

Georgia: 2003 Article IV Consultation—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2003 Article IV consultation with Georgia, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **July 7, 2003**, with the officials of Georgia on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on September 17, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff statement of **October 14, 2003** updating information on recent developments.
- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its October 17, 2003 discussion** of the staff report that concluded the Article IV consultation.

The document(s) listed below have been or will be separately released.

Joint Staff Assessment of the Poverty Reduction Strategy Paper
Poverty Reduction Strategy Paper
Selected Issues Paper and Statistical Appendix

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: <http://www.imf.org>

Price: \$15.00 a copy

**International Monetary Fund
Washington, D.C.**

INTERNATIONAL MONETARY FUND

GEORGIA

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for the 2003 Consultation with Georgia

Approved by José Fajgenbaum and Michael T. Hadjimichael

September 17, 2003

The 2003 Article IV consultation discussions were held in Tbilisi during June 24–July 7, 2003, together with further discussions for the third review under the PRGF arrangement, which had started in October/November 2002 and February/March 2003. The team comprised Mr. Neuhaus (head), Ms. Brukoff, Messrs. van Selm and Maliszewski (all EU2), and Messrs. Abrego (PDR), Hajdenberg (FAD), and Frydl (MFD). Mr. Dunn, the Resident Representative, assisted the mission. Mr. Gigineishvili, Assistant to the Executive Director for Georgia, participated in the meetings. The mission met President Shevardnadze, the State Minister, key economic and social ministers, the President of the National Bank of Georgia (NBG), the Speaker and other members of parliament, and representatives of the business sector, donors and civil society.

At the conclusion of the last Article IV consultation on October 26, 2001, Directors welcomed the prudent macroeconomic policies that had supported growth, price and exchange rate stability, and a reduction in the external debt burden. They considered, however, that Georgia's medium-term outlook remained challenging because of widespread poverty and still high external indebtedness. They called for a more effective fight against corruption to improve the business climate, and noted that achieving medium-term fiscal viability while providing adequate basic services required a strong revenue effort, underpinned by improved tax administration and a broadened tax base. In light of the Financial System Stability Assessment (FSSA) findings, Directors called for strengthened supervision to address remaining vulnerabilities. They also urged the authorities to make progress on energy sector reform.

Georgia's three-year PRGF arrangement was approved on January 12, 2001. Compared with the originally envisaged access of SDR 108 million (72 percent of quota), only four disbursements totaling SDR 49.5 million were made (in January, March and November 2001 and July 2002).

Georgia accepted the obligations of Article VIII, Sections 2, 3, and 4, of the Fund's Articles of Agreement in December 1996, and its exchange system remains free of restrictions on payments and transfers for current international transactions.

Contents	Page
Basic Data	4
Executive Summary	5
I. Recent Developments and Performance Under the Program	6
II. Report on the Discussions	11
A. Past Achievements and Future Challenges	11
B. Medium-Term Economic Strategy and Outlook	14
C. Structural Reforms	17
Public sector reforms	17
Energy sector reforms	18
Financial sector reforms	20
Trade liberalization and external competitiveness	20
D. Program Issues and Macroeconomic Policies for 2003-04	21
E. Statistical Issues and Standards	22
III. Staff Appraisal	23
Tables	
1. Selected Economic and Financial Indicators, 1999-2003	26
2. 2002 Quantitative Performance Criteria and Indicative Targets	27
3. 2003 Quantitative Indicative Targets	28
4. General Government Operations, 2002-2003	29
5. Accounts of the National Bank of Georgia, 2001-2003	30
6. Monetary Survey, 2001-2003	31
7. Macroeconomic Framework, 1999-2008	32
8. Summary Medium-Term Balance of Payments, 1998-2008	33
9. External Financing Requirements and Sources, 1998-2008	34
10. Indicators of Financial Obligations to the Fund, 2002-2008	35
11. External Debt Indicators Relative to Exports	36
Boxes	
1. Tax Reform	10
2. Poverty in Georgia	14
3. Medium-Term Macro-Economic Framework	16
4. Privatization and State Property Management	18
5. The Electricity Sector	19
Figures	
1. Inflation and Real GDP	6
2. External Sector Developments, 1995-2003	6

3.	Exchange Rate Developments, January 1998-June 2003	7
4.	Nominal Monthly Wages in U.S. Dollars, 1997-2002.....	8
5.	Monetary Indicators, 1995-2002.....	8
6.	Tax Revenue and Fiscal Balance, 1994-2002	12

Appendices

I.	Fund Relations	37
II.	IMF-World Bank Relations	41
III.	Relations with EBRD.....	47
IV.	Statistical Issues	49
V.	Public Debt Sustainability Analysis.....	52
VI.	Medium and Long-Term Growth Prospects	54

Georgia: Basic Data, 1997-2002

I. Social and Demographic Indicators

Area	69,700 sq. km
Population density, 2002	65.8
Population, 2002 (in thousands) 1/	4,585.70
<i>Of which:</i> percent urban	52.3
Rate of population growth, 2002 (in percent)	-0.66
Life expectancy at birth (in years)	71.5
Infant mortality rate, 2002 (per 1,000 live births)	23.8
Hospital beds, 2002 (per 1,000 people)	3.8
GDP per capita, 2002	
In lari	1,626
In U.S. dollars	778.1

	1997	1998	1999	2000	2001	2002
II. Economic Indicators						
	(Annual percent change)					
Real sector						
GDP volume	10.6	2.9	3.0	1.9	4.7	5.6
Consumer prices						
Period average	7.0	3.6	19.1	4.0	4.7	5.6
End-of-period	7.2	10.7	10.9	4.6	3.4	5.4
	(Percent of GDP)					
Government finances						
Revenue and grants	14.4	15.6	15.4	15.2	16.3	15.8
<i>Of which:</i> revenue	14.1	14.7	14.6	14.9	15.6	15.6
Expenditure and net lending	21.2	21.8	22.1	19.2	18.3	17.8
Balance (commitments)	-6.8	-6.1	-6.7	-4.0	-2.0	-2.0
Balance (cash)	-6.1	-4.9	-5.0	-2.6	-1.6	-1.9
	(Percent change, end-of-period)					
Money and credit 2/						
Net domestic assets of the NBG	82.2	69.9	15.3	6.9	-3.9	8.8
Credit to the rest of the economy	63.4	40.3	34.3	30.9	10.8	24.7
Broad money						
Including foreign currency deposits	45.5	-1.2	20.7	39.0	18.5	17.9
Excluding foreign currency deposits	35.4	-11.5	9.6	33.5	5.7	14.5
	(In millions of U.S. dollars)					
External Sector						
Exports (goods)	493.5	478.3	477.0	527.7	473.0	468.6
Imports (goods)	-1,052.4	-1,163.7	-1,013.0	-937.0	-934.8	-944.1
Trade balance	-558.9	-685.4	-536.0	-409.2	-461.8	-475.6
Current account (including transfers)	-364.1	-370.3	-217.5	-175.6	-179.2	-202.5
Official reserves, end-of-period						
(In millions of U.S. dollars)	173.3	118.4	132.4	109.4	161.1	197.7
(In months of imports)	1.5	1.0	1.3	1.0	1.4	1.8
Memorandum items:						
GDP, current prices (in millions of lari)	4,638	5,040	5,665	6,013	6,638	7,457
Exchange rate, lari/U.S. dollar						
Period average	1.30	1.39	2.02	1.98	2.07	2.20
End-of-period	1.30	1.79	1.96	1.98	2.06	2.09

Sources: Georgian authorities; and Fund staff estimates.

1/ Include estimates of population in Abkhazia and South Ossetia.

2/ Valued at end-of-period actual exchange rates.

EXECUTIVE SUMMARY

- **Since the conclusion of the last Article IV consultation in October 2001, Georgia's macroeconomic performance has been encouraging.** Underpinned by a prudent monetary policy, GDP growth has been solid, inflation has remained around 5 percent, and the lari has been broadly stable against the U.S. dollar. The passage of fiscal measures in 2003, such as the new budget systems law and a revenue-neutral tax reform, were significant milestones that should help the authorities to strengthen budget formulation and revenue collection over time.
- **However, there were significant fiscal slippages in the first half of 2003,** stemming from optimistic budget assumptions on certain receipts that did not materialize, and a slackening of the tax effort early in the year. While the authorities secured parliamentary approval of some revenue enhancements and implemented some administrative spending cuts, they were unable to obtain parliamentary support for a revised 2003 budget intended to fully close the emerging fiscal gap. As a result, staff does not propose to complete the third review under the PRGF arrangement, which expires in January 2004. Discussions on a successor arrangement are expected to begin before the end of this year.
- **Going forward, the authorities are urged to target an increase in the tax to GDP ratio of at least 4 percentage points over the medium term to secure fiscal sustainability, unwind domestic arrears, and support critical programs identified in the government's poverty reduction strategy.** Accomplishing this will hinge on major improvements in tax and customs administration to curb evasion. A prudent monetary stance should continue to anchor price stability and underpin the managed float of the lari.
- **The authorities have implemented some critical elements of the structural reform agenda.** Progress on financial sector reforms has been significant, with the key elements of the framework for banking supervision largely in place. In the area of public sector operations, the authorities introduced institutional changes in the oversight and divestiture of state property, strengthened customs regulations, and launched audits of key state-owned enterprises. Electricity cash collections have continued to rise, aided by disconnection of nonpaying users. A court-ordered reduction in the electricity tariff below cost-recovery levels is expected to be reversed in December 2003, and power distribution outside of Tbilisi has been brought under private management.
- **Decisive efforts are needed to expedite structural reform, especially in the areas of civil service reform and trade liberalization.** Moreover, steadfast implementation of further energy sector reforms (as agreed with donors) will be essential to stem fiscal pressures and stabilize power supplies.
- **The authorities need to redouble their efforts to tackle pervasive corruption and tax evasion.** This will be key for generating the resources necessary to discharge core government obligations and fostering a business climate conducive to higher private investment. Strong efforts will also be required to improve the links between the government's expenditure planning framework and the objectives of the Economic Development and Poverty Reduction Program (EDPRP).

