A need for effective fiscal rules and further macro-stabilization for ensuring debt sustainability in Georgia

by

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Abstract

A rapid and significant build up of Georgia's public and external debt in last four year has created a need for a sustainability assessment. By analyzing the government's external liabilities together with the country's external debt position (government external debt plus private sector external debt) I come to an interesting finding. While there is still a substantial fiscal space for further government borrowing, Georgia's external debt might be reaching the level that can lead to a debt distress. Since the government has been borrowing mostly from the external sources, any further borrowing by the Georgian government will add to the external debt unless domestic savings increase and domestic government liabilities grow as a share of total government debt.

In order to ensure medium to long term debt sustainability, a comprehensive and effective rules-based fiscal framework is necessary. In addition, better policies are needed for further macro-stabilization that will reduce the volatility of Georgian economy and facilitate debt management.

Acknowledgements

I would like to express my gratitude towards my supervisor Professor László Mátyás, as well as to my Professor Balázs Romhányi for their valuable assistance and insightful comments during the thesis writing process. I would also like to thank John Harbord from Center for Academic Writing for his valuable help.

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Introduction

In the wake of the global recession, governments all around the world drastically increased spending either to stimulate their economies or bail out the troubled financial institutions and other businesses which contributed towards the significant buildup of public debt. Reinhart and Rogoff (2010) showed that central government debt rises by about 86%, on average, within three years after the economic crisis. Georgia was no exception to the global trend. Nominal public sector debt (domestic and external) of 21.5% to GDP in 2007 peaked at 39% in 2010, which then again dropped to 34% in 2011 (IMF, 2012). Total external debt (what government and private sector owes to the rest of the world) to Gross Domestic Product ratio stood at 79%, which ranks Georgia at 15th place with highest external debt to GDP ratio in a 136 low and middle income country sample (World Bank, 2012). If the country continues to borrow, institutional reforms that increase debt tolerance levels, might not be sufficient factor to ensure medium to long term public and external debt sustainability in Georgia.

Large discretionary spending to stimulate the economy as a result of the global economic recession and brief war with Russia in 2008, as well as spending to buy electoral votes in the run up of 2010 elections, were the reasons for soaring public debt from 2007 till 2010. The upcoming elections in 2012 and 2013 again pose a risk for additional borrowing and spending. The Georgian government's summer job program for students, which aims to employ 25,000 students during the summer 2012, is an example of implicit buying of electoral votes by the ruling party (Transparency International, 2012). An inability of Georgian government to meet the budget deficit target and start disciplining itself is showcased by the fact that all but one Performance Criteria set by the IMF for 2011 was met by Georgian government except the government fiscal deficit (IMF, 2012).

International Monetary Fund's Debt Sustainability Analyses (DSA) in 2012 shows a more favorable outlook for Georgia's public and external debt for coming five years than was projected a year ago. The reason lies in the fact that public debt was reduced to 34% in 2011 due to an unexpected growth in GDP,

appreciating Georgian currency and higher than expected privatization receipts. Shrinking public debt is in itself a positive fact but it also demonstrates Georgia's extreme vulnerability to unexpected changes in key variables. Sudden changes in economic environment can make the debt unsustainable if the country keeps its debt close to its sustainability thresholds. This emphasizes the urgency and importance of debt analysis, identification of weaknesses in country's macroeconomic and institutional environment, and necessity of smart policies that will help to prevent unnecessary future borrowing to the detriment of financial stability.

The thesis will assess the sustainability of public finances under the current legislature, because all necessary preconditions exist at the moment for government to abuse their power and put debt sustainability in danger. The analysis will be carried out by assessing the consequences of current legislature in a short to medium term. In developed economies fiscal sustainability is often a long term issue. However in a country like Georgia, where institutions are still weak to ensure smooth flow of democratic and economic processes or a peaceful transfer of political power from one ruling party to another, analysis of sustainability for a shorter timescale makes more sense.

The first chapter of the thesis reviews the literature and theory about public and external debt sustainability. The second chapter assesses Georgia's current debt stocks based on the theory and tools reviewed in the first chapter. The third chapter analyzes the current rules-based fiscal framework and suggests more comprehensive rules as a pre-requisite for debt sustainability. The final chapter identifies the room for further macro-stabilization and improvements in institutional framework that will reduce the risks of debt distress in the future.

Chapter 1. Literature Review

Government and external debt[1] are interconnected through various endogenous variables and are asymmetrically affected by government policies. For that reason, analysis of only one type of debt is not sufficient to define whether the country is on a sustainable path or not. For example, a country might be running a continuous budget surplus which is necessary for sustainability of public debt, but it might also have a large current account deficit (not supported by non-debt creating inflows, such as FDI), which will lead to an explosion of external debt and can eventually bring the country into a debt crisis (Akyüz, 2007). This chapter reviews the theory and literature behind the notion of debt sustainability, both public and external. It illustrates the interconnectedness of these two types of debt and shows the importance of addressing the sustainability of public and external debt simultaneously.

1.1 Theory on Public Debt

A simple economic theory suggests that public debt will increase if the interest rate paid on the outstanding debt is higher than the GDP growth rate in an economy. In order to keep the debt to GDP ratio unchanged or decreasing, the government will have to run a primary budget surplus to service the debt. A positive growth-adjusted real effective interest rate (interest rate less the growth rate) ensures that Ponzi financing – repaying the old debt by issuing the new – will not be feasible since it would lead to debt explosion (Akyüz, 2007).

In contrast, if the interest rates are lower than the growth rates, the debt can remain unchanged or decrease even if the government runs a budget deficit. However, the IMF has pointed out that only very few countries without concessional borrowing (borrowing below the market rates from multilateral or bilateral

[1] I will use the term "government debt" or "public debt" interchangeably to describe the debt that the government owes to domestic or non-domestic creditors. Wherever necessary, I will specify further the type of government debt: "external government debt" or "domestic government debt". I will be using the term "external debt" to refer to the debt that the government and private sector together owe to non-domestic creditors. Similarly to "external government debt", whenever I am referring to external debt that the private sector owes to non-domestic creditors, I will be using the term "private external debt".

sources) have had growth rates higher than interest rates (IMF, 2003). In the case of the rest of the developing countries, it has been due to the concessional borrowing that the real effective interest rates have been lower than the growth rate of the economy. This has allowed some countries to run budget deficits while allowing the public debt to decrease. In such cases Ponzi financing would also be possible, unless the deficits are extremely large (Akyüz, 2007).

In economic theory fiscal sustainability is analyzed from static (financing current expenditure with current revenues) as well as from inter-temporal perspective (Akyüz, 2007). The inter-temporal budget constraint condition implies that the present value of the primary surpluses should be higher than the present value of the primary deficits with the sufficient amount to cover the difference between the initial debt stock and the present value of the terminal debt stock (IMF, 2000). As McCallum (1984) points out countries will not jeopardize their fiscal sustainability if they run small overall surpluses which after debt interest repayment would turn into small primary deficits. In such a case, McCallum argues that debt will grow less slowly than the interest rate; therefore the fiscal policies will remain sustainable. He also argues that if the debt is growing slightly faster than the interest rate, given that the real growth of a country is above the growth rate of the debt, debt ratio will be considered sustainable. However, sustainability judgments based on present value budget constraint (PVBC) do not take all economic variables into account (IMF, 2000). Using PVBC as a benchmark to define the sustainability of debt is limited in nature because it only uses the stock of government debt, projected surpluses and deficits and the interest rate on government debt to define the sustainability (IMF, 2000).

The most important question that the theory has tried to answer is about the sustainable level of the debt. However, these thresholds are largely arbitrary since they depend on numerous other interconnected endogenous or exogenous factors (Akyüz, 2007). Pasinetti (1998) for example, criticizes the 3% deficit and 60% public debt to GDP ratios proposed by the Maastricht Treaty. He strongly doubts the economic reasoning behind choosing these arbitrary numerical targets as he argues that they have no robust theoretical backing. Kraay and Nehru (2006) also find that setting the arbitrary debt thresholds make little

sense since they fail to take into account the role of constantly changing policies and institutions that matter for the debt sustainability. They also find that the policies are a key determinant factor for debt distress in low income countries. Reinhart, Rogoff and Sevastano's (2003) argument is in line with that of Kraay and Nehru's (2006) that the strength of institutions is crucial. They also argue that country's debt tolerance depends on its history of default (history determines whether markets believe in the countries' ability to serve their debt obligations and "assign" thresholds respectively). Calvo (2003) even argues that investor behavior can suddenly change when no significant changes in economic fundamentals have happened; hence an argument against setting the arbitrary thresholds.

According to OECD's online glossary of statistical terms, "a set of policies are sustainable if a borrower is expected to be able to continue servicing its debt without an unrealistically large future correction to the balance of income and expenditure" (OECD, 2012). Therefore, the important question here is if current policies can be continued without putting government solvency in danger, which does not necessarily mean that the government debt has to stay fixed (IMF, 2000). As a result, setting limits on government spending and debt becomes a less important objective (even though some sort of arbitrary targets are needed to define a course for a fiscal policy). As an alternative to setting a debt to GDP limit, Akyüz (2007) suggests choosing the debt level at an earlier point in time as a target and adjusting policies to approach that target.

Various sustainability tests and indicators have been suggested by the economic theory. Co-integration analysis can show whether the fiscal policies are sustainable if the spending moves in the same direction as the revenues (IMF, 2000). More intuitive indicators have been also suggested that assess the fiscal sustainability of the countries (IMF, 2000). For example, Buiter (1985) develops an indicator which compares the net government worth to output. However, the problem with this method is that information about net government worth is often difficult to obtain. Blanchard (1990) also derives a couple of indicators that point out to changes that need to be done to keep the current debt ratio constant. One is the primary gap indicator that gives us the primary balance that is needed to keep the debt level unchanged.

Another indicator that Blanchard develops is the tax revenue to GDP indicator. If the indicator is negative, it means that increase in tax revenue is required to keep the debt level fixed (IMF, 2000)[2].

The above given indicators and tests have been used widely because they suggest a very intuitive and easy to understand indicators of sustainability gaps (IMF, 2000). However they are limited in scope since they only suggest the changes in policies to keep the debts at some fixed level (IMF, 2000). This is not necessarily an objective for countries with low debt or high net worth that can afford their debts to grow (IMF, 2000). Therefore, simple tests and their relative ease of interpretation come with cost of imperfect assessment of sustainability (IMF, 2000).

1.2 Theory on External Debt

Analysis of debt sustainability should include the analysis of both public and external debt since these two are strongly interconnected through different endogenous variables, such as growth rate, exchange or interest rates (Akyüz, 2007). Moreover, external debt can become public debt through the contingent liabilities, if the government has to bail out the financial sector in case of external debt distress (Goldstein, 2003).

External debt ratio to remain stable, the net outflow of the resources from the country should be equal to difference between net capital inflows and servicing of external debt (Akyüz. 2007). Unlike the fiscal policy that is directly influenced by the government's decision to spend or not, the effect of policies on external debt is less direct (for example there is a less direct link between the government policies on international trade and changes in terms of trade) (Akyüz, 2007). In developing countries with a low industrial base, productivity and competitiveness, the growth normally will be accompanied by increased

[2] Akyüz (2007) and IMF (2000) have been used more heavily as sources in this chapter. The reason for it is that Akyüz analyzes the debt sustainability with a strong focus on emerging markets which is obviously more relevant to examining Georgian debt. It also scrutinizes the IMF's Debt Sustainability Framework for low income countries that I am also extensively referring to in this thesis. Similarly, the IMF (2000) paper summarizes the debt literature that was available before 2000, therefore offering various perspectives on debt sustainability in one paper.

demand in imports, widening the current account gap, as was the case with Central and Eastern Europe countries (Marer, 2013). External financing is needed to close the current account gap as well as to service the external debt. In the case of the prolonged current account deficit, savings and foreign exchange gaps need to be closed otherwise it can lead to external debt crisis (Kregel, 2004).

