Challenges in the Government Debt Portfolio Affecting the Fiscal Sustainability Stance in Georgia

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Abstract:- For supporting fiscal sustainability, which affects general economic conditions, including economic growth, a detailed examination of debt-related indicators is crucial. In this paper, an in-depth investigation of the risk factors is done regarding Georgia's government debt. Particularly, there are risks associated with currency devaluation, refinancing (liquidity), interest rates, and unproductive spending. According to the research, there are some challenges that need to be addressed by policymakers. It should be mentioned that the challenges exist despite the relatively low level of government debt in Georgia.

Keywords:- *Government Debt; Debt Sustainability; Risks.*

I. INTRODUCTION

By its broadest definition, government debt refers to the financial liability of the state to other parties (IMF, 2014). Based on the "Global Debt Database," over the last decades, almost all sovereign countries bear a substantial amount of debt to their residents and non-residents (IMF, 2023). At least theoretically, utilizing borrowed resources has good and bad sides. Particularly, good sides is increased ability of a government to finance the current needs of society above those guaranteed by taxes and other kinds of revenues. In this way, credit resources are an option for financing the increasing expansion of public and state activities defined by Wagner law (Holtfrerich, 2013). On the other hand, an uncontrolled amount of public debt can harm a country's fiscal, financial, and/or macroeconomic stability. The latter can occur in situations where risks related to government debt are neglected and/or when the credit resource is spent mostly on current needs without receiving any long-term benefit in return. Based on this theoretical judgment, the main goal of the paper is an evaluation of the risk indicators relevant to government debt in Georgia. It should be mentioned that some of these indicators are under the oversight of responsible governmental agencies in the country, but their policy approach to these indicators has some drawbacks that create challenges.

II. LITERATURE REVIEW

According to economic theory, the worst part of public debt stems from the default risk, which unfavorably affects economic growth (Woo, Kumar, 2015). The majority of defaults happen when the government's debt management procedure is unhealthy and there is insufficient oversight of debt-related data (Martinez et al., 2022). One study found that a nation's current macroeconomic state is greatly impacted by variations in the history of servicing and repaying its public debt (Chudik et al. 2017).

Many studies show that productive expenditures financed by credit resources are crucial for successful debt management on the one hand and for supporting economic growth on the other. To go back to the roots, this idea was originally developed by late representatives of the classical economic school. The idea was refined by German historical and other economic schools (Holtfrerich, 2013). In modern times, many economists empirically support that idea. Teles and Mussolini (2014) showed that under a healthy fiscal situation, increasing government debt could support economic growth, but productive spending is necessary. Moreover, according to some research, ineffective management of government debt causes it to increase at a higher speed (Wheeler, 2004).

Some authors point out the importance of lower debt service costs instead of a lower absolute amount of government debt. For instance, according to Joseph Stiglitz, the amount of debt is not a concern until it is spent in a productive way, but as it continues to grow, service costs on debt may increase dramatically. Under this situation, debt service costs limit the government's ability to spend resources productively (Stiglitz, 2015).

Some research shows that a good institutional environment is the foundation for a successful debt management process, which has a role in supporting economic health in any country. Good institutions make credit-resource-financed expenditures that support economic growth (Kourtellos et al. 2013). In this paper, we will touch on some legislative aspects in this regard, but the analysis of institutions is the subject of other research.

Additionally, mentioning the fiscal rules cannot be avoided in this paper as a risk limitation mechanism. Sulkhan Tabaghua (Tabaghua, 2023) analyzed the performance of fiscal rules in Georgia in 2023. The analysis showed that Georgia is a disciplined country without material or permanent breaches of the rules, and the country has a good position in this regard.

III. EVALUATION OF RISK INDICATORS ASSOCIATED WITH GOVERNMENT DEBT IN GEORGIA

When examining the government's debt-related issues, it is crucial to evaluate how susceptible it is to various risk factors. The realization of these risks on a significant scale is associated with the emergence of unforeseen obligations for the government, posing a notable threat to fiscal sustainability. As a result, to make informed decisions about fiscal policy, careful monitoring and regular assessment of the risks have fundamental value.

