any borrowing-capital investment plans for the municipalities in the near future.

Besides the legal limits on borrowing and central government discretionary control, under the new law there are certain instruments that should assure the municipalities to be credible and disciplined if they want to borrow. Finally, the government issues guaranties for local borrowing only if the liability is undertaken in accordance with the law. All these measures together should keep LSG in check in the future.

S&P RATING PROCESS FOR MUNICIPALTIES CREDIT RATING:

- **rating request in advance before the management meeting:**

- five years of annual finacnial statements
- interim financial statements
- narrative descriptions of operations and products
- other documents that analysts deem pertinent toa particular rating determination

- **the management meeting discussion:**

- econmic envuironemtn and prospects
- overview of major business segments
- management's financial policies and performance goals
- accounting practices
- management's projections, inco, me and cash flows statements and balance sheets
- capital spending plans
- financial alternatives and contingency plans

- **S&P review and analysis**
- **the rating comittee meeting**
- **the apeal period**

- **the press release**
- **reports and ongoing surveilance**
- **credit watch**