**INTRODUCTION**

Against a background of fiscal restraint, governments in developing countries have come to realize that private resources must be mobilized to support the growing demand for infrastructure services. One way is through privatizations and concessions for private provision of infrastructure services which are taking place at a growing pace. Decisions for the provision of these services are also being increasingly decentralized with municipalities playing a growing role in forging partnerships with financiers, operators and constituents. Municipal governments seek to fund capital investments and cover operating costs through local taxes and user charges and, as available, central government transfers. Where essential services—that are not provided through private operations—cannot be funded by current revenues, the financing gap that emerges would have to be filled through borrowings. In many developing countries, local government borrowings have largely been confined to loans from commercial banks or specialized financial institutions, often with central government guarantees.

This note discusses the conditions underlying the development of municipal credit markets which can provide a vehicle to narrow local government resources gap through debt funding supported by the taxing power of local governments and revenue bonds secured by the earnings of such projects as water facilities and toll roads. (A separate note reviews the main characteristics of the US municipal bond markets which are a primary vehicle for local infrastructure finance.)

**MUNICIPAL DEBT MARKETS AS A SOURCE OF LOCAL GOVERNMENT FINANCE IN DEVELOPING COUNTRIES**

Developing countries have been able to attract local and foreign equity capital for private infrastructure investments. Mobilizing debt funding however has been more difficult, particularly for sub-sovereign government entities.

As far as local infrastructure finance is concerned, foreign exchange resources could be a complement to, but not a substitute for, local currency funding. Indeed, some sub-sovereign entities or projects with strong revenues base can mobilize and afford the costs of external funds, especially when borrowings cover foreign exchange outlays or finance projects that generate foreign currency receipts. However, without the necessary complement of domestic resources, foreign borrowings might not be a "sustainable" funding source for many local governments across the spectrum of infrastructure projects. Moreover, external funding may in some cases add penalties to borrowing costs. Take the hypothetical case of a relatively well managed sub-sovereign entity (say a public utilities company) that is seeking debt finance for its expansion plans. With a credit rating of say "A" for local currency debt, it might have issued domestic debt at a cost of "yA". Assume that it cannot borrow on the local market (given the market inadequate size and depth) and must seek instead external financing. Its rating for foreign currency debt would be capped by the country's sovereign rating, say "BB", as a result of which the cost to the company of foreign currency debt would be "yBB" (more "burdensome", all other things being equal, than "yA"). Moreover, when
raising foreign currency debt, borrowers may often need to swap back the debt proceeds, or part thereof, into local currency funds thus adding swap transaction fees and risks to the overall cost of debt. Finally, when debt is denominated in foreign currency, utilities companies or local government issuers would be increasing their currency exposure as a result of the mismatch between their foreign currency denominated liabilities and their revenues mostly accruing in local currency (save for some international transport and telecommunications projects).

The challenge is to expand the “market-based” funding pool for local governments by tapping private individual and institutional savings. In some developing countries, there is a growing demand for diversified long-term assets, beyond the traditional obligations of sovereign or corporate issuers. (For instance, infrastructure, particularly transportation-related, projects are being funded through capital market debt issues based on stand-alone credits similar to US municipal revenue bonds. Debt Securitization is also taking place backed by export trade receivables.)

**CONDITIONS FOR THE DEVELOPMENT OF SOUND MUNICIPAL CREDIT MARKETS IN DEVELOPING COUNTRIES**

There are challenges associated with local government access to private savings in developing countries, where financial and institutional capacity at the local level is often constrained and where local infrastructure investments are sometimes associated with inefficient implementation, unattractive returns and high credit risk—hardly an inducement for investors seeking competitive risk-adjusted returns, and lenders wary of poor credit. The development of domestic municipal bond markets should thus go hand in hand with improvements in the local government revenues base and in the institutional framework within which municipal services are delivered. Of importance also is the development of effective mechanisms to diversify and transfer risks. But first, the broad macro-economic framework should be such as to foster domestic savings and the efficient allocation of credit.

**Macro-economic Issues**

Municipal credit markets develop as a sub-set of domestic capital markets which, beyond the confines of municipal governments, require rational macro-economic, fiscal and monetary policies. Like other fixed income instruments, municipal issues will remain attractive to bondholders only when inflation is kept in check. Moreover—as a result of political constraints—local government borrowings in developing countries may de facto become part of the overall public sector debt. This makes it crucial for countries seeking to expand local borrowing operations to ensure that the consolidated public—including local government—debt remain consistent with macro-economic policy objectives and fiscal targets. Departure from these principles might have destabilizing effects at the macro level. Genuine municipal bond markets imply that municipal issues should entail no sovereign support or guarantee which might create contingent liabilities at the sovereign level. As a result they would be priced at market-determined rates usually at a spread above central government securities.