Historically, Georgia has been characterized by a low level of government debt compared to many other countries. Particularly over the last two decades, global government debt has increased substantially, and by 2020, it will have reached 99% of global GDP. Over the same period, Georgia maintained its government debt below 40% on average. As a result, the size of the debt makes the country's fiscal stance flexible to various kinds of shocks. However, the analysis shows that there are some risk factors that increase the vulnerability of debt level.

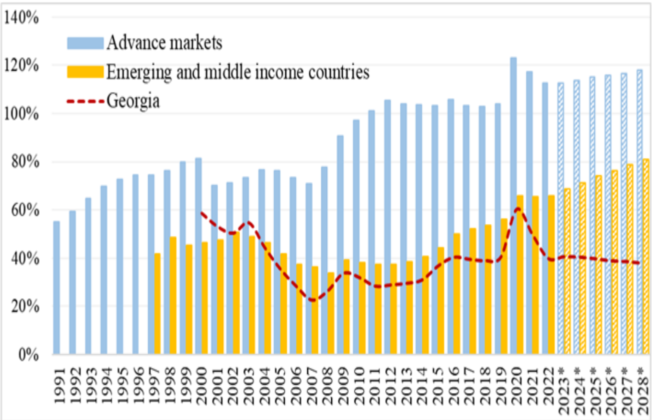

Fig 1. Government debt to GDP ratio for country groups and Georgia (Source: IMF, Author's calculations)

Despite the fact that many countries, including Georgia, use tools like the "Debt Sustainability Analysis Framework" or the "Medium-Term Debt Management Strategy," they do not fully guarantee the implementation of correct policy directions or policy measurement indicators.

In this paper, we will explore four types of risks. Particularly: 1) currency depreciation risk; 2) refinancing (liquidity risk); 3) interest rate risk; and 4) the risk of unproductive expenditures.

- *Currency risk*

In Georgia, the current legislation classifies loans denominated in foreign currency as the government's external debt (the Organic Law of Georgia, "On Economic Freedom, 2011; The Law of Georgia, "On Public Debt, 1998).This implies that the impact of currency risk is applicable primarily to the foreign debt portfolio. The risk comes from the fact that the state budget of Georgia can only generate financial resources in the national currency, which need to be converted to foreign currency to repay foreign debts (Papava, Charaia, 2021). This point applies to interest expenses as well, making exchange rate fluctuations a significant source of pressure on the state budget.

In recent years, the government of Georgia has faced significant currency risk due to the fact that foreign debt on average constitutes 75–80% of the total debt portfolio. The most recent period, when the currency fluctuation had a significant impact on debt stock, is the 2020–2023 period. Over this period, both the increase and decrease in government debt were significantly influenced by the fluctuations in the GEL exchange rate. For example, only in 2020, the government debt increased by 4 billion GEL (8.1% of the 2020 GDP) solely due to the depreciation of the GEL exchange rate compared to the previous year. Conversely, in 2021 and 2022, the strengthening of the GEL reduced government debt by 2.7 billion GEL (4.55% of 2021 GDP) and by 4.2 billion GEL (5.92% of 2022 GDP), respectively.

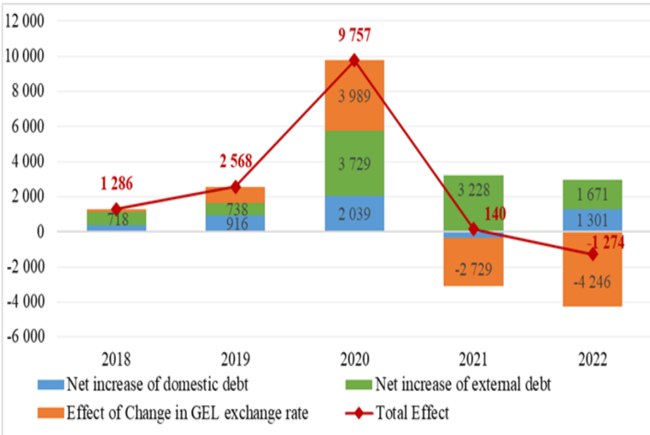

Fig. 2. Sources of changes in government debt portfolio (billion GEL) (source: MOF, Author's calculations)

It should be mentioned that currency risk historically has had the same pattern, as the share of external debt in the government debt portfolio is historically high. Particularly since 1996, the share of foreign debt (obligations denominated in foreign currency) in the government debt portfolio has averaged around 80%, and by the end of 2022, it was 74.8%.