A country can run into a financial crisis even with a balanced budget or surplus if it runs a large current account deficit for a prolonged time period (Akyüz, 2007). In 1980s, a 14% current account deficit brought Chile into the financial crisis even though it had a balanced budget and an increasing savings pattern (Edwards, 2001). The balance of payment problem can also affect the fiscal sustainability if it changes the variables such as interest rates, growth rates, exchange rates and stock of debt (Akyüz, 2007). For example, if the private debt increases rapidly, it will also have repercussions on the ability of the sovereigns to borrow (interest rates also rise for public borrowing) as has been the case in Latin American countries (Reisen and van Trotsenburg, 1988). Therefore, it is important to ensure the sustainability of public as well as of external debt, since large deficiencies in one of them can be contagious to the whole economy.

Interconnectedness of public and external debt can be also demonstrated by the following example. A large unfavorable change in investor sentiment, due to growing public debt, will have a negative effect on fiscal sustainability as they tend to cause currency depreciation and raises real effective interest rate on public debt (Blanchard, 2004). Therefore, larger the debt denominated in foreign currency bigger the burden for the government or the private sector to repay the debt. By contrast, due to a depreciating currency, imports will become more expensive and exports will become cheaper – leading to improvement in current account balance. Therefore, the interplay and the strength of these two processes will determine what effect the changing market sentiment will have on overall debt position of a country (Akyüz, 2007).

To assess government and external debt sustainability of low-income countries, the International Monetary Fund and the World Bank have developed a debt sustainability framework (DSF) that is used to "support low-income countries in their efforts to achieve the Millennium Development Goals without creating future debt problems" (IMF, 2006 p.2). It projects the external and public debt developments under the current policies and then it applies different stress tests to baseline scenario to assess the vulnerability of the countries to shocks. Nevertheless, the IMF staff itself has noted that DSF projections have been over-optimistic (IMF, 2003). Despite this, DSF is an important, the most comprehensive framework for assessing the debt sustainability in low income countries that often lack technical expertise to independently carry out in-depth debt burden investigation.

1.3 Theory on Rules-based Fiscal Framework

Literature agrees on the importance of the effective policies and strong institutions which are crucial for debt sustainability and reduction of debt distress risks. However, to further improve the credibility of the government's fiscal policies, effective fiscal policy rules are needed. Kopits and Symansky (1998) argue that such rules aid macroeconomic stability, support other financial policies, help achieve long-term sustainability, reduce negative spillovers, and improve overall policy credibility. In 1990s only a handful of countries had fiscal rules in place, while by early 2009, the number had increased to 80 (IMF, 2009).

Fiscal policy rule is a permanent constraint on a budgetary aggregate through simple numerical limit (Kopits and Symansky, 1998). However, comprehensive fiscal rules also entail few important characteristics, such as flexibility to respond to shocks, transparency and enforceability in case of non-compliance, which are crucial for its effectiveness (Kopits and Symansky, 1998).

Only through effective and comprehensive rules-based fiscal framework will the Georgian government be able to increase credibility of its fiscal policies that will reduce risks of debt distress and ensure long term fiscal sustainability.

Chapter 2. Sustainability of Georgia's Public and External Debt

A rapid increase of Georgia's public and external debt in last five years should be an issue for concern, since countries with weak institutions can sustain lower debt stocks than their rich counterparts. In addition, Georgia's small economy is extremely susceptible to foreign shocks that can quickly alter its macro variables that subsequently can have important repercussions on sustainability.

This chapter analyzes Georgia's public and external debt burdens and assesses their sustainability in the light of the theory presented in the previous chapter. First section summarizes Georgia's current fiscal position and history of the public and external debt accumulation. Second section of the chapter examines country's public debt sustainability. And lastly, third section examines the sustainability of Georgia's external debt.

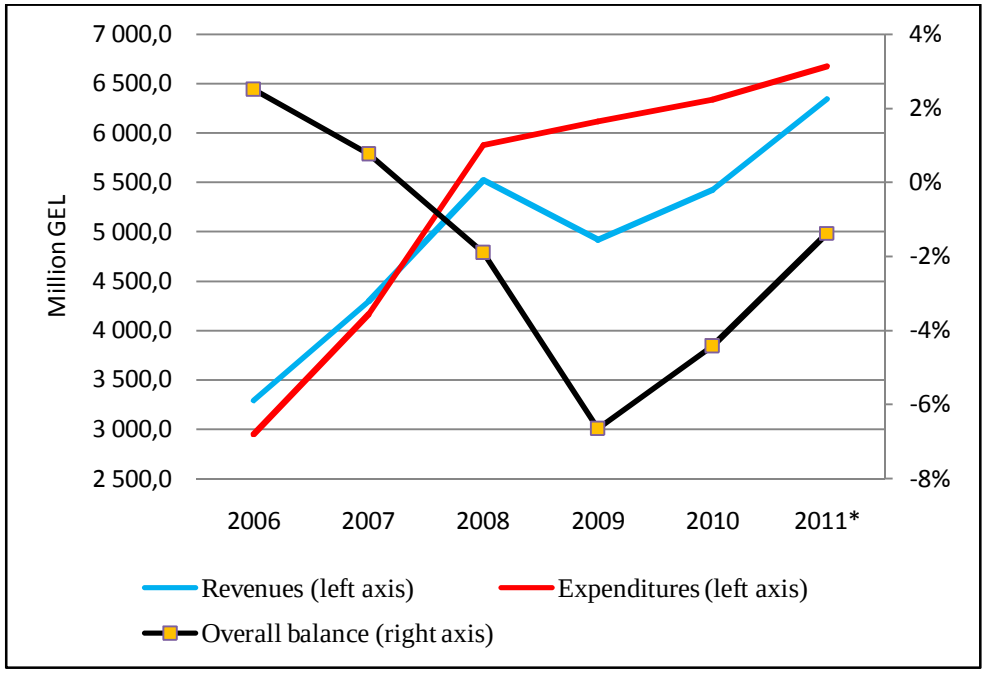
2.1 Georgia's Current Fiscal Position

In March, 2010, Transparency International Georgia reported "an unprecedented increase" in spending ahead of the May local government elections. The report identified a 34% rise of funding for local self-governing entities, doubling the funding of Rural Aid Program, an increase in capital city municipality staff by 400, and an increase of pensions and issuing of transport vouchers for Tbilisi pensioners (Civil.ge, 2010). Even bigger spending in 2009 and 2010 came from the President's Economic Stimulus Package (Civil.ge, 2009) which proposed spending of 2.2 billion GEL (appx. 1.3 billion USD) on infrastructure development projects as a response to the global economic recession (for a comparison, Georgia's total revenue in 2009 was 4.9 billion GEL). Figure 1 shows how government revenues shrank but expenditures continued to grow after 2008.

In the Figure 2 a clear trend of increase in foreign debt can be observed as a result of discretionary policies justified by the necessity to combat the economic downturn as well as to win electoral votes by

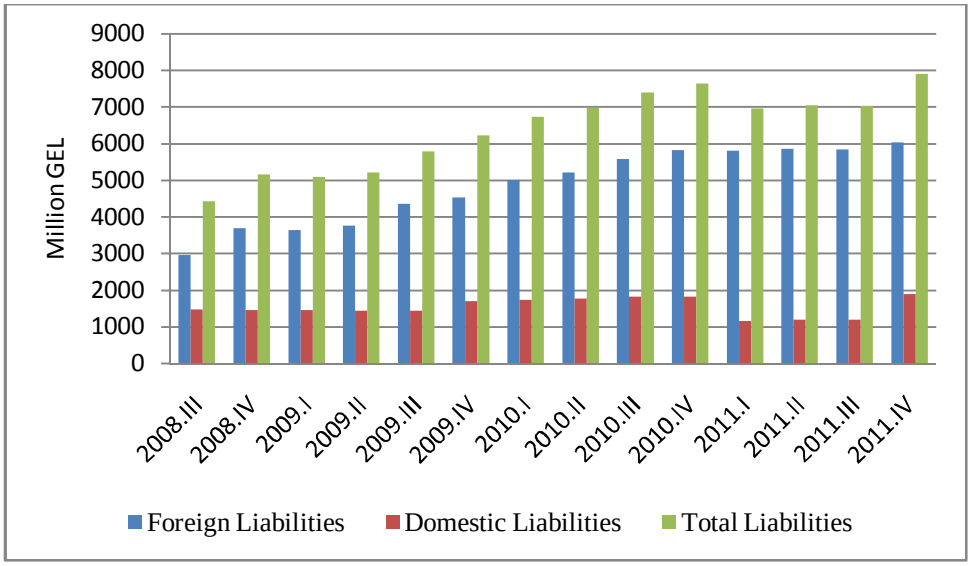
extensive spending in the run up to the local elections in May, 2010. In a Letter of Intent sent by Georgian government to IMF Acting Managing Director in May, 2011 (IMF, 2011), the reason for not meeting one of the Performance Criteria was the food and fuel vouchers, which the government claims to have given away to alleviate social pressure caused by the double digit inflation of 12% in 2010 (IMF. 2011).

Figure 1. Georgian government spending, revenues and overall balance.



Based on data by Ministry of Finance of Georgia.
*2011 values are based on preliminary data.

Figure 2. Stock of outstanding domestic and external debt of Georgian government

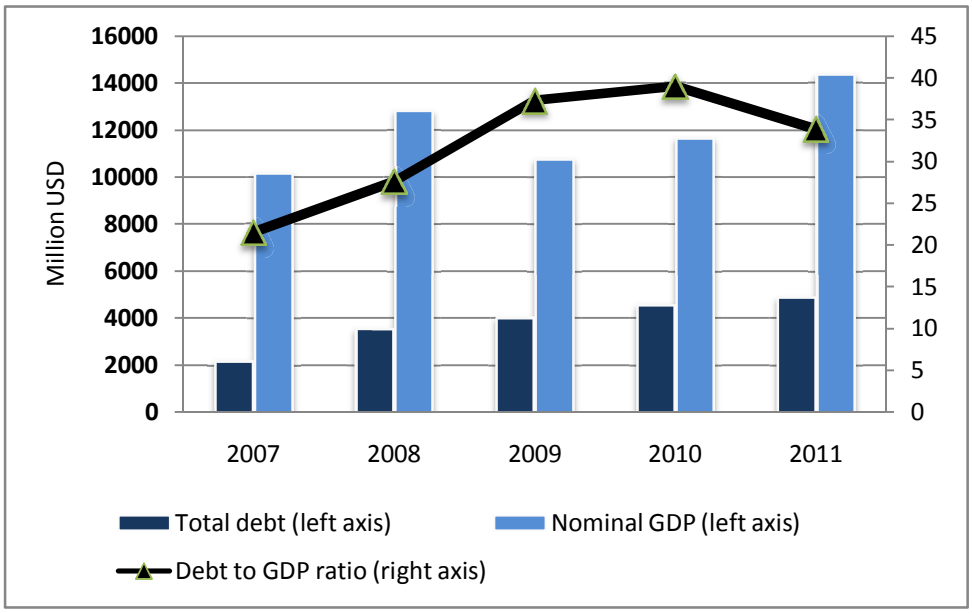


Based on data by the Ministry of Finance of Georgia.

