

THE IMPACT OF EXTERNAL DEBT ON INFLATION RATE IN GEORGIA**Keti TSKHADADZE***Tbilisi State University, 0177, Georgia**K.tskhadadze@iset.ge***Abstract**

The purpose of this paper is to analyze the impact of external debt on inflation rate in Georgia. As external debt plays significant role in country's development it is important to examine the relationship between the levels of external debt and its impact on GDP development and inflation. For analyzing the correlation between the external debt, economic growth and inflation we use the data that goes back to 15 years. We use an empirical investigation in order to see how the effect of external debt on inflation varies with financial market development.

Key words: *Currency risk, exchange rate, external debt, Georgia, inflation*

JEL Classification: E31, F62, H63

I. INTRODUCTION

External debt is one of the ways for a country to attract foreign funds for domestic investment financing that promotes economic growth. It plays significant role when the country is in a relatively low level of development and when it does not have a developed local financial market. As a result, borrowing from local market is related to higher costs. We need to emphasize that not only underdeveloped countries are borrowing from abroad, but advanced economies are also using foreign funds and the level of external debt in the debt portfolio is quite high.

The theoretical literature pays significant attention to the variety of factors that can trigger external default and debt crisis. In some cases countries are unable to repay their debts because they are either insolvent or illiquid; insolvency depends on its stock of debt relative to its ability to pay, which is measured, for instance, by GDP, government revenues or exports.

Despite of the fact that external debt offers countries additional funding for lower cost, it is also related to the various risks. One of the main risks is that the country may be concerned about its insolvency risk that comes from exchange rate volatility, or external interest rate shock. If the local currency depreciates against external debt currency, then debt burden will increase. Therefore, if the external debt level in total is higher, this burden becomes even bigger. Insolvency risk also may be caused by interest rate shocks. When foreign interest rate increases, external debt servicing becomes expensive and government deficit enlarges. In order to finance this deficit one of the choices for a country is to issue securities and as a result increase debt level even further. So, this channel works like a self-fulfilling mechanism. On the other hand, higher foreign interest rate makes foreign investment even more attractive for investors and the probability of capital outflow increases. This creates pressure on the exchange rate and solvency risk for this country increases. As we see the exchange rate regime can cause an external imbalance that leads to debt accumulation and moreover, a currency crisis that is triggered by overvaluation can lead to severe balance sheet effects if part of the debt is in a foreign currency (Manasse, Roubini et al, 2003).

Side effects of high level of external debt come from international rating agencies. Countries with high level of external debt seem riskier to rollover and manage their liabilities. Because of this fact international rating agencies may downgrade those countries sovereign rating. Correspondingly, risk premium will increase and foreign financing will become more expensive for the country. As a result, it may face default.

As Manasse and Roubini (2005) state external debt to GDP ratio is a better indicator of country's defaultness than the public debt to GDP ratio itself. The sustainability level of external debt differs across countries and depends on the various macro fundamental indicators. The authors find that the most debt crises can be classified into three categories such as debt unsustainability due to high debt, episodes of illiquidity and episodes of exchange rate weaknesses. For one country 15% of GDP external debt may be the reason of default while for the other country 115% of GDP may be manageable.

Countries with high external debt are more vulnerable to external shocks, and historically external shock has become the reason why countries are defaulting on their debts for several times. As the world is more globalized, countries are linked to each other by various channels such as international trade, financial linkages,

international investment and so on. Changes in economic circumstances in one-country affects the other country's economy. As history shows crisis immediately spreads in the region. For example:

1. In 1997 Thailand crisis that was caused by financial collapse of Thai baht, forced the government of Thailand to float its currency because of the lack of foreign currency. At the same time Thailand had acquired foreign debt. The crises strongly infected Thailand, Indonesia, and South Korea, afterwards Malaysia, Philippines, and almost all East Asian countries.

2. Mexican peso crisis in 1994 is an example of currency crises that was caused by an unexpected devaluation of peso against US dollar. Devaluation caused capital outflow from Mexico, as a response banks raised interest rates, but higher cost of debt hurt the economy. This crises spread in Brazil and southern cone countries such as Argentina, Chile, and Uruguay (Fischer, 1998).

So, high level of external debt may cause crisis not only domestically, but also in the region. Therefore governments should be careful while having relations with other countries that have high levels of external debt. Moreover, countries that have experienced default on debt in the past have higher probability of new default. The role of foreign debt on inflationary pressure is significant and it is also influenced by the degree of financial market development. It is found that in high inflation countries the effect of external debt is positively effectual on inflation whereas it is negatively effective in general. (Manasse and Roubini, 2005).

II. THE CASE OF GEORGIA

Public debt remains one of the major economic policy issues and the debt levels, especially among the heavily indebted poor countries and low-income countries have raised major concerns among the international financial institutions resulting in some initiatives as from the developed countries as from the international financial institutions. In recent years difficulties that are associated with external debt have taken different forms, starting from default on domestic and external debt to liquidity crises (Maana, Owino et al, 2008).

