



STATE AUDIT
OFFICE
OF GEORGIA

Performance Audit of Public Debt Management

2014

Performance Audit of Public Debt Management



Tbilisi
2014

Table of contents

Executive Summary -----	6
Recommendations: -----	7
1. Introduction -----	8
1.1. Audit Motivation -----	8
1.2. Audit Objective and Questions -----	8
1.3. Audit Scope -----	9
1.4. Audit Methodology -----	9
1.5. Criteria -----	9
1.6. Background Information -----	10
1.6.1. Organizational Structure of Public Debt Management in Georgia -----	10
1.6.2. Borrowing Process in Georgia -----	11
1.6.3. Public Debt Portfolio -----	13
2. Public Debt Accounting Practice and Resulting Problems -----	16
3. Setting the Borrowing Needs -----	22
4. Existing Practice of Public Borrowingv-----	24
4.1 Public Debt Management Strategy -----	24
4.2 The Importance of Comparative Analysis -----	25
4.3 Debt Sustainability Analysis and Risk Assessment Practice -----	27
4.4. Development of the Government Securities Market and Existing Challenges -----	29
4.5 Additional Resource for Banking System to Finance Economy -----	33
Bibliography: -----	33
Annex 1: borrowing process of domestic debt -----	34
Annex 2: Terms of the loan extended by World Bank and ADB -----	35
Annex 3: Public Debt Service -----	37

Executive Summary

Public debt is created by the act of public borrowing. This is a process through which governmental units, in exchange for money give promises to external or domestic creditors. The issue of public debt is one means of financing government expenditures, alternative to taxation and to direct currency creation. With the prudent debt management borrowed funds may stimulate the economic growth and may create substantial benefits for a country.

As the Georgian economy grows, the challenges arise regarding the borrowing opportunities available for the developing country. To respond with the mentioned challenges the Government requires to have a prudent debt management activities implemented in practice. Moreover, there is an increased interest from the Georgian society with the mentioned topic. Taking into account all the above mentioned issues, State Audit Office found it necessary to examine the existing practice of public debt management in Georgia during the period 2010-2014. The audit has revealed a number of deficiencies in the public debt management:

- ❖ Reported public debt of Georgia doesn't include the debt of State-Owned Enterprises (SOE) that constitute implicit contingent liabilities. Therefore, in case of default/insolvency of the entity there is a risk of the reduction in assets and/or increase in liabilities of the state. These in turn, may negatively affect the country's financial position. Additionally, if the contingent liabilities would not be considered in the different analysis (for instance, debt sustainability analysis), possible threats and risks related to the public debt management may not be properly evaluated.
- ❖ Ministry of Finance (MOF) does not have the public debt management strategy document. Based on the international experience, existence of this document is an important prerequisite to achieve the debt sustainability in the medium and long-run. The importance of the debt management strategy is increased taking into account the existing challenges regarding the borrowing possibilities.
- ❖ The creditor selection process is not documented and in the explanatory note - enclosed to the project Government Decree does not contain the information and analysis of the alternative funding opportunities. Therefore, information given in the explanatory notes does not ensure the transparency of the borrowing process and does not create the environment of the informed decision making.
- ❖ Risk assessment and debt sustainability analysis were not conducted on a regular basis. This, in turn, creates the risk that potential threats would not be identified and prevented in a timely manner.
- ❖ Stable emissions of the Government Securities are not enough for the development of the domestic credit market. More than 90% of the Government Securities are acquired by the commercial banks indicating on the low level of investor base diversification. According to the international best practice, one of the most important prerequisite for the Government's securities market development is an existence of diversified investor base.
- ❖ There is no formal guideline or methodology incorporated, describing the planning process for setting the Gross Borrowing Requirements. Within the Ministry of Finance the process is regulated by charter of the ministry. Though, in the mentioned document except the Public Debt and External Financing Department, it is not clearly defined the functions of other entities engaged in the process. As a result, process of determining borrowing needs for the planning year is not carried out according to the predefined and formally approved rules/procedures.

Considering all the shortcomings prevailing in the public debt management the State Audit Office of Georgia elaborated corresponding recommendations to improve the existing public debt management practice.

Recommendations:

To improve the public debt management in Georgia, State Audit office of Georgia issued the following recommendations:

- The MOF should completely disclose information regarding implicit contingent liabilities acquired by the public sector identifying their corresponding owners and characteristics of the debt instrument;
- The MOF, while conducting macroeconomic analyses regarding the public debt, should take into consideration the amount of contingent liabilities and draw considerable attention to the evaluation of the risks stemming from them;
- To make amendment in the “State Debt Law” of Georgia so that the definition of the public debt met the requirements of international standards.
- The MOF should develop a debt management strategy, which would be in compliance with country’s overall development strategy and will facilitate achieving the intended goals.
- The detailed comparative analysis of the available funding opportunities should be prepared by the MOF and enclosed it to the project Government Decree with other relevant documents.
- The Ministry of Finance of Georgia should regularly, at least on an annual basis, carry out debt sustainability assessment and monitor the debt portfolio risks.
- The MOF, in concurrence with NBG, should elaborate a development strategy for state securities domestic market and analyze potential incentives/activities that would trigger the further development of domestic securities market.
- The MOF should implement the rules/procedures for defining borrowing needs that would actually make the process of setting the borrowing needs formal;
- General Charter of the MOF should be amended to define exact roles and responsibilities of each department involved in the process of setting borrowing needs.

1. Introduction

Public debt is one of the most important components of country's financial management. The basic reason of borrowing is to finance budget expenditures, by which the society will be provided with public services. In terms of insufficient financial resources, borrowing provides an opportunity to avoid suspension of different investment projects, growth of taxes and/or reduction of current expenditures, which will have a negative impact on the implementation of various social projects. As a result, with the prudent public debt management, government might enhance the economic growth of a country. But, on the other hand, improper debt management instead of economic growth might lead the country to a severe debt crisis. Therefore, to ensure the sustainable growth of a country, prudent public debt management plays a crucial role.

Improper assessment of the threats and risks related with the growing public debt volumes brought some devastating economic result in many countries all over the world. It's a well-known fact that debt crises in Latin American countries in 1980s and 1990s had a significant impact on the world economy. The Latin American debt crisis was followed by the 1997-1998s Asian and Russian crises. Lastly, the global financial crises of 2008 together with the debt crises in Greece had a negative influence on whole European region. Globalization and liberalization of international capital markets made it necessary to revise the existing practice of public debt management. In response to the international debt crises, efficient public debt management has become a priority in many developing countries and emerging market economies.

1.1. Audit Motivation

The State Audit Office (SAO) of Georgia in its reports on the Government Report "On the Execution Process of the State Budget has identified several risks related to the public debt management. In addition, in recent years the topic was extensively discussed in public media reflecting the growing interest of society with the topic in question. It should be noted, that it has been no public debt management performance audit carried out in Georgia¹. The World Bank (WB) and International Monetary Fund (IMF) recommend conducting the audits of the public debt management activities regularly, while it is essential to achieve effective public debt management².

Importance of the topic is emphasized by the fact, that in recent years the share of public debt was gradually increasing and at the end of 2014 debt stock amounts 10,397.4 mln GEL - an 18% increase from 2010 level. Additionally, it should be mentioned that in a period of 2010-2014, on average 850.8 mln Gel has been paid for the debt service (Principal + Interest).

1.2. Audit Objective and Questions

Audit objective is to determine whether the existing public debt management practice ensures the debt sustainability in medium and long-term periods and whether the principle of economy is considered when borrowing. To this extent the audit team elaborated the following audit questions to be answered in the audit process:

1. IN 2013 THE WORLD BANK MISSION ASSESSED THE DEBT MANAGEMENT BASED ON THE METHODOLOGY DEVELOPED IN THE WORLD BANK'S DEBT MANAGEMENT PERFORMANCE ASSESSMENT TOOL (DEMPA). ACCORDING TO DEMPA, ONE OF THE PERFORMANCE INDICATORS, INCLUDED IN THE ASSESSMENT, IS AUDIT (DPI-5) THAT REQUIRES REGULAR INTERNAL AND PERIODIC EXTERNAL AUDITS TO BE CONDUCTED. AS A RESULT THIS INDICATOR FOR GEORGIA WAS ASSESSED WITH THE LOWEST GRADE "D".

2. IMF AND WB, (2003): GUIDELINES FOR PUBLIC DEBT MANAGEMENT, P.16

1. Is the definition of public debt sophisticated?
2. Does the existing practice provide transparency of identifying borrowing needs?
3. Are the measures taken to ensure the debt sustainability in consistence with internationally recognized practice?
4. Does the DMO select the best funding source by balancing cost and risk?

1.3. Audit Scope

The auditee is Ministry of Finance of Georgia (MOF). The audit team has studied the public debt management activities in the period of 2010-2014. One of the audit objectives was to confirm the public debt stock. To this extent the SAO requested from the National Bank of Georgia extracts of the transactions from local and foreign currency treasury single accounts. The provision of the mentioned information has been suspended by Ministry of Finance. Consequently, audit team was unable to get the evidence on the intended audit objective.

1.4. Audit Methodology

The performance audit of public debt management has been carried out in accordance with the international standards of supreme audit institutions (ISSAI 3000, 3100, 5400-5499)³. The techniques employed were interviews with the staff of MOF engaged in the public debt management process and analysis of the corresponding documents. In addition, the explanatory notes enclosed with the draft Government decree on external borrowing, were analyzed by the audit team.

1.5. Criteria

National laws and regulations governing sovereign debt activities:

- ❖ State Debt Law of Georgia;
- ❖ the Law of International Treaties;
- ❖ the Budget Code;
- ❖ the annual Budget Law;
- ❖ Regulation on the issue, circulation, registration and redemption of treasury bills and treasury notes issued by the Ministry of Finance;

3. <http://www.issai.org/4-auditing-guidelines/general-auditing-guidelines/>

Guidelines of International Organizations and Best Practices:

- ❖ United Nations Conference on Trade and Development (UNCTAD): Principles of Responsible Sovereign Lending and Borrowing;
- ❖ Manual on effective debt management – UN;
- ❖ World Bank, Guidelines for Public Debt Management (2003) and accompanying document;
- ❖ IMF, Public Sector Debt Statistics: Guide for Compilers and Users;
- ❖ Public Debt Management Procedures Manual – MEFMI – Public debt management procedures manual;
- ❖ INTOSAI working group on public debt- Guide for Auditing Public Debt Management.

