

ABOUT "SOVEREIGN" LOANS AND WHY IT MUST BECOME "ORDINARY"

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1. Introduction

In the last 20-30 years, in most countries with market economies have risen public spending faster than current income. It became necessary that a state must find additional financial resources, which can be achieved either by increasing and / or the imposition of new taxes, by increase of state corporate profits, either by state credits; the solution of money paper emission is much narrower for Romania and EU countries, be cause of monetary conditions imposed by EMU and B.C.E.

Increase of taxes or establishing of new taxes is uncomfortable for the state, so it uses frequently public credits, i.e. internal and external loans and a part of the income of the population temporarily available at banks as deposits. Thus, the state may have money available to cover its needs.

2. Methodology and objectives of research

Article seeks that, on basis of sovereign loans particular elements, which I consider to be inconsistent with the basic principles of prudent banking, the banking system, in principal affected by the credit state crisis, must change the mechanisms and procedures for giving credits to states, thus prudent banking rules applying to all borrowers.

The emphasis is on the need that state or lending institution (or issue securities / bonds) to provide guarantees, their value influencing the decision to grant credit and its value, in the same way as ordinary credits.

In this respect, the paper shows that the use of evaluation systems based on economic indexes doesn't work better. In many cases the result is often avoided because it creates political complications (What kind of parameters to consider? or Are the calculations good?) and uses old statistics (however over 6 months).

The article is based on developments of public debt from 2000 to the present, this evolution showing that the approach based on economic indicators is not fulfilling its role of measuring the power of a State or government to pay its debts.

3. State credits versus individual and business credits

Referring to the sovereign loans, a prominent bank president said that <<banks were "saturated" to lend more money to Greece>> and perhaps to other states in its situation.

As we will see below, not just banker's allegations about lending of state entities (governments, agencies, national companies) fall into sin of libertinism, but also the actions that they do. These actions reflect the common behavior in relationship between banks and state, a behavior very different of that practiced in relation with individuals and private business.

The chart no. 1 shows the situation of General government gross debt (percent of GDP) in some countries in the euro area, which shows that Greece and Italy had problems before of 2000 year (when the ratio value was still above 100%), which shows that these countries are heavily indebted. Even might ask: ***How were admitted Italy and***

Greece in the Euro zone, where the debt limit imposed by the Maastricht Treaty is 60% of GDP?

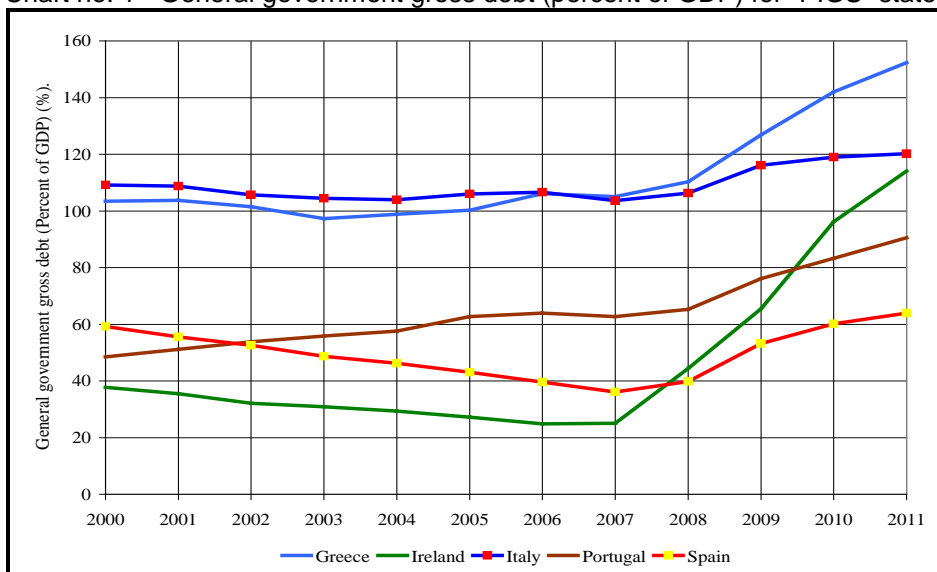
Persistence of this problem over 10 years can not be attributed only to these states, but also those who credited, which would have to impose the payment of these debts. It is obvious that instead of a tougher position, the banks accepted a "rollover" or even an increase in debt, that, under the sharp drop in GDP (caused by the global financial crisis), has led to a dramatic increase of General government gross debt (percent of GDP) to 120% for Italy and 150% for Greece.