I. RECENT DEVELOPMENTS AND PERFORMANCE UNDER THE PROGRAM

1. **Macroeconomic performance during the past year-and-a-half has been encouraging (Table 1).** Real GDP grew by 5.6 percent in 2002 and by 8.6 percent during the first half of 2003, led by farming, construction and transport. As a result of a prudent monetary stance, inflation slowed from 5.4 percent during 2002 to 5.1 percent during the 12 months to August 2003 (Figure 1). The NBG has broadly maintained the level of gross reserves (despite lower than projected external inflows) at US\$196 million or 1.6 months of non-pipeline imports in August 2003 (Figure 2). The exchange rate has remained broadly stable in nominal terms, but weakened by 6.9 percent in real effective terms in the year ended June 2003 (Figure 3). Georgian wages in U.S. dollar terms have been increasing gradually, but remain substantially lower than in Russia and Turkey, the two main trading partners (Figure 4), although productivity gains with respect to major partners have been lagging.

2. **Fiscal performance improved somewhat in 2002, but weakened again during the first half of 2003.** Tax revenue increased marginally in 2002, but the September performance criterion and the December limit on domestic arrears were missed, owing to unbudgeted spending on energy and the withholding of revenue by the Adjara province (Table 2). These difficulties were compounded in 2003 by optimistic budget assumptions on external and privatization receipts that did not materialize, and by a slackening of the tax effort early in the year, leading to a non-observance of the March and June indicative arrears targets (Table 3). Excise collections have been disappointing, as quarterly indicative targets for 2002-03 set as guideposts to curb evasion were missed. Table 4 provides an overview of fiscal developments in 2002 and 2003.

Figure 1. Georgia: Inflation and Real GDP
(In percent)

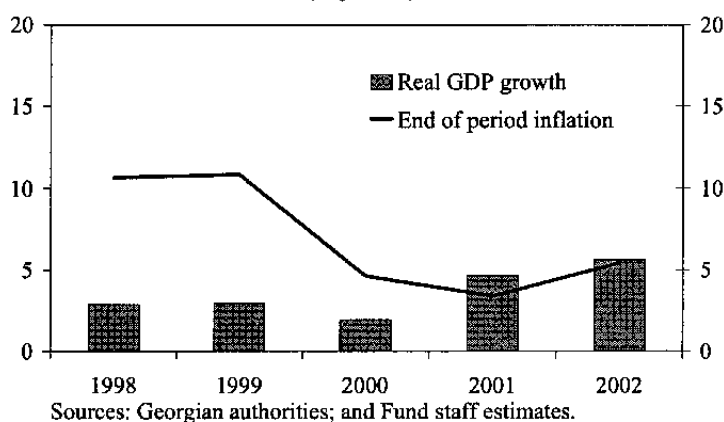


Figure 2. Georgia: External Sector Developments, 1995-2003

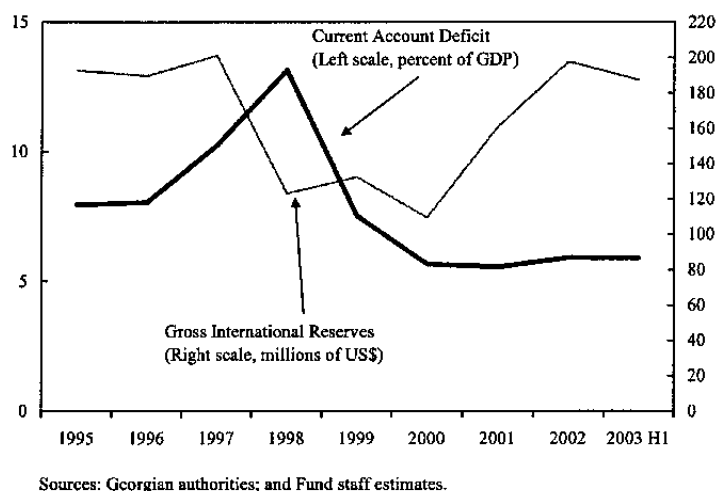
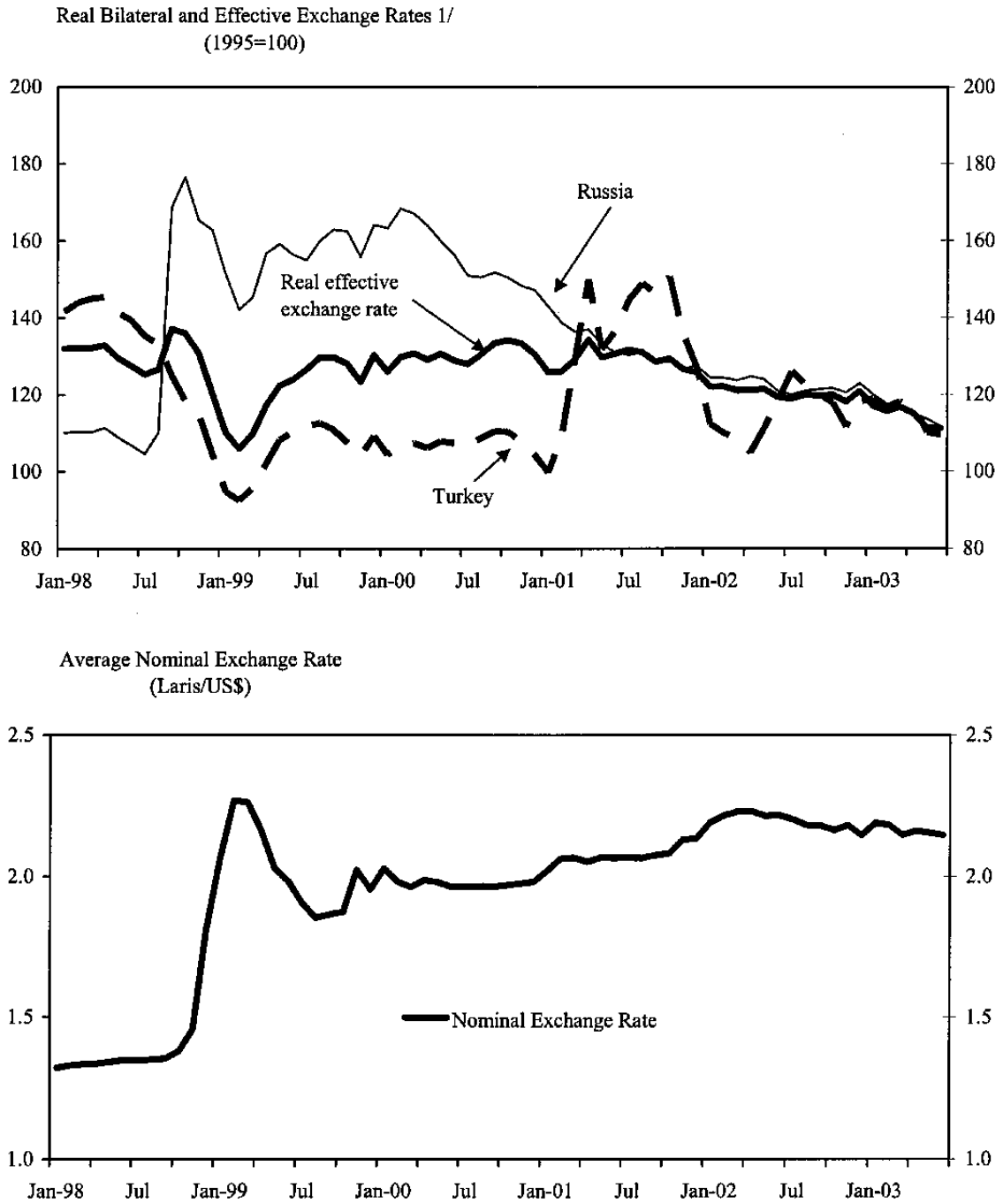


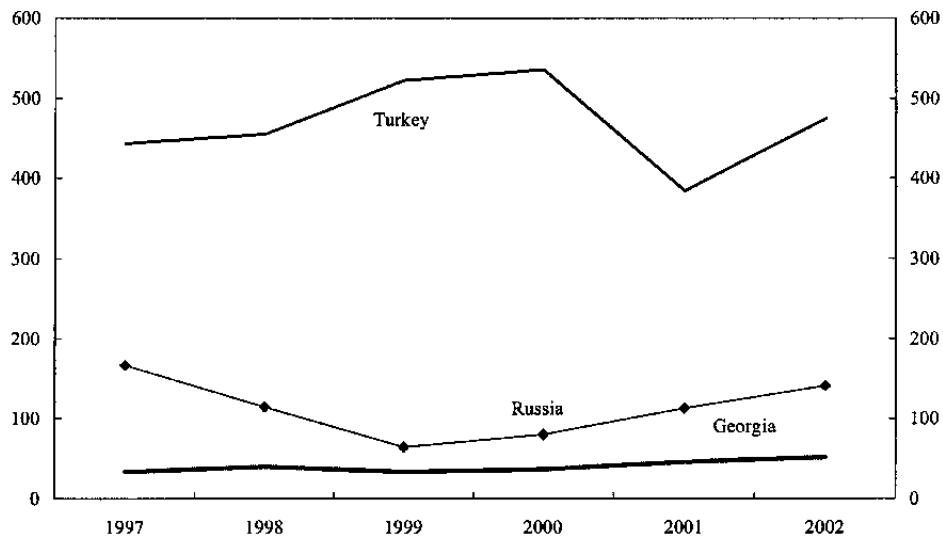
Figure 3. Georgia: Exchange Rate Developments, January 1998-June 2003



Sources: Georgian authorities; and Fund staff estimates.