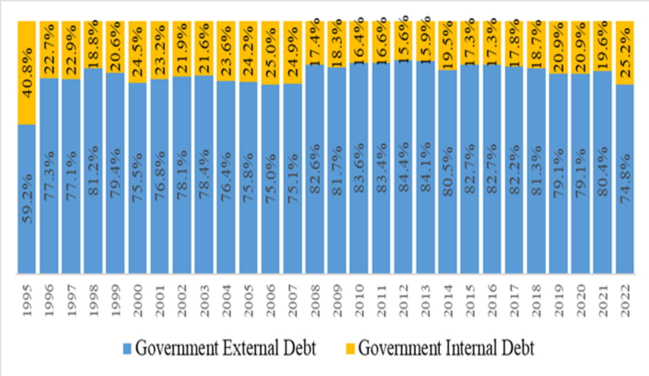

Fig 3. Share of external and domestic debt in government debt portfolio in Georgia (source: MOF, Author's calculations)

Historically, the foreign debt portfolio has been denominated in six major currencies (EURO, USD, SDR, CNY, JPY, KWD). Over the last decade, the currency composition of the government's external debt portfolio has changed dramatically. In particular, by 2012, more than half of the portfolio (51%) was denominated in SDR but by the end of 2022, the share had decreased to 18%. In the same period, the share of euro-denominated debt increased significantly by 41 percentage points and reached 56% by the end of 2022. According to the government's debt management strategy for 2023-2026, increased orientation to EUR is mainly related to the process of economic integration with the European Union (MTDS 2019-2021; 2023-2026). Moreover, the strategy defines EUR as debt's "target" currency, and based on declared policy, an increase in Euro-denominated debt is expected to continue. It should also be mentioned that, over the last decade, the share of debt denominated in USD also decreased by seven percentage points to 24%, and currently, most of the USD-denominated debt (about 1.4 bln. GEL) is five-year maturity Eurobonds issued in 2021.

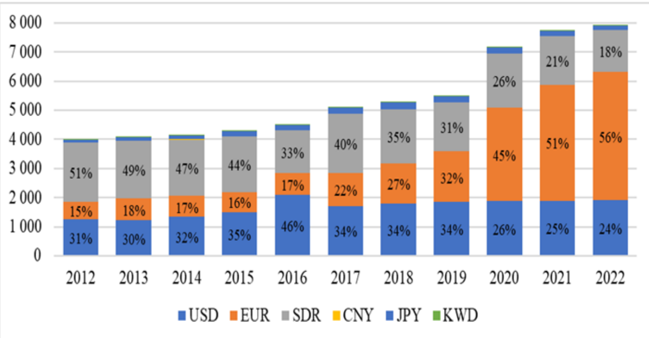

Fig 4. Currency composition of the government's external debt portfolio (mln. GEL) and its share in total debt (source: MOF, Author's calculations)

Based on the currency decomposition of government debt in Georgia, the primary risk factor is the fluctuation of the exchange rate between the GEL and the EUR.

➢ *Refinancing (liquidity) risk*

From the point of view of refinancing (liquidity) risk, Georgia is historically a low-risk country. The average time to maturity (ATM) of government debt varies between 7-8 years in recent years and is far from the minimum threshold of 5.5 years set by the current government debt management strategy (MTDS 2023-2026).

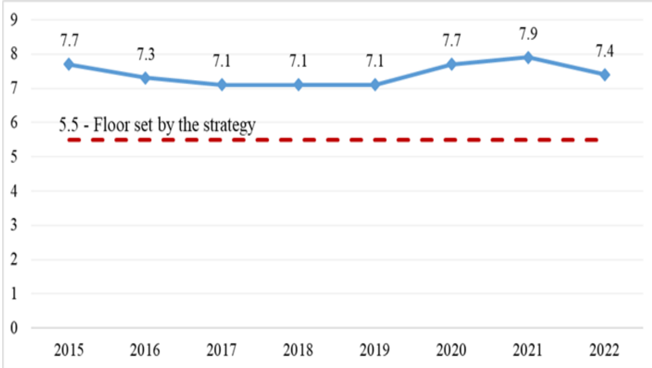

Fig 5. Dynamics of ATM for total government debt (in years) (source: MOF, Author's calculations)

The indicator solely for external debt is even higher. Particularly, the weighted average residual maturity of the external debt portfolio in Georgia is around 8-9 years. The indicator is supported by the orientation to long-term financial resources and the average contractual maturity of the external debt portfolio, which has been maintained above 20 years over the last decade. It is also worth noting that these financial resources have a grace period of around 7-8 years.

