

Municipal Bonds Market in Latin America and a Case of Developing a Market in Ecuador

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ABSTRACT

The need to meet the deficit gap on public infrastructure, together with urban growth in Latin America has multiplied demand for investment in water systems, wastewater collection and treatment, roads, and other facilities. While the projections of urban financing needs may differ among analysts, there is general consensus that substantially higher levels of financing on urban amenities will be required in the future. The advantages of using bonds to finance urban infrastructure are increasingly evident in emerging economies. Infrastructure project financing in Latin America calls for a change from a model that has proven to become a vicious cycle of debt. Ecuador is leading the region on the trend of restructuring its debt with international financial institutions and looking for new and fairer ways of debt. Infrastructure financing needs of municipalities in Ecuador have traditionally been met from grants and transfers from higher levels of government, state-owned institutions, and to a much lesser extent by bilateral and multilateral agencies providing grants and loans. This document presents an overview of Municipal Bonds market in Latin America, and presents a case for building a market in Ecuador.

1. INTRODUCTION

Investment can be regarded as an act of forgoing current consumption by allocating economic resources such as labour and capital to create increased capacities for future production and income. In the case of infrastructure, investment typically involves building new or maintaining existing long-lived physical assets.

Infrastructure investment mostly requires significant outlays during the asset-building phase of a project. On the other hand, the revenue flow to be generated from an infrastructure project, or its funding (in the case

with social infrastructure) is spread over the economic life of the asset. This can lead to a divergence between the supply of and demand for project funds over time, even for projects that have the potential for full cost recovery.

2. INFRASTRUCTURE PROJECT FINANCING

The financing vehicles used by governments fall into two broad categories:

- 'pay-as-you-go' (PAYGO) — various fund sources within the public sector.
- capital-market financing — borrowing or equity contribution from private sources.

Traditionally, these funds were largely allocated through capital outlay and work program budget appropriations. Recent decades have seen an increased use of off-budget financing, reflecting the shift of some infrastructure responsibilities to government businesses.

3. PROPOSING A MARKET FOR MUNICIPAL BONDS IN ECUADOR

3.1 LEGAL FRAMEWORK

According to Ecuador's Constitution (Article 238) and the new territorial organization of the State, the following councils should be known as autonomous decentralized governments: rural parish councils, municipal councils, metropolitan councils, provincial councils and regional councils.

Focusing on a municipal analysis and according to the organic code COOTAD (*Código Orgánico de Organización Territorial, Autonomía y Descentralización*, by Spanish) in Article 53, defines the municipalities as "legal persons of public law, with

political, administrative and financial independence." COOTAD (Article 163) also provides that municipalities must obtain incomes from management of own resources, and from state transfers.

Another source of income can be obtained by attracting internal or external savings to finance investment projects. These resources come from the placement of securities; going to public debt and resources from prior year positive balances.

3.2 MUNICIPALITIES IN ECUADOR

Ecuador currently has 221 cantons, which are also called Municipalities and they enjoy political, administrative and financial independence. The municipal revenues depend heavily on transfers from the general budget of the state; the other amount that is part of municipal revenue comes from the generation of own income.

While the investment for public work at 2009 was \$ 1.336 million, in 2010 was \$ 1.173 million and 2011 was 1.471 million.

The category that was used to further investment by public works was Public Works and Highways Transportation with an average of \$ 303 million, followed by Construction and Beautification with an average of \$ 233 million and finally Constructions and Buildings with USD 209 million.

3.3 BOND RATING

Almost all countries that have introduced municipal bond financing have also introduced or supported the introduction of credit-rating agencies (Cheung and Chan, 2002). However, the role of credit ratings in newly formed local credit markets is significantly different from the public monitoring function that is so critical to efficient bond market operations over the long run.

Typically, bonds can be issued in the domestic market only if they attain a minimum credit rating from an authorized credit-rating agency. This arrangement has several shortcomings as a precedent for a self-sustaining bond market. First, the arrangement substitutes a quasi-private rating process for full public disclosure. Second, the underlying information necessary for an adequate credit assessment may not be provided to the credit-rating agency and is very rarely the subject to public disclosure requirements. This is even worst in Ecuador where most local councils do not even have books of account.

4. FUTURE RESEARCH

To resolve this potential development clash, it is critical to enable the emergence of an orderly and efficient municipal bond market so that it can make its full contribution as an integral part of the development of the financial system. To achieve this, it is important to understand what are the specific features that make the municipal bond market different from other segments of the domestic bond market, focusing in particular on the structure of the market, the structure of incentives among market participants, the evolution of market development constraints as part of the development of the financial systems, and to understand what are the implications of these specific features for the design of policy reforms in the structure of incentives for market participants and in the legal, regulatory and institutional environment for the market.

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