1/ Based on INS exchange rates and CPI for all non-EU2 partner countries, and on EU2 staff estimates for EU2 partner countries. An increase in the rate indicates a depreciation of the lari.

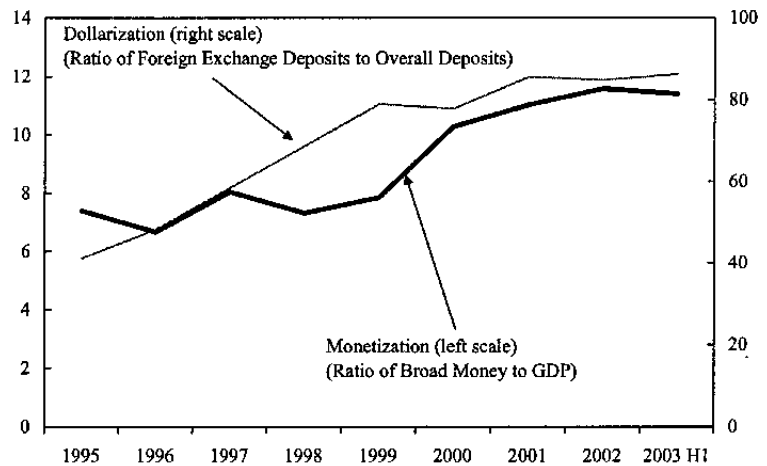
Figure 4. Georgia: Nominal Monthly Wages in U.S. Dollars, 1997-2002



Sources: Georgian authorities; and Fund staff estimates.

3. **Steady remonetization has continued**, with broad money rising from 7 percent of GDP at end-1997 to 11 percent in June 2003 (Tables 5 and 6 present an overview of monetary developments in 2002-2003). Much of this has been in the form of foreign-currency deposits, currently representing 86 percent of total deposits (Figure 5). However, the NBG recently took steps to mitigate dollarization by differentiating reserve requirements according to currency denomination of deposits, reducing reserve requirements on lari deposits from 13 percent to 8 percent, while keeping the requirements for foreign currency deposits at 13 percent.¹ The NBG has also diversified monetary control instruments in line with past MFD recommendations by relaunching credit auctions.

Figure 5. Georgia: Monetary Indicators, 1995-2002



Sources: Georgian authorities; and Fund staff estimates.

¹ In addition, half of the reserve requirement on lari deposits can be met with existing current account balances at the NBG, further reducing effective reserve requirements on lari deposits.

4. **The NBG continues to use net domestic assets as its immediate operational target.** It also closely monitors growth in reserve money and broad money in light of price and exchange rate developments. Reserve requirements and the recently revamped credit auctions serve as the main instruments for monetary control and liquidity management, together with intervention in the foreign exchange market to accumulate reserves. In the medium term, the authorities hope to broaden the menu of monetary control instruments, including through more active use of “repos” for open market operations. To that end, they are counting on a further deepening of domestic financial markets, particularly the further development of a secondary market in government paper.²

5. Because of protracted slippages under the program (see below), which precluded the consolidation of 2003 principal maturities owed to the Paris Club, **Georgia had accumulated US\$31 million in arrears to its bilateral creditors by end-August 2003.** It has, nonetheless, remained current in its interest payments to them and on all obligations to multilateral creditors.³

6. **Structural reforms in the fiscal, energy and banking sectors have advanced, albeit with delays.** Regarding public sector operations, the government:

- Secured approval of a budget systems law in April 2003 (improving budgetary design and execution by expanding budget coverage, introducing a commitment control system, establishing a single treasury account, and requiring an explicit medium-term macroeconomic framework);
- Adopted a revenue-neutral tax reform in August 2003 (Box 1);
- Issued decrees to strengthen customs controls and permit seizure and sale of delinquent taxpayer assets; and
- Initiated external audits of three problematic state-owned enterprises (SOEs)—the Railways, Poti Port and Madneuli Mining—to address governance issues and set transparency and accountability standards for other SOEs. It also vested privatization and

² For details, see the chapters on inflation and on banking sector reforms and financial developments in the companion selected issues paper.

³ No agreement has been reached with Turkmenistan on the treatment of pre-2001 arrears—which are ineligible for rescheduling under the Paris Club agreement—or on the rescheduling of 2001-02 maturities. Nevertheless, Georgia has been amortizing the former and paying moratorium interest on the latter as if they had been rescheduled, according to an informal arrangement involving in-kind payments.

asset management responsibilities under the Ministry of Economy and a new Enterprise Management Agency under its jurisdiction.

Box 1. Georgia: Tax Reform

In spite of gains over the past five years, Georgia still has one of the lowest tax-to-GDP ratios within the CIS. This stems mainly from weak tax administration and widespread smuggling and corruption, but tax policy has also played a role. Numerous amendments since the previous tax code was enacted in 1997 and privileges introduced by decree often benefited interest groups, though some reduced the tax burden on the poor. The multiplicity of exemptions, nuisance taxes, and transitional provisions have complicated the tax code and hampered tax administration.

The revenue-neutral tax reform bill just approved addressed some of these flaws and incorporated many Fund staff recommendations. The highlights are:

- A more than four-fold increase in the annual turnover threshold for mandatory VAT registration to GEL 100,000 (equivalent to US\$46,500), with a voluntary range above GEL 75,000.
- Introduction of a small business tax at 5 percent of annual income for certain taxpayers with turnover below the new threshold, in lieu of the taxes on economic activities, income profits, and the VAT and road tax.
- Introduction of a presumptive fixed tax for individuals not employing workers and carrying out independent economic activities, who will be exempt from all other taxes (VAT and small business taxpayers would be ineligible for that tax).
- Elimination of “nuisance” taxes, including on resorts; hotels; advertising; use of national symbols; road billboards and posters; and fuels and lubricants.
- Elimination of excise taxes on tires and on certain fish products; excises are now imposed only on fuels and lubricants, tobacco, alcohol and cars.

The increase in the VAT threshold and creation of the small business tax will simplify tax administration and free resources to strengthen enforcement. The new threshold covers one-fifth of taxpayers who account for 90 percent of collections. The revenue loss is to be compensated by the tax on small businesses.

The above innovations represent an important step in the right direction, but they need to be accompanied by improvements in equity and efficiency of the tax system. Most income tax exemptions, although not onerous, are poorly targeted and could be replaced by more equitable, transparent and cost-effective transfers to qualifying low-income households. Moreover, several VAT exemptions should be eliminated to broaden the tax base and simplify administration.

7. In the **electricity sector**, cash collections from different groups of customers have continued to rise (despite significant lingering evasion), aided by disconnection of nonpaying users. The September 2002 structural benchmark for collections from direct customers of the wholesale electricity market was widely missed, but results improved during the first half of 2003; collections from budgetary organizations have remained on course since Q3 2002.

These efforts were undercut by a court-ordered 11 percent reduction in power tariffs since March 1, 2003, but tariffs will be reinstated at cost-recovery levels as of December 1, 2003, including cross-subsidization of low-income strata in Tbilisi by large users. In all, the energy sector's quasi-fiscal deficit is projected to decline from 5.9 percent of GDP in 2002 to 4.7 percent in 2003. After posting sizable losses in recent years, the privately-owned distribution utility AES-Telasi was sold to the Russian group UES in July 2003. The new owners have promised to stabilize power supply, including through imports from Russia.

8. In the **financial sector**, the authorities passed an anti-money laundering law aligned to international best practice (except for a pending amendment on seizure of confiscated property) and established a Financial Monitoring Service under the NBG's auspices. As envisaged in the program, they amended *fit and proper* criteria for bank owners and managers and strengthened the supervisory framework by adopting the main operational recommendations of the 2001 FSSA. Reflecting these developments, nonperforming loans fell from 11.6 percent of total bank loans at end-2001 to 7.4 percent in June 2003. As described in the companion selected issues paper, stress tests conducted by NBG staff show that since 2001, the banking system has become more robust to shocks, though several non-systemic banks would experience significant shortfalls in their capital adequacy ratios and one large bank would fall marginally below the Basel minimum standards in some of the scenarios examined.