1.6. Background Information

1.6.1. Organizational Structure of Public Debt Management in Georgia

According to the International Monetary Fund and World Bank Public debt management is the process of establishing and executing a strategy for managing the government's debt in order to raise the required amount of funding at the lowest possible cost over the medium to long run, consistent with a prudent degree of risk. Also, when required, the implementation of defined strategy may include the possible ways of achieving other debt management goals. For instance, the development of domestic financial market may be set an objective by the government.

In Georgia, public debt management is regulated by the following legal acts: Constitution of Georgia; the State Debt Law of Georgia; the Law of International Treaties; the Budget Code; the annual Budget Law; the Central Bank of Georgia Act, the Law of Restructuring of Tax Repayments and Government Loans; the Economic Freedom Act.

Ministry of Finance is responsible for the management of the public debt. According to the “State debt law” of Georgia, with the Government's consent⁴ and in concurrence with the NBG, MOF is authorized to sign loan agreements, issue Government securities, extend guarantees for the loans taken by Georgian economic agents and on-lend the borrowed funds⁵. In addition MOF is responsible also for servicing and registering the loans. Within the MOF the Public Debt and External Financing Department (PDEFD) is assigned to implement the above mentioned functions in practice. In the PDEFD operates two divisions: Public Debt Management division (PDM) and International Investment Projects and Euro Atlantic Integration Division (IPEI).

4. BEFORE THE CONSTITUTIONAL CHANGES (OCTOBER, 2013) PRESIDENT'S CONSENT WAS REQUIRED.

5. STATE DEBT LOW OF GEORGIA, (CHAPTER I, ARTICLE 2, PARAGRAPH 2)

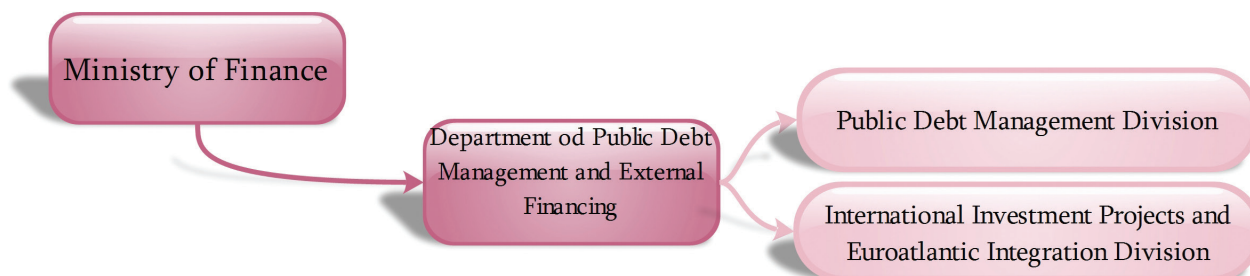


Figure 1: Organizational Structure of Public Debt Management in Georgia.

- ❖ PDM division is responsible for:
 - Preparing the annual financing plan for the gross borrowing requirement;
 - Defining the limits for the external and domestic debt;
 - Participating in the negotiation for the budget support loans;
 - Recording the loans in the public debt information systems (DMFAS, e-DMS, DMNAT);
 - Analyzing the loan terms;
 - Preparing the analytical information about the public debt;
 - Servicing the public debt;
- ❖ IIPEI division's main functions are concentrated on the investment projects. Their main duties include:
 - Negotiation and drafting the loan agreements with the multilateral and bilateral creditors;
 - Financial monitoring of the investment projects;
 - Participating in the annual state budget planning process.

1.6.2. Borrowing Process in Georgia

Public debt is created by the act of public borrowing. This is a process through which governmental units, in exchange for money give promises to external or domestic creditors. For governments the purpose of the exchange is that of securing current purchasing power with which they may purchase resource services, or final products. The issue of public debt is one means of financing government expenditures, alternative to taxation and to direct currency creation.

In Georgia, borrowing process is split up in several steps and a number of state entities are engaged in it. Main authority in the process is MOF, which is responsible for the operational activities as well as for strategic planning. The process of borrowing is different for domestic and external debt. The borrowing from the external sources is regulated by the

“State Debt Law” and the “Law on International Treaties”. For the Domestic debt raising legal framework comprises the “State Debt Law” and regulation “On the Issue, Circulation, Registration and Redemption of Treasury Bills and Treasury Notes Issued by the Ministry of Finance of Georgia “.

Initiation of the external borrowing might be proposed directly by the MOF or by the spending agency. It depends on the purpose of a loan. Particularly, for the budget support loans initiator is MOF but in case of investment project financing, spending agency together with MOF initiates the borrowing activities. The package including the loan purpose and project overview together with the corresponding opinions issued by the NBG, Ministry of Justice, Ministry of Economy and Sustainable Development and interested spending agency, is presented to the Government of Georgia to get the consent for the negotiation process.

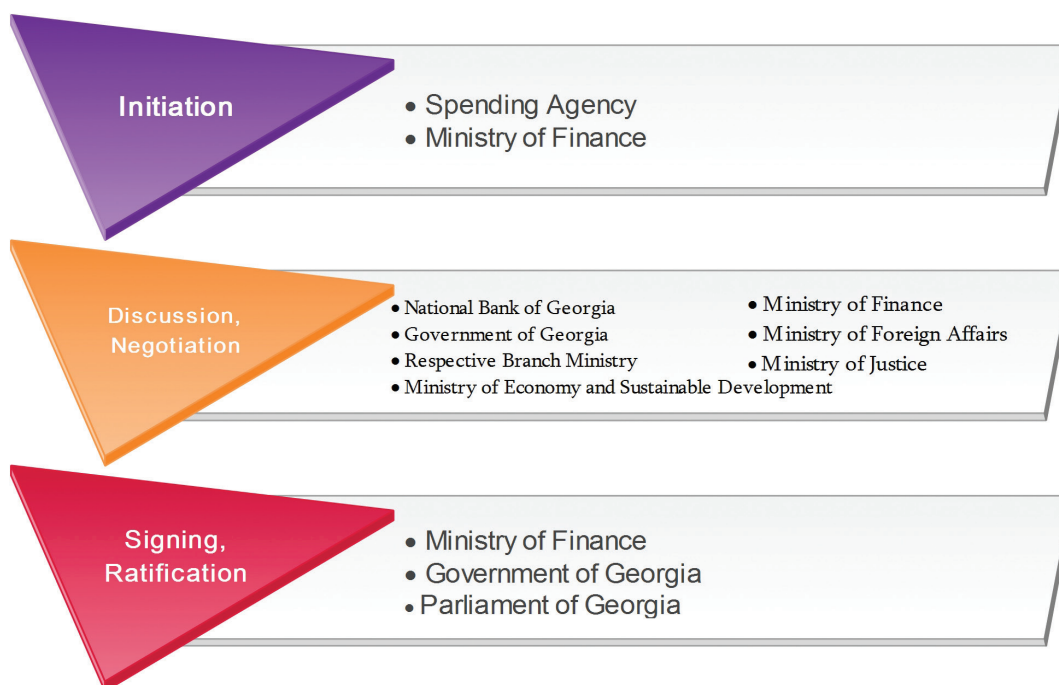


Figure 2: Institutions involved on each stage of external borrowing.

In the negotiation process representatives from MOF, NBG, Ministry of Justice, Ministry of Foreign Affairs, Ministry of Economy and Sustainable Development and other corresponding ministries or related state entities are included. After the draft loan agreement is settled with the external creditor draft loan documents go through the same procedure to be discussed by the above mentioned ministries. On that stage Ministry of Justice issues the legal opinion on the drafted loan. Based on the provided comments and/or confirmation letters of the corresponding ministries, Government of Georgia issues a decree to give the authorization to MOF to sign the loan with the settled terms and conditions.

At the last stage of borrowing process, MOF signs the loan contract and registers the debt in the database. As the loan agreements with the external creditors are considered as an international treaty it needs to be ratified by the Parliament of Georgia. This rule does not apply to all external loan agreements. For instance, issuance of the Government

securities on the international capital markets and loans raised from the IMF funds allocated to Georgia does not require the ratification of the Parliament⁶.

In case of domestic borrowing, two institutions - Ministry of Finance (MOF) and National Bank of Georgia (NBG) are involved in the process. According to the “State Debt Law”, MOF has the responsibility to define domestic debt’s volume and financial terms in consultation with NBG. Detail information about the stages of domestic borrowing and responsibilities of involved entities is represented in annex 1.

1.6.3. Public Debt Portfolio

According to “the Law on the Public Debt” of Georgia, the public debt is defined as the sum of all domestic and external debts, raised directly or guaranteed by the MOF, on behalf of Georgian Government, denominated in the local or foreign currency that takes the forms of direct loans, Government Securities and the financial resources taken from the IMF⁷. In Georgia, the public debt is classified as a domestic or external debt based on the currency. Therefore, domestic debt constitutes all liabilities denominated in local currency and external debt-denominated in foreign currency.

As of December, 2014 the public debt portfolio amounted to 10,397.4 mln GEL (35.7% of projected GDP). The major share of the debt is represented by direct liabilities (99.95%), while an indirect liability - state guarantee – constitutes only 4.7 mln GEL. Lately, domestic and external debts are characterized by upward trending. In 2014 the public debt stock increased by about 12% in comparison with 2013. It should be noted that during 2010-2014 years the external debt stock grew on average by 3%, while the domestic debt increased on average by 10%. It was mainly caused by the significant increase of domestic debt in 2014 (27%).

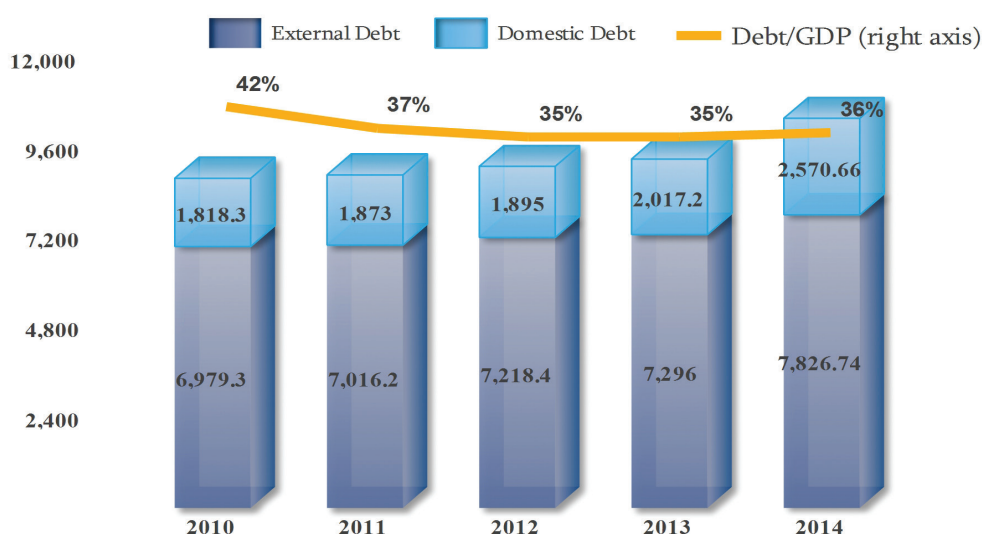


Figure 1: The share of the public debt in GDP.