Even to characterize the debt of a state are diverse and complex kinds of

analysis, we believe that they do nothing but to hide the real situation behind the figures. **In our opinion, the strict application of simple rules of credit, which will be mentioned in the article, is enough for a good analysis in case of giving a credit to a state.**

It is the prerogative of a bank to can establish a state credibility, referring its public debt, following the compliance of its credit agreements and possibly their refinance. As the bank can do this for millions of individuals and business, more easily it can follow the tens or hundreds of public entities.

Chart no. 1 - General government gross debt (percent of GDP) for "PIGS" states



Processing after I.M.F. data (<http://www.imf.org/external/data.htm>)

A special problem is to obtain loan guarantees, one of the basic conditions to obtain a credit. This rule, otherwise we can not call it, that a state does not provide guarantees for loans contracted, is, according to facts spent in the last 30 years, a big mistake.

If in the distant past "the word of a king" was the supreme guarantee, being, probably, other advantages of the status of its financing, the financial and social situation now is different, governments

are often changed and the new government "forgets" the old debts and acquires new loans to solve its problems.

Given that state sovereignty was limited, the state property, in time, has accents matching with a private property, and if this is true, *the state property* (or part of it) *can get quality to be a guarantee for bank loans and ownership of these collaterals* – e.g. foreign exchange reserves, gold, silver and other precious metals and gems, real estate

(land and buildings), securities (shares, bonds), fuel and grain reserves, rights (e.g. royalties on oil or gas extracted in the national territory, state revenues (customs duties, excise duties, fiscal monopolies, etc..) or even works of art or heritage – *could be transferred from debtor to creditor.*

We do not see why the actions of a state at a national or international companies or investment funds, interests in partnerships for management of infrastructure objectives shouldn't be credit guarantees. Obviously, the state properties are diverse and these aren't the subject of this article, **but the principle to present guarantees must be applied to state loans, as in case of usual loans.**

Amid crisis of sovereign debt, mostly related to the case of Greece, in the current discussions appears the anecdotic idea that debt is possibly to be cover by sale of Greek islands. In this way practically it's recognized the need of loan guarantee.

An operation for the sale of state properties to pay debts owed, as suggested, involves several drawbacks, such as:

- sales value would be small, well below assessed value, this situation being caused by the seller situation, witch should in short time to conduct transactions;
- legal problems could delay this operation. Undoubtedly, the transfer of ownership or other rights under these circumstances, it is very difficult to do;
- a difficult political and social situation, practically a social-political crisis, would aggravate very much all efforts, and a opposition to such measures may appear both in the political (parliamentary opposition) and social (unions and other organizations).

If in this kind are treated states as banks' debtor, how are treated individuals or representatives of private companies?

At the request of credit, the representative of the bank (credit officer, agency or branch manager) does not tell to client that <<my bank is "saturated" to lend more money to you>> but, as everyone knows, will require to fill a credit dossier which will be further analyzed, and the individual or company will qualify for this credit or not.

Why the states should qualify for credits otherwise than non-governmental economic entities? The mere existence of public institutions or states does not constitute a guarantee for the loan.

It is known that one of the consequences of international financial crisis was the interdiction of a type of credit called in Romania "with identity card". The mere existence of a person, as evidenced by a identity card of the applicant and some persons-guarantors, may not be a real guarantee for a bank.

But what are the general criteria operated on lending to individuals and private businesses?

Lending operations of commercial banks are based on prudential banking as a fundamental principle of banking policy. Essentially be observed some general rules such as:

- an economic history without problems, this means a fortune or a social capital which may be bank guarantee and credibility in relation to bank because of reimbursement on time for loans previously received;
- a credited business must generate revenues and cash to repayment and interest payment. For individuals are considered only certainly and permanent income;
- loans, regardless of amount or repayment period, is given to a fixed destination, mentioned in contract.