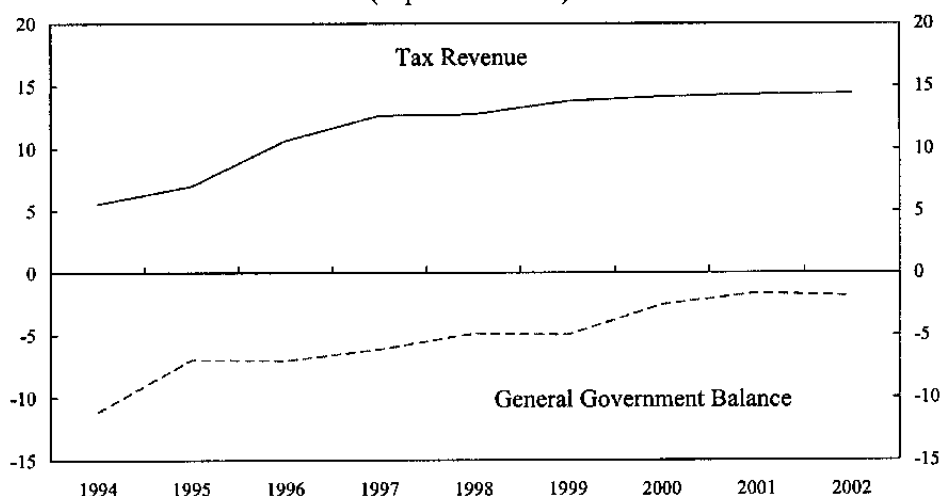
II. REPORT ON THE DISCUSSIONS

9. **The 2003 Article IV consultation and program discussions were held against the backdrop of protracted deviations from the Fund-supported program**, owing to a fragile fiscal situation and limited political support for key legislation to strengthen the public finances and address other issues. The government reiterated its commitment to an open and market-based economy in order to gradually integrate Georgia into the world economy. More specifically, the PRGF-supported program approved in 2001 has aimed at strengthening the fiscal position to underpin the prudent monetary stance and generate resources for priority programs. Other pillars of the program are a series of structural reforms and improvements in governance to enhance resource efficiency and the investment climate.

A. Past Achievements and Future Challenges

10. **Georgia has faced daunting challenges since independence, in an environment rife with political tension, declining living standards, and severe economic dislocations**, including dwindling tax revenue and loss of Soviet-era energy subsidies and market access. Weakened by civil war and de facto secession of Abkhazia and South Ossetia, Georgia nonetheless has had to build basic national institutions and embark on fiscal consolidation (Figure 6) and first-generation reforms, including privatization, land reform, and energy sector rehabilitation. Heavy energy-related foreign borrowing in the first years of independence saddled the country with a debt overhang, and the crises in Russia (1998) and Turkey (2001) further battered Georgia.

Figure 6. Georgia: Tax Revenue and Fiscal Balance, 1994-2002
(In percent of GDP)



Sources: Georgian authorities; and Fund staff estimates.

11. **Against this backdrop, the authorities pointed to several achievements in the mid-1990s**, including strides in structural reform and fiscal retrenchment during 1994-97; price and exchange rate stability after a hyper-inflation episode; accession to the World Trade Organization (WTO) in 2000; and convergence of economic legislation toward international best practice. Staff noted that the tax code adopted in June 1997 had initially provided a sound legal basis for taxation, but had been diluted by subsequent amendments granting piecemeal exemptions. Progress in targeting expenditure had been limited as the practice of identifying “protected” items under the 1996 Budget Systems Law had made it hard to reallocate spending towards new priorities. The banking sector had been strengthened in recent years, but remained small and vulnerable, inhibiting domestic savings and investment. High spreads between deposit and lending rates reflected the absence of a sound credit culture and difficulties enforcing legal claims against collateral. The authorities recognized that the slowdown in the reform effort in recent years had contributed to the weakening in growth performance, after brisk growth in the mid-1990s. They concurred with the staff’s view that the reform drive needed to be reinvigorated, including by broadening political support for this endeavor and clearly articulating to the public the rationale for the government’s economic strategy.

12. **Both current and former Georgian officials took a broadly positive view of the effectiveness of Fund advice to Georgia in the context of surveillance and discussions on the four programs undertaken since Georgia joined the Fund in 1992.** They stressed that Fund-supported programs in the mid-1990s had been crucial in achieving price and exchange stability, and noted that under the 1996 ESAF and 2001 PRGF arrangements, policy advice from Fund staff had continued to provide key support for reform. These officials also considered that Fund technical assistance had been instrumental in creating an institutional

framework to underpin a market economy, emphasizing its contribution to establishing the treasury and strengthening the banking sector. Further, the mission's interlocutors noted that Fund advice and technical assistance on tax policy and administration had contributed to impressive initial progress in increasing revenue, which has since continued, albeit at a slower pace. One former senior official felt that in the early years of transition, the Fund should have advised against the authorities' plan to introduce a VAT to replace a simpler turnover tax in light of the capacity constraints at that time (in the event, VAT was introduced in 1992). However, the current authorities and staff agreed that overall VAT performance had been a success, and that this tax has become a highly effective source of government revenue in recent years, although there is scope for further improvement in the VAT's administration, as discussed below. The effectiveness of past Fund advice will be taken up in greater detail in the forthcoming ex-post assessment of the current PRGF arrangement.

13. **Corruption continues to be broadly perceived as resilient, diverting scarce public resources, exacerbating income inequalities and weakening confidence.** Staff stressed that, in the absence of a rapid turnaround in governance, the authorities risked losing credibility, while the investment climate would remain depressed and it would be difficult to bolster tax collections to permit higher core spending. Past attempts to deal with the problem, including establishment of an Anti-Corruption Bureau and enactment of decrees in 2001-02, have yielded few results,⁴ suggesting that a new social and political compact—perhaps after the November 2003 legislative elections or, at a minimum, after the presidential elections in early 2005—was imperative to rein in vested interests and complicit law enforcement agencies. Several factors contribute to the poor governance climate in Georgia, including political fragmentation, a tradition of clan and family based loyalties, weaknesses in the legal and judicial systems, and a culture of non-payment that is perceived as socially acceptable. Noting that government has often distanced itself from difficult adjustment measures and portrayed them as imposed by donors, **staff urged the authorities to display greater program ownership** and clearly communicate its economic strategy to parliament and the public. **Staff also underlined the need for greater continuity in the economic team**, given that its rapid turnover (e.g., four ministers of finance, seven directors of inland taxes and eight customs heads in the past five years) hampered efforts to bolster revenue and improve spending discipline.

14. **Regarding performance under the current PRGF arrangement, the root cause of periodic fiscal slippages has been stubborn tax evasion** (particularly on fuel and cigarette excises and customs duties), compounded by reluctance of Adjara to transfer shared revenue

⁴ In 2002, Georgia ranked 85th in Transparency International's *Corruption Perception Index* for 102 countries. The latest EBRD *Business Environment and Enterprise Performance Survey* showed that although the business climate has been improving in some respects over time, bribery indicators are deteriorating and firms in Georgia perceive corruption as a greater obstacle than elsewhere in the CIS.

to the center. Weaknesses in budgetary design and execution also have played a role. Coupled with limited availability of non-inflationary domestic financing and shortfalls in donor assistance prompted by Georgia's uneven performance, this has often led to budget sequestrations and jeopardized steady clearance of domestic arrears. **On the structural front, delays in passing key reforms have stemmed from capacity constraints, poor internal coordination and, more recently, political tensions ahead of the November 2003 parliamentary elections.**

B. Medium-Term Economic Strategy and Outlook

15. Looking ahead, the authorities and staff agreed that the Economic Development and Poverty Reduction Program (EDPRP) just issued provides a useful framework for tackling key economic and social challenges, including combating poverty (Box 2).⁵ Under its "realistic scenario," output growth would accelerate to 4 percent a year in the medium term, more than halving by 2015 the share of the population below the poverty line. The authorities recognize that to sustain or exceed this target and underpin price stability, they will need to persevere with fiscal consolidation, accelerate structural reform, and foster good governance.

Box 2. Poverty in Georgia

Despite positive growth and substantial foreign aid, **widespread poverty has been brought on by the dramatic drop in incomes after independence and the subsequent collapse in social services.** In recent years poverty has broadly mirrored overall growth trends. After improvements in poverty indicators in the mid-1990s, poverty and inequality increased during 1998-2000 in line with the deceleration in economic growth; the depth and severity of poverty increased between 1998 and 2000 by 84 percent and 94 percent, respectively.

In 2001-02, overall poverty decreased slightly and inequality declined, as growth picked up. Urban poverty responded to growth earlier and more strongly—in 2002 the urban poverty headcount was 17 percent lower than in 1999 (using the World Bank's poverty line), reflecting non-agricultural sector recovery after the Russian crisis. In contrast, droughts caused rural poverty to increase in 2000. It subsequently stabilized in 2001, followed by a slight decline in 2002.

Government has not provided an effective income redistribution mechanism and has failed to provide adequate social safety nets. This largely stems from low tax collections, which have led to accumulation of regressive wage, pension, and social assistance arrears. Although public spending on health and education grew during the late 1990s, it remains 90 percent lower than in the pre-transition period (1 percent of GDP for health and 2.2 percent for education in 2001). Also, **demands for high informal payments further limit access to quality health care and education,** while poor targeting of social spending and energy subsidies have compounded the problem.

⁵ For details and a joint staff assessment of the poverty reduction strategy, see EBD/03/78 and EBD/03/79, 8/22/2003.