Table 1. Summary of Georgia's external debt 2003 to 2017

Year	Gross External Debt (Thousand of USD)	External Debt as a % of GDP
2003	2,861,026.7	72%
2004	3,050,926.2	60%
2005	3,210,441.8	50%
2006	3,800,154.3	49%
2007	5,827,760.9	57%
2008	7,785,447.4	61%
2009	8,959,344.7	83%
2010	10,238,775.3	88%
2011	11,717,897.8	81%
2012	13,414,895.7	85%
2013	13,433,486.1	83%
2014	13,989,408.5	85%
2015	15,259,138.2	109%
2016	15,880,996.7	110%
2017	17,271,408.7	114%

Source: <https://www.nbg.gov.ge/index.php?m=304&lng=eng>

National Bank of Georgia (2017) indicates that gross external debt statistics are harmonized with BOP statistics. They include both public sector and private sector external debt. As well as external debt statistics are compiled according to the methodology provided by the IMF's "External Debt Statistics: Guide for Compilers and Users" (2003).

The gross external debt of Georgia amounted to 17.3 billion USD (45.8 billion GEL) as of 31 December 2017, 114 percent of the annual 2017 GDP. Increase in external debt shown in the table 1 was due to transactions and other changes. Overall, Georgia has a high level of government external debt (81% in total). This makes government debt portfolio highly vulnerable to the exchange rate shocks. In 2014, when GEL depreciated against USD by around 30%, public debt increased from 33.9% of GDP to 35.4%, while external debt to GDP changed insufficiently from 26.4% to 26.6%. For such kinds of situations local market development is very important in order to substitute external debt by domestic one. Moreover, when countries are developing and concessional loans come to be restrictive, external debt becomes more expensive and borrowing domestically is preferable to get rid of currency risks.

Large external debt is one of the main causes for inflation. Deficits in their turn increase foreign obligations, as they are mainly financed by an increased external debt. Excessive external debt, which is directed towards financing mainly social obligations are inflationary (Boschen and Weise, 2003).

Empirical evidence suggests that there are number of macroeconomic factors, which predict debt crisis and the entry into it; high levels of external debt increases the probability of a default and the entry into the default. For predicting debt crisis measuring of debt-servicing obligations, low GDP growth, current account imbalances, tight liquidity, low trade openness and monetary conditions are very important factors. Unlike to the currency crisis, external debt crisis last long and it also shows persistence. Once the country is in a crisis it becomes quite difficult to get out of the one, as it is usually connected with long spells.

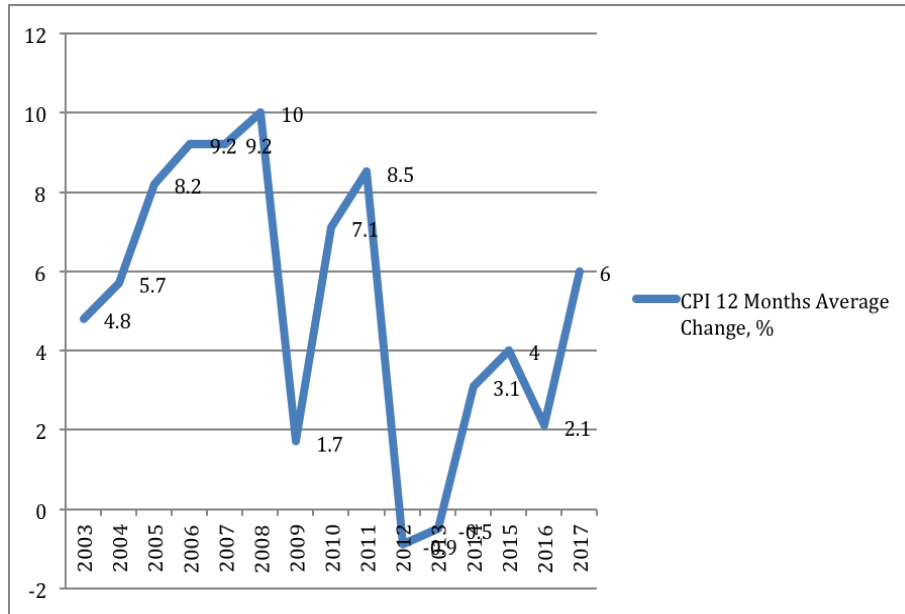


Figure 1 - CPI 12 Months Average Change, % (2003-2017)