State debtor are subject to the same set of strict requirements? We will see below, after a presentation of state loans.

Regarding the refund period, they are:

➔ *short-term loans* (up to one year) - treasury bills, treasury certificates, etc.. - Contracted by the state to cover temporary resource gap due to mismatch between the time of the approved expenses and reception of revenues provided, due to decrease of revenue provided or when it need arises additional costs;

➔ *medium-term loans* (2-5 years) and long (over 5 years) - bonds, rent, etc.. - Contracted by the state to cover budget deficits, which have become chronic, or to finance capital spending higher.

In the public credit relations, the state appears as debtor, its creditors are, in addition to banks and banking consortia (which we refer in this article), insurance and investment companies, industrial enterprises, etc.

Destinations that receive amounts borrowed are different, they being used primarily for:

- financing the state budget deficit and temporary state budget deficits and social security budget, also;
- refinancing and early repayment of government debt;
- funding of projects / programs for development of priority sectors of the economy;
- financing of economic restructuring.

Compared with credits to individuals and private companies, the state loans have some *characteristic features*:

➤ loan's contractual terms are not imposed unilaterally by the bank, like for individuals, but they are agreed by parts. If for commercial loans only the bank impose all conditions, excepting for loans for large companies, *certain elements*, such as issue and redemption conditions, *kind and value of subscribers income, and other necessary elements are established unilaterally by the state*;

➤ Banks require individuals and businesses for providing a credit to present a certain material guarantee.

Conversely, for a state loan, **the state does not give such a guarantee to its creditors.**

As we know, the system of state loans differ from the system of regular credits, in fact that:

✓ **the state does not provide guarantees to creditors.** In addition, a less credibility or a lack of credibility did not prevent banks to lend state entities;

✓ **a loan finance only few investments that can generate income,** but more it cover deficits or refinance and repay government debt;

✓ **destination of funds is rarely known and controlled by the lender.**

In fact, for a state loan operation, the lender buys securities (treasury bills, treasury bills, treasury policies, bonds, etc.) that give the impression or are considered as investments. The state doesn't use money for a direct investment, but most likely to cover the current deficit, that means the state make outlays whose structure is unknown.

It creates such a fundamental contradiction between how is perception of bank about the loan, for it (the bank) is an investment, and use of that loan by the state, for current expenses (so far from an investment which is generating economic income).

Obviously, the loan will be used in certain areas, but it will be reimbursed from incomes of other economic areas. If this can be tolerated in the short term, a long term payment of this kind generates a loss and a chronic underfunding of the sectors that bring income, these being drained by higher taxes for debt return.

In addition, the practice until now has shown that repayment of loans by state is very difficult, in many cases states calling at convenient solutions, particularly, in the sense that only borrowers-countries can apply them, namely: consolidation, moratorium, repudiation or inflation the latter can be used only for internal credits in national currency, but also for foreign loans by the United States. They (U.S.) may pay their

loans by printing dollars, as cynically admitted recently, Alan Greenspan.

4. Romania's public debt

Public debt includes all amounts owed by the state (central government, local administrative units and some public institutions) to its internal and foreign creditors, and **government debt** refers to all reimbursable funding and obligations of state, contracted or guaranteed by the Government and Ministry of Finance.

Romania's internal public debt is created primarily by:

- issuance of bonds in national currency and foreign currency;
- state loans from B.N.R. and Romanian commercial banks;
- investments made in the general current account of state treasury by banks.