16. In the next few years, the economy will be bolstered by construction activity and transit fees from energy pipelines. Nevertheless, significant downside risks in the outlook require the authorities' attention (Box 3, Tables 7 to 11, and Appendix V).

Georgia is quite vulnerable to external shocks given the high external indebtedness, limited gross reserves, and concentration of exports by commodities and destinations. An update of Georgia's debt sustainability analysis indicates that, notwithstanding a steady improvement in debt indicators over the coming years, external obligations are likely to remain burdensome.⁶ Furthermore, stress tests show that indicators could deteriorate substantially under adverse external or domestic developments (e.g., sluggish export growth or a large currency depreciation). A concessional restructuring of Georgia's bilateral debt would considerably improve debt indicators and the prospects for medium-term sustainability. On the domestic side, the main risks could come from continued political and economic gridlock or failure to address head-on the serious governance issues; if so, the fiscal fragilities noted above could fester, reforms could stall, and large domestic and foreign investments needed for rapid growth might not materialize. Strong policies could mitigate these risks, but to be successful they also require better government communications to rally public support, firm policy ownership, and elimination of capacity bottlenecks in the civil service.

17. Tax revenue, projected at 15.8 percent of GDP this year, is low by regional and international standards. The authorities shared staff's view that an increase in the revenue ratio of at least 4 percentage points over the next five years will be necessary to secure fiscal sustainability and unwind domestic arrears. They agreed that these gains would hinge on **major improvements in tax and customs administration** to reap the potential from excise taxes and customs duties (FAD assistance in this area will be provided in late 2003).⁷ The tax reform just passed, together with recent regulations overhauling VAT refunds, should simplify compliance, curb false claims, and facilitate tax enforcement. New taxes approved in August 2003 (on construction, street markets, and gambling) will make a modest additional contribution. The authorities also secured parliamentary approval in August 2003 for broadening the mandate of the Ministry of Finance to include strengthened investigative powers needed to underpin anti-smuggling efforts, a measure they viewed as critical to achieving these goals. The Extraordinary Legion of the Ministry of Finance, which previously held some of these functions, is to be abolished, and the investigative powers of the Ministry of Interior for these types of economic crimes will be eliminated. Before these measures become operational, several months may be needed to pass required enabling legislation,

⁶ Further details are provided in the chapter on External Debt Sustainability in the selected issues paper.

⁷ Estimates by international donors suggest that an increase in revenue in the order of 4 percent of GDP would be feasible over the medium term by combating tax evasion, particularly of fuel excises and import duties, which currently yield revenue far below potential.

which may face resistance from the disempowered agencies. Looking ahead, the officials recognized that it will be necessary to clearly determine the roles and responsibilities of different tax enforcement bodies and resolve the revenue-sharing dispute with Adjara.

Box 3. Georgia: Medium-Term Macro-Economic Framework

Despite progress over the years in reform and fiscal consolidation, Georgia continues to face significant medium-term vulnerabilities. In the **fiscal area**, tax revenue needs to be bolstered for adequate social spending and public investment. The medium-term scenario projects tax collection going up over time, premised on reforms in tax policy and administration. Non-tax revenue will be boosted by pipeline transit fees to be paid from 2005 in the case of the Baku-Tbilisi-Ceyhan oil pipeline and 2006 in the case of the South Caucasus gas pipeline (SCP). These fees will rise to 1 percent of GDP a year by 2009. It will be crucial to ensure that SCP in-kind payments to government are transparently monetized and recorded at market value in the budget. Improved revenue should allow the government to pay off domestic arrears (currently at 5.2 percent of GDP) over time. The medium-term scenario assumes securitization of domestic arrears by early 2004, premised on no further accumulation of new arrears.

The main **external risks** stem from high indebtedness, export concentration and low official reserves. Sustained and diversified export growth, which is key for gradually narrowing the current account deficit, requires a business-friendly environment and smooth operation of VAT refunds to exporters. The debt burden needs to be lightened through avoidance of commercial borrowing and concessional treatment of bilateral obligations. Large FDI flows are projected in conjunction with the oil and gas pipelines, but improvements in governance and the investment climate will be essential to attract substantial non-energy FDI. A manageable current account deficit and adequate financing should permit a continued gradual buildup of foreign reserves. The baseline scenario assumes 2003 principal maturities due to the Paris Club will be rescheduled on the same terms as those due in 2001-02. An update of the debt sustainability analysis suggests that Georgia would continue to face a heavy debt burden in the coming years (for details, see the External Debt Sustainability Analysis in the companion Selected Issues paper). Starting from the DSA base year of 2003, a hypothetical stock operation on Naples terms would reduce the NPV of debt to revenue from 275 percent in 2003 to 226 percent by end-2006 and to 201 percent by end-2008.

The **growth rate** in the EDPRP's "realistic scenario" would accelerate to 4 percent over the medium term, slightly above the 1998-2002 average. Appendix VI on growth accounting shows this is feasible if the business climate is improved and structural reform vigorously implemented. However, a sustained 8 percent growth rate as in the EDPRP's "optimistic scenario" is unlikely. The EDPRP targets a decline in the share of the population living on less than US\$2 per day from one-half in 2001 to one-fourth in 2015 in the realistic scenario. Inflation would remain at 4-5 percent as the NBS maintains prudent monetary policies.

18. **There was broad agreement during the discussions that sustained and equitable growth also hinges on better public spending and stronger expenditure controls to check the fiscal deficit.** Staff recommended that the new budget systems law be elevated to the status of an organic law (i.e., which can only be overturned by a qualified majority and cannot be superceded by regular laws) as soon as practicable. Budgetary design and implementation should be further enhanced by using conservative assumptions to forestall future sequestrations, and by improving strategic planning and linkages with EDPRP priorities. The authorities indicated that completing the transition to a single treasury account,

making the new commitment controls fully operational, and expanding its coverage to extrabudgetary funds, while aligning cash management and accounting with best practice, should significantly improve budget execution. Here, again, they are counting on FAD assistance.

19. Discussions with government officials and the business community highlighted the need for bolder efforts to improve Georgia's business environment and investment climate. As noted earlier, investors generally perceive the business environment as bureaucratic, non-transparent, and vulnerable to corruption. Opaque regulations, erratic enforcement, sluggish administrative procedures, and frequent and unpredictable demands for bribes tend to hamper investment and entrepreneurship. Staff's interlocutors agreed that, despite these long-standing impediments, there has been little enthusiasm in the government or political will to remove them. More specifically, the consensus view is that **a two-pronged effort is needed to effectively fight corruption:**

- **Petty corruption** should be combated by enforcing penalties, reforming the civil service (see below), and expanding productive employment opportunities.
- **Large-scale corruption** must be curbed by reducing rent-seeking opportunities, reining in complicit law enforcement agencies, and imposing stiff criminal sanctions. The authorities underlined that some of the initiatives mentioned above (e.g., anti-money laundering law, tighter criteria for bank ownership or management, SOE audits, and renewed steps to curb tax evasion) would buttress their drive against fraudulent behavior.

C. Structural Reforms

Public sector reforms

20. The mission's interlocutors expressed diverse views regarding the appropriate role and size of government. Against the backdrop of the EDPRP's rising demands for greater state intervention in the delivery of social services and safety nets, there was also a call by some MPs and businessmen for significant tax cuts that would only be viable if the government is downsized. Clear societal choices need to be made in the coming years to reconcile these views. Meanwhile, **staff urged the authorities to finalize their civil service reform strategy**, which could ease the trade-off somewhat. The current version, prepared with donor assistance, calls for a reduction by 30 percent (21,000 staff) during 2003-05 in the civilian workforce of central government ministries, public entities (e.g., regulatory bodies and port authorities), and local governments. Retrenchments would be mainly by attrition and exclude the defense and security forces and educational institutions. After some modest reductions in the first half of 2003, the authorities expect to reduce central government staff by 20 percent this year and to begin retrenching local governments.⁸

⁸ Out of the total labor force of 2.7 million persons, the central government employs 132,000 persons (of which slightly over half in defense and security). Provincial and local governments employ another 161,000 persons.

21. **The reform would also include merger or elimination of ministries, an upgrade in entry-level pay to a “subsistence minimum,” and differentiated increases for technical and managerial personnel to facilitate recruitment.** The authorities said they were considering a sizable increase in the wage bill over the medium-term. Staff urged them to avoid such an increase until revenue performance is significantly bolstered, and questioned whether generalized increases under consideration in entry-level wages (instead of targeted safety nets) were best suited to combat poverty. The authorities said that public wages had been compressed for quite some time and catch-up increases would eventually need to be accommodated. They noted, nonetheless, that the costing of different civil service reform scenarios would need to be finalized soon, so as to tailor wage increases to the country’s fiscal constraints.

22. **The authorities indicated that the three major SOE audits should be concluded within the next four to eight months at a total cost (borne by the companies) of US\$0.8 million.** Staff urged the authorities to publish the results and implement the recommendations, ensuring that other SOEs are also audited routinely by reputable and independent experts. **At present, the government does not envisage any major privatizations in the next few years, and it will focus on putting state companies in a solid footing under the aegis of the new Enterprise Management Agency (Box 4).**

Box 4. Georgia: Privatization and State Property Management

Georgia has undertaken significant privatization over the past decade. Virtually all small firms and over 1,000 medium and large ones—converted into joint-stock companies—have been privatized. However, a significant proportion of large enterprises continue to be state-owned. The government has not effectively controlled these firms, many of which systematically evade taxes and dividend payments to the budget. To address these problems, the Ministry of State Property Management was dissolved in Spring 2003 and its tasks divided between the Ministry of Economy, which will assume responsibility for privatization, and a new Enterprise Management Agency (EMA), responsible for overseeing management of SOEs by appointing supervisory boards and preparing enterprises for privatization. The EMA, financed through a 15 percent share of post-tax SOE dividends, expects to hire international experts on accounting, audit practices, and enterprise valuation to develop objective, independent management information systems.