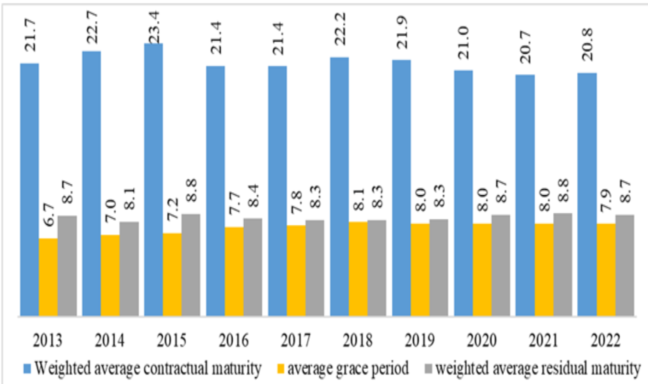

Fig 6. Dynamics of the average maturity indicators of the government's external debt in Georgia (in years) (source: MOF, Author's calculations)

Interest rate risk. Analyzing the government debt portfolio by types of interest rates reveals a trend toward an increasing share of floating interest rate loans. In particular, compared to 2013, the share of debt with a floating rate in the total debt portfolio increased from 21% to 36%. The increase is entirely caused by the orientation toward foreign credits with floating rates.

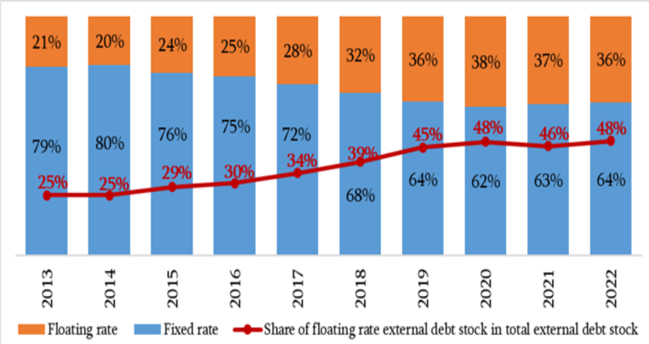

Fig 7. Share of fixed and floating rate debt in the government total debt portfolio (source: MOF, Author's calculations)

It should also be noted that relatively short-term components of domestic debt (6-month, 1-year, and partly 2-year securities), the total volume of which is 25% of the domestic debt portfolio (by the end of 2022), despite the fixed nature of their interest rate, are sensitive to changes in interest rates. In particular, due to their short-term nature, the need for their refinancing arises frequently, and when the interest rates change, the service costs on the renewed securities issued for refinancing also change.

As a result of this tendency, the interest rate on government debt and interest costs are becoming more sensitive to global monetary policy. Moreover, since 2022, this risk factor has been realized. In particular, after 2022, global monetary policy is being tightened significantly, which has a dramatic impact on the dynamics of interest rates, including the EURIBOR and SOFR rates, which are benchmarks for the government's external loans denominated in EUR and USD with floating rates. As a result, from 2022, the weighted average interest rate of the government debt of Georgia is characterized by a significant increase, and as of July 2023, it is at the historical maximum of the last decade.

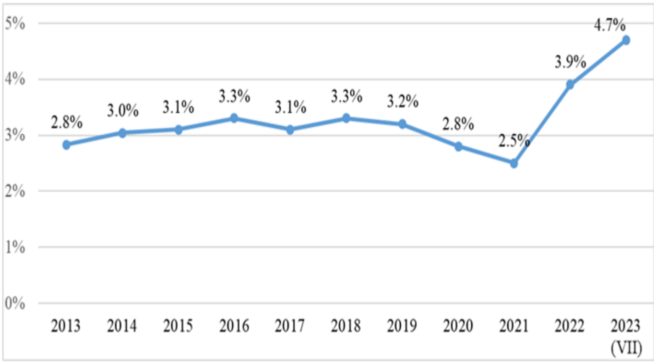

Fig 8. Weighted average interest rate on government debt portfolio in Georgia (source: MOF, Author's calculations)

Under the conditions mentioned above, the costs of government debt service (interest costs) are expected to increase significantly. This expectation is supported by the forecasts published by the Ministry of Finance in 2023, according to which, in the following years, the nominal interest costs of government debt are going to grow dramatically alongside the ratio of interest costs to consolidated budget revenues.