**Institutional and Regulatory Issues**

The development of municipal credit markets also requires that local governments have sound institutions, predictable fiscal relations with the central government and an efficient organizational setting for services delivery. This implies transparent city budgets, credible accounting systems and independent audits, a sound competitive environment with rational pricing policies and monitorable performance criteria for monopoly services. Private provision of infrastructure services and concession arrangements—many of them already proven—must be encouraged and developed. Public utilities companies should be autonomous and have a secure recurrent income through reliable services to consumers. To play their role effectively, capital markets must rely on well functioning banking institutions with reliable payment systems and custodial services.

Municipal credit markets also require adequate legal and regulatory frameworks covering supervision, disclosure, and debt issuance, settlement and repayment. Regulations allowing municipal bankruptcy would be needed in the event of default. Strains on municipal finances which might show in periods of economic downturn are likely to be combined with declining central government transfers and mounting taxpayers resistance to higher levies. Creditors’ rights and the seniority of their claims on municipal assets should thus be well specified as these claims (even on “dedicated” revenues/taxes) would likely be weighted against the effects of disrupting the provision of critical public services and actually subordinating such other municipal liabilities as employees pension claims.

**Credit Issues**

Credit risk accounts for a critical component of investment risk, since as a result of issuer’s default, returns and initial capital could be lost. Credit quality thus becomes a determinant parameter as far as market
acceptance and pricing of debt are concerned. Countries with developed financial markets rely fairly strongly on credit ratings which provide independent “opinions” to investors as to the creditworthiness of debt issuers. Moreover, there is a scope for developing countries to increase the use of financial and legal structures that enhance the credit quality of municipal debt—guarantees, insurance, securitization and derivative products—and improve investors acceptance of debt issues. In countries with sound banking systems, it might also be possible to issue municipal debt backed for instance by bank letters of credit, with the effect of transferring all or part of investors’ exposure away from issuing municipalities to more creditworthy commercial banks.

**Credit Rating.** Local governments planning to tap the credit markets may find it beneficial to avail themselves of a credit rating by a recognized rating agency. A rating entails a credit agency review that would measure local government ability to service debt in light of available taxes and other resources, and assess their record in honoring financial commitments, especially under adverse circumstances. Relevant areas of focus would be the economic and social characteristics of the constituency, and the structure of the government debt and financial operations (including sources of revenues, spending requirements and unencumbered cash available). Improving the credit standing of municipal issuers requires that municipal tax bases be expanded, tax rates rationalized, and that local (including infrastructure) investments be screened to select those that have large pay-offs in helping cities develop services, expand business and increase employment.

As a general rule, no issuer will receive a rating that is higher than the sovereign rating of the jurisdiction in which the issuer is located—the so-called “sovereign risk ceiling”. This reflects the risk that the depreciation in the value of the local currency or imposition of foreign exchange controls might restrict the ability of sub-sovereign issuers to honor their debt service obligations. Under certain circumstances however, securitization, through offshore receivables for instance, may provide the basis for a credit rating that may be above that of the sovereign.

**Bond Insurance.** Bond insurance should not be viewed as a substitute to the creditworthiness of municipal issuers but as a mechanism that enhances market acceptability of a debt issue and/or reduces its cost. Extending municipal bond insurance—an important feature of today’s US municipal bond markets where some 50% of total issues are insured—in developing countries would be contingent inter alia upon the existence of: a large pool of debt instruments, including corporate and municipal issues, which could be insured—allowing for the necessary diversification underpinning the insurance concept; and consistent credit ratings that respond to the credit-conscious investor base of the municipal markets.

