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CHALLENGE OF FINANCING DEFICITS IN THE TRANSITION ECONOMY

The October 8, 1997 session of the Washington International Financial Management Forum was very pleased to welcome Gennifer Sussman, Associate Director, Office of Technical Assistance, U.S. Treasury Department, as its guest speaker. Mrs. Sussman spoke on the "Challenge of Financing Deficits in the Transition Economy." She was introduced to the meeting by Don Drach, Deputy Director, Office of International Liaison, U.S. General Accounting Office. Following is a transcript of her remarks together with a resume of the question and response period which transpired.

Remarks of Mrs. Sussman

It is a pleasure to be here today. I am going to discuss some of the issues that we face in working with the transitional economies of central and eastern Europe and the former Soviet Union. Our program is focused on these although we have expanded somewhat outside that area and I will touch on our experiences in these countries as well. But I thought I should talk about process as well as some of the technical issues that we face and the special characteristics of some cases in former Communist countries.

What is the purpose of technical assistance and what is so special about the way we do our technical assistance? We have four teams and we focused on taxes, banking, budgeting and government debt management. These are areas in which the U.S. Treasury has some expertise. So there are specific areas where we provide technical assistance and these are coordinated with other AID programs in other areas.

I am going to focus on what we do in our team. Now, our approach is primarily to have individual advisers that will go to a country that has a need for assistance in setting up its government debt market. We don't go into projects, we don't take teams, we place individual advisers and we typically go to a country for a two year assignment and we work with the Ministry of Finance and the Central Bank. It is a very nuts and bolts approach to what each country needs. The advisers tend to come out of Wall Street so they have extensive backgrounds. They are usually senior people, some of them have made their money and want to do something interesting, some of them are younger and are taking a break from a career and then coming back to it. But they come with a tremendous amount of expertise and dedication and they really are the experts. They are really a long way from where we sit here in Washington when they are out in Kazakhstan or elsewhere and they are providing expert advice to the Ministry of Finance and the Central Bank.

Most of our program focuses actually on the less developed countries of the former Communist world. Our group has not been active with Russia. Our program began about 1993. We have done a little work in Poland, Czech and Hungary, but our resident advisers are spread around in countries which are at the starting end of the spectrum. We just placed an adviser in Georgia who helped them with their first issuance of treasury bills. We have been in at the start of the market in Armenia, we have had someone in the Ukraine for a couple of years, we have had people in Kazakhstan, Kyrgystan and Latvia, and we are about to put someone in Albania when things settle down a bit. So these are pretty much places that are starting on the road to good fiscal and financial management.

The funding source for our program is through the foreign assistance budget. The money comes to us from USAID and it is funded through the SEED Act -- Support for European Democracies -- and the Freedom Support Act for the former Soviet Union. So it's the funding source that determines primarily where we work. These are programs that are intended to phase out. The idea is that those countries will graduate and in fact some of the more advanced economies are starting to graduate from the program. We have been starting to work a little bit in other parts of the world. We have a budget adviser in South Africa and we have a budget adviser in Haiti. For obvious reasons often the budget adviser goes in first, because unless you have some idea how you are spending and what your sources of revenue are and what your deficit is, you are not going to have much of a Treasury market.

When is a country ready for technical assistance from this program? We usually go in where there is an IMF agreement, which means that the country is on the way towards financial and economic stabilization, and there is a framework for tackling the problems we deal with, also where the U.S. government has a policy interest in stability in the country, in having a relationship with the Ministry of Finance, and the U.S. Treasury has a feeling that the government is going in the right direction and has some interest in working there.

A country has to request an adviser, but often they don't know what is offered unless you go in and explain it to them. And it very much depends on targets of opportunity. It is very difficult to plan, it is very difficult for us to say we will be in such and such country in two years. As with countries such as Albania and Bulgaria, you wait and see what's happening. When the time seems to be right, you go in and sit down with the people in the Ministry of Finance and the Central Bank to see what their needs are and go from there.