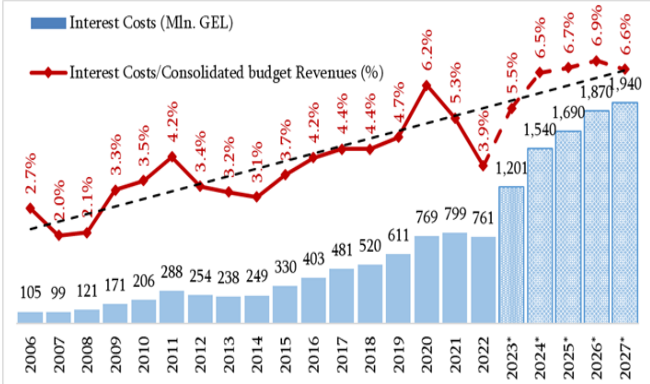

Fig 9. Interest costs on government debt in nominal terms (billion GEL) and as % of consolidated budget revenues (source: MOF, Author's calculations), (* - indicates projections)

It is essential to highlight that the borrowing policy in relation to the types of interest rates is presented in the government debt management strategy documents. Specifically, according to the 2019-2021 strategy document, due to the countercyclical nature of debt service costs, it was considered appropriate to increase the share of floating interest rate loans in the debt portfolio. According to the newest strategy document for 2023-2026 years, minimum threshold for fixed-rate external debt was set at 50%.

Against this approach, it should be highlighted that historically, interest rates have not always been countercyclical by nature. To be specific, the so-called "stagflation" periods may simultaneously occur as a result of an economic downturn, a decrease in non-deficit budget revenues, and an increase in interest rates. The simultaneous impact of the mentioned events dramatically increases debt service costs in "bad periods", creates significant pressure on the country's budget, and may shake fiscal sustainability. In addition, it significantly reduces the ability of the government to make productive expenditures (Stiglitz, 2015).

The risk of unproductive expenditures. As mentioned above, in economic theory, a consensus has been reached to a significant extent regarding the fact that the mobilization of a moderate amount of credit resources by the government and spending it in a productive way (on infrastructure, education, and reforms) contributes to economic growth. Based on this assumption, an evaluation of the directions in which the credit resource, mobilized by the state, is allocated in Georgia is crucial. For this purpose, the first step we need to take is a review of the debt-related legal framework in the country.

According to article 12 of the Law of Georgia "On State Debt", "credit resources raised from domestic sources are used for the purposes determined by the annual budget law". According to Article 15 of the same law, the issuance of state securities can be carried out:

- In order to finance the short-term cash needs and the budget deficit;
- To promote the development of the capital market;
- For other purposes determined by the annual budget law.

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A similar definition is presented for external debt. In particular, according to Article 23 of the law, the credit funds received from abroad are used for the purposes defined by the law of Georgia on the state budget.

Based on the mentioned definitions, there are no material legal restrictions in determining the purpose of credit resources, and in this regard, the government has considerable discretion. This practice represents a type of challenge, since it potentially affects the productivity of spending financed by debt. According to the principles developed by the United Nations Conference on Trade and Development (UNCTAD), large-scale, systematic borrowing by countries to finance budget deficits, if it is not determined by state necessity, may have a negative impact on the country's credit situation and the implementation of sustainable economic policies (State Audit Office of Georgia, 2015).

Observing the actual trends of expenditures financed by borrowed funds reveals that during the last two decades, 45% of the total credit resource received from external sources represents investment credits, which are used to finance investment (infrastructural) projects. The second-highest part of credits (43%) is budget support by nature. In some cases, these types of credits serve as financial support for reforms. However, in most cases, unlike investment credits, they are used to finance current needs (State Audit Office of Georgia, 2023). It should be mentioned that more than half of the budget support credits were mobilized during the 2020-2021 period for financing anti-coronomic crisis measures (MoF, 2022). The third part of the credit was mobilized in 2008, 2011, and 2021 by issuing Eurobonds. The Eurobonds issued in 2011 and 2021 fully served to refinance the Eurobonds issued in 2008 and 2011, respectively (MoF 2011; MoF, 2021). As for the financial resources obtained from the first Eurobonds issued in 2008, they did not have a clearly defined purpose in advance (MoF, 2008).