6. State Debt Law of Georgia - article 2
 7. “State Debt Law of Georgia”, Article 1(a).

Analyzing the public debt statistics in absolute terms might be misleading. Therefore, it makes sense to analyze the public debt in comparative terms using various macroeconomic variables that are in practice the source to repay the debt obligations. Public debt to GDP ratio is the mostly used indicator. In Georgian case, this indicator is characterized by downward trending and is significantly less than the threshold (60%) defined by the “Economic Freedom Act”. Apart from this indicator, to evaluate the sustainability and solvency of a country, IMF examines public debt to budget revenues and public debt to export ratios. It should be noted, that public debt to export ratio is decreasing while public debt to budget revenues, after the decrease in 2010-2012, has started to increase in 2012-2014. The thresholds set by the IMF regarding these indicators were not breached⁸.

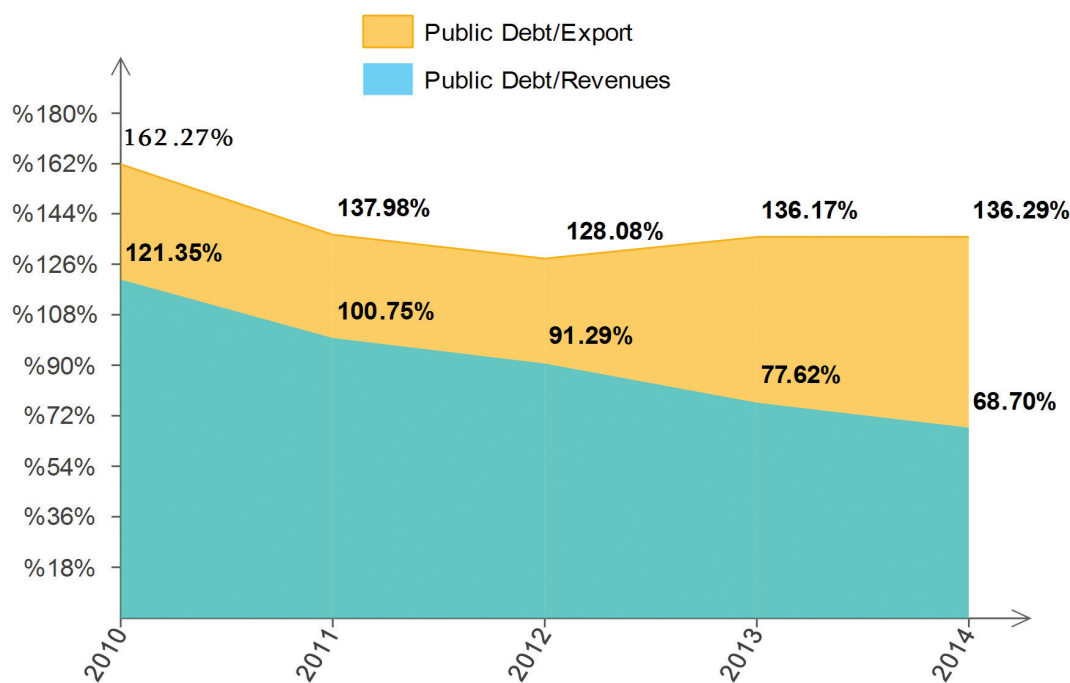


Figure 2: Public Debt to Export Ratio and Public Debt to Budget Revenues Ratio (%).

Generally, Government of Georgia borrows funds both in local currency, by issuing Government debt securities in the respective domestic market and in foreign currencies by borrowing from the international finance institutions and bilateral creditors. In recent years, debt contracted with multilateral creditors dominates in the public debt portfolio⁹.

8. Thresholds set by the IMF for low-income countries: public debt/export – 200%, public debt/budget revenues – 300%.

9. In the current portfolio multilateral creditors are represented by the following institutions: IMF, WB, EBRD, ADB, EIB, IFAD.

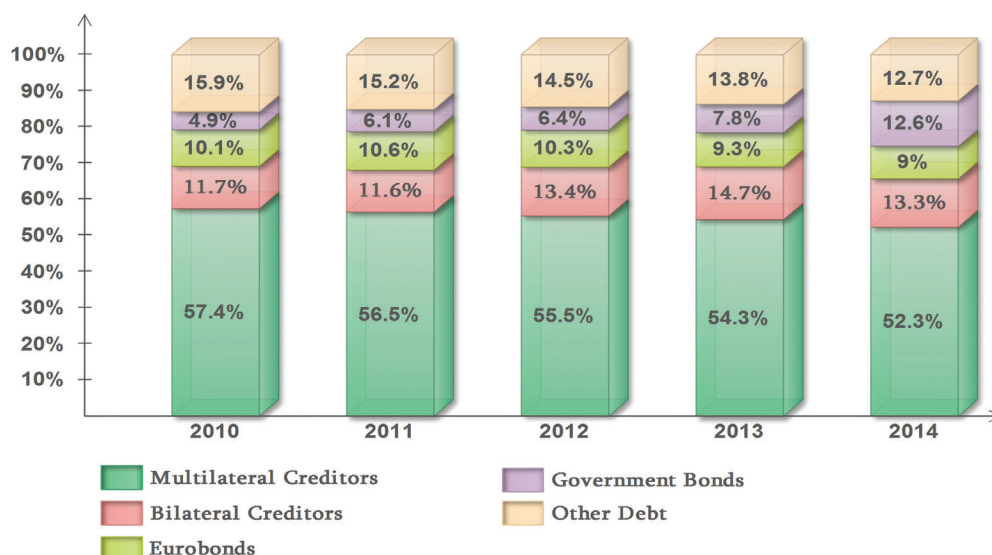


Figure 3: Public debt Composition in terms of Creditors.

Although the share of multilateral debt decreased in the portfolio during the last 5 years, it still remains significant and there is no sign that the dependence on the multilateral creditors will diminish in the near future. In the current portfolio, most of the debt (1,771.1 mln USD) Government of Georgia owes to the World Bank, represented by IDA and IBRD. The largest multilateral creditors are: WB (60.8%), ADB (20.8%), EIB (8.3%) and IMF (5.8%). The funds attracted from bilateral creditors increased by approximately 2% and the largest bilateral creditors are: Germany (39.9%), Japan (18.8%), Russia (12.7%) and France (8.3%).

In terms of currency structure of the debt, external debt consists of liabilities denominated in 6 various currencies. In the portfolio important role plays debt contracted in SDR and USD. In recent years, the share of Euro denominated loans is gradually increasing from 12% in 2008 to 17% in 2014.

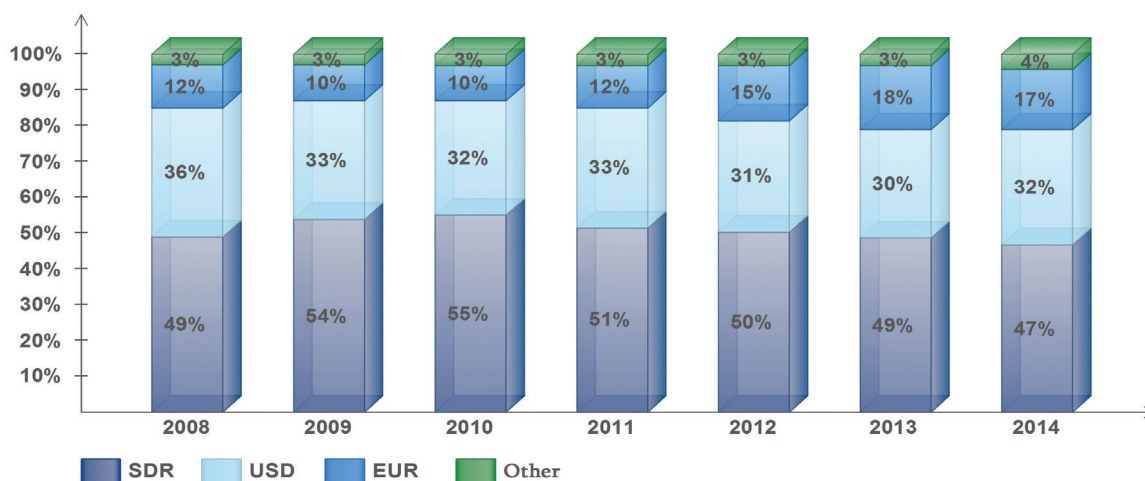


Figure 4: External Debt Currency Structure.

According to the Ministry of Finance, Georgia’s domestic debt portfolio consists of Treasury Securities with the maturities up to 12 month (T-Bill), medium and long-term Government securities with the maturities 2, 5 and 10 years, “historical debt”¹⁰ and the debt owed to the NBG. Since 2009, the only source of the domestic debt is the Government Securities issued on the local financial market. The issuance of the Government securities was launched in 2009. If at the beginning only short-term (6 month and 12 month) T-bills and 2 year T-Bonds were issued, from 2013, term structure of Government securities has increased. At the moment, 12 months T-bills, 2, 5 and 10 years T-Bonds are in circulation. As a result, portfolio of domestic debt securities is more diversified and weighted average term to maturity of the portfolio has also increased. To be more precise, as of December 2014, weighted average term to maturity of the portfolio was equal to 3.3 years compared to 1.2 years in 2010.