While nominal GDP shrank from 12.8 billion USD in 2008 to 10.8 billion USD in 2009, the government's liabilities increased, as did the debt to GDP ratio from 27% in 2008 to 37% in 2009 (Figure 3). Even with economy bouncing back in 2010 the debt to GDP ratio again increased to 39% of GDP. It is noteworthy that government spending was financed mostly by foreign borrowing, increasing the country's exposure to exchange rate[3] risks (Figure 2).

In 2011, Georgian public debt shrank to 34% due to a higher than expected nominal growth, an appreciation of the Georgian lari and higher privatization receipts. Due to the small economy and its high sensitivity to foreign factors, final accounts can often yield positive as well as negative surprises. High unpredictability and vulnerability to foreign shocks is a reason why th debt must be kept below the threhold level to leave some fiscal space for maneuvre should it become necessary.

Figure 3. Nominal GDP, total government debt and government debt to GDP ratio



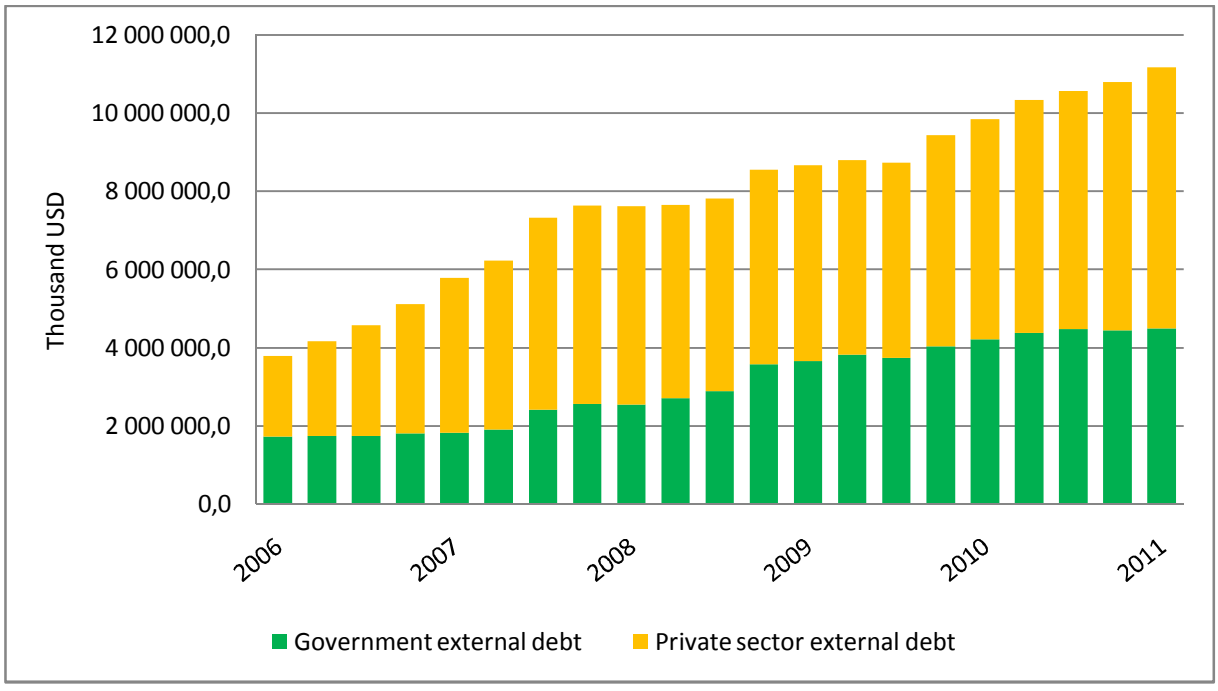
Based on data by International Monetary Fund

[3] Georgia currently has a managed exchange rate float, which means that the Central Bank interferes in foreign exchange markets to stabilize the rates if they move out of the certain band. As a result, exchange rates with major currencies have fluctuated within narrow bands, avoiding the adverse effects of exchange rate fluctuations in debt servicing. Georgia's strong position on international currency reserves has made exchange rate control relatively easy.

Georgia's new constitution, which will go in effect in 2014, will significantly reduce the power of the President in favor of the Prime Minister and the Parliament (Civil.ge. 2010). While the shift of decision making power to the Parliament and the PM means more obstacles to exercise discretionary fiscal policies after 2013, the possibility and freedom for wasteful spending in 2012 and 2013 remains. In addition, as the world struggles to recover from the recession and a risk for double-dip recession remains, possibility of future discretionary spending in Georgia, justified by the need of fiscal stimulus, is not unlikely.

Private foreign debt has also been increasing almost at the same pace as the government foreign debt, bringing it currently to 79% to GDP ratio which is one of the highest among low and middle income countries. Only 14 countries, in a sample of 136 countries (on which data on GDP and external debt is available), had higher external debt to GDP ratio than Georgia in 2010 (World Bank, 2012).

Figure 4. Growth of government and private external debt



Based on data by World Bank data

To understand what risks the increased government and private foreign liabilities are posing to debt sustainability, we need to examine Georgia's given debt stocks in the light of the theory discussed in the first Chapter.

2.2 Sustainability of Public Debt

The most comprehensive analysis for low-income countries' public and external debt is carried out by the IMF within the Debt Sustainability Framework (DSF) (IMF, 2006). The DSF is a joint effort of World Bank and International Monetary Fund to analyze the external and public debt sustainability in low-income countries. The Framework helps the countries to mobilize financing and avoid the excessive build-up of debts (IMF, 2006).

IMF produces public and external debt projections by inputting multiple macro variables into the DSF template (IMF, 2006). In addition it also applies stress tests to baseline scenario to expose the countries' vulnerability to foreign shocks. It assesses the current debt distress level of the countries based on indicative debt burden thresholds that depend on the quality of the country's policies and institutions (IMF, 2004).

IMF has been carrying out regular analysis of Georgian public and external debt. However, the numbers in the projections often deviate from actual realized data. This fact illustrates how instable and sensitive Georgia's small economy is to various domestic and foreign disturbances. For example, according to IMF's debt sustainability analysis conducted in 2006, the public debt to GDP ratio of 36% in 2005 was projected to fall to 20.2% of GDP by the end of 2010 (IMF, 2006). However the actual public debt at the end of the 2010 stood at 39.1% according to the IMF statistics (IMF, 2011). Even though the nominal public debt fell to 34% in 2011 due to the unexpected nominal growth, appreciating currency and the privatization receipts, the fact that the current projections often mispredict the future, necessitates a careful consideration.

To better demonstrate the above argued point, we need to look at the Table 1, which compares the data from two different points in time. Data in black shows the projections of different fiscal and macroeconomic indicators by IMF and World Bank in 2006 for the years 2006 till 2010. The data in red

shows the actual realized data by the end of 2010. One can clearly see how radically the actual fiscal and macroeconomic indicators differ from the projections made four years before.

Table 1. Comparison of IMF's 2006 projections of some of Georgia's public finance indicators with actual values at the end of 2010.

Values in % of GDP unless otherwise indicated		2006	2007	2008	2009	2010
Public sector debt	**Estimate in 2006**	**30.4**	**25.6**	**23.8**	**21.5**	**20.2**
	Actual in 2011	**27.3**	**21.5**	**27.6**	**37.3**	**39.1**
out of which foreign currency denominated	Estimate in 2006	23.3	20.2	18.2	16.5	15.3
	Actual in 2011	21.3	16.8	23.5	31.7	33.6
Change in public sector debt	Estimate in 2006	-5.9	-4.8	-1.8	-2.3	-1.3
	Actual in 2011	-6.8	-5.8	6.1	9.7	1.8
Identified debt creating flows	Estimate in 2006	-11.2	-2.0	-0.9	-0.8	-1.3
	Actual in 2011	-8.3	-7.0	1.0	9.1	1.9
External debt (including public sector external debt)	**Estimate in 2006**	**23.0**	**20.2**	**18.2**	**16.5**	**15.4**
	Actual in 2011	**37.8**	**38.5**	**44.0**	**58.0**	**67.1**
Primary deficit	Estimate in 2006	1.2	1.4	1.0	0.7	0.2
	Actual in 2011	2.3	4.2	5.7	8.2	5.6
Revenue including grants	Estimate in 2006	25.8	24.5	24.5	25.0	25.1
	Actual in 2011	26.7	29.3	30.7	29.3	28.2
Primary (noninterest) expenditure	Estimate in 2006	27.0	25.9	25.5	25.7	25.3
	Actual in 2011	29.0	33.4	36.4	37.5	33.8
Other identified debt-creating flows	Estimate in 2006	-8.4	-0.6	-0.3	-0.1	0.0
	Actual in 2011	-5.2	-5.2	-3.7	-2.0	-1.1
Privatization receipts (negative)	Estimate in 2006	-8.0	-0.6	-0.3	-0.1	0.0
	Actual in 2011	-5.2	-5.2	-3.7	-2.0	-1.1
Real GDP growth (in percent)	Estimate in 2006	7.5	6.5	5.5	5.0	5.0
	Actual in 2011	9.4	12.3	2.4	-3.8	6.4
Average nominal interest rate on public debt	Estimate in 2006	1.7	1.9	2.1	1.7	1.6
	Actual in 2011	2.6	2.6	3.3	3.2	3.1
Inflation rate (GDP deflator, in %)	Estimate in 2006	10.0	6.0	5.0	5.0	5.0
	Actual in 2011	8.5	9.7	9.6	-2.0	8.7

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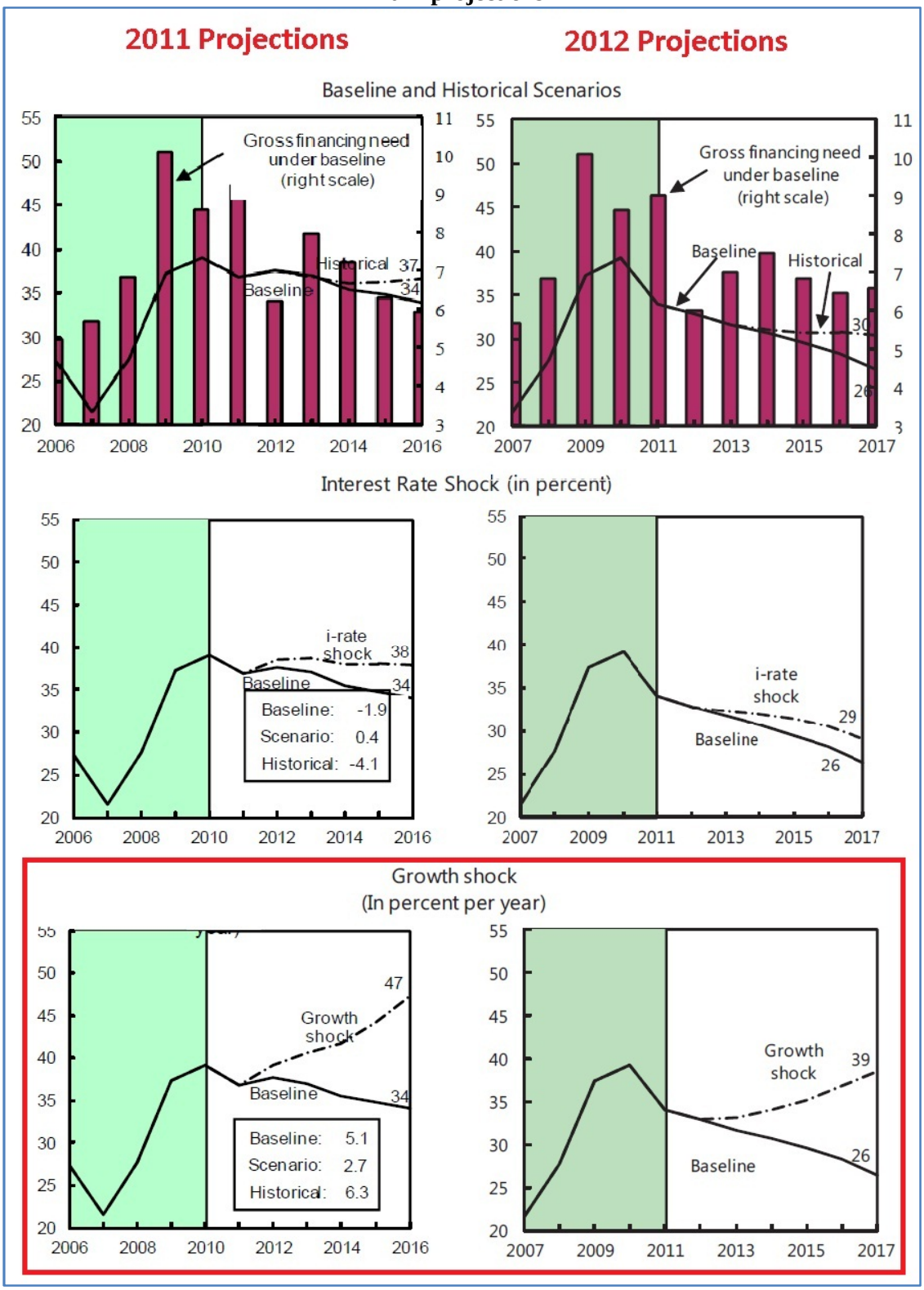
Sources: 1. Georgia: joint bank-fund debt sustainability analysis prepared by IMF and World Bank staffs. November, 2006
2. Georgia: Ninth Review Under the Stand-By Arrangement and Request for Waiver of Nonobservance of Performance Criterion—Staff Report; Staff Supplement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Georgia. International Monetary Fund. June, 2011