The largest divestiture this year was the Zestafoni ferro-manganese plant, sold to an Austrian company in July 2003 for US\$7.1 million, with a commitment by the buyer to an US\$18 million, three-year investment program. Earlier in the year, Azoti, a large chemical factory, was sold to the Russian gas company Itera for a symbolic price. Total privatization proceeds for 2003 are projected at 0.3 percent of GDP. The authorities have no major plans for privatization in 2004. Other large SOEs need to be restructured before they can be privatized. In August 2003, the authorities agreed with an Italian firm on a 15-year rehabilitation plan for the Rustavi Metallurgical Plant.

Energy sector reforms

23. **Under the Energy Sector Action Plan agreed with donors in 2002, the government undertook to overhaul the sector to secure stable power supply and**

financial viability of the industry. The authorities noted that, since early 2003, important segments of the industry have been under private management contract, and more forceful disconnection of non-paying customers has improved collection rates, particularly in Tbilisi (Box 5). Supporting actions urged by the Fund and other donors include taking a firm stance toward nonpaying customers; curtailing widespread theft and fraud in the system; and resisting political pressures to tamper with the established tariff formula based on long-run marginal cost. As agreed with donors, government also needs to set up a Debt Resolution Agency to tackle the domestic debts of the energy sector, including verification and settlement of reciprocal claims and obligations of public agencies.

Box 5. Georgia: The Electricity Sector

Like other FSU countries, Georgia has subsidized electricity for social protection and to soften industrial budget constraints. Low collections and pricing below cost have generated quasi-fiscal (QF) deficits of 6 percent of GDP a year. Social energy subsidies have been poorly targeted and those to enterprises have helped perpetuate non-viable industries. These QF losses were initially financed by accumulation of foreign debt, representing a major part of the overhang in external indebtedness. When foreign resources dwindled, financing of QF deficits shifted toward de-capitalization of the system, leading much of the infrastructure to its current state of disrepair. As a result, protracted blackouts have undermined economic activity and caused social discontent. Without timely measures, the financial burden and physical decay may lead to collapse of the electricity system, with grave fiscal, social, and political consequences (for details, see the chapter on energy sector reforms in the accompanying selected issues paper).

Energy sector reform since 1996 has focused on de-monopolizing the vertically integrated industry, privatizing certain segments, establishing an independent regulatory framework, and raising tariffs toward cost-recovery levels. In 1996, the system was separated into distribution, generation, and transmission and dispatch companies. An independent regulatory agency (GNERC) was established in 1997; the wholesale electricity market (GWEM) started operating in 1999; and privatization started in late 1998, when the American-owned AES group bought the Tbilisi distribution company Telasi (subsequently sold in August 2003 to the Russian UES group). The government has signed management contracts for other key segments (the wholesale market, distribution utilities outside Tbilisi, and the transmission and dispatch company) to improve efficiency and payment discipline. Results so far have been mixed. GWEM—tasked to enforce payments (by disconnecting non-paying customers) and allocate them transparently—has moved in that direction, but has not fully succeeded due to technical, governance and political problems. Similarly, the transmission and dispatch company has failed to reduce electricity theft and overall losses and has acted inconsistently on disconnections. Likewise, distribution utilities outside Tbilisi have yet to boost receipts significantly and transfer them to GWEM. Resident nonpayments are aggravated by unpaid electricity consumption by breakaway Abkhazia, equivalent to 0.3 percent of GDP in 2003. This problem is likely to increase over time as Abkhazia's economy is rehabilitated. Moreover, taxation of energy companies has changed frequently and erratically, and the sector has been burdened by old debts to suppliers and the government. These factors, combined with periodic droughts and breakdowns of thermal plants, have hampered supplies and the finances of the energy companies.

Strong and sustained efforts will be needed in the period ahead to improve the sector's technical and financial viability. Bringing distribution outside Tbilisi under private management in early 2003—the key element of the action plan agreed with donors in late 2002—should help boost collection rates, though government must show firm support for cutting off non-paying customers, and adopt a more rational and consistent tax policy for the sector. Government also needs to attack corruption in the sector; ensure timely payments for electricity consumed by budget organizations and SOEs; forbid barter and offset operations to settle energy bills; and work with donors to set up a Debt Resolution Agency to deal with internal energy debts.

Financial sector reforms

24. **The monetary authorities consider that the legal and regulatory basis for effective banking supervision is now in place.** They have introduced greater flexibility into on-site examinations: full inspections for banks with 3-5 CAMEL ratings are now conducted semi-annually, while banks rated 1-2 are fully examined every 18 months except for occasional targeted inspections. The NBG plans to encourage consolidation of the industry (by increasing minimum capital requirements to €5 million in line with European standards), and later on to introduce a deposit insurance scheme. Activities of five microfinance institutions are currently unregulated and draft NBG proposals to fill the vacuum need to be agreed with government and submitted to parliament. Regarding the **anti-money laundering (AML) law** approved in June 2003, the Financial Monitoring Service will issue enabling regulations by year's-end. The authorities said they planned to propose amendments to the AML law by spring 2004 to enable effective enforcement of property confiscation for violators. Staff took the view that recent measures on differentiated reserve requirements could play a small positive role in mitigating dollarization, but stressed that its long-term reversal must be rooted in sound macroeconomic fundamentals, good governance, and greater political stability.

Trade liberalization and external competitiveness

25. **Georgia's natural resource endowment, location, reasonable transport infrastructure, and educated labor force, as well as its liberal trade regime, provide the potential for rapid export growth and development as a regional transit hub.** A recent World Bank study stresses, nonetheless, the need to address the unfavorable business climate and corruption.⁹ It also urges the strengthening of property rights, development of adequate standards, and increased utilization of available GSP preference schemes.

26. Georgia currently ranks 1 (liberal) in the PDR trade-restrictiveness index, compared with a ranking of 2 in 2001.¹⁰ Based on margins allowed during WTO accession, Georgia adopted measures in late 2002 that raised the number of tariff bands from three to 22 and the maximum tariff from 12 percent to 30 percent. These measures reduced the simple average tariff from 10.9 percent to 8.2 percent, but increased the *weighted-average* tariff from 10.3 percent to 11.3 percent and the standard deviation from 3.3 to 5.6. The improved ranking is based on the decline in the simple average tariff but disregards the increases in the weighted average and dispersion of tariffs. Fund and Bank staff encouraged the authorities to reverse these protectionist measures, which were spearheaded by interest groups. More

⁹ World Bank, *Georgia: Diagnostic Trade Integration Study*, June 2003, Washington, D.C.

¹⁰ Georgia does not use non-tariff barriers, except for environmental, security and health reasons.

generally, and noting that widespread smuggling leads to an effective duty collection rate on non-pipeline imports of 3.6 percent, **staff proposed a shift to a low uniform import tariff**, which would significantly reduce distortions and rent-seeking opportunities, while providing ample scope for curbing smuggling and raising collections. This should be accompanied by the introduction of a duty-drawback system and improvements in the VAT refund mechanism for exporters, as discussed above. The authorities found merits in this proposal and undertook to study it further. Staff encouraged them to finalize their trade liberalization strategy by year's-end, so that it could become an important element of a successor Fund-supported economic program.

27. **The authorities considered that foreign tariffs are not an important barrier for access to external markets, although quality and health standards continued to pose serious obstacles.** Georgia has signed free trade agreements with seven CIS countries (Armenia, Azerbaijan, Kazakhstan, Russia, Turkmenistan, Ukraine, and Uzbekistan), as a result of which a large share of its international trade takes place at zero tariffs.

D. Program Issues and Macroeconomic Policies for 2003-04

28. **The authorities' program for 2003 targets output growth of 4.8 percent and end-period inflation of 4.5 percent.** The external current account deficit is expected to widen to 11.1 percent of GDP (from 6 percent in 2002), much of it covered by rising pipeline-related FDI; excluding pipeline imports, the deficit would narrow from 5.6 percent of GDP to 5.3 percent. Because of the fiscal overruns observed thus far in 2003, **staff urged the authorities to secure parliamentary approval of a tax reform and a revised 2003 budget to close an estimated gap of 1.6 percent of GDP as a prior action** for completion of the third review under the PRGF arrangement. The objective was to reduce the overall cash balance of the general government from 1.9 percent of GDP in 2002 to 1.0 percent in 2003, and thereby enable a reduction in domestic arrears of 0.7 percent of GDP.