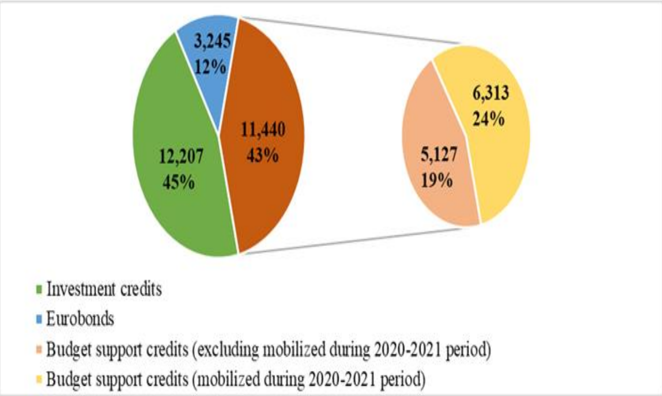

Fig 10. Types of credit resources mobilized from external sources over the 2004-2022 period (mln GEL) (source: MOF, Author's calculations)

A good point about the debt management process is defined by the government debt management strategy, according to which, from 2022, investment credits will be taken only for financing large and complex projects, for which the support of development partners is favorable and is accompanied by expertise and knowledge sharing (Government Debt Management Strategy 2022-2025 and 2023-2026 for years).

According to the same strategy, budget support loans will be signed only to support transformational reforms. In addition, an annual maximum amount of 250 million USD has been set for this kind of loan (Government Debt Management Strategy for 2022-2025 and 2023-2026).

As for the domestic credit resources, they are used to finance the current needs of the budget. Historically, over the last decade, the share of domestic debt in the government's total debt portfolio has been around 20%. But it should be mentioned that government debt management strategy and capital market development strategy define government securities market development as one of their goals. For this purpose, in order to increase the volume and liquidity of treasury securities, a significant increase in treasury securities issuance is planned in the coming years at the expense of decreasing credit resources borrowed from abroad (Government Debt Management Strategy for 2022-2025 and 2023-2026).

Table 1. Expected net growth of government debt components (mln. GEL)

	2023	2024	2025	2026
Net issuance of treasury securities	1 400	1 500	1 600	1 700
Net increase in external debt	1 074	720	600	400

Source: Government Debt Management Strategy for 2023-2026

An analysis of the spending purpose of borrowed funds shows that some parts of external resources can be classified as borrowed for financing productive investments. However, around half of the external resources over the last two decades were used to finance existing budgetary needs. The same is true for domestic credit resources, which are usually fully spent based on existing needs.

In addition, as mentioned above, in order to promote the development of the capital market in the coming years, it is planned to further increase domestic debt and expand its share in the government debt portfolio, despite the fact that the spending purpose of the mobilized resource from this source is not clearly defined.

Taking into account the mentioned conditions, it is advisable to determine the purpose of credit resources mobilized by the government at the legislative level in a more clear way. This kind of change in legislature is expected to increase the productivity of borrowed funds and decrease associated risks.

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IV. CONCLUSIONS

According to the research, some risk factors related to Georgia exist and have a significant influence on debt dynamics. To be specific, Georgia faces significant risk in terms of the exchange rate, as the majority of the debt is denominated in foreign currency, and fluctuations in the exchange rate affect the debt level severely. Another risk factor is interest rate risk. In recent years, global monetary policy tightening has increased global reference rates and, as a result, weighted average interest rates on existing debt portfolios for countries that have a high share of floating interest rate debts (like Georgia). The last risk factor is potential unproductive investments financed by credit resources in Georgia. The risk factor exists because there is no clear definition in Georgian what should be financed by credit resources.

To overcome the first two obstacles, the recommended path is a gradual decrease in the share of foreign currency-denominated debt and floating interest rate-bearing loans in the government debt portfolio. As for the third challenge, there is a necessity for a change in legislation.

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