The most notable difference between the projections in 2006 and actual data is the growth of external and public debt. External debt (including public sector's external debt) in 2010 was four times higher than the projected number in 2006. Similarly, public debt in 2010 was twice larger than the 2006 projection. On the opposite side, the actual privatization receipts were higher in all years from 2006 to 2010; so were the revenues (including grants).

One can argue that the large mismatches between projected and actual data happened due to large changes caused by the global recession. However, a Request for a Stand-By Arrangement and an Arrangement Under the Standby Credit Facility report, issued in April, 2012, includes another set of projections for the period of 2012 to 2017 with the results also different from the projections made a year ago. This proves two important points. First, that Georgian policy makers shouldn't completely rely on the IMF projections, even though the DSA is the most comprehensive debt analysis for countries like Georgia. But second, it also proves how susceptible Georgia's small economy is to sudden changes in revenues, fluctuations in exchange rates and other external factors.

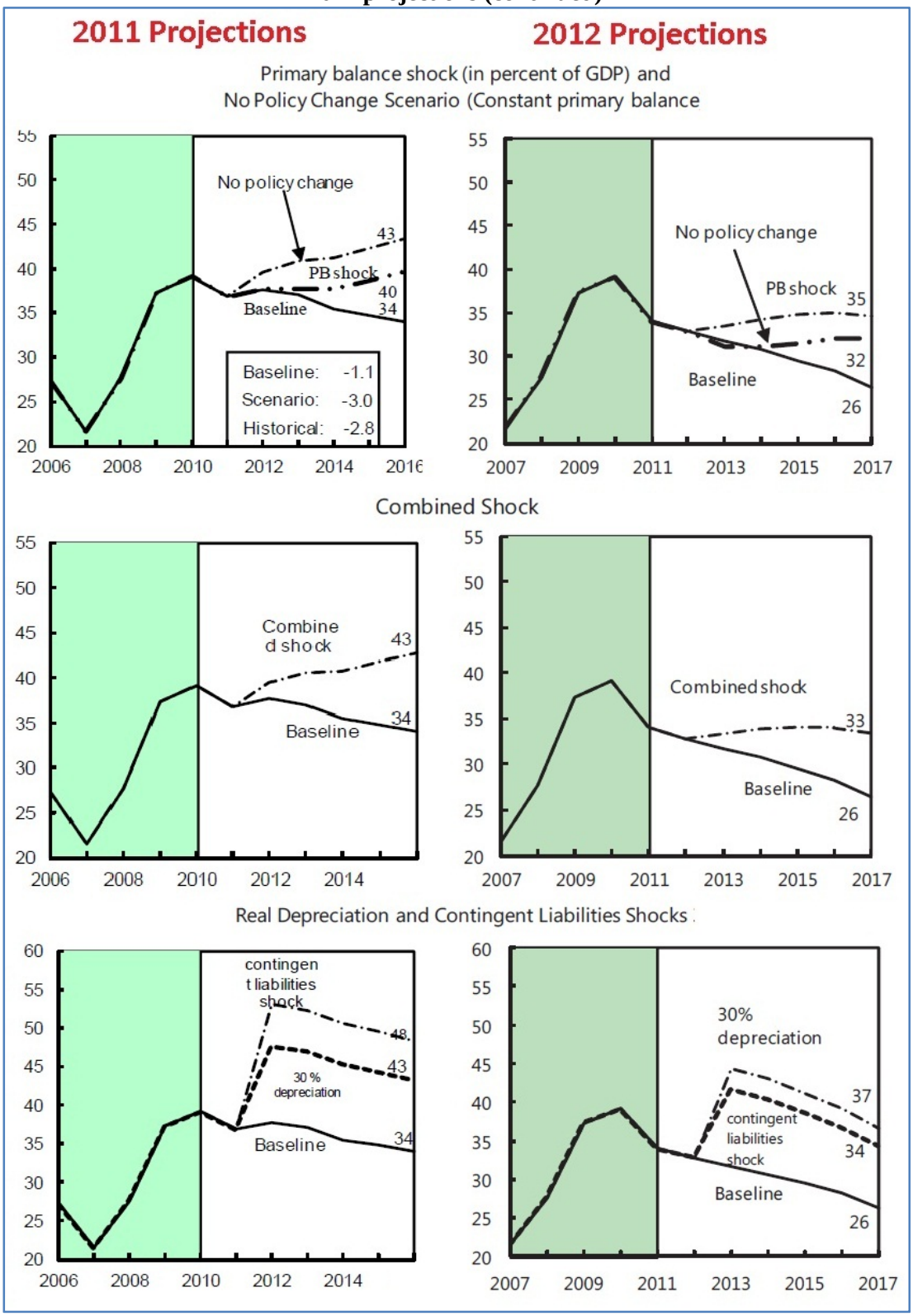
Figure 4 and 5 below compares the projections made in 2011 (IMF, 2011) and in 2012 (IMF, 2012). According to the 2012 report, public debt shrinks to 26% of GDP by 2017 instead of the 34.8% projected one year ago. Likewise, the external debt goes down to 42.5% by 2017 instead of the 48.5% of GDP. In all shock tests, except the growth shock test, the debt projections have a downward trend. However, when growth shock test is applied, the debt does get on an increasing trend in comparison with the baseline. Growth shock entails a deteriorating global growth and low export prices for Georgian commodities (metals mainly), lower remittances and lower capital inflows. The IMF thinks of a growth shock as a most extreme case which would open a cumulative 827 USD million balance of payments gap between 2012 and 2017 for Georgia (IMF, 2012). However, as the prospects of double dip recession in Europe are still not off the agenda, Georgian government should also prepare for any possible developments in the world economy and subsequently its consequences on Georgia's finances and debt.

Figure 5. Debt Sustainability Analysis for Georgia's government debt. Comparison of 2011 and 2012 projections



Source: IMF Country Report 12/98. April. 2012 and IMF Country Report 11/146. June. 2011
Note: Debt to GDP ratio on the left scale

Figure 6. Debt Sustainability Analysis for Georgia's government debt. Comparison of 2011 and 2012 projections (continued)



Source: IMF Country Report 12/98. April. 2012 and IMF Country Report 11/146. June. 2011
Note: Debt to GDP ratio on the left scale

Currently the IMF assigns Georgia's debt a "moderate" risk rating, a downgrade from the "low" risk rating in 2009 ("Moderate" debt burden means that debt indicators are below thresholds but they breach them when the stress tests are applied (IMF, 2012)). This downgrade reflects the deteriorating public finances because of the global financial crisis and its effects on Georgia's economy through balance of payments, a brief war with Russia in 2008 and the subsequent discretionary spending (IMF, 2010). Under the baseline scenario in 2012 projections, the public debt goes down to 26% of GDP, which is still not the debt level that entitled the country a "low" debt risk ranking in 2007 (Georgia's public debt in 2007 was 21.5%).

Georgia's public debt projections show a declining trend in spite of its rising debt stock (Figure 5 & 6). As already discussed in Chapter 1, this can happen because the growth rate is higher than the interest rate on the debt. The country has managed to have the interest rate below its growth rate because of the large concessional borrowing from bilateral or multilateral creditors. For example, the nominal interest rate on public debt in 2011 was 3.6% and a growth rate 6.8% (IMF, 2012). However, as the country progresses and starts to borrow money from the international financial markets, the average interest rates will approach and overtake the growth rate. Cline (2003) argues that the average real interest rate for international borrowing cannot be lower than 6%. In fact, Georgia issued its first $500 million 10 year maturity bonds in 2011 at 7.125% yield (IMF, 2011). IMF forecast for GDP growth is 6% in 2012 and 5.5% each year after. Therefore, as the average interest rate approaches the growth rate in Georgia (the interest rates on public debt have been steadily rising from 2.6% in 2007 to 3.6% in 2011), the importance of balanced budget or even a budget surplus becomes an imperative, because the Ponzi financing becomes impossible. In the Appendix I, I calculate the maximum interest rate of 4.7% that would keep the debt stable at its current level of 34% to GDP. If we compare this number to the actual yield of 7.125% on Georgia's government bond issued in 2011, we can see that Georgian government would have to pay a higher than the debt stabilizing interest rate on its debt, if concessional borrowing did not have such a high share in total government debt portfolio. This demonstrates the importance of reducing the deficit in

a medium run as Georgia starts to borrow more from the markets and the average interest rates grow. (Interestingly, by using the formula in Appendix I, if the primary deficit is reduced to -1% of GDP, the debt stabilizing interest rates would increase to 7.4% which would be closer to yields on Georgia's recently issued 10-year bonds).

The most important question that the theory has tried to answer is about the sustainable level of the debt. However, these thresholds, as already mentioned in Chapter 1 are largely arbitrary since they depend on numerous other interconnected endogenous or exogenous factors. IMF revisited the debt threshold topic in 2012 and proposed updates in methodology for defining debt distress thresholds for low-income countries. IMF uses the Country Policy and Institutional Assessment (CPIA) index for categorizing countries into three different groups and defines their sustainable government external debt thresholds. Georgia, with a CPIA of 4.43, had a debt threshold of 50% present value of debt to GDP according to previous IMF (2004) calculations. However, in the new model, the countries with a CPIA above 3.75 and with large remittances (remittances in Georgia in 2011 was 9% of GDP) are allowed to have present value debt thresholds up to 58% to GDP. Georgia's current external public debt is well below the threshold, therefore, relatively large fiscal space remains.