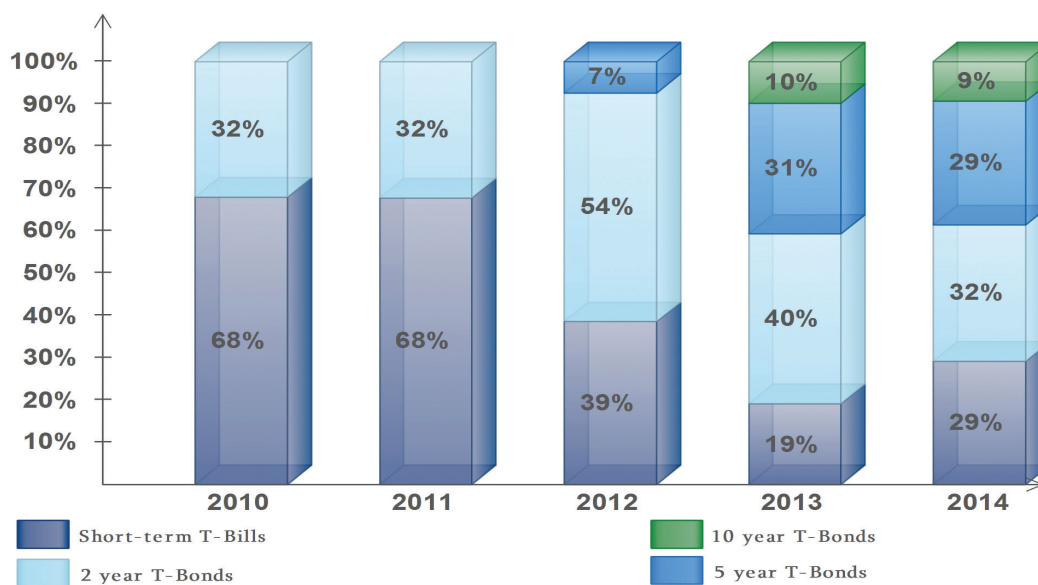


Figure 5: The Structure of Domestic Securities

Treasury bills represent short-term discount securities issued by the MOF. These securities are redeemed at nominal value on maturity date. Treasury bonds represent medium-term coupon bonds. A coupon should be paid semiannually. One Government security costs 1000 GEL. Terms and conditions of the emission, circulation, accounting and redemption of domestic securities are set by the MOF in concurrence with the NBG.

Since 2014, MOF along with the ordinary treasury bills and bonds, issues special treasury bonds (called - Additional Resource for Banking System to Finance Economy). These special bonds are long-term bonds and aim to facilitate the banking sector with long-term money. In particular, this instrument should provide business sector, via banking system, with long-term loans denominated in domestic currency. These long-term treasury bonds are issued through auctions and their maturity is 2 or 5 years. They have the same coupon rate as ordinary treasury bonds with the same maturity. After selling those bonds, MOF deposits received money with the same maturity on saving deposit account in those commercial banks, which had purchased these bonds. Interest on these deposits equals coupon rate +1%. During 2014, issued special treasury bonds amounted to 200 mln GEL, from which only 172.8 mln GEL was placed.

10. “Historical Debt” comprises the liabilities from Soviet era and only approximate amount of this debt is reported (672.3 mln GEL)

2. Public Debt Accounting Practice and Resulting Problems

An appropriate definition of the public debt has a considerable practical importance as it increases the reliability of the Government financial reports and makes it to be comparable on the international level. According to the international standards, sound public debt definition should fulfill the following requirements:

- ❖ “precision to avoid doubt or dispute about the inclusion or exclusion of particular elements;
- ❖ clarity to make the reports readily understandable by users;
- ❖ consistency from year to year, with other financial statistics or accounting records within a particular country and, where relevant, between countries;
- ❖ appropriateness for the purpose the criteria for inclusion of particular elements should be based on their relevance to the objectives that the reports are designed to satisfy;
- ❖ comprehensiveness to ensure that all particular elements of debt are brought within the scope of appropriate approval, planning, management and control procedures.”

Generally, according to the Guidelines of the International Financial Institutions, public debt is defined as the sum of all liabilities acquired by the public sector (central government and its political subdivisions) and agencies controlled by the government. According to the Government Finance Statistics Manual (GFSM), public debt comprises the liabilities acquired by the government sector¹¹ that contains debt acquired by: the central, state and local governments; public corporations and enterprises; other governmental or quasi-governmental organizations and government units (including contingent liabilities) acquired by private enterprises or other state entities¹².

The International Monetary Fund (IMF) defines public debt as debt of the general Government and public corporations, where these two sectors set up the public sector¹³. The World Bank differentiates two broad components of the total public debt. These two components are: public debt and publicly guaranteed debt, where:

- ❖ Public debt is the sum of all obligations of the central Government; states; provinces or similar political subdivisions and their agencies; and autonomous public bodies such as State enterprises and subsidiaries on which they have joint ownership and a major shareholding with the private sector.
- ❖ Publicly guaranteed debt is the sum of all obligations of the private sector that is guaranteed for repayment by a public entity.

Box 1 provides the definition of public debt elaborated by different countries and INTOSAI working group on public debt. In general, the definitions of the public debt make emphasize on the fact that it constitutes an obligation of the public sector.

11. According to the System of National Accounts (SNA 2008), the public sector unifies General Government and Public Corporations.

12. IMF, (2001): Government Finance Statistics Manual, (Washington, D.C., IMF).

13. IMF, (2011): “Public Sector Debt Statistics – Guide for Compilers and Users, p. 6.

Box 1: Public Debt Definition

Slovenia:

„Public debt contains liabilities acquired by the institutions financed from the central government or local municipality’s budgets, public non-financial corporations and other governmental enterprises (including Slovenian Health Insurance Institution, Pension Fund).

Lithuania:

“Public debt is the aggregate amount of the obligations assumed, but not discharged yet by the general government sector entities entitled to borrowing in respect of the repayment to creditors of the funds borrowed under government securities which were distributed, including loan agreements, leasing (financial lease) agreements signed and other debt instruments.”

INTOSAI Working Group on Public Debt (WGPD):

“Public debt consists of liabilities, direct commitments and contingent obligations incurred by the institutions composing the public sector”.

In Georgia, public debt comprises the debt raised from external creditors – public external debt and debt from domestic creditors – public domestic debt. The definition of the public debt is given in the “State Debt Law” of Georgia, where it is defined as the sum of all the domestic and external debt, raised directly or guaranteed by the MOF, on behalf of Georgian Government, denominated in the local or foreign currency that takes the forms of direct loans, Government Securities and the financial resources taken from the IMF. Thus, according to the given definition, in order to consider the liability in the public debt portfolio, participation of the MOF, in acquiring that liability, is an essential requirement. Based on the given definition the institutional composition of the public debt cannot be detected. Subsequently, it has been detected that Georgian public debt comprises the debt of the central government, National Bank of Georgia and guaranteed private debt. The institutional composition of the public debt does not follow the internationally accepted structure of the public sector proposed by the IMF.

Based on the IMF classification of public sector, the institutional composition of Georgia’s public debt is presented on the diagram #2. According to the IMF definition, the debt of the public non-financial corporations is part of the public sector debt. Public non-financial corporation are all resident non-financial corporations controlled by general government units. Thus, state owned enterprises are non-financial corporations and their debt should be considered in the overall public debt portfolio. However, the MOF does not take into consideration the amount of the debt acquired by these institutions when publishing the information about the public debt.

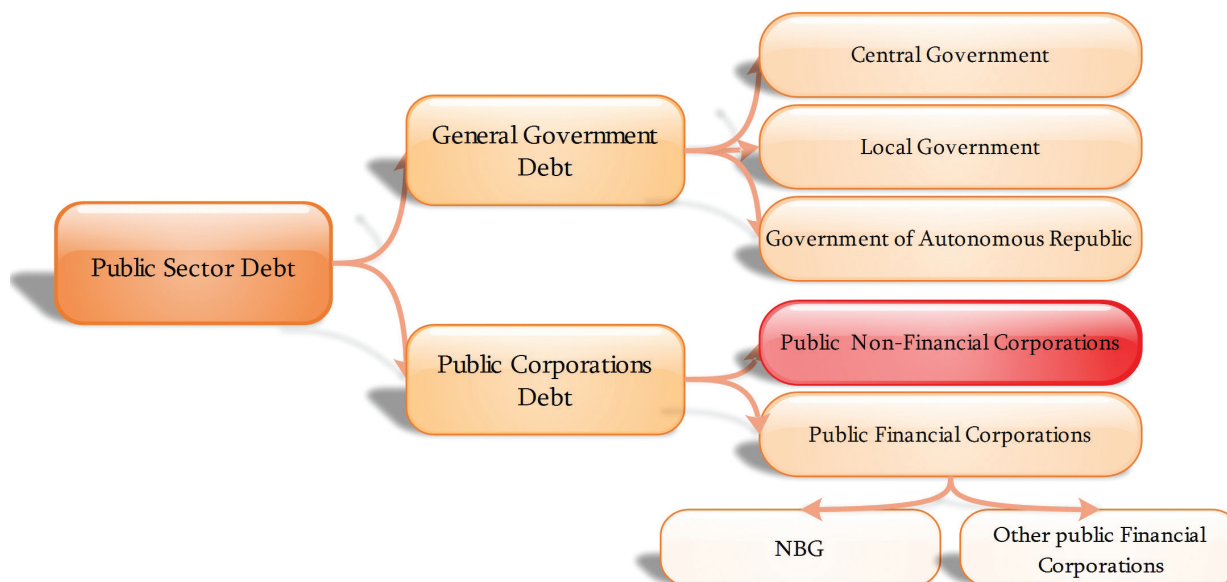


Diagram 1: Public Sector Composition (IMF)

According to the international practice, debt acquired by the SOEs is classified as an implicit contingent liability. Implicit contingent liabilities are not considered as direct contractual liability of the government. But, in case of default or insolvency of the public corporation, Government (If the Government decides to intervene) might become the last resort to solve the financial problems of the public corporation. Therefore, public corporations defaulting on its debt expose the Government to the risk of losing the assets and/or increase of state liabilities. Thus, having the incomplete information on public sector liabilities and/or assessing the consequent risks improperly could significantly affect the country's financial position. To this extent IMF recommends to record and publish the data on the implicit contingent liabilities in the government's budget documents¹⁴. This, in turn, guarantees the transparency of the information regarding the liabilities acquired by the entire public sector.

Furthermore, exclusion of the SOEs debt from the public debt portfolio deprives the stakeholders from the real standing of the public debt and hinders reliability of the debt indicators. For example, based on the information provided by the MOF, public debt at the end of September, 2014 amounted to 9,649.2 mln Gel. Consequently, corresponding debt burden indicator (debt over GDP) was During this period, foreign indebtedness of SOEs amounted to 2,516.66 mln Gel and if considered this amount for calculation of debt burden indicator, it would be increased by about 8% and amount to 41.7%. Therefore, this indicator would be deteriorated.

Exclusion of the SOEs debt from the public debt portfolio has several negative implications on public debt management. For instance, it questions the reliability of the published data and deprives the stakeholders from the real standing of the public debt. Additionally, this fact might have the influence on the planned debt management strategy.