**Pricing of Local Government Debt**

In countries with market-determined interest rates, the “risk-free” central government securities—deemed to be free from credit risk as these carry the full faith and credit of sovereign governments when they issue debt in their national currency—provide the reference yield curve (benchmark) for pricing other debt obligations including corporate and municipal issues across the maturity spectrum. Some developing countries still conform to a different pattern where administered interest rate structures make the ready identification of a benchmark difficult. (In China for instance, where the bond market is under relative government control, non sovereign debt issues must comply with the State credit plan. Coupon rates on corporate bonds and rates on commercial bank deposits may not be higher than those on government securities of comparable maturities.) Efficient credit markets require that the level and structure of rates reflect economic conditions where: (i) short-end, base rates (e.g., US federal funds rate) are set by monetary authorities in the context of monetary policy objectives; and (ii) long-term rates reflect inflation expectations as expressed by the “market”—i.e., investors in the primary or secondary markets. Debt by non-sovereign, including municipal, borrowers can then be priced at a spread above the reference risk-free yield curve, where spreads reflect issuers’ parameters in terms of creditworthiness, liquidity and size. When the government market cannot provide a benchmark due to the absence of market-determined interest rate structures, or the absence of securities in specific maturity ranges—such as India where there were no government debt issues beyond a ten-year maturity—efforts have to be made to develop “synthetic” benchmarks (or proxy yield curves).

**Infrastructure Banks**

Mobilizing foreign equity to fund infrastructure investments in developing countries has now become common, although selective in terms of countries and sectors, and often flowing in enclave investments. A strong challenge for local governments is to raise debt finance in the domestic as well as eurobond markets. A number of developing countries have established “municipal development funds” as a channel for municipal credit. Many of these funds have been mainly substitutes for government grants to municipalities.
Others now seek to serve as a bridge to private credit markets in borrowing on the domestic or foreign markets—though mostly with central government guarantees—and lending to municipalities, directly or through domestic banks.

A challenge would be to move this concept further along commercial principles, and assess the feasibility of establishing “infrastructure banks” that could issue "market-based" long-term debt (neither guaranteed nor subsidized by the government) for viable, revenue generating infrastructure investments. The in-built diversification of the portfolio of these banks resulting from the variety of sub-sectors/borrowers, and hopefully the quality of their investment portfolio: (i) would provide a good security for, and strengthen the credit quality of, the debt issued; (ii) could open for smaller borrowers (companies and local authorities) the access to the debt market; and (iii) would allow the use of credit enhancement mechanisms (such as bond insurance) which may be brought to bear only in the case of an expanded and diversified pool of debt. These might be domestic or international funds that raise resources through bond issues in developed and/or developing countries. (The US “State Revolving Funds” provide an example of infrastructure banks with an element of public support where lending is mostly accomplished in leveraging central and state capital grants through bond issuance on the municipal debt markets.)

CHALLENGES AHEAD

In developing countries, municipal infrastructure investments require an enhanced institutional base and increased financial resources. Private provision of services and concession arrangements are rapidly developing across countries and sectors. Where these cannot be put in place for the delivery of essential services, fiscal resources could be leveraged by tapping the long-term credit markets best suited to the long-dated maturity requirements of infrastructure finance. A number of developing countries have made progress along this path, with Latin American relatively advanced in the process. In other regions, South Africa has a relatively developed capital market and a public debt market with a meaningful volume of local government debt outstanding. Some large cities have been able to issue foreign currency denominated debt in the eurobond markets. In April 1994, the city of Prague issued US$250 million in five-year, fixed-rate notes that had a “BBB” investment grade rating. More recently, in July 1996, Rio de Janeiro issued US$125 million in three-year, fixed-rate “direct, general, unsecured and unconditional” obligations of the city. Despite a “B” non-investment grade rating, the issue (priced at a spread of some 400 basis points over the reference three-year US treasury note) was well received by international investors. Other large developing country cities are now considering debt issues on the eurobond market.

In the municipal finance sector, the World Bank is currently directing efforts at: assisting in regulatory reforms; clarifying inter-governmental fiscal relations; promoting the private provision of local services; addressing resource and capacity constraints associated with decentralization; strengthening the institutional setting for service delivery by local governments; and supporting capital market reforms.

Parallel efforts—involving commercial banks, debt underwriters, institutional investors, bond insurers, utilities operators, rating agencies, regulators and central and local governments—should be directed to creating the conditions for the development of domestic credit markets for local infrastructure finance and helping developing countries establish markets for general obligation bonds (issued against the tax collection powers of local governments) and revenue bonds (secured by user fees) which would not create or imply contingent liabilities at the sovereign level.

Beyond the broad financial sector reforms required to foster domestic savings and efficient credit allocation, such efforts should aim at: (i) improving guidelines regarding accounting, disclosure, auditing and credit rating; (ii) developing underwriting and distribution capabilities for domestic debt issues; (iii) structuring credit enhancement mechanisms involving bond insurance, securitization and other risk diversification and transfer measures; (iv) helping define benchmarks for pricing municipal obligations; and (v) assessing the feasibility of establishing commercially viable infrastructure banks.

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