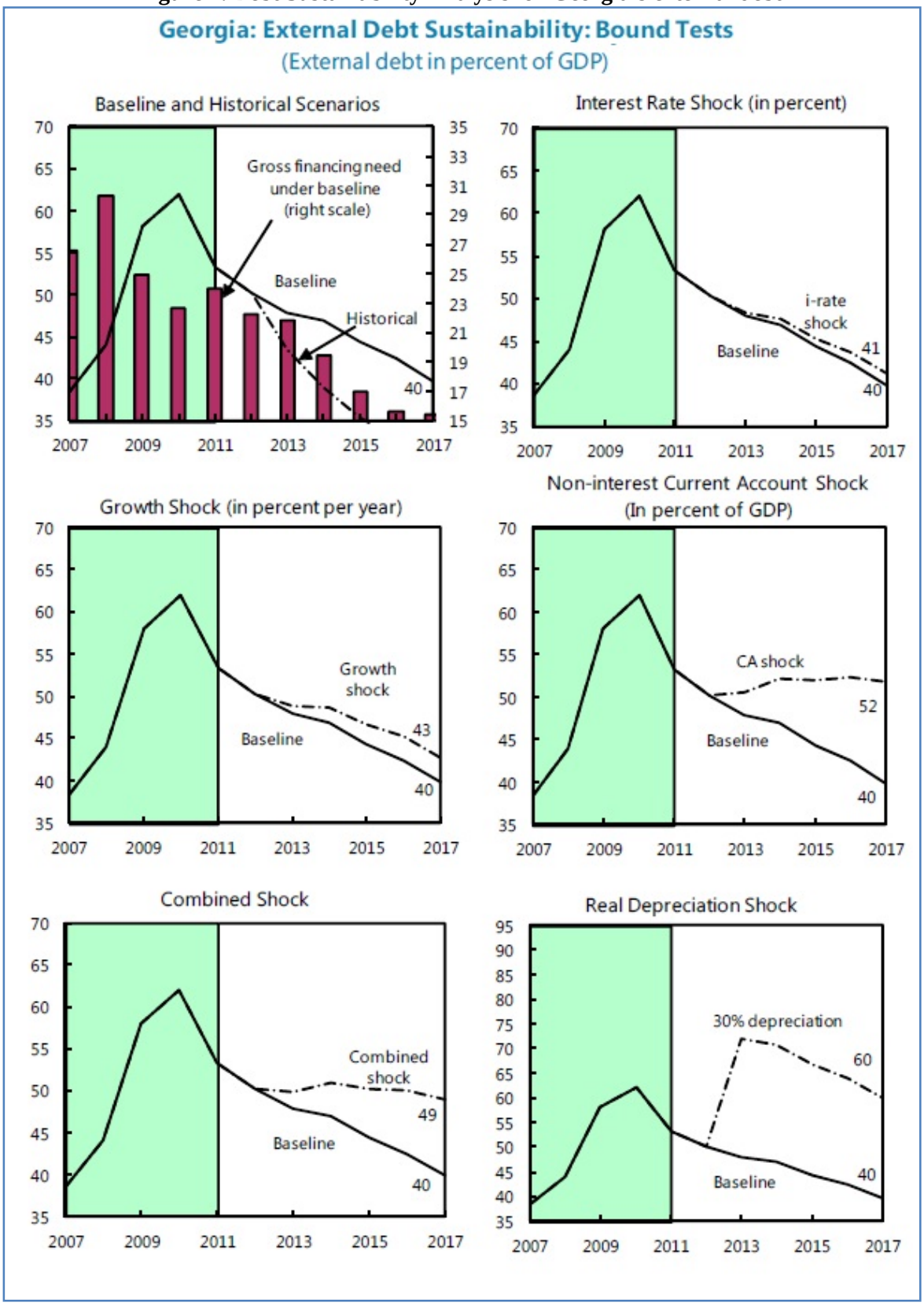
IMF's debt threshold for Georgia doesn't show an urgent need for reduced government borrowing. However, as shown in Figure 2, the Georgian government has borrowed extensively from abroad which affects the country's external debt picture. In order to properly assess the debt sustainability and demonstrate the necessity and importance of reduced government debt, we need to discuss it as a part of a much larger external debt (government's external debt plus private external debt).

2.3 Sustainability of External Debt

Similarly to government debt, IMF's Debt Sustainability Analysis also shows a decreasing trend for external debt (Figure 7). Even when stress tests are applied, external debt still continues to decrease but at a slower pace and ends up at a higher ratio by 2017. Only in the case of the current account and a combined shock,[4] external debt in 2017 is almost same value as in 2012. Same criticism applies here as well that debt projections might be unrealistically optimistic (Akyüz, 2007). As shown above, Georgia's public finances have often deviated (sometimes with large margins) from the projections. Therefore, much attention is also necessary when relying on IMF's external debt projections.

[4] Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

Figure 7. Debt Sustainability Analysis for Georgia's external debt



Source: IMF Country Report No. 12/98. April, 2012

Kraay and Nehru (2006) find three significant factors for external debt distress – the debt burden, the quality of institutions and shocks that affect the real GDP growth. They find that improvement of institutions and policies have same order of magnitude effect on debt sustainability as does the debt reduction. Through regression analysis they show that institutional framework (measured with CPIA index) is more important (significant at 1% level) for low-income countries than it is for the whole country sample (that includes middle and high income countries). Kraay and Nehru (2006) find that for countries with CPIA of 4 (Georgia's CPIA is 4.43), their external debt tolerance might be as high as 160%!

However, take-aways from Reinhart, Rogoff and Sevastano's (2003) analysis for Georgia is much direr. They analyze the data of large sample of low and middle income countries that have defaulted or had major debt restructuring in recent history. They show that 53 defaults or restructuring out of 99 examined cases happened on countries with external debt to GDP ratio less than 60%, and 13 defaults or restructurings happened in the countries with debt to GDP ratio less than 40%. The most famous cases of defaults from very recent history, Mexico and Argentina, happened at 47% (in 1982) and 50% (in 2001) of GDP respectively (Reinhart, Rogoff and Savastano, 2003). Georgia's current external debt stands at 79% of GDP which poses a reason for concern. With this level of external debt, Georgia is in 15 highest external debt holder low and middle income countries. Even with CPIA rating of 4.43, Georgia's fiscal and financial institutions are weaker than of those of developed countries, which makes it more exposed to external debt distress risks.

To show better that Georgia's external debt might be approaching the dangerous zone, we can look at the Table 2. The table shows the external debt to exports ratios and external debt to GNP ratios of the low and middle income countries at which they either defaulted or had to restructure their debt. At the end of the table, the average of the group and Georgia's external debt to GNP and external debt to exports are compared (World Bank, 2012). Georgia's debt to GNP ratio is 10% above the average of the group, while the debt to exports ratio is almost 30% points below the average. The below figure says nothing about

strength of institutional frameworks of the countries, that has an important role to play in debt tolerance of the countries (moreover that CPIA index methodology has evolved overtime and CPIA indices from different periods wouldn't be comparable). However, for the sake of demonstration, comparing the group average with that of Georgia gives us a reason to treat Georgia's growing external debt with more care. (It is noteworthy that the below sample of the countries belonged to the middle income group by the time of their adverse credit events, while Georgia's current classification is 'low-middle income country'.)

Table 2. Comparison of external debt ratios in middle income countries at the time of adverse credit event with Georgia's external debt-to-GNP and external debt-to-exports ratio.

	Initial year of credit event	*External debt-to-GNP ratio in initial year*	*External debt-to-exports ratio in initial year*
Albania	1990	45.8	616.3
Argentina	1982	55.1	447.3
Bolivia	1980	92.5	246.4
Brazil	1983	50.1	393.6
Bulgaria	1990	57.1	154.0
Chile	1972	31.1	n.a.
Costa Rica	1981	136.9	267.0
Dominican Republic	1982	31.8	183.4
Ecuador	1982	60.1	281.8
Egypt	1984	112.0	282.6
Guyana	1982	214.3	337.7
Honduras	1981	61.5	182.8
Iran	1992	42.5	77.7
Jamaica	1978	48.5	103.9
Jordan	1989	179.5	234.2
Mexico	1982	46.7	279.3
Morocco	1983	87.0	305.6
Panama	1983	88.1	162.0
Peru	1978	80.9	388.5
Philippines	1983	70.6	278.1
Poland	1981	n.a.	108.1
Romania	1982	n.a.	73.1
Russian Federation	1991	12.5	n.a.
Trinidad and Tobago	1989	48.1	112.8
Turkey	1978	21.0	374.2
Uruguay	1983	63.7	204.0
Venezuela	1982	48.6	220.9
Average		*70.6*	*254.3*
Georgia		**80**	**225**

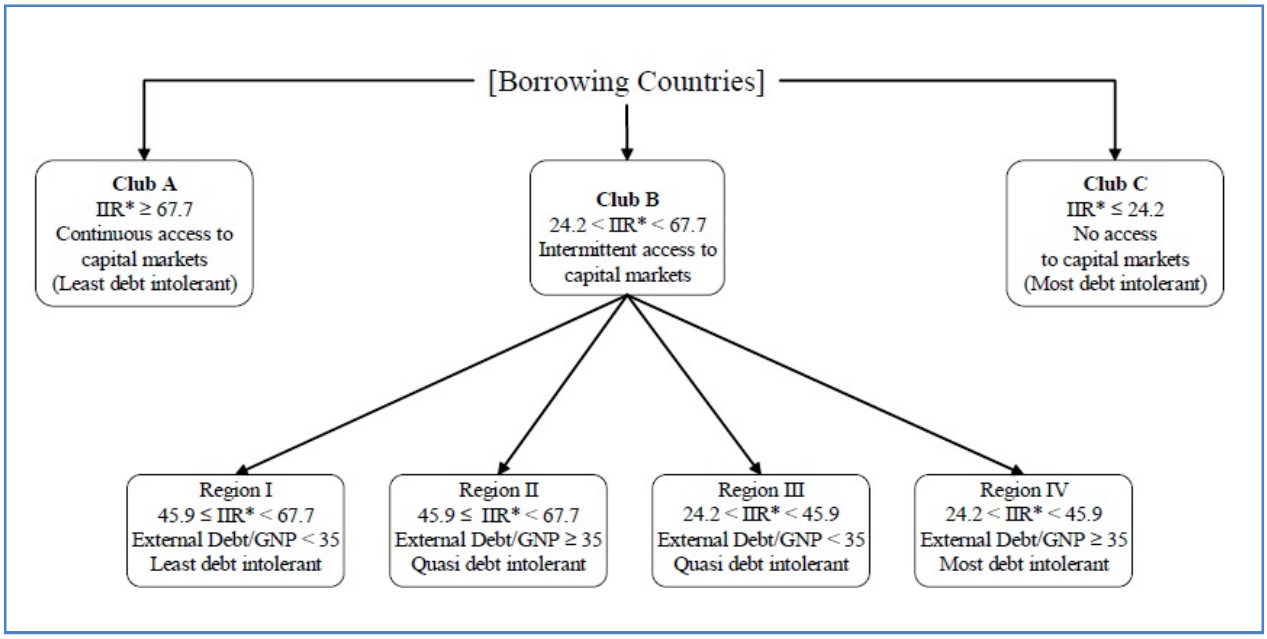
Source: Reinhart, Rogoff, Sevastano. (2003) and National Statistics Office of Georgia.

Similarities between the growth patterns of the countries in the above sample and Georgia, emphasizes the need of careful treatment of Georgia's external debt. The oil shocks of 70ies and 80ies forced the countries in Latin America and elsewhere to borrow from abroad to cover the increasing current account deficits and avoid severe income adjustments (Orlando and Teitel, 1986). Akin to Latin America (IMF, 2006), Georgia also has relied less on domestic debt and has borrowed mostly from abroad (National Bank of Georgia, 2012).