14. IMF, (2007): Code of Good Practices on Fiscal Transparency, pp.47-49

Moreover, several macroeconomic indicators might be affected. For example, MOF published the volume of outstanding public debt at the level of 9,649.2 mln GEL (as of September 2013), while for the same period only external debt of SOEs amounted in total 2,516.66 mln GEL (1,436.12 USD)¹⁵. In terms of debt burden indicator – debt to GDP ratio was at 33.1%¹⁶ but considering the external debt of SOEs in the portfolio, debt/GDP ratio would have been increased by 8% to 41.7%. Additionally, considering the domestic debt of the SOEs would have increased the debt burden indicator to higher levels.

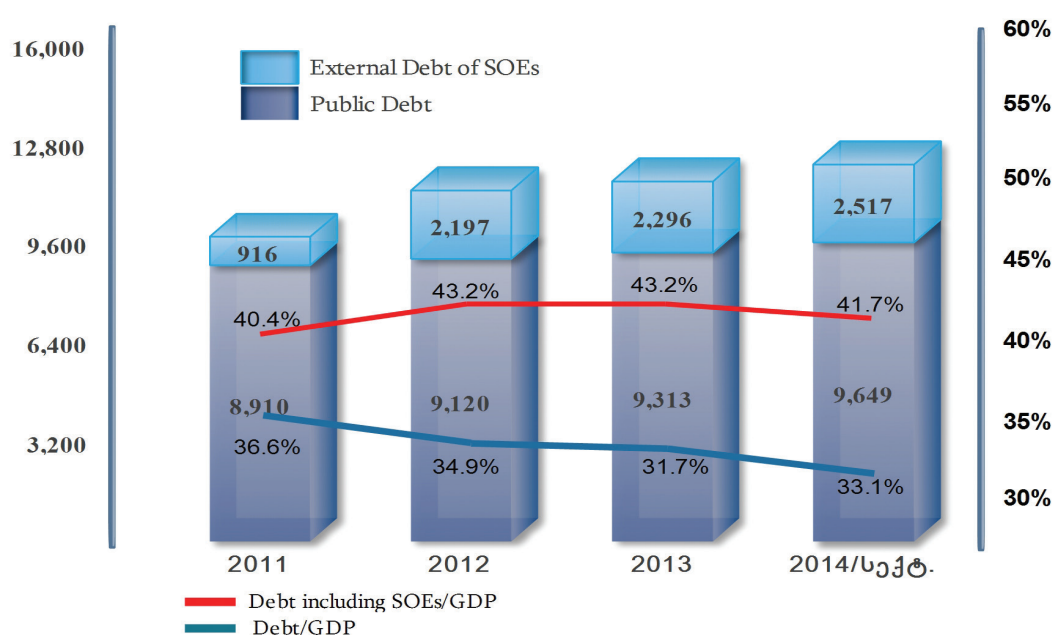


Figure 6: Public Debt considering external debt of SOEs¹⁷

The importance of this issue is augmented if we consider that in the Socio-Economic Development Strategy document – “Georgia 2020”, the level of public debt to GDP is set to be maintained below 40% in the medium-run.

Bearing in mind all the above mentioned issues, Georgian public debt definition and the practice of reporting the information on public debt do not comply with internationally recognized requirements and might not guarantee the completeness and transparency of information about the public debt. As a result, provided information regarding public sector indebtedness and consequent debt indicators do not provide a real picture of the situation and therefore, timely prevention of potential threats may not be assured.

Conclusion:

Reported public debt of Georgia doesn’t include the debt of SOEs that constitute implicit contingent liabilities. Therefore, in case of default/insolvency of the entity there is a risk of the reduction in assets and/or increase in liabilities of the state. These in turn, may negatively affect the country’s financial position.

15. Source: NBG

16. Indicator is calculated based on the projected GDP for 2014 (29,176.4 MLN GEL). (Source: MOF).

17. Debt of state owned enterprises encompasses foreign indebtedness of public non-financial organizations.

In addition, budgetary documents disclosed by the government do not include complete information regarding the contingent liabilities. Therefore, the completeness and transparency of information about the public sector's obligations could not be guaranteed.

Moreover, omitting the liabilities of SOEs in various analyses (for instance, public debt sustainability analyses) bears a risk that potential threats and risks related to the public debt sustainability would be evaluated improperly. Also, the definition of the public debt does not correspond to the IMF, the World Bank and other international organizations requirements.

Recommendation:

To identify the risks associated with the realization of contingent liabilities and to achieve the completeness and transparency of the public debt information, the SAO recommends:

- The MOF should completely disclose information regarding implicit contingent liabilities acquired by the public sector identifying their corresponding owners and characteristics of the debt instrument;
- The MOF, while conducting macroeconomic analyses regarding the public debt, should take into consideration the amount of contingent liabilities and draw considerable attention to the evaluation of the risks stemming from them;
- To make amendment in the “State Debt Law” of Georgia so that the definition of the public debt met the requirements of international standards.

3. Setting the Borrowing Needs

Determining the borrowing needs correctly has a substantial importance. To set Government borrowing need for an upcoming year(s) is a complex process and requires a significant amount of information and coordination among different government agencies. By making the correct estimates Governments avoid over-borrowing, which is costly and could lead to a deterioration of the government's fiscal position. Even, under-borrowing may cause significant troubles for the Governments that could lead to a liquidity crisis.



Diagram 2: The general formula for setting the borrowing needs.

In general, reliable estimate of borrowing needs should cover the financing the following components: debt coming due within a year + estimated budget deficit + an estimate of net financial assets + an estimate of the contingencies¹⁸. Various countries all over the world use the different modified versions of this general approach to set the borrowing volume for the upcoming year. For instance, OECD standardized method for calculating gross borrowing needs states that it is a sum of the budget deficit (Net Borrowing Requirement) and debt coming due within a year (Total Redemptions).

From the above mentioned components of the borrowing needs calculation, with the maximum accuracy could be determined the amount of the principal due to payment for the upcoming year. To this extent, Debt Management Office (DMO) needs to have up to date and complete public debt database. The amounts of the remaining three components are subject to the comprehensive methods of estimation, using the internationally recognized forecasting models. As the Government mobilizes the financial resources mainly by means of state budget revenues, there is a need of close cooperation of DMO with the budget and macroeconomic analysis departments¹⁹.

According to the General Charter of the MOF, PDEFD is responsible to participate in preparation of the annual borrowing plan to include it in the annual state budget law. In that process limits on the public debt are set and the sources (proportion of domestic and external debt) of financing the budget deficit are agreed. Except from the PDEFD, other agencies (Budget department, Fiscal forecasting department) within the MOF are also included in the process.

In practice, planning of the amount to be borrowed through each type of borrowing sources is conducted differently. In particular, funds needed for the investment projects implementation are defined by the spending agencies itself. The volume of borrowing for budget deficit financing is estimated by the PDEFD. If the borrowing amount is not sufficient to finance the deficit, in consultation with the budget department deficit is corrected by contraction in the expenditures.

18. INTOSAI Development Initiative and Working Group on Public Debt (2012): "Guide for Auditing Public Debt Management", p. 59.

19. World Bank, (2009): Guide to the debt management performance assessment (DEMPA) tool, p. 23.

Based on the information extracted from the spending agencies and Budget department defines the expenditures side of the state budget. Fiscal forecasting department, using the extrapolation method, makes forecasts of the future revenue streams and provides it to the budget department to define the estimated budget deficit. At the same moment, PDEFD sends to the Budget department information about the external financing opportunities. It should be noted, that information on the disbursement of the investment loans are mainly defined by the corresponding spending agencies. Thus, PDEFD defines the estimated volume of the budget support loans that could be attracted from the external creditors. In addition, PDEFD coordinates with the Fiscal forecasting department to get the data on the exchange rates forecasts and with the NBG to get the information on how much can be attracted on the domestic financial market through issuance of the government securities.

All the above mentioned communication and data gathering process is conducted in informal way and there is no official document regulating these procedures. In comparison to the existing practice of setting the borrowing needs, SAO team was not able to find any documented evidence that the stated procedures are consistent in time and follows to the internationally used general approach. In addition, as there is no debt management strategy document, it could not be assured that planned borrowings are in line with the Government strategy.

Conclusion:

The process to determine the required annual amount of borrowing does not follow to any officially set and approved rules or procedures manuals. Within the MOF the process is regulated by the General Charter of the MOF where it is not clearly defined the functions of other entities engaged in the process. Moreover, there is no formal methodology or method incorporated showing the steps and methods to calculate the gross borrowing requirement. Documentation of the procedures would have increased the transparency of the procedures setting the borrowing needs.

Recommendation

In order to implement transparent process of defining borrowing needs, and for the creation of institutional memory, which would promote smooth functioning even in case of a high turnover of the staff, the SAO recommends:

- MOF should implement the rules/procedures for defining borrowing needs that would actually make the process of setting the borrowing needs formal;
- General Charter of the MOF should be amended to define exact roles and responsibilities of each department involved in the process of setting borrowing needs.

4. Existing Practice of Public Borrowing

4.1 Public Debt Management Strategy

A country should define long term strategic goals within the public debt management process. Consequently, the debt management strategy should cover particular activities for reaching those goals. Based on the international practice, the objective of the public debt management is to raise the required amount of funding at the lowest possible cost over the medium to long run, consistent with a prudent degree of risk and to facilitate the timely repayment of the liabilities. Apart from this, the development of the domestic credit market could be one of the objectives of the debt management strategy.

In general, sound debt management requires that government not only raised the funds at low cost but also to structure the composition of its debt portfolio in such a way as to minimize the impact of relevant shocks on its budget or long-term expenditure plan²⁰. The funding strategy should define how the responsible agency plans to mobilize sufficient financial resources for the subsequent year²¹. Funding strategy must be in line with the strategic goals of a country and might be a part of the overall medium-term debt management strategy. The desirable composition of the debt instruments in the portfolio could be determined in the debt management strategy document. Therefore, it is an international practice that the assessment of the debt management performance has been conducted against the benchmark portfolio defined in the strategy document. But, it is worth to note that, not achieving the benchmark may be desirable on some occasions and as a result it might be a difficult task to evaluate performance of debt managers against a benchmark portfolio. However, nonexistence of the benchmark portfolio makes the task more complicated. As the MOF does not have the debt management strategy in place, audit team was unable to use the above mentioned approach to assess the performance of the debt managers against predefined portfolio benchmark.