In addition to the resident adviser, we have a team of intermittent specialists. If a country is trying to write its public debt law or deal with settlement issues we can bring in a specialist in that area for a short term assignment. Needless to say when you are dealing with the whole spectrum of setting up a government's securities market, the resident adviser isn't going to know it all and there are often areas where they need specialized support.

We manage actually from both Washington and Budapest. We have an office in Budapest and each team has an associate director in Washington and a senior adviser in the field. They are the front line technical managers of the program and do a lot of travel around the region. By definition it is a high maintenance program. We hire a support consultant to aid the subcontractor in each country. They deal with the logistics of making sure people have computers, assistance and so forth, then we are their technical life lines. We spend a large part of our day on e-mail and and fax as well as telephone, but given the time differences we have to rely a lot on electronic communications in trying to provide support to the field.

The mission of our particular group is to try and provide a noninflationary means of financing the country's operating deficit. These countries in general are running quite substantial deficits. The deficits are often not well defined in the sense that there is still a lot of stuff that's not on budget and there is a lot of past history that might not yet be fully acknowledged in the budget -- countries are dealing with substantial arrearages, dealing with revamping pension plans. So it is almost a parallel process of getting good budgeting and getting acknowledgement of what are, in fact, the liabilities -- all of the government's guarantees, which are contingent liabilities; external debt which may not be properly tallied. So there is a whole parallel process of getting your arms around what, in fact, is the size of the problem at the same time you are starting to market the financing of the deficit itself.

The IMF usually looks very carefully at the numbers and there is a target deficit although countries may go over that. But the sources of funding these deficits are moneys from the international financial community, or initially the Central Bank basically printing money which is highly inflationary. So to come in and start a government securities market where you are harnessing the money in the country and providing a securitized source of financing to the government is starting it on the path to controlling inflation and to better financial management.

We also provide a tool for undertaking of monetary policy, because the Central Bank, as it does here, needs a stock of securities for conducting open market operations and for control of the money supply. Typically the Central Bank, as it is here, is the agency issuing government securities. The Ministry of Finance is the issuer and the Central Bank is the issuing agent. There is often a lot of back and forth about who, in fact, is going to establish the rules and actually run various parts of the operation as there would be in any country. But there is a need to work very closely with the two institutions, and historically, typically they have not worked well together. Central banks tend to be very independent. The Central banks in that part of the world, like many, tend to have the better educated, better trained people. And these are not people who have a history of problem solving, of working together, of picking up the phone and saying there is an issue to be solved. It is partly a function of the fact that the telephone lines don't work well. Our international lines to the U.S. system work better than the phones to the next agency. And so there is simply a lot to be done to teach the people how to work together, how to set up a working group, how to set up an interagency or interdepartmental group. So while you have advisors with a lot of financial expertise, a lot of the work that they do day to day uses basic management and problem solving skills.

We see this development of the primary market for government securities as an important step in establishing financial discipline, because it does put financing of government on a sound footing and also the government securities market then provides a building block for the broader capital markets. Typically the sale of treasury bills starts out with a three month bill and then gradually, as there is acceptance, the maturity schedule can expand to six-months, one-year, and on out to two-years and five-years. Then you start to have a bench mark yield curve and the other interest rates in the country, as they do in this country, have something to be measured against as the capital markets get going. Once there are other instruments in the market, the treasury market becomes a benchmark to measure against.

Another thing we do actually is to serve as financial adviser on international transactions. Many of these countries now are getting credit ratings. They have a parade of investment bankers, many of them American, but also from other countries, coming through and selling their wares. And these countries really have no idea how to select a good investment banker, how to deal with the document process and make sure it protects the issuer as well as the investor. We have one man who is a specialist in this who works out of Budapest and who has been extremely valuable starting Poland, Romania and Kazakhstan through their process. Ukraine is now going to go into the international market. So we are working with these countries and basically training these people in how to go about this. There is a lot of political pressure from the investment banks, who would like to get the deal signed and sealed and supporting budgets. It really goes back to exactly what they should be doing, whether they should be doing a deal in yen or dollars and so on.