It is important in which sectors the borrowed external finances will eventually end up. In Georgia, the top three sectors for which the private sector has issued credits for are, trade sector, construction and industry (National Bank of Georgia, 2012). So, one can argue that Georgia shouldn't worry about its external debt sustainability because the borrowed money from abroad has ended up in the sectors through which the productive capacity of the country can be improved, which will eventually help the exports and close current account gap. However, in 1970s in Latin countries, commodity exports were increasing and productive capacity was being raised through investment in capital projects; therefore a delay in adjustment after first oil shock in 70ies was justified (Orlando and Teitel, 1986). Nevertheless, many countries experienced adverse credit events due to large external borrowings needed to close current account gaps. Edwards (2001) argues that a country with a (arbitrarily defined) large current account deficit, will not almost inevitably face a crisis. But, if the question is interpreted more broadly, asking whether there are costs involved in running "very large" deficits, then the answer is a qualified "yes", he argues.

In contrast with Kraay and Nehru's (2006) finding that countries with CPIA of 4 can tolerate external debt as much as 160%, Reinhart, Rogoff and Savastano's (2003) model again yields a much darker outlook for Georgia's external debt (Figure 6).

Figure 8. Defining debtors' clubs and external debt intolerance regions



Source: Reinhart, Rogoff, Sevastano. (2003)

The model uses the Institutional Investor's country rankings, as well as external debt to GNP ratios to define the debt tolerance levels of the countries. Club A contains advanced economies who have had IIR above 67.7 (IIR varies from 100 for highest credit rated country to 0 - worst) from 1979 to 2002 and who basically have enjoyed continuous access to capital markets. Club B, under which Georgia's economy falls (together with most of the emerging markets) yields a very interesting picture. In 2010 Georgia's IIR was 33.5 (since there is no long term IIR available for Georgia, I am using Georgia's 2010 IIR ranking as a proxy) and external debt to GNP ratio 80% which puts the country into Region IV, a "most debt intolerant" country category.

In spite of the grim outlook of Georgia's external debt yielded by the above model, Georgia seems to be managing its current external debt with ease at the moment. The external debt, even if it is one of the highest among the low and middle income country group, hasn't caused any signs of debt distress. Georgia's ability to issue its first 5 year maturity bonds in 2011 with a highly favorable 7% yield and its first 10 year maturity bonds with also favorable 7.125% yield (IMF. 2012) is a proof of stable debt dynamics. The reason can be the fundamental reforms that the government has undertaken in the public and financial sector that has increased the trust of creditors Georgia. High economic growth outlook, low

inflation in 2011, high international reserves and other favorable macro factors can also be contributing to investor trust. In addition, as Georgia has never defaulted on its debt before, markets might be "assigning" lower debt distress probability than to countries with default or restructuring history (Reinhart, Rogoff. 2003).

Defining a public or external debt threshold level is a complicated task and depends on many characteristics, such as an economic development level and a size of the country, structure of financial markets and institutions, external imbalances, debt maturity and the monetary regime (European Commission, 2009). Since no structural reforms can be undertaken in a short run to make any considerable changes to any of the above criteria, government should be fully aware of the consequences should it try to increase borrowing again contributing to total external debt growth.

Government's domestic borrowing has its disadvantages in terms of higher market determined interest rates and crowding out of private investment (IMF, 2007). For this reason, Georgian government has almost exclusively borrowed from abroad, contributing to high external debt. As shown above, the space for public borrowing still remains, but Georgia's external debt stance might not be as favorable as the fiscal one. Continued government borrowing from external sources, will mean increasing external debt, unless the private sector external borrowing slows down (which is hard to imagine in the wake of low domestic savings (discussed further in Chapter 4)).

To conclude, a rapid increase of Georgia's public and external debt in last five years warrants a careful treatment by those in charge of government finance. Moreover, because the fiscal rules come into effect only in 2014, an opportunity for discretion remains which can increase the risks for debt distress. The following Chapter discusses the Economic Liberty Act, a law that proposes fiscal rules for a first time in the history of the country. Effective fiscal rules are of crucial importance to ensure fiscal and external debt sustainability.

Chapter 3. A Need for an Effective Rules-based Fiscal Framework in Georgia

To limit the government discretion and increase the investor credibility in Georgia's fiscal policies, a comprehensive rules-based fiscal framework (RFF) is needed. An effective RFF that is tailored to Georgian macroeconomic environment and has a strong statutory basis would eliminate the common pool problem and keep public finances under control regardless of the constitutional arrangement of the country.

Previous chapter demonstrated the necessity of sustainable government spending policies that will not jeopardize the debt sustainability in future. This chapter analyzes the Economic Liberty Act, a piece of legislature that among other things, also proposes fiscal rules to control government expenditure. Therefore, this chapter aims to identify the flaws of the legislature and proposes a comprehensive and effective RFF that is home-grown, enforceable and will help to keep the debt on a sustainable path.

3.1 Analysis of the Economic Liberty Act

In October, 2009 President of Georgia introduced the Economic Liberty Act (civil.ge. 2009), the first incidence of a fiscal rule in the history of Georgia and first government initiative to discipline itself. The law that was proposed in 2009 was soon forgotten by everyone to be only remembered and ratified by the parliament on July 1, 2011. 3% limit on deficit, 30% to GDP government expenditure limit and 60% to GDP government debt limit are proposed by the law to control the government profligacy.

Any government attempt that aims to discipline itself by imposing restrictions on certain macroeconomic indicators with the aim to curb the inflation, encourage growth and ensure long term fiscal sustainability should be welcomed. However the Economic Liberty Act is only a superficial piece of legislature which copies certain numerical ceilings from other countries' experiences without any further elaboration on how they should be exercised or enforced.

The Economic Liberty Act is a first law that tries to send a signal to the markets about government's readiness to start disciplining itself through fiscal policy rules. The financial stability, that the Act is supposed to bring, will be an illusion unless it is thoroughly revised according to different internationally adopted criteria (Kopits- Symansky criteria (1998) for fiscal policy rules) and skewed towards the benefit of the economy and people, instead of the rent-seeking officials.

The law can be summarized into the following table:

Table 3. Economic Liberty Act

The area that the law regulates	Main stipulations
Article I: Public Participation in Setting the Tax Rates	Introducing the new taxes or increasing the tax rate on already existing taxes (except the excise tax) ought to be done only through public referendum. Replacing the one tax with an alternative given that the tax rate does not increase, or reduction of the tax can be carried out without a referendum. Tax progressivity can also be adopted without a referendum. ***Escape clause***: Government can increase a tax rate for a period of up to three years without a referendum.
Article II: Numerical Ceilings for Macroeconomic Aggregates	1. Government spending (including capital spending) cannot exceed 30% of the GDP. 2. Overall budget deficit cannot be higher than 3% of the GDP. 3. Government nominal debt to GDP ratio cannot exceed 60%. ***Escape clauses****:* If government oversteps the numerical limits stipulated in (1) and (2) clauses, it should present a plan to the parliament on correcting the overspending in the following two years. Non-compliance to (1) and (2) clauses of the Article II will be also approved

	by the parliament in case of a war, a recession or other extraordinary circumstances.
Article III: Principle of Budget Universality	➢ All revenues of state or local budgets should be directed towards the single account of state budget. ➢ No earmarking is allowed, except the cases when a grant from a donor is designated to be spent on a specific project.
Article IV: Free Movement of Capital	➢ Any restrictions on currency exchange, bank account management or flow of capital on bank accounts are prohibited, for residents as well as for non-residents. ➢ Every individual has an unconstrained freedom for moving the capital out of the country. ➢ Capital movement in the country is free except of the capital linked to criminal activities.

I will only discuss the Article II of the Economic Liberty Act since its stipulations directly affect the fiscal sustainability. I will not discuss Articles I, III and IV even though they affect debt sustainability at varying degrees. Legislature on taxation is an integral part of an effective fiscal policy of the country and eventually can have an important effect on government debt. However, taxation is an enormous topic and an analysis of it is beyond the scope of this thesis. The Article III about Budget Universality is important to an extent that it limits the borrowing at a sub-national level (funds are disbursed from the state budget to local governments and municipalities). Therefore, I will not analyze this Article further as there is no need for any fiscal rule to discipline sub-national government spending. I will not discuss the Article IV of the law because it does not affect (at least not directly) the government's ability to spend. However, it does affect the buildup of external debt if domestic demand of capital is met by foreign debt-creating borrowing by private sector. Georgian government shouldn't restrict the flow of debt-creating capital (and the Article IV is in line with this claim); instead they should encourage saving among domestic citizens

(through mandatory pension saving scheme, for example) if the government's objective is to avoid the buildup of excessive external debt.

3.2 Criticism of Article II of the Economic Liberty Act

As already mentioned, the precedent of introducing a set of fiscal policy rules is new for the Georgian state. Any attempt by the government to impose restrictions on certain macroeconomic indicators with the aim to attain fiscal sustainability and encourage growth, should be encouraged. However, the Act is a superficial piece of legislature, with a number of major flaws. If the government wants to have a comprehensive and effective RFF in place by the time it goes into effect in 2014, the Act should be revised and tailored to Georgia's macroeconomics, it should be made flexible to accommodate downturns and upturns of the economy and should become enforceable.

Article II of the Economic Liberty Act which sets numerical ceilings for macroeconomic aggregates simply copies certain numerical values from other countries' RFFs without taking Georgia's macroeconomic characteristics into account. Therefore, one of Kopits–Symansky's (1998) criteria that any RFF framework should be home grown and home owned is completely neglected.

Three fiscal rules, which set the numerical limit on fiscal variables, should be analyzed in detail:

60% debt to GDP ratio rule. As already discussed above, possibility for borrowing, up to 58% present value of debt to GDP is possible without causing a debt distress (nominal value of the debt will be higher than 58%). For a country with Country Policy and Institutional Assessment score of 4.43 nominal borrowing of 60% to GDP shouldn't cause problems to fiscal sustainability (IMF, 2012). However, any increase in government's external borrowing will increase country's total external debt. As also shown above, Georgia's external debt position might not be as favorable as the fiscal one. Therefore a lower debt to GDP ratio should be proposed not to cause external debt distress. If the private sector's external

borrowing reduces (which cannot happen in a short run or even medium run) due to some government policies, government debt threshold can be revised upwards.

As a result of a low debt fiscal rule, sovereign borrowers might want to turn to domestic borrowing, which in turn will crowd out domestic investment or to Central Bank borrowing which will increase the inflationary pressures (Kopits and Symansky, 1998). A clause on limits to domestic or CB borrowing should be added to Georgian RFF not to make already scarce domestic savings even scarcer for private investment.

3% overall deficit target. Flexibility of this fiscal rule is essential to accommodate the busts in the business cycle. Instead of including an escape clause allowing more than 3% deficit spending in case of the "economic recession", a cyclical deficit rule should be introduced. Definition of "economic recession" is unclear. By contrast, a cyclically adjusted balance will clearly show a below 3% deficit that is not caused by a business cycle. This will eliminate a possibility of contractionary cost cutting that can exacerbate the crisis as the government cuts planned spending to meet the deficit target (IMF, 2009). As Blanchard and Giavazzi (2004) have shown spending cuts often affect capital spending, which is easiest to cut but can have high negative long term costs.

30% expenditure to GDP rule. Budget aggregates expressed in nominal terms are most vulnerable to the inflation. Higher inflation also means higher debt service expenditure that is denominated in foreign currency, which will again influence the expenditure composition. Instead of the nominal expenditure rule, a real expenditure target should be used (IMF, 2009)

3.3 Accountability, Enforcement and Monitoring of the Economic Liberty Act

As Kopits-Symansky (1998) guidelines specify, fiscal rules fixed by a higher powered law, such a constitution, will most likely have a stronger effect than a policy guideline. However, the Economic Liberty Act says nothing about the possible penalties that the spendthrift official would have to face. Ex

post noncompliance to the rule can vary from reputational to judicial or financial (in case of EMU) sanctions in different countries (Kopits and Symansky, 1998). For a country like Georgia, with a short democratic history, both judicial and reputational penalty would be of a better use for the maximum enforcing effect. Enforceability is an integral part of RFFs (IMF, 2009). Therefore, a good fiscal law should include: first, sanctions against the rule violators and second, an independent authority able to enforce the punishment in case of non-adherence to fiscal rules. Chamber of Control in Georgia could overtake such responsibility if it is given enough power and independence to act. The International Budget Partnership (2010) report assesses Chamber of Control as having a moderate strength in carrying out its current mandate.