Importance to have the debt management strategy is increased considering the challenges Georgian government is facing at the moment in terms of external borrowing opportunities. In particular, as the development of the Georgia reaches to some certain levels, in the near future country would not be able to borrow on concessional terms. Therefore, access to the concessional credit resources²² would be limited for Georgia that will increase the borrowing expenses on external loans and the maturity profile of the loans will be shortened. For example, since 2014 Georgia is being graduated from the IDA loans and since then, it would be only able to borrow on commercial rates from the IBRD. The same is expected to happen with loans withdrawn for ADF (Asian Development Fund). At the moment, Georgia may borrow on concessional terms from ADF, but in the near future loans form Ordinary Capital Resources (OCR) will only be available for the Government of Georgia²³. Loans from IBRD and OCR are contracted with variable interest rates (LIBOR, EURIBOR). As a result, graduation from IDA and ADF will most probably increase the share of loans with the variable interest rates in the public debt portfolio. Despite the fact that, at the moment, the nominal value of variable interest rates is low²⁴ it is important that the Government had the strategy to overcome the increased costs stemmed from the unexpected increase of the variable interest rates in the future. This is also very important to ensure the public debt sustainability.

20. Melecky, M., (2007): "A Cross-Country Analysis of Public Debt Management Strategies", The World Bank Banking and Debt Management Department, p.5.

21. OECD (2014): Sovereign Borrowing Outlook.

22. Access to the concessional loan depends on gross national income per capita and the creditworthiness of the borrower country assessed by the lender. In case of WB, if for a certain period (3-5 year) the gross national income per capita is more than 1,195 USD dollar, bank will review accessibility on the concessional loans. The mentioned threshold in case of ADB is 1,205 USD dollar.

23. Additional information about lending see in the annex 2

24. In 2014, on average, these variable interest rates amounted to: EURIBOR 6m=0.28%, LIBOR 6m=0.33%

Due to the above mentioned circumstances, a country should elaborate the debt management strategy, including the funding strategy and facilitate minimization of debt costs and risks, even in case of non-concessional borrowing. Also, this document should facilitate the debt sustainability in the medium and long term.

Conclusion:

Based on the international experience, the existence of the debt management strategy is an essential prerequisite for the effective debt management. The MOF has no debt management strategy and taking into account the challenges existing in terms of borrowing opportunities might be deemed as a significant deficiency in the public debt management.

Recommendation

As a response to the country's existing challenges regarding the borrowing opportunities, also, to achieve the compliance with the international standards and to ensure the effective debt management, the SAO recommends:

- ➔ The MOF should develop a debt management strategy, which would be in compliance with country's overall development strategy and will facilitate achieving the intended goals.

4.2 The Importance of Comparative Analysis

Based on the international standards, the government should borrow the financial resources with the most beneficial terms and conditions, bearing in mind that debt sustainability condition would not be violated²⁵. It is important to examine the reasons of choosing to borrow funds with the non-concessional terms while the low-income country has access to the concessional borrowing.

According to the Ministry of Finance, the creditor selection process does not follow to any officially set rules or guidelines. At first, relationship experience with the creditor is considered. Based on the previous experience MOF officials are aware what kind of projects might be financed from the particular multi or bilateral creditor. Moreover, with some multilateral creditors (WB, ADB) Georgia has entered into the country partnership framework. Nevertheless, it's not disclosed if the department reviews alternative borrowing possibilities and monitors financial markets for refinancing opportunities. The concessionality is a crucial determinant for choosing creditors. Concessionality of a loan is defined based on the guideline elaborated by the IMF, where the loan is considered to be concessional if its grant element²⁶ is more than 35%. In 2010-2014²⁷, Georgian government signed 50 loan agreements with the external creditors. During this period most of the debt (42) was contracted with the multilateral creditors. With the largest multilateral creditors (WB, ADB) Government of Georgia signed the Country Partnership Frameworks (CPF). There are separate CPF signed for budget support loans and for loans financing the investment projects. With this document Government of Georgia agreed with the creditor total amount of loan sources to be available in the medium-term. Financial terms are determined separately for each borrowing during the corresponding loan negotiation process. Average interest rate

25. World Bank, (2009): Guide to the debt management performance assessment (DEMPA) tool, pg. 29.

26. The grant element measures the concessionality of a loan. It is defined as the difference between its nominal value (face value) and the sum of the discounted future debt-service payments (net present value) to be made by the borrower, expressed as a percentage of the face value of the loan. Whenever the interest rate charged for a loan is lower than the discount rate, the resulting present value of the debt is smaller than its face value, with the difference reflecting the grant element of the loan.

27. Data is collected from the Ministry of Finance and covers contracts signed by the august 2014.

of the loans signed with the multilateral creditors in the reported period has been in the range of 1%, while the average maturity has been equal to 20 years. Half of the loans were contracted with the variable interest rate (LIBOR, EURIBOR).

Regarding the bilateral creditors in the last 5 years 8 contracts were signed with them and the total amount of these contracts amounted to 226.4 mln Euros. In contrast with the funds borrowed from the multilateral creditors, average interest rate on the mentioned loans has been approximately 3.2% and average maturity amounted to 17 years.

Among the contracts signed with bilateral creditors there are loans with the interest rates higher than weighted average interest rate of the external debt portfolio ($\approx 2\%$). For example, to finance the project: “Rehabilitation of Municipal Infrastructure Facilities in Batumi – Phase III” Government of Georgia signed a loan agreement with KFW, where the maximum interest rate has been set at 5.5% per annum. The exact interest rate has been determined when the loan was disbursed. Based on the information provided by the Ministry of Finance the rate was determined at 4.2%. The explanatory note enclosed with project Government Decree contains only the general information about the financial terms of the loan and it is not presented the justification of signing the loan with these particular terms. Moreover, it is not clear that proposed terms and conditions are the most beneficial ones available in the market in the given period.

In addition, for the project “Black Sea Energy Transmission Network Project” (BSTN) KFW allocated debt of 75 million Euros that was disbursed in 2 tranches and the interest rates for each portion of the loan were 6.683% and 5.703%. With the different financing terms the project was also financed by other creditors (EIB, EBRD).

Financial conditions of the loan	Creditor		
	KFW	EIB	EBRD
Loan amount	75,000,000	80,000,000	57,022,774.42
Currency	EUR	EUR	EUR
Interest rate ²⁸	6.19%	EURIBOR+0.75%	EURIBOR
Maturity	14	20	15
Grace period	4	4	3
Commitment fee	0.25%	0.1%	0.5%
Management fee	1%	0.25%	-
Grant Element ²⁹	17.38%	27.04%	28.57%

Table 1: Financial terms and conditions of the loans available under the “BSTN” project.

The explanatory note, attached to the project government decree, describes only general financial conditions of the loan and nothing is said about the advantages of this particular financial terms proposed by the KFW. As a result, it is not clear why the Government borrows the funds on non-concessional terms (Grant Element<35%) even when it has access to the concessional borrowing.

In General, the explanatory notes of the loans signed in the period of 2010-2014 contain only the following information:

28. Frequently, loans are disbursed in several tranches that may have set the different interest rates. Therefore, in the table for such loans average interest rate is reported.

29. IMF calculator and unified discount rate (5%) is used for counting grant item. In case of variable interest rate loans average interest rate form the loan signing till now is used.

- ❖ Brief explanation of the project;
- ❖ Financial condition of loans: the loan amount, currency, interest rate and related expenses of borrowing;
- ❖ Grant amount under the project;
- ❖ Project implementation agency and project completion dates.

As a result, explanatory notes presented to the Government do not guarantee the informed decision making process. It is not disclosed the advantages of the presented financial terms of a loan over the alternative funding sources (If available).

Conclusion:

During the last five years Government of Georgia generally borrowed funds with concessional terms but at the same time loans with non-concessional terms were also contracted. There is no evidence that MOF conducts an alternative funding analysis to choose the most beneficial terms of financing when borrowing on non-concessional terms. Therefore it is not clear what has triggered the Government to contract the loan with the proposed financial terms and conditions.

Recommendation:

To ensure the transparency of the borrowing process and to facilitate the informed decision making when borrowing, SAO recommends:

- ➔ The detailed comparative analysis of the available funding opportunities be prepared by the MOF and enclosed it to the project Government Decree with other relevant documents.

4.3 Debt Sustainability Analysis and Risk Assessment Practice

According to the principles elaborated by the United Nations Conference on Trade and Development (UNCTAD), to achieve the sound public debt management, sovereigns should have a debt management strategy document in place and should regularly conduct a debt sustainability analysis.

Informed and prudent borrowing decisions require a systematic assessment of the evolution of debt burden indicators under different scenarios (sensitivity analysis). Thus, to ensure the debt sustainability in medium and long-term and to achieve the country development goals, government should take care of the risks the public debt portfolio is mostly exposed to (interest rate risk, exchange rate risk, refinancing risk). It's important to identify not only the current costs of the debt portfolio but, also, the future expanses that government would have to pay to its creditors. . It should be noted that cost minimization should not be achieved on the expense of increased risks. As there is a tradeoff between cost and risk both variables should be taken into account simultaneously and the the optimal (tolerable) level should

be attained. Cost minimization with the prudent degree of risk is the most important goal and principle of the sound debt management.

Debt sustainability analysis (DSA) is also one of the important parts of the debt management. DSA is tool to better detect, prevent, and resolve potential crises. The objective of the framework is threefold:

- ❖ Assess the current debt situation, its maturity structure, whether it has fixed or floating rates, whether it is indexed, and by whom it is held;
- ❖ Identify vulnerabilities in the debt structure or the policy framework far enough in advance so that policy corrections can be introduced before payment difficulties arise;
- ❖ In cases where such difficulties have emerged, or are about to emerge, examine the impact of alternative debt-stabilizing policy paths³⁰.

In the process of loan taking Public Debt and External Financing Department pays a significant attention to the level of concessionality of a credit. The concessionality of a credit is measured based on the grant element level of a loan. In addition, department examines the average time to maturity (ATM) indicator and when applicable makes selection of a loan maturity and grace period according to the current debt amortization schedule. As was mentioned above 35% is considered as a threshold of loan concessionality, but regarding the ATM such kind of threshold does not exist. Moreover, the conducted analysis is not documented. The MOF does not assess the sustainability of the debt portfolio and does not conduct the sensitivity analysis regarding the changes in various macroeconomic variables.

In 2014, MOF publish the first debt sustainability analysis of the sovereign's debt portfolio³¹. The document was enclosed to the project 2015 State Budget Law. With the presented debt sustainability analysis baseline and alternative scenarios of public debt evolution in medium term is analyzed. The analysis is conducted based on the model incorporated by the IMF for Lower Income Countries. In the alternative scenarios permanent GDP growth and Real Interest Rate shocks are generated. Regarding the primary deficit and nominal interest rate shock bound tests are employed.