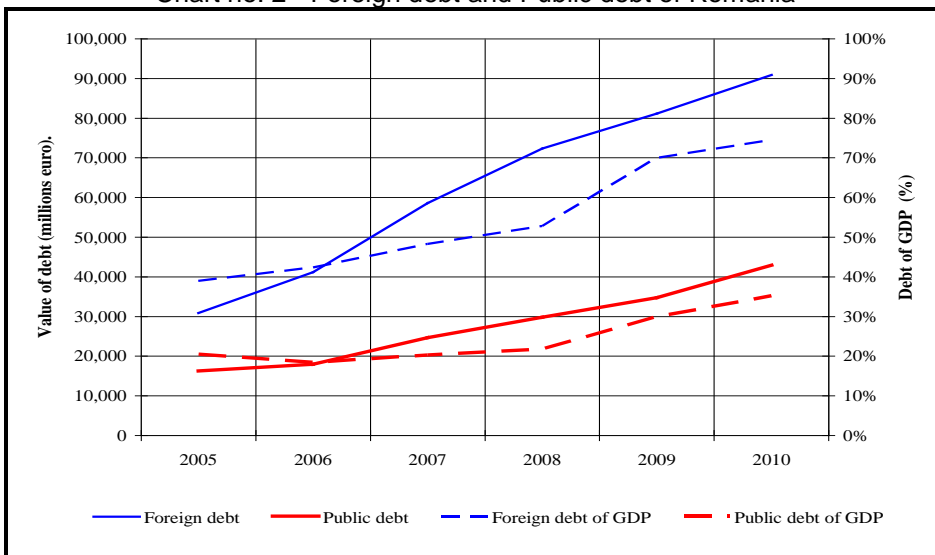
Romania's foreign debt is created mainly by:

- issues of bonds in foreign currencies on foreign financial market;
- loans from foreign governments, foreign government agencies, multilateral financial institutions or other international organizations;
- syndicated loans from foreign banks or foreign companies or direct loans from private investors;

Like evolution, Romanian public debt grew from 20.5% of GDP in 2005 to 35.2% of GDP for fiscal year 2010, and the external debt, during the same period, increased from 39 % of GDP to 74.5% of GDP (chart no. 2).

Financial needs of the state were covered in an overwhelming proportion by foreign loans, however, during 2005 - 2010 share of foreign loans in public debt fell from 97.2% to 86.4%.

Chart no. 2 - Foreign debt and Public debt of Romania



Processing after I.M.F. data (<http://www.imf.org/external/data.htm>) and Monthly Bulletins of NBR in the years 2006 - 2011

The data presented show that Romania has still a low gearing ratio compared with the limit provided by the Maastricht Treaty, 60% of GDP. Although our country certainly fits this conditionality, BNR Governor, Mugur

Isarescu, said on late of 2010 that "there are countries in Latin America which went into default with a debt of 20% of GDP". There are works in the economic literature which say that, although official ceiling for European governments debts

is 60% of GDP, in emergent countries, and Romania are in this category, a public debt of 40% of GDP makes the financial markets to become more nervous. Also, Romania's representative to the IMF, Mihai Tanasescu, a former finance minister, warned that "rapid increase in debt didn't lead to a real economic development" and that Romania can't afford a public debt exceeding 35% of GDP for the current state development of the country. Tanasescu's statement was made on January 27, 2010, when debt was 29% of GDP. But, if an economic analyst would see with attention the chart 2, might say: Look, we passed 35% of GDP (35.2% of GDP on the end of 2010) and nothing happened!

If at the surface the situation is calm, regular news announce us that the Romanian state negotiates another loan from banks in Romania or a bond issue, those facts clearly indicates that the Romanian state is unable to keep deficits under control. The small values in statistics for these deficits should not mislead finance experts, including those from abroad, because many of them know that Romanian government does not pay debts to companies and individuals from Romania than into the deficit limits agreed with the IMF.

Even if the Romanian state debt is still at a level which is not, formally, worrying, what can be observed is that the degree of growth is high and if this

growth of debts level will maintain, in 2013 or 2014 we shall reach at critical values.

5. Conclusions

The crisis of sovereign debts is one of long-term if we consider that the loans are, in majority, of medium and long term, and requiring not only temporary arrangements to solve it, as we did before, but sacrifices and tough reforms to lead at effective payment of these debts.

Also, we must rethink the system of state loans. **The solving involves the strict application of prudential rules** (by imposing guarantees), this increasing efforts of states to borrow money and changing government's attitudes about the coverage of chronic deficits, in the sense that a state must manage itself more efficiently or must increase its revenues.

If for the big banks, in 2007, there was the finding that they are "too big to fall" for sovereign debt, **some countries are too big to be saved**, meaning that their debts are too large to be paid by the rest of countries from their area.

Practically, **the solutions of sovereign debt crisis should be search only in financial system, using own economic and legal instruments**, the intervention of state having only role to delay the consequences.

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