There are very common universal problems in working in these transitional economies. First of all there isn't a framework. Usually you start up a market without an institutional framework and then you gradually try to build the legal and institutional framework. Some countries have one piece of it and some others have another. There is a fundamental lack of trust in government which is not surprising. There is unclear authority to issue. Often the authority of the Ministry of Finance to act as an issuer of debt is not clear in the absence of a public debt law. It may or may not be established in budget law. There is a lack of confidence in the banking system.

Initially the major institutions participating in the government securities market are the major banks, many of them are still government-owned, many of them are insolvent. This is obviously a situation that is changing very fast. Over the period of the last three years of watching, the banks are starting to be privatized, but often the largest and most difficult banks are the last to be privatized. It is difficult to be sure whether you really have got competition among the banks. And so you simply set up the rules in such a way that you try and assure as much as possible that the banks actually are competing among themselves.

But the people tend to not have their money in the banks. They don't trust the banks despite the fact that interest rates are quite substantial and if the money were invested in government securities or in the economy, they would be doing much better. There is still sufficient mistrust that the money doesn't get into the banking system unassisted. So once you have a primary market and you are selling treasury bills, how do get beyond that; how do you persuade the individual investor to put money into the system? It is probably going to be the case that a mutual fund approach is going to be an easier way of doing this, gradually getting other financial institutions into the area and expanding the ability to get money into the system.

Inflation is only recently under control in these economies, if it is at all. That makes if very difficult to have any realistic expectations of what interest rates are going to do. If you have dramatic changes in inflation from month to month, you should get substantial moves in interest rates. But it makes it very difficult for people in government who are used to controlling everything, to let go and actually let the banks or outside investors or individuals bid for government securities without knowing what the outcome is going to be. They tend to think that if they can just figure it out they would know what interest rates should be. And historically it has been proven over and over again that if they will let go and let competition set the price, the interest rates will start to come down. But it is very difficult for people who are so used to a controlled environment to accept that.

I mentioned the fact that there has been a lack of a budget framework and no proper definition of what is a deficit. There is still strong pressure for the government to guarantee everything. There is not a history of risk taking. The idea of the private sector should be taking risks and you can't turn around and expect the government to guarantee every private deal that is going to be done. It is difficult. And helping these countries set up some way of evaluating risk, of dealing with contingent liabilities and budgeting for having a risk fund for guarantees is another important part of getting control of the whole picture.

Some of the mechanics are a problem. Reregistration tends to take a long time, impairing settlement. There is a lack of transparency so that people will know what is going on in the market. And some things that are usually somewhat easier to clear up -- the book entry system, the ledger system, the ledger of national debt. When we went into Ukraine two years ago, it took three weeks to get changes in the registration of a security. Well, it was a long period during which something can go wrong and often does. And so tightening those time frames up to international standards has been a substantial interest in many of these places.

The path that we see these countries as being on is to start out with the first issuage of government securities, sold in significant volume to the banks inititially and then gradually getting nonbank participation in the market. As part of that the banks develop an understanding that the function of a financial intermediary is to make a market, to actually go out and find sources of money instead of just saying "we have capital." And it is easier to buy securities then to figure out the risk of lending it to the private sector.

So then comes nonbank investor participation. Often outside investor participation helps a lot because if foreign banks are participating in the market that does help build confidence among domestic investors. In fact, foreign banks are starting to form institutions that are starting to buy in these markets because the interest rates are good. Whether they are always commensurate with the risk they take is an open question. But without question, investors are looking for yields and they will buy in those markets. Then, in time, debt financing this year's deficit entirely within the year in which it is incurred and then they can start looking at financing past deficits, which often are outstanding debts to the Central Bank and fully securitizing their debt.