29. During the August extraordinary sessions of parliament, **the government secured approval of the tax reform (see Box 1) and certain revenue measures yielding some 0.2 percent of GDP in 2003 (see paragraph 15), but it was unable to bring the revised 2003 budget to a vote. It decided therefore to introduce expenditure cuts equivalent to 0.8 percent of GDP by decree**, and indicated that it will continue to improve tax administration to limit the cash fiscal deficit to 1.7 percent of GDP, while reducing domestic arrears by 0.3 percent of GDP during 2003.¹¹ With technical assistance from FAD and after the accumulation of new arrears has stopped, the authorities plan to securitize the legacy arrears outstanding in early 2004, yielding a positive real remuneration. Staff recognized the administrative complexity of securitizing arrears, but took the view that it was important to

¹¹ The cuts are concentrated on goods and services, defense and security outlays, and capital expenditure, but they also involve some relatively small cuts in social spending.

demonstrate a firm government commitment to the timely and orderly liquidation of arrears. To reduce electricity sector quasi-fiscal losses, the authorities undertook to raise bill collections further and set a floor on transfers from the utility distribution company outside Tbilisi (UDC) to the wholesale electricity market during the rest of 2003.¹²

30. **The mission urged the authorities to adhere closely to their revised fiscal path for 2003, which will require a substantial effort during the second half of the year, given the slippages observed during the first semester.** The authorities should track developments closely and take quick actions to offset any emerging deviations from the indicative targets agreed with the mission (see Table 4). **Staff also urged the authorities to base the 2004 budget on conservative assumptions to forestall future sequestrations.** The officials plan to send the draft budget bill to the president by end-September, with a view to a parliamentary vote by end-2003.

31. In the absence of the measures (prior actions) that would have permitted completion of the third review under the PRGF arrangement, **Georgia will continue accumulating arrears on principal maturities due in 2003 to Paris Club and other bilateral creditors** (projected at US\$49 million). The authorities indicated that cash settlement of these arrears would be virtually impossible because they amount to over one-fourth of the current gross official reserves, but they plan to request a rescheduling of these arrears as well as the consolidation of maturities coming due in 2004 in the context of a successor PRGF arrangement.

32. The NBG's monetary program for 2003 assumes continued remonetization of the economy. **The authorities said that the managed exchange rate float, with intervention to bolster the currently low level of gross reserves, had served them well and would be maintained in the foreseeable future. Staff supported this approach,** but advised the authorities to let the lari float more freely if it came under pressure, in which case credit conditions might need to be tightened to check inflation. For 2003 as a whole, the NBG foresees a modest increase in net foreign reserves, while gross reserves would decline to 1.3 months of non-pipeline imports.

E. Statistical Issues and Standards

33. **The authorities have been improving the compilation of macroeconomic data, and core statistics for surveillance and program monitoring are adequate and timely. Nevertheless, there is significant room for improving the national accounts, balance of**

¹² The guideposts discussed with staff aim at raising collections from direct customers of GWEM to 75 percent in Q3 and 80 percent in Q4 2003 and to 90 percent from budgetary organizations in both quarters; UDC transfers to GWEM are to rise to at least 30 percent in Q3 and 50 percent in Q4 2003.

payments, customs, and fiscal statistics (Appendix IV). This will require adequate funding and staffing of the State Statistics Department, which should be given a high priority. In addition, to help improve data quality, the authorities will need technical assistance. They also would be advised to subscribe to the Fund's General Data Dissemination Standards (GDSS) as soon as practicable. The authorities have recently completed the fiscal Review of Standards and Codes (ROSC) and have agreed to the publication of the ensuing report, which focuses on reducing corruption and increasing transparency; the report also includes recommendations to improve fiscal data quality, financial controls, and internal and external audits.

III. STAFF APPRAISAL

34. Georgia has made impressive economic strides in the past decade of transition. In a difficult environment, it has established the foundations for an open, market based economy, achieved a large fiscal adjustment to underpin price and exchange rate stability, and embarked on major first-generation reforms. The challenge ahead is to build on these gains to fulfill the aspirations outlined in the EDRP.

35. In the stock-taking dialogue with the government and stakeholders, pervasive corruption and tax evasion stood out as the main roadblocks that must be urgently removed. These dysfunctional practices have grave economic and socio-political costs, diverting scarce public resources, depressing the business climate, and breeding distrust in the government's legitimacy and its ability to deepen reforms. From the economic point of view, more specifically, corruption and tax evasion starve the government of resources to discharge its core obligations and, by raising the cost of doing business, hamper the mobilization of vital private investment. Capacity constraints and weak program ownership are also a source of concern.

36. Despite the significant reduction in the government deficit since the early 1990s, fiscal performance in recent years has been uneven. Faced with the persistent tax evasion and a limited amount of sustainable non-inflationary financing, the government has been unable to obtain parliamentary support for realistic budgets and thereby prevent the recurrent buildup in domestic arrears. This problem has been compounded by failure to enforce revenue sharing mechanisms with sub-national governments and by fiscal pressures from the energy sector.

37. Against this backdrop, a number of recent measures—including a budget systems law and a revenue-neutral tax reform—could have an important pay-off over time. Looking forward, staff would advise the authorities to introduce supporting improvements in budgetary design and implementation. The single treasury account and the commitment controls need to become fully operational, while cash management and accounting procedures need to be aligned with best practice. On the revenue side, every effort should be made to improve tax and customs administration—especially to curb the evasion of cigarette and fuel excises and of customs duties.

38. **To offset a shortfall in grants and privatization receipts and overruns in expenditure earlier this year, the government has introduced several expenditure cuts and revenue enhancements. However, without parliamentary approval of a revised 2003 budget that would have closed the potential fiscal gap and authorized the securitization of outstanding domestic arrears by year's end,** completion of the third review under the PRGF arrangement could not be considered. As the arrangement expires in January 2004, it has been agreed to initiate discussions on a successor arrangement before the end of the year. Meanwhile, the authorities would do well to adhere closely to the quarterly quantitative guideposts discussed with staff through end-2003 (which will require a substantial fiscal effort in the second half of the year), and to formulate and secure timely approval of a 2004 budget based on plausible assumptions to forestall the need for ad-hoc sequestrations.

39. **Steadfast implementation of the energy sector reforms agreed with donors is essential to stem fiscal pressures and stabilize power supplies.** The reinstatement of the autonomy of the sector's regulatory body in August 2003 and the return to cost-recovery tariffs anticipated in December 2003 were difficult political decisions for which the authorities should be commended. Staff also welcomes the improvement in collection rates achieved thus far, while stressing the need to intensify these efforts and to continue the policy of disconnection of nonpaying customers. It will be important, furthermore, to set up an adequate institutional framework to verify and settle legacy domestic debts of the energy sector in a timely and orderly manner.

40. **Important initiatives are under way to improve public sector operations, including audits of problematic state enterprises, institutional changes in the oversight and divestiture of state property, and design of a civil service reform.** Staff encourages the authorities to pursue these activities expeditiously, especially to follow up on the audit recommendations and finalize the strategy and costing of civil service reform. Capacity building, including through technical assistance from the Fund and other donors, can play a useful supporting role in these endeavors.

41. **The prudent stance maintained by the monetary authorities has played a crucial role in anchoring price stability.** Staff supports the authorities' view that the managed float of the lari (with intervention aimed at building up reserves) has served them well, but would advise them to remain vigilant and float the currency more freely if it were to come under pressure. The NBG has introduced useful refinements in monetary control and financial sector regulation and supervision. It should now move to secure approval of the key missing piece of the anti-money laundering law dealing with confiscation of delinquent property, and put in place an effective supervisory framework for microfinance institutions. The new reserve requirements differentiated by currency denomination of deposits could play a marginally positive role in mitigating dollarization, but long-term reversal of this phenomenon hinges on sound economic fundamentals, good governance, and greater political stability.

42. **To fully exploit its development potential, Georgia needs to persevere with the adjustment and reform effort and substantially improve the business climate.** Further liberalization of the trade regime, possibly moving to a uniform tariff, would also help foster rapid and outward-looking economic growth. Moreover, a concessional treatment of bilateral obligations, coupled with a sustained fiscal effort, would help achieve longer term debt sustainability.

43. **Core statistics published by the authorities are timely and adequate for surveillance and program monitoring purposes.** Despite improvements in many areas, thanks in part to Fund technical assistance, there is scope to upgrade the statistical database, especially the compilation of national accounts, as well as the balance of payments and fiscal statistics. Staff encourages Georgia to subscribe to the Fund's General Data Dissemination Standards (GDDS) as soon as practicable.

44. The staff recommends that the next Article IV consultation with Georgia be held within the 24-month-cycle, subject to the applicable Executive Board decision on Article IV consultation cycles.