Source: <https://www.nbg.gov.ge/index.php?m=304&lng=eng>

Georgia has been one of the most successful transition countries in fighting inflation through the years and it achieved a single digit inflation rate in 1996-1997 (Gigineishvili, 2001). In the figure 1, we analyze the data for the years 2003-2017 and it is visible that during the 2003-2007 inflation rate shifts up from 4.8% to 10%. During the 2003-2007 period prices have continued to change quite rapidly while exchange rates were more or less stable. According to the national bank of Georgia, changes in the exchange rate and nominal wages along with the seasonal price fluctuations appears to be the major determinants of inflation in the country. In 2004-2007 years Georgia faced major reforms and all of the developments were reflected in various international economic ratings. By the end of 2008 the growth of the Georgian economy was delayed because of the war with Russia in August. In 2009 foreign direct investments decreased by 58%, overall economy of the country by 3.7% and the state debt increased significantly in the following two years. In 2010-2012 the Georgian economy started to come out of the crises; in 2011 the inflation rate was 8.5% and began to decrease over the following years. In the years 2014-2017 the country started advancing at a slow pace, the average growth rate of the economy was 3.4% and Georgia’s exports decreased by 27%, which was mainly due to the crisis in Russia and Azerbaijan. Remittances from abroad also decreased and the reduced foreign income led to the devaluation of the national currency (Bakradze and Billmeier, 2007).

III. CONCLUSION

The main objective of the paper was to examine the effects of external debt on inflation. External debt plays significant role when the country is in a relatively low level of development and when it does not have a developed local financial market. External debt offers countries additional funding for lower cost but it is also related to the various risks. It is obvious that if the local currency depreciates against external debt currency, then debt burden will increase. Therefore, if the external debt level in total is higher, this burden becomes even bigger. Countries with high level of external debt seem riskier to rollover and manage their liabilities. Because of this fact international rating agencies may downgrade those countries sovereign rating. In the paper we investigated the behavior of inflation in Georgia in 2003-2017 years. Overall, Georgia has a high level of

government external debt and this makes government debt portfolio highly vulnerable to the exchange rate shocks. For such kinds of situations local market development is very important in order to substitute external debt by domestic one. Moreover, when countries are developing and concessional loans come to be restrictive, external debt becomes more expensive and borrowing domestically is preferable to get rid of currency risks. High level of external debt may cause crisis not only domestically, but also in the region. Therefore governments should be careful while having relations with other countries that have high levels of external debt.

IV. REFERENCES

1. Aghion, P., Bacchetta, P., & Banerjee, A. (2000). A simple model of monetary policy and currency crises, *European economic review*, 44(4), pp. 728-738.
2. Bakradze, G., Billmeier, A. (2007). Inflation Targeting in Georgia: Are We There Yet? IMF working papers, pp. 10-15, WP/07/193.
3. Boschen, J., Weise, C. (2003). What starts inflation: Evidence from the OECD countries, *Journal of Money, Credit and Banking*, 35, pp. 323-349.
4. Catao, L., Sutton, B. (2002). Sovereign Defaults: The Role of Volatility, IMF Working Papers, pp. 2-12, WP/02/149.
5. Cecchetti, S., Mohanty, M., and Zampolli, F. (2011). The real effects of debt, *Bank for International Settlements*, 10(2), pp. 163-183.
6. Detragiache, E., Spilimbergo, A. (2001). Crises and liquidity: evidence and interpretation, IMF Working Papers, pp. 3-12, WP/01/2.
7. Domac, I., Yucel, E.M. (2005). What triggers inflation in emerging market economies? *Review of World Economics*, 141(1), pp.141-164.
8. Fischer, S. (1998). The Asian crises: a view from the IMF, <https://www.imf.org/en/News/Articles/2015/09/28/04/53/sp012298>, accessed February 4, 2019.
9. Khan, M.S., Senhadji, A.S. (2000). Threshold Effects in the Relationship Between Inflation and Growth, IMF working papers, pp. 3-17, WP/00/110.
10. Loungani, P., Swagel, P. (2001). Sources of inflation in developing countries, IMF working paper, pp. 3-14, WP/01/198.
11. Maana, L., Owino, R., and Mutai, N. (2008). Domestic Debt and its Impact on the Economy, 13th annual African econometric society in Pretoria, South Africa, pp. 2-20.
12. Maliszewski, W., (2003). Modeling inflation in Georgia, IMF Working Papers, pp. 3-10, WP/03/212.
13. Mannase, P., Roubini, N., and Schimmelpfennig, A. (2003). Predicting sovereign debt crisis, IMF working papers, pp. 3-8, WP/03/221.
14. Manasse, P., Roubini, N. (2005). "Rules of thumb" for sovereign debt crises. <https://www.imf.org/en/Publications/WP/Issues/2016/12/31/Rules-of-Thumb-for-Sovereign-Debt-Crises-17889>, accessed February 4, 2019.
15. National Bank of Georgia. (2019.) Statistical data, <https://www.nbg.gov.ge/index.php?m=304&lng=eng>, accessed February 11, 2019.
16. Petrovic, P., Nojkovic, A. (2010). Inflation triggers in transition economies: their evolution and specific features, [http://avs.ekof.bg.ac.rs/Petrovic,%20Mladenovic,%20Nojkovic%20\(2011\).pdf](http://avs.ekof.bg.ac.rs/Petrovic,%20Mladenovic,%20Nojkovic%20(2011).pdf) accessed February 4, 2019
17. *** (2014) External Debt Statistics: Guide for Compilers and Users, IMF working paper, Washington, D.C.