Then you get around to looking at sound risk management and looking at what is being borrowed domestically and externally -- what are the risks -- and trying to get a framework for making sound decisions as to what you should be borrowing domestically and what externally. At this point there is a tendency to want to do external debt as soon as you are able because it looks cheaper. It often isn't cheaper given the currency risks involved and economically its not very sound to be financing your basic arrearages with foreign debt when you don't know where you are getting a source of repayment. It is much better to be financing your domestic deficit domestically and use your external financing for infrastructure projects, things that are going to build the economy and one hopes build a source of repayment. But there is not a lot of analytical capability. It is a very ad hoc decision as to what is done domestically and what is done externally, without a sound basis.

And then cost of finance really comes fairly late. If you are going to get these markets going you really need to throw them open, have an auction process and let the bidders bid for the debt. Trying to manage costs comes actually somewhat later in the process. We try to encourage them to work on some of the other things and worry less about costs because those tend to take care of themselves over time.

Looking at some of the countries that we have been dealing with, there are very interesting comparisons. Ukraine is a vast country with enormous potential. Institutionally it has been very difficult to work in. I know that some of you have been working in these parts of the world and have had experiences, probably similar ones. We were not able to get advisers into the Ministry of Finance of Ukraine, which has been typically referred to as a black hole. It has been very difficult to get information and find out who is doing what. We put an adviser in the Central Bank who has been very successful. Often where there is a small group of well trained people, they are young people. They are a sponge for information, they are willing to try and start doing things right and you can make major headway in one area while you are waiting for another area to open up. The Ukraine has come a long way towards financing its deficit internally. It started with its first issuance in early 1995 and it is now financing the bulk of its domestic deficit. There is still a lot of short term debt and it is difficult to roll over. As they can extend the maturity structure it will be easier to roll it over. There is a substantial amount of outside investment, but still a lot of Central Bank participation in buying securities, which means that it is securitized, but you don't really want that much of it going to the Central Bank.

Now finally the Ministry of Finance has opened up and has accepted a budget adviser. We are also placing an advisor to work with the Ministry on both domestic and external issues. We hope to open up lines of communication between the Ministry of Finance and the Central Bank, because it is not ideal to be issuing debt without good information from your Ministry of Finance as to what is going on with the budget and the revenues and what actually needs to be financed.

Armenia is a small country. There we were lucky and found an adviser who had actually spent his formative years in Armenia and spoke the language, which is very unusual. This is someone who came out of Moody's and went in and really started their market for them. They now have a Minister of Finance who is thirty two and the key person at the Central Bank is twenty eight and moving up -- very sharp, well educated young men who are moving into positions of real power. That provides an opportunity to do a lot more than in some other countries where the people from the old hierarchy are still very much in control. There you find the more innovative young people coming in the middle ranks, but not really able yet to do everything they would like to do.

Romania has been a real turn around, because as you know there has been a change of government. While things have been stalled we have been working in Romania for three or four years. We had an adviser there for about a year before he was able to do a great deal. Then with the change of government and a real commitment to do things right, there was an overnight change in regard to writing a public debt law, having an interagency working group. The Minister said "it will be done and it will be done right" and there was an immediate change and things have been moving very fast there and moving very well. They have been doing a sort of subscription process for government securities, setting interest rates. We finally persuaded them to go to a market process which has been working very well. Inflation has been bouncing around in Romania this year so that is a problem. Interest rates got pushed up substantially.

Then you find funny situations like in Lithuania where there is not a large deficit. They have tended to just go to external debt because they have got a credit rating. They need to build their domestic market for consistency, but right now they have forced interest rates down to three and a half to four percent with inflation running ten percent. This makes no sense at all -- so you know somebody is trying to control the market. Again what is typical is a lot of institutional obstacles to getting a good secondary market going.