According to the assessments made by the SAO the analysis could not be deemed as complete and requires further improvements. The analysis lacks some important points, such as:

- ❖ The critical threshold for the debt to GDP ratio is not specified. For example, Economic Freedom Act defines this threshold as 60%, IMF – 50% and Georgia's Socio-Economic Development Strategy document - "Georgia 2020"- 40%;
- ❖ In the alternative scenarios, it is not presented the approach and the amount of formation of various exogenous shocks;
- ❖ The realism of the macroeconomic assumptions is not justified;
- ❖ Stress testing in a presented DSA is not presented in a complete way nor there is given any justification why some macroeconomic variables were subject to permanent shocks and others - to temporary shocks. Moreover, results of combined shocks (combination of different shocks) are not discussed and therefore, presented.

30. IMF, (2013); Staff Guidance Note on the Application of the Joint Bank-Fund Debt Sustainability Framework for Low-Income Countries.

31. It covers loans of the central government and National Bank of Georgia

Conclusion:

In the audit period, the debt portfolio risk assessment (sensitivity analysis) and the debt sustainability analysis has not been conducted on a regular basis. As a result, it creates the risk that potential threats would not be identified and prevented in a timely manner. Moreover, the analysis to detect the concessionality of a credit is not documented and enclosed to any formal document.

Recommendation:

For the prevention and timely detection of the risks threatening the debt sustainability in medium and long-term, the SAO recommends:

- The Ministry of Finance of Georgia should regularly, at least on an annual basis, carry out debt sustainability assessment and monitor the debt portfolio risks.

4.4. Development of the Government Securities Market and Existing Challenges

According to the “State Debt Law” of Georgia, the resources accumulated via domestic debt should only be used to finance the budget deficit and/or to cover a short-term cash difference of the state budget. The link between the projected budget deficit and projected increase in domestic liabilities³² is shown on the graph 7. It can be seen that by the domestic debt the budget deficit is financed.

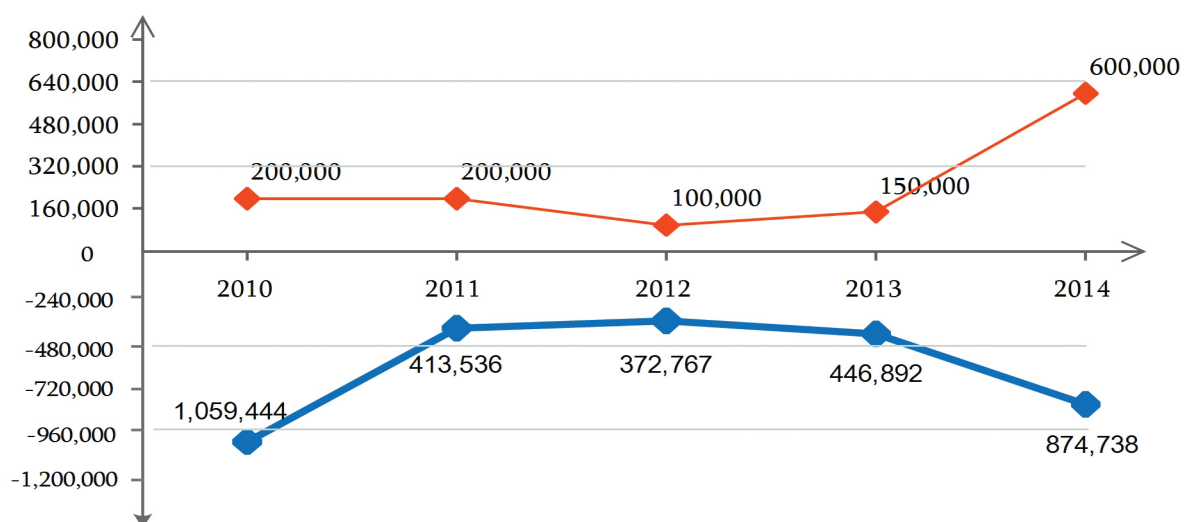


Figure 7: The Dynamics of Budget Deficit and Net Increase in Domestic Liabilities

32. Increase in domestic liabilities is equal to income generated by selling the Government T-Bills and T-Bonds minus the repayment of the Government securities due

Based on the information provided by the MOF, emission of the Government securities regularly is also conducted to support the development of the corresponding market. The necessity of the domestic credit market development is augmented by the fact that as the creditworthiness of a country is increasing access to the concessional lending would be restricted. Therefore, external financial sources would only be available at commercial terms. Taking into account the fact, that exchange rate fluctuations do not affect domestic debt portfolio, ceteris paribus, domestic debt has a comparative advantage over external financing. Hence, for a country with the limited access to the concessional financing development of the domestic financial market is a substantial challenge. However, for the domestic market development only stable emission of securities is not enough and there is a need to increase the investor base.

According to the World Bank guideline, to achieve a stable and sustainable demand on the domestic securities there should exist diversified investor base. The group of investors should unify resident and non-resident investors that would be represented by the commercial banks, insurance companies, pension funds and various individual investors. Diversification of investors promotes active trade, increases liquidity and gives the government possibility to mobilize resources in various market conditions³³. In Georgia, at the moment, mostly investments in treasury securities are done by commercial banks operating in Georgia. During last 5 years, more than 90% of treasury securities were procured by the commercial banks.

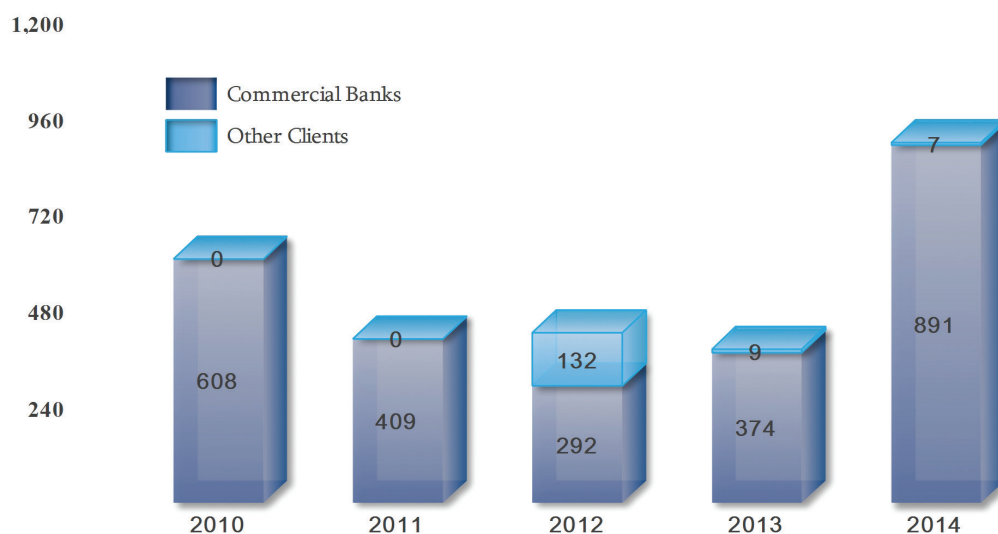


Figure 8: Volume of Government Securities sold on primary market in 2010-2014 (mln GEL)

As the commercial banks are main holders of the Government securities, it increases the risk that government debt crowds out credit to the private sector and becomes a source of vulnerability (Crowding-Out Effect). In general, banking sector tends to invest money in government securities and earn profits by crediting a public sector. But, considering the negative impact of crowding-out the investments from private sector governments should seek effective way to avoid the high dependence on commercial banks when issuing the securities on domestic market. Therefore, it is important to look for the investor base diversification possibilities by creating reasonable incentives for other investors to invest in Government securities.

33. World Bank (2007): "Developing the Domestic Government Debt Market – from diagnostics to reform implementation", P. 35

Conclusion:

Funds mobilized through the issuance of the Government securities were mainly used to finance the budget deficit. It should be noted that the emissions were also aimed to develop a domestic securities market. However, for a sustainable development of a domestic market only stable emissions are not enough. To be more precise, based on the international experience, the main tool for a financial market development is a diversification of investor base.

Recommendation:

In order to develop domestic market of state securities, the SAO recommends:

- ➔ The MOF, in concurrence with NBG, should elaborate a development strategy for state securities domestic market and analyze potential incentives/activities that would trigger the further development of domestic securities market.

4.5 Additional Resource for Banking System to Finance Economy

Since 2014, the MOF has started issuing treasury bonds called - Additional Resource for Banking System to Finance Economy. These bonds are long-term bonds and aim to support long-run financing of private sector. Namely, this instrument should provide business sector, via banking system, with long-term loans denominated in local currency. According to the MOF, this mechanism was launched in concurrence with the NBG to facilitate the banking sector with long-term funds and to trigger the development of the economy. The State Audit Office of Georgia has expressed its opinion on the above mentioned mechanism in the reports on state budget³⁴.

It should be noted that the MOF did not provide a documentary justification of the need and the reasonableness of the issuance of these treasury bonds. In particular, information about the demand and interest from the banking sector with this particular mechanism has not been disclosed. Also it is not clear how the Government is going to assess the success/failure of this mechanism and what will be the assessment criteria. Apart from this, it is worth to mention that according to the “State Debt Law” of Georgia funds mobilized through the domestic debt should only be used to finance the budget deficit and/or to cover a short-term cash difference of the state budget. The aim of the mentioned mechanism - implemented in 2014 and also planned for the subsequent fiscal year, does not comply with purposes indicated in the law, as the funds mobilized under this mechanism would not be used for financing the budget deficit or short-term cash imbalances. These bonds have concrete aim - to facilitate the banking sector with long-term financial resources.

Recommendation:

In order to secure a compliance of the above mentioned mechanism with “the State Debt Law” and to evaluate the real

34. Opinion on Draft Law of Georgia “On the State Budget of Georgia for 2014”; Report on the “Execution of the State Budget for 2014”.