Transparency is an important part of the RFF since it leads to an increased credibility in fiscal rules and government's commitment that it will adhere to the rules. Increased transparency means better possibilities for outside monitoring, which eventually should translate into lower interest rates. International Budget Partnership, which assesses the transparency of the country budgets, assigned the Georgian budget a score of 55 out of 100 in 2010 report. While the indicator for Georgia has improved from 34 in 2006 to 55 in 2010 and stands now above the index average, Georgia's budget transparency is still opaque in the area of end-year budget and audit reports (Transparency International Georgia, 2010). In addition, transparency at all stages of the budget implementation is important since for a credible rules based fiscal framework, a policy rule must comply with ex ante, as well as with ex post budgets (Kopits and Symansky, 1998). Transparency is also necessary for audit and accounting procedures to avoid creative accounting and concealing the noncompliance to the fiscal rules.

To make the RFF more transparent, an active outreach campaign to inform the media, citizens and enterprises, should be carried out on a regular basis as well (Kopits, 2011). The campaign must be accompanied by a lively debate by all stake holders to ensure the broader legislative consensus. Active engagement of the electorate in the RFF preparatory stage can lead to a complete and competent rules

based fiscal framework. Georgian government should initiate discussions to involve public in improving the RFF that will go into effect on December 31, 2013.

IMF (2009) study shows that countries with fiscal rules have had larger reductions in debt to GDP ratios. A study also found that the adjustment was more front-loaded. Entering 2014 with a comprehensive and effective RFF is crucial for Georgia as it will compel the officials to attain larger debt reductions. Reducing external public borrowing is important not to put total external debt sustainability in danger. More importantly, being on a shrinking debt path is essential to reducing yields on government paper in a period when Georgia is slowly starting to move from concessional to market borrowing.

An analysis of countries that have fiscal rules in place (IMF, 2009) also show that fiscal rules have been more credible where prior fiscal adjustment had already taken place. For fiscal framework to be credible and effective as it enters into force in 2014, it is imperative that a steady downward fiscal adjustment continues in the rest of the 2012 and 2013 (as projected by IMF (2012)).

Stable economic environment is necessary, for fiscal rules not to cause additional volatility (IMF, 2009). Therefore, steady political and economic developments should be the government priority in 2012 and 2013 as two important upcoming elections might create political turmoil.

3.4 Assessment of the Economic Liberty Act with Kopits-Symansky (1998) Criteria

Below is a more detailed examination of the Economic Liberty Act based on Kopits-Symansky (1998) criteria approved by the IMF executive board. These are:

Definition: The question here is where the RFF is well defined, whether time-frame, performance indicators or institutional coverage is well stipulated in the law. By above discussion the Act clearly fails to fulfill this requirement.

Transparency: As also already mentioned, problems with end-year budget, as well as with audit reports makes impossible to judge whether government has been profligate or opposite. When the Act enters the force in 2014, the obscurity with audit and end-year budget reports should be eliminated in order to increase the credibility of the law.

Adequacy: Question asked is whether the law is going to achieve the stated objective. As discussed superficiality and lack of detail in the law poses no possibility to effectively achieve the necessary goals.

Consistency: This criterion judges where the RFF is consistent with other existing laws. However, a good example of inconsistency can be found even within the law between the articles I and II. While government allows itself to overspend in case of recession it makes raising taxes a complicated task in the boom times.

Simplicity: Thorough and adequate RFFs can be documents with a lot of economics inside which can be hard for citizens, investors and other stake holders to understand. This question however does not apply to Economic Liberty Act since it is a very simple, 2 page superficial piece of legislature. It is because of this exact reason that it simple to understand, not because it has been written succinctly to make it an easily comprehensible document to public.

Flexibility: A fiscal policy rule should be flexible and able to absorb exogenous shocks, as well as accommodate business cycles. 3% overall deficit rule is not flexible to accommodate recessions. 30% nominal expenditure rule fails to pass the flexibility test too.

Enforceability: Rules stipulated in Economic Liberty Act are not enforceable in practice, because there are no sanctions proposed for the rule violators, as there is no supervisory agent named in the law that would oversee and enforce fiscal rules.

Efficiency: Are the fiscal rules efficient? Can they achieve efficiency while working in tandem with other laws? In the wake of faulty tax and labor code, as well as other incapable regulators and ineffective spending programs, the Act will not achieve its stated goals.

The Economic Liberty Act fails to meet the majority of the Kopits-Symansky (1998) criteria. Urgency and a necessity of robust rules-based fiscal framework cannot be overemphasized. To avoid the short-sightedness of the government and a common pool problem, and to ensure debt sustainability in a medium to long term, a comprehensive RFF should be designed and adopted by the parliament.

Chapter 4. A Need for Further Macro-Stabilization for Better Debt Sustainability

Effective fiscal rules are integral part of long term fiscal sustainability. Even if they only curb fiscal profligacy of government officials, they also affect country's external debt sustainability as it limits the government borrowing that further contributes to buildup of country's foreign indebtedness (assuming that country borrows extensively from abroad, which is the case in Georgia). In addition to fiscal rules, macro-environment enhancing policies ensure the facilitation of debt management and lowering of risks for debt distress. Through macro-stabilizing policies, economy's vulnerability to foreign shocks can be reduced.

To support the discussion, a comparison between Georgia's growth patterns from 2003 to 2007 to those of Central and Eastern Europe (CEE) countries is carried out and a few important similarities are discovered. Because EU-10 countries were stronger integrated into the global economy, the effect of the economic downturn was more adverse on these countries than on Georgia. However, by analyzing the similarities, we can spot the channels of volatility where policy improvements are needed. The comparison also helps to identify the good policies that some of the CEE countries had in place that helped them avoid the sharp contraction in growth during the global recession.

In a nutshell, better macro-stabilization is a key to improving debt sustainability and increasing debt thresholds.

4.1 EU-10 Growth Model and Take-aways for Georgia

Economic growth in EU-10 countries (countries that joined EU in 2004 and 2007) followed a growth model from 2000 till 2007 that made them vulnerable to external shocks. As the recession hit, every EU-10 country experienced the negative growth (except Poland), some of them up to -18% (Latvia in 2009)

(IMF, 2010). Many features that characterized the EU-10 growth model before 2007 also apply to Georgia's growth from 2003 to 2007. The lessons that the CEE countries learned as a result of the recession, should be also carefully observed by Georgian policy makers to design shock proof policies.

The main features of EU-10 growth model were (Marer, 2013):

(1) The fast-paced expansion of domestic demand;

(2) Growth that was facilitated by the rapid expansion of credit;

(3) Credit was financed largely by capital inflows;

(4) Large capital inflows allowed the countries to run continuous current-account deficits;

(5) CA deficits were made possible by the region's speedy integration into the global economy;

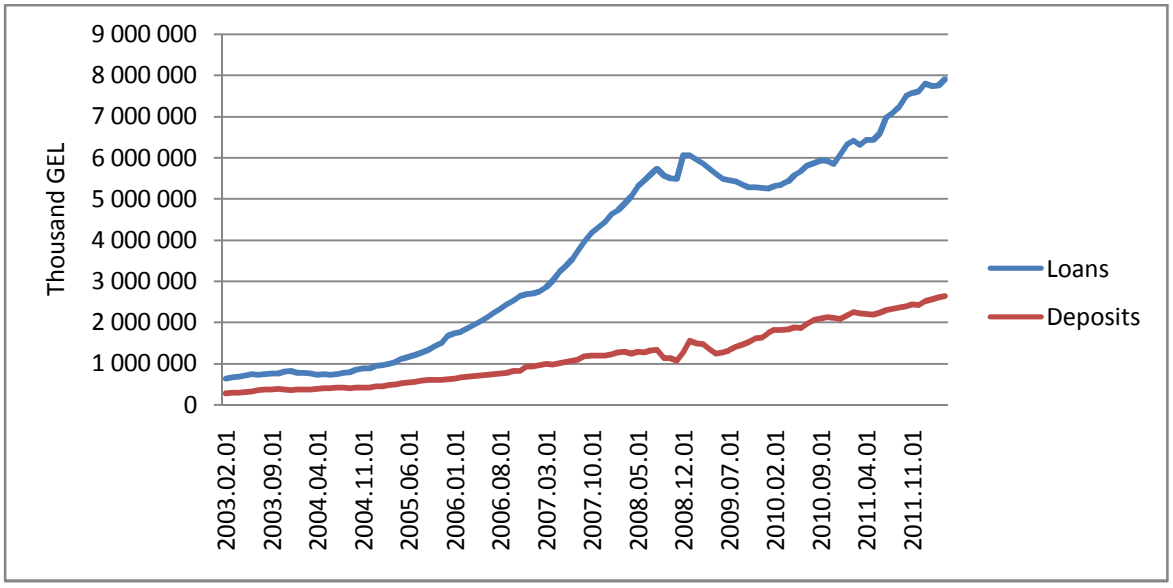
(6) Countries experienced significant appreciation of their real exchange rates.

Georgia's growth from 2003 till 2007 had a few important similar patterns to the EU-10 growth. By analyzing these similarities, we can identify the areas where better policies are needed that will insulate Georgia from future shocks that can complicate debt sustainability in future.

4.1.1 Similarities Between EU-10 and Georgia

Georgian government carried out effective reforms in the public sector, improved efficiency of government agencies, eradicated corruption, reformed police and started a relentless fight against crime, recovered tax collection system and started to invested heavily in infrastructure. As a result the GDP growth accelerated and domestic demand started to increase. Because of the low savings rate by Georgian citizens, Georgian banks (like those in EU-10 countries) also used wholesale funding to provide credit to Georgian consumers. (Figure 9). Low domestic savings rate, as already discussed above, was a reason for sharp increase in external borrowing.