Very often the tax regime is unclear or is inconsistent concerning the taxation of government securities. It makes it very difficult to trade because you know what will happen if you hold them to maturity, but you don't know what you will actually be liable for if you trade. Often there are transaction taxes on both sides of the transaction, so again if something trades it sets up unrealistic costs. That's a problem we have in Moldova, that's been a problem in Lithuania. Often it is a question of going in and finding sufficient focuses as to who can deal with the problem. Everyone knows it is a problem, but getting someone to do something about it is difficult. It is a question of setting down what the obstacles are and who has to do what to get them fixed. Just trying to work through all of that.

Georgia has been very interesting because they are just starting out to sell their first treasury issue. There it was interesting because they are very strong willed and much more willing to ask questions then I found out in a lot of other countries. They are very confused for instance about what is the role of a securities commission as opposed to the role of the government in issuing its own debt. In their mind, this was all "capital markets." The only two people in the ministry who knew a lot about securities were doing SEC-type stuff so they were going to do the government debt issuance also. So in talking through the whole issue of roles and responsibilities and some sort of separation of those functions, they were extremely responsive. We happened to be there just when they were really start-ing to deal with it. But it was an interesting process of starting at the beginning and trying to sort out these roles.

I think I am going to stop at that point and let you ask questions. Just to close I might mention that one of the things that the U.S. brings to bear -- we don't tell countries how to do it, we try to tell them how a lot of different countries are doing it and what the different models might be. Often the way we do it in this country isn't the way you would do it if you would set out to design a model particularly in the regulatory area. But we do have a lot to offer, and in the debt management and treasury issuance area most of the western European economies are shifting towards the way that the U.S. does it. So there is a general shift to the way we in treasury do debt management in the United States.

One thing we do particularly well in this country is long-term debt financing and it is partly due to the tax exempt structure of revenue bonds. But in most countries it is very much troublesome, especially in the transitional economies who are looking for ways to do long-term financing and will be gradually looking at the U.S. model. There is a tremendous amount to be done in these countries in how you deal with infrastructure finance, what's the relationship between the central and provincial local governments, how much control should the central government have? All these things are open and will take years to resolve. So I am sure it is the same in areas you are working in more closely such as auditing and accounting. You tackle specific problems and try to keep things moving knowing there is a whole raft of other things that have to move forward at the same time -- collateral law, bankruptcy law -- in order to have a good market.

Question and Response Period

Jim Durnil of the National Rural Electric Cooperative Association inquired how receptive are they to your advice? Mrs. Sussman responded that in general they have had good luck since they only go in where they were asked and say very specifically that they want an advisor and they will provide office space. So far we have managed to avoid the situation where an adviser who is isolated, but that can happen. I think we have had some luck, but it is also partly due to how it is set up. Mr. Durnil followed up by inquiring if there were some units that are more receptive than others. Mrs. Sussman replied that was definitely true. It also depends on how interested the Minister is. If your middle management are interested you may still not be wholly effective until they move to higher levels.

Don Lounberg of the Barents Group said he wondered how a country would pick an adviser. It seemed to him that you could have AID and others colliding with the World Bank and IMF and others, so if you are a country how do you pick a donor you will listen to? Mrs. Sussman stated that there is some colliding, but in the area we work in there is not that much and it is because of the way we work. Some donors are doing projects and some donors are placing advisers. There is a whole network of central banks that provide central banking advisers. That is worked through the IMF and certain central banks provide advisers in specific areas. So we don't normally provide advisers on central banking or monetary policy. AID does capital markets development through consulting firms. There are a number of outfits that will do capital market development projects. We actually haven't found anyone else that is doing this government securities market development with rare exceptions. There is a Swedish expert who is providing external debt advice in Lithuania and we have been working with him. But the roles are well defined ahead of time. The idea is that Treasury is working in areas that have been carved out. There shouldn't be a lot of run ins. Our banking team, which works in bank supervision, always looks to see whether there is another specific group there. But in our area there is not that much of that.