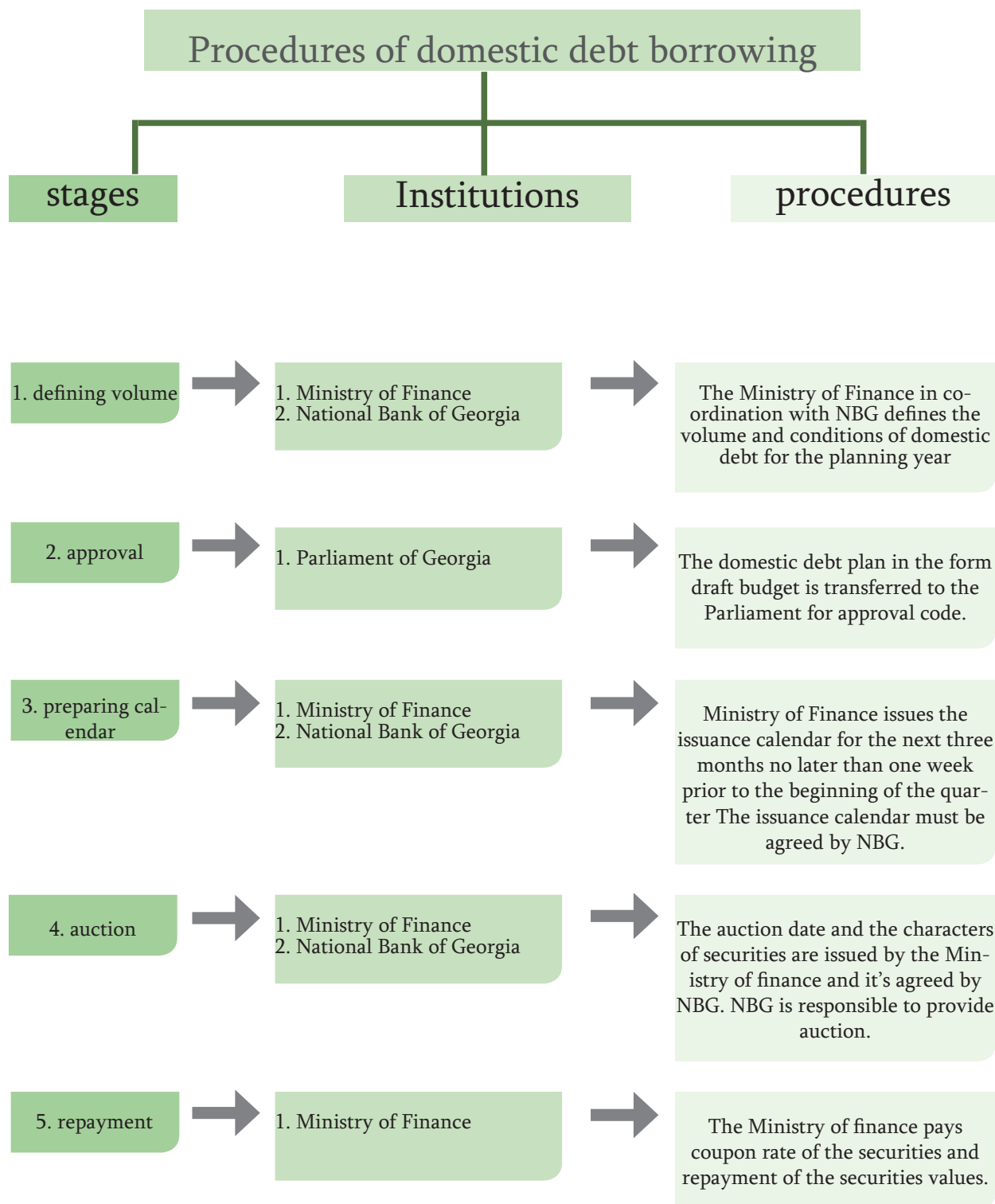
impacts of this mechanism, the SAO recommends:

- ❖ The relevant amendment in the “State Debt Law” of Georgia should be made;
- ❖ The MOF should elaborate a document in which would be presented the assessment criteria for the implemented mechanism and based on it obtained results should be evaluated.

Bibliography:

1. IMF and World Bank, (2003): Guidelines for Public Debt Management;
2. IMF and World Bank, (2014): Revised Guidelines for Public Debt Management;
3. IMF, (2001): Government Finance Statistics Manual, (Washington, D.C., IMF);
4. IMF, (2007): Code of Good Practices on Fiscal Transparency;
5. IMF, (2011): Public Sector Debt Statistics – Guide for Compilers and Users;
6. IMF, (2013): Staff Guidance Note on the Application of the Joint Bank-Fund Debt Sustainability Framework for Low-Income Countries;
7. INTOSAI Development Initiative and Working Group on Public Debt (2012): Guide for Auditing Public Debt Management;
8. INTOSAI Public Debt Working Group, (2007): ISSAI 5422 - An Exercise of Reference Terms to Carry Out Performance Audit of Public Debt;
9. INTOSAI's Public Debt Committee (2007): ISSAI 5440 - Guidance for Conducting a Public Debt Audit - The Use of Substantive Tests in Financial Audits;
10. INTOSAI Committee on Public Debt, (1995): ISSAI 5421- Guidance on Definition and Disclosure of Public Debt;
11. MEFMI, (2011): Public Debt Management Procedures Manual, Vol., 1;
12. OECD (2014): Sovereign Borrowing Outlook;
13. OECD, (2010): A Suggested New Approach to the Measurement and Reporting of Gross Short - Term Borrowing Operations by Governments, Financial Market Trends, Volume 2010 – Issue 1;
14. United Nations ESCAP, (2006): The Manual on Effective Debt Management.
15. World Bank, (2007): Developing the Domestic Government Debt Market – from diagnostics to reform implementation;
16. World Bank, (2009): Guide to the debt management performance assessment (DEMPA) tool;
17. World Bank, (2013): Debt Management Performance Assessment (DEMPA) – Georgia, August;
18. UNCTAD, (2012): Principles on Promoting Responsible Sovereign Lending and Borrowing;
19. “State debt law of Georgia”;
20. “Law of International Treaties”
21. The State Audit Office of Georgia, (2013): Opinion on Draft Law of Georgia on the State Budget of Georgia for 2014;
22. The State Audit Office of Georgia, (2014): Opinion on Draft Law of Georgia on the State Budget of Georgia for 2014;
23. The State Audit Office of Georgia, (2014): Report On The Execution Process of the State Budget for 2014
24. Government of Georgia (2014): Socio-economic development strategy of Georgia, strategy 2020

Annex 1: borrowing process of domestic debt



Annex 2: Terms of the loan extended by World Bank and ADB

In the debt portfolio of Georgia the World Bank is presented by 2 organizations: IDA (International Development Association) and IBRD (International Bank for Reconstruction and Development)

Terms of IBRD loans						
Average Repayment Maturity ³⁵	8 years and below	Greater than 8 to 10	Greater than 10 to 12	Greater than 12 to 15	Greater than 15 to 18	Greater than 18 to 20
Flexible loan with a variable spread	Libor+ 0.33%	Libor+ 0.43%	Libor+ 0.53%	Libor+ 0.63%	Libor+ 0.73%	Libor+ 0.83%
Flexible loan with a fixed spread	Libor+ 0.6%	Libor+ 0.75%	Libor+ 0.85%	Libor+ 1.05%	Libor+ 1.25%	Libor+ 1.35%
Front-End Fee				0.25%		
Commitment fee				0.25%		

Terms of IDA loans			
Type of the lending	Maturity	Grace period	Interest rate
Regular	40 year	10 year	0.75%
Blend	25 year	5 year	2.0%
Hard	25 year	5 year	2.25%
Front-End Fee		-	
Commitment fee		0.5% ³⁶	

Source: World Bank

Since 2008 Georgian government borrows funds from ADB (Asian Development Bank). The resources are mostly allocated from Asian Development Fund (ADF) and Ordinary Capital Resources (OCR) of ADB. The purpose of the loan can be both funding investment projects and budget deficit.

35. Detailed information about calculating the average repayment maturity of the loan could be extracted from WB official web page: "http://treasury.worldbank.org/bdm/pdf/ARM_Illustration.pdf"

36. The commitment fee is charged on undisbursed balances of the loans. In case of IDA loans rate is defined each year on 30th June and must not be more than 0.5%.

Terms of ADF loans				
Type of the lending	Maturity	Grace period	Interest rate in grace period	Interest rate after grace period
Regular	32 year	8 year	1.0%	1.5%
Blend	25 year	5 year	2.0%	2.0%
Commitment fee				
Administrative cost				

Terms of ADF loans			
Average Loan Maturity	≤ 13 year	13-16 year	16-19 year
Interest rate	Libor+0.5%	Libor+0.6%	Libor+0.7%
Administrative cost		-	
Commitment fee		0.15%	

Source: ADB

Annex 3: Public Debt Service

Terms and conditions of loan repayment are given in the loan agreement signed between the Government and creditor. Loan expenses made by government for the last 5 year are presented below:

		2010	2011	2012	2013	2014
Domestic debt	Principal	442,649.8	336,904.0	396,802.1	269,932.8	339,518.7
	Interest	68,126.4	101,094.3	115,706.9	98,550.3	105,357.9
External debt	Principal	122,908.6	110,808.6	95,220.6	430,445.5	499,469.7
	Interest	132,520.9	181,453.3	132,627.1	134,267.3	139,483.4
Total	Debt Service	766,205.7	730,260.2	740,356.7	933,195.9	1,083,829.7
	% of budget Expenditure	11.0%	9.8%	9.4%	13.7%	12.0%
	% of budget Revenue	10.8%	9.8%	10.4%	11.6%	11.8%
	% of GDP	3.7%	3.0%	2.8%	3.5%	3.7%

Public debt service (thousands GEL) in 2010-2014.

Since 2010, total debt service (principal + interest), on average, amounted to 3.34% of GDP and 11.2% of the total budget expenditures. In 2013 and 2014 loan repayment has been significantly increased.

Annex 3: Public Debt Service

Terms and conditions of loan repayment are given in the loan agreement signed between the Government and creditor. Loan expenses made by government for the last 5 year are presented below:

		2010	2011	2012	2013	2014
Domestic debt	Principal	442,649.8	336,904.0	396,802.1	269,932.8	339,518.7
	Interest	68,126.4	101,094.3	115,706.9	98,550.3	105,357.9
External debt	Principal	122,908.6	110,808.6	95,220.6	430,445.5	499,469.7
	Interest	132,520.9	181,453.3	132,627.1	134,267.3	139,483.4
Total	Debt Service	766,205.7	730,260.2	740,356.7	933,195.9	1,083,829.7
	% of budget Expenditure	11.0%	9.8%	9.4%	13.7%	12.0%
	% of budget Revenue	10.8%	9.8%	10.4%	11.6%	11.8%
	% of GDP	3.7%	3.0%	2.8%	3.5%	3.7%

Public debt service (thousands GEL) in 2010-2014.

Since 2010, total debt service (principal + interest), on average, amounted to 3.34% of GDP and 11.2% of the total budget expenditures. In 2013 and 2014 loan repayment has been significantly increased.

TBILISI. K. STAMEBULI ST.96

www.sao.ge