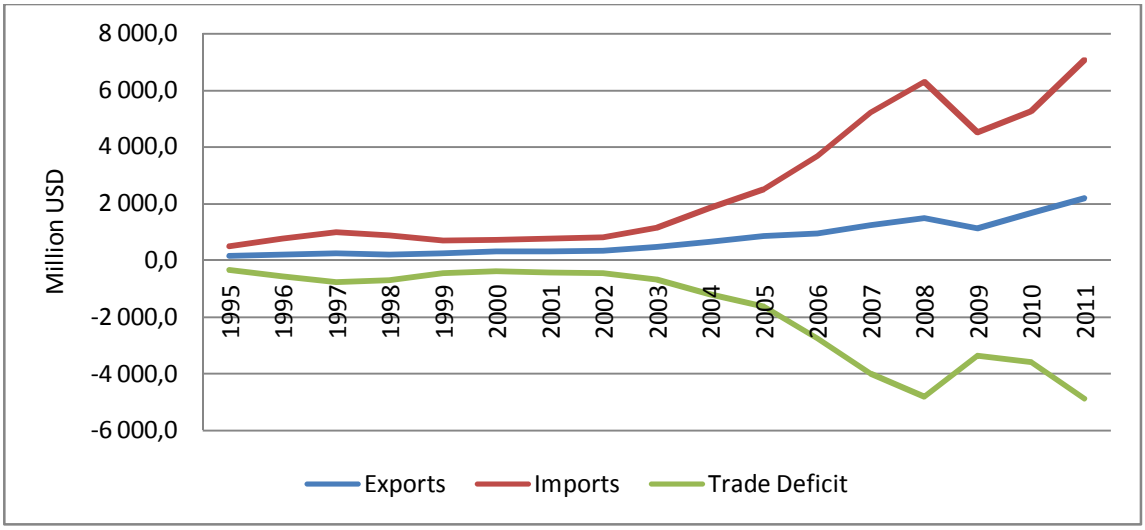
Figure 9. Loans and deposits in Georgian banks



Source: National Bank of Georgia

As the demand grew, because of the uncompetitive and dilapidated domestic production, imports grew faster than the exports, increasing a current account deficit (Figure 10). Increasing trade deficit has been a headache for Georgian policymakers and politicians, as it requires attracting more external financing (debt creating or non-debt creating) to cover the gap. Large current account deficit also exposes the country to foreign price shocks. Increasing food and energy prices in the world was transmitted into a double digit inflation in Georgia in 2010 (IMF, 2011). Large inflation in itself causes the debt repayment harder since most of Georgian debt is denominated in foreign currency. It also makes exercising of fiscal rules more cumbersome. If the expenditure rule is in place, for example, higher inflation implies less goods and services that the government can procure (IMF, 2009). As also discussed in Chapter 2, large continuous current account gaps do not come without costs and can lead to strong adverse consequences (Edwards, 2001).

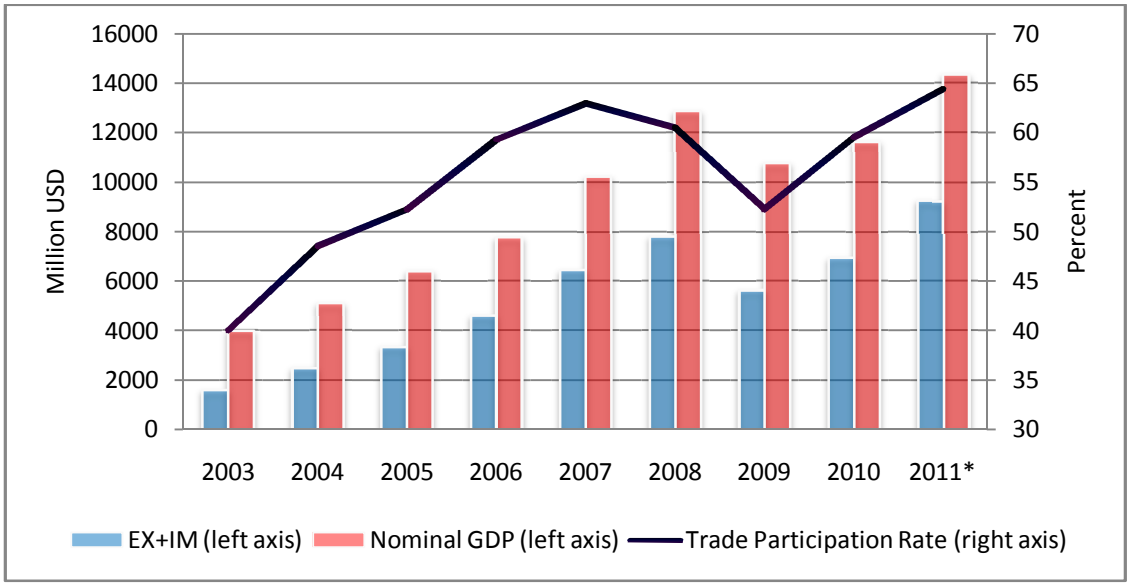
Figure 10. Georgia's exports, imports and trade deficit



Source: National Statistics Office of Georgia.

Trade participation rate of Georgia grew from 40% to 60% of GDP until 2007 when the global recession brought it back down to 52% (Figure 11). GDP growth in 2008 was 2.3% in 2008, down from 12.3% in 2007. In 2009, there was a GDP contraction of -3.8%. As a result of slowing economy and reduction in Foreign Direct Investments large external borrowing was necessary to close the balance of payment gap (as it did in EU-10 countries (Marer. 2013)).

Figure 11. Georgia's integration into the global economy through trade



Source: National Statistics Office of Georgia

4.1.2 What can Georgia Learn from EU-10 Experiences?

As the experience of EU-10 countries show, some of the features of its growth model left them vulnerable to foreign shocks and caused large GDP contractions in 2007, 2008 and 2009 (Marer, 2013). However, several policies and institutional choices in different countries provided protection against some of the shocks. Georgia can learn from EU-10 as well as its own mistakes and make changes to policies accordingly to better insulate from future shocks.

Labor costs. It is important that unit labor costs match the labor productivity in order to stay competitive (Felipe & Kumar, 2011). Poland's policies that helped to increase its competitiveness but left unit labor costs unchanged (EBRD, 2010) were one of the reasons of Poland's continued growth during the recession (Marer. 2013). By contrast, Greece's wage increases over the years unmatched by suitable productivity increase, led to excessive borrowing to finance current consumption which led to its current economic tragedy.

Flexible labor markets guarantee that the competitive wages are paid to labor. Georgia already has a very flexible labor market (maybe too flexible) (Jobelius, 2011). However, the biggest problem, lack of education and training of labor (World Economic Forum. 2011), should be targeted by policy makers immediately to increase competitiveness of Georgian labor.

Credit expansion. Credit expansion should be non-excessive which will prevent disproportionate increase in loan-to-deposit ratio (Marer, 2013). Credit expanded excessively in Baltic States from 2000 to 2008, which made it more vulnerable to global recession (The World Bank. 2010). Similarly, as seen from the Figure 9 above, loans given to residents in Georgia was much higher than the deposits made by residents in Georgian banks. The gap was filled by wholesale funding and by capital from foreign parent banks which had clearly two adverse effects. First, it increased Georgia's external debt to GDP ratio and second, as the recession hit the credit stopped to flow, creating a need for government borrowing to close the balance of payments gap.

In the future, policies that will promote domestic savings in Georgia should be encouraged. One example of a good policy is cancelling income tax on returns on deposits or starting a mandatory pension saving scheme (Jappelli and Pistaferri, 2002).

Level of external debt. A large external debt that Georgia built up after the global recession, represents a channel of volatility. The EU-10 countries who had the highest external-debt-to-GDP ratios (Latvia, Estonia, Hungary, Bulgaria, Lithuania) were the ones who suffered with largest contractions in GDP growth during the crisis (IMF, 2010). Therefore, the policies that will put the debt on the downward path are needed. Alternatively, the government can have a clear role to play in limiting additional external debt build up by restricting further external borrowing to finance the deficits.

Learning from the EU-10's bad and good experiences, as well as from personal experience, Georgia can continue its reforms in a way that fast impressive growth is not followed by a painful output contraction, which would jeopardize the debt sustainability. By designing better policies, a country can avoid adverse macroeconomic volatilities and stay on a sustainable growth path.

Conclusions and Policy Recommendations

Georgia's macroeconomic outlook is fairly positive with 6% growth projected in 2013 and 5.5% projected for the years after (IMF, 2012). It is still an imperative that the government stays on a deficit reducing path and does not borrow unless absolutely needed.

Georgian public debt is on a sustainable path and will stay so unless large foreign shocks throw it off the track and forces the government to borrow to correct the adverse effects of the recurring recession. Even if the Georgian government borrowed and debt-to-GDP ratio increased, it still wouldn't put fiscal sustainability in danger, as there is still enough fiscal room available. On the other hand, as shown in Chapter 2, the country's total external debt position (government plus private debt) might not be as favorable as the fiscal one. As a result, any additional government borrowing will add to external debt, unless it is compensated by a decrease in private borrowing. Article IV of the Economic Liberty Act will guarantee the freedom of movement of capital from 2014, which will disallow any government to apply any restrictions on private external borrowing. As a result, unless the domestic savings start to increase, government should avoid any further external borrowing as it might increase country's external debt distress.

In order not to put country's debt sustainability in danger, an effective and comprehensive rules-based fiscal framework is needed. The Economic Liberty Act, which proposes three fiscal rules and which comes into effect in 2014, has a several important flaws that need to be corrected if the medium to long term debt sustainability is in benevolent government's interest. The following changes to the law should be applied:

- Instead of the overall deficit rule, cyclically adjusted budget deficit rule of 3% should be adopted.
- Instead of the nominal 30% to GDP expenditure rule, a real expenditure rule should be proposed.

- Before the external debt to GDP is put on a downward path, having a 60% debt to GDP ratio represents an opportunity for a profligate government to borrow and increase the risks of external debt distress.
- Punishment for non-adherence to the rule should be clearly defined in the law. For Georgia, financial as well as reputational penalty is advised for non-compliance.
- Effective enforcement mechanisms should be designed. Chamber of Commerce can be a potential enforcing agency, if it is given necessary independence and power to act.

Further macro-stabilization is necessary to reduce Georgia's sensitivity to foreign or domestic disturbances. The government should intensify working towards the following directions:

- Avoiding excessive growth of external borrowing by limiting government's external borrowing, as well as by promoting domestic savings. Mandatory private pension contributions can be a good start.
- Constant current account deficit will not come without costs. As shown above, in some countries, large deficits has led to financial crisis even when the country had a balanced budget and increasing domestic savings pattern. Therefore, policies that promote exports are needed. Georgian competition authority needs to be restored that will ensure a fair game on the markets that in the medium run will improve competitiveness of Georgian firms and help exports.
- Global Competitiveness Report (2012) identifies insufficiently trained labor and poor work ethic as two of the most important obstacles for doing business in Georgia. To increase the country's productivity and exports, better educational policies should be designed and implemented.

Effective rules-based fiscal framework can be designed relatively easily and quickly than macro-stabilization policies, that require more in-depth analyses and longer period to demonstrate its positive effects. However, the combination of these two are needed to attain medium to long term fiscal sustainability.

Appendix I. Calculating Debt Stabilizing Nominal Interest Rate for Georgia

$$D_{t+1} = D_t + i_t D_t - p_{t+1} + \Delta D$$

where the D_t is the debt stock in given year, where D_{t+1} is a debt stock in the following year, where i_t is the nominal interest rate, p_{t+1} is the primary balance and ΔD is the change of debt stock.

By dividing the elements of above given identity, we obtain the following:

$$\frac{D_{t+1}}{Y_{t+1}} = \frac{D_t + D_t i_t}{Y_t} \times \frac{Y_t}{Y_{t+1}} - \frac{p_{t+1}}{Y_{t+1}} + \Delta D$$

Using some more algebraic manipulations, we get:

$$\frac{D_{t+1}}{Y_{t+1}} - \frac{D_t}{Y_t} = i_t \frac{D_t}{Y_t} \times \frac{Y_t}{Y_{t+1}} - \frac{p_{t+1}}{Y_{t+1}} + \frac{D_t}{Y_t} \times (\frac{Y_t}{Y_{t+1}} - 1)$$

By using the forecast values (IMF. 2012) for the nominal growth (11.5% (5.5% of real growth plus 6% of inflation) from 2013 till 2017, outstanding debt stock in the current year for Georgia (34% to GDP) and the forecast primary balance (-1.9% to GDP) in 2013 (which reduces afterwards, but I will use the 2013 value for the calculations), we calculate the nominal interest rate that would be necessary to keep the debt stabilized in Georgia.

$$i_t \times 0.34 \frac{1}{1.06 \times 1.055} + 0.019 + 0.34 \times (\frac{1}{1.115} - 1) \leq 0$$

$$i_t \leq 0.047$$

Interestingly, by reducing the government deficit to -1%, the debt stabilizing interest rate would increase to 7.4%.

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