Table 1. Georgia: Selected Economic and Financial Indicators, 1999-2003

	1999	2000	2001	2002		2003
				Program 1/ Estimate	Estimate	Projection
(Percentage change relative to previous year, unless otherwise indicated)						
National income and prices						
Nominal GDP	12.4	6.1	10.4	9.4	12.3	9.0
GDP at constant prices	3.0	1.9	4.7	3.5	5.6	4.8
Nominal GDP (millions of lari)	5,665	6,013	6,638	7,264	7,457	8,126
Consumer price index, period average	19.1	4.0	4.7	6.0	5.6	4.4
Consumer price index, end-of-period	10.9	4.6	3.4	5.0	5.4	4.5
General government						
Tax revenue	21.5	8.8	11.7	12.0	13.1	19.2
Current expenditure	13.6	-3.4	0.1	7.7	7.0	15.3
Capital expenditure	...	...	138.1	53.0	9.3	30.7
External sector						
Exports	-0.3	10.6	-10.4	3.0	-0.9	11.2
Imports	-13.0	-7.5	-0.2	6.7	1.0	31.4
Imports, excluding oil and gas pipelines	-13.0	-7.5	-0.2	6.7	-0.3	9.8
Money and credit (end-of-period)						
Reserve money	18.8	26.8	9.9	12.5	18.4	11.3
Broad money (including foreign exch. deposits)	20.7	39.0	18.5	18.8	17.9	15.5
Velocity, level 2/ ²	12.7	9.7	9.1	8.3	8.6	8.1
Gross international reserves						
In months of imports of goods and services (excl. pipeline imports)	1.3	1.0	1.4	1.7	1.8	1.3
In millions of U.S. dollars	132	109	161	193	198	159
Exchange rate, lari/U.S. dollar						
Period average	2.02	1.98	2.07	...	2.20	...
End-of-period	1.96	1.98	2.06	...	2.09	...
(In percent of GDP, unless otherwise indicated)						
General government						
Total revenue and grants	15.4	15.2	16.3	16.9	15.8	17.1
Tax revenue	13.8	14.2	14.3	14.7	14.4	15.8
Total expenditure and net lending	22.1	19.2	18.3	18.0	17.8	18.5
Current expenditure	20.0	18.2	16.5	16.2	15.7	16.6
Fiscal balance, commitment basis	-6.7	-4.0	-2.0	-1.1	-2.0	-1.4
Net change in expenditure arrears	...	1.4	0.2	-0.7	-0.4	-0.3
Statistical discrepancy	...	0.1	0.1	0.0	0.5	...
Fiscal balance, cash basis	-5.0	-2.6	-1.6	-1.8	-1.9	-1.7
External sector						
Trade balance	-19.1	-13.4	-14.4	-14.1	-14.0	-19.1
Trade balance excluding pipeline-related imports	-19.1	-13.4	-14.4	-14.1	-13.7	-13.3
Current account balance						
Excluding transfers	-14.3	-9.4	-10.6	-10.8	-9.8	-15.5
Including transfers	-7.8	-5.8	-5.6	-6.2	-6.0	-11.1
Net change in external arrears	2.0	2.2	0.2	0.0	0.0	1.3
External debt	60.9	53.0	53.5	...	54.9	47.7

Sources: Georgian authorities; and Fund staff estimates.

1/ Program based on the second review under the PRGF-supported arrangement, which was completed on July 12, 2002.

2/ Annual GDP divided by end-period M3.

Table 2. Georgia: 2002 Quantitative Performance Criteria and Indicative Targets 1/

	Stocks 2/			Cumulative Change from End-December 2001									
	End-Dec. 2001	March 2002			June 2002			September 2002			December 2002		
	Actual	Indicative target	Adjusted target	Actual	Indicative target	Adjusted target	Actual	Perform. criteria	Adjusted target	Actual	Indicative target	Adjusted target	Actual
(In millions of lari)													
1. Quantitative targets 3/													
Floor on general govt. tax revenue (including special funds) 4/	951.5	223.6	223.6	227.4	490.4	490.4	488.8	774.7	774.7	778.1	1065.7	1065.7	1076.0
Ceiling on cash deficit of the general govt. 5/	109.1	26.9	33.3	33.7	54.3	84.8	60.2	84.4	123.7	69.4	129.7	173.7	139.0
Ceiling on domestic expenditure arrears of the general govt.	11.3	-5.0	-5.0	-4.4	-19.0	-19.0	-0.4	-32.0	-32.0	-12.1	-45.0	-45.0	-29.8
Ceiling on net credit of the banking system to the general govt. (NCG) 6/	724.6	2.5	-2.3	-4.1	11.5	24.9	-1.3	24.0	32.7	-22.5	50.0	24.1	-10.9
Ceiling on net domestic assets (NDA) of the NBG 6/	796.4	24.8	19.9	14.3	22.9	36.3	22.7	26.5	35.2	20.1	43.4	17.6	17.9
(In millions of U.S. dollars)													
Floor on total net international reserves (NIR) of the NBG 7/	-170.5	-5.5	-6.2	-5.3	4.7	-9.8	-7.0	13.4	-0.3	4.9	4.8	12.7	28.5
Ceiling on contracting or guaranteeing													
A. Short-term external debt (less than one year)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
B. Nonconcessional medium- and long-term external debt	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(In millions of lari)													
2. Indicative targets													
Ceiling on reserve money	429.9	13.0	13.0	2.9	32.8	32.8	7.7	55.3	55.3	30.7	53.7	53.7	79.1
Floor on cigarette and petroleum revenues	110.1	30.3	30.3	29.3	66.4	66.4	57.4	104.9	104.9	90.5	144.3	144.3	124.9
(In millions of U.S. dollars)													
3. Adjusters													
A. Net foreign-currency non-project flows 7/													
Projection			-3.3			1.9			0.9			-7.7	
Outturn			-4.1			-12.6			-12.8			0.2	
Adjustment to NIR target			-0.7			-14.4			-13.7			7.9	
(In millions of lari)													
B. Net external non-project flows to the budget 6/													
Projection			-24.3			-26.4			-41.9			-73.7	
Outturn			-19.4			-39.8			-50.6			-47.8	
Adjustment to NDA and NCG targets			-4.9			13.4			8.7			-25.9	
C. External project financing minus non-project grants plus external interest payments 5/													
Projection			44.7			60.7			89.6			134.9	
Outturn			51.1			91.2			128.8			178.9	
Adjustment to cash deficit target			6.5			30.4			39.3			44.0	

Sources: Georgian authorities; and Fund staff estimates.

1/ Section 1 of this table shows quantitative targets for 2002 based on cumulative changes from end-December 2001. Some ceilings and floors are subject to possible adjustment, as indicated in footnotes 5, 6, and 7, based on deviations from projections of external financing, reported in Section 3 of the table. Indicative targets are shown in Section 2. Continuous performance criteria are described in paragraph 53 of the MEFP (EBS/00/258).

2/ Year-to-date flows for tax revenues, cash deficit, expenditure arrears, and cigarette and oil revenues.

3/ Quantitative targets for 2002 and 2003 are based upon accounting exchange rates of 2.15 lari/US\$, 1.28 US\$/SDR, and 0.90 US\$/euro.

4/ Special state funds include the Pension, Employment, and Road Funds. Privatization receipts are excluded.

5/ The program target on the cash deficit is adjusted for deviations from projected disbursements of external project finance minus non-project grants plus external interest payments (Section 3C) as specified in the TMU (EBS/02/117), subject to a cap on cumulative upward adjustment of lari 80 million.

6/ Program targets on NCG and NDA are adjusted for deviations from projected net external non-project flows to the budget (Section 3B) as specified in the TMU (EBS/02/117), subject to a cap on cumulative upward adjustment of lari 25 million.

7/ The program target on NIR is adjusted for deviations from projected net foreign-currency non-project flows (Section 3A) as specified in the TMU (EBS/02/117), subject to a cap on downward adjustment of US\$20 million.

Table 3. Georgia: 2003 Quantitative Indicative Targets 1/

	Stocks 2/		Cumulative Change from End-December 2002								
	End-Dec. 2002	Mar. 2003			Jun. 2003			Jul. 2003		Sep. 2003	Dec. 2003
	Actual	Indicative target	Adjusted target	Actual	Indicative target	Adjusted target	Actual	Indicative target	Preliminary	Indicative target	Indicative target
(In millions of lari)											
1. Indicative targets 3/											
Floor on general govt. tax revenue (including special funds) 4/	1076.0	272.0	272.0	273.4	585.5	585.5	576.0	685.8	689.8	924.0	1284.0
Ceiling on cash deficit of the general govt. 5/ 8/	139.0	36.9	39.1	11.6	50.3	59.7	42.2			98.3	136.0
Ceiling on domestic expenditure arrears of the general govt.	-29.8	22.1	22.1	34.9	18.3	18.3	32.9	27.5	19.2	-6.0	-16.0
Floor on cigarette and petroleum revenues	124.9	31.0	31.0	23.9	66.7	66.7	53.7			100.2	146.3
Ceiling on net credit of the banking system to the general govt. (NCG) 6/ 8/	713.7	18.3	13.8	4.6	33.7	16.9	26.9			29.9	55.1
Ceiling on net domestic assets (NDA) of the NBG 6/	814.2	11.2	6.7	-5.7	33.5	16.6	-12.2			32.1	47.8
Ceiling on reserve money	509.0	-8.0	-8.0	-18.4	11.0	11.0	-3.8			64.1	57.5
(In millions of U.S. dollars)											
Floor on total net international reserves (NIR) of the NBG 7/	-142.0	-8.9	-8.0	-5.9	-10.5	-7.7	3.9			14.9	4.5
Ceiling on contracting or guaranteeing											
A. Short-term external debt (less than one year)	0.0	0.0	0.0	0.0	0.0	0.0	0.0			0.0	0.0
B. Nonconcessional medium- and long-term external debt	0.0	0.0	0.0	0.0	0.0	0.0	0.0			0.0	0.0
(In millions of lari)											
2. Adjusters											
A. Net foreign-currency non-project flows 7/											
Projection				-9.45		-19.60				-21.4	-31.8
Outturn				-8.5		-16.8				n.a.	n.a.
Adjustment to NIR target				1.0		2.8				n.a.	n.a.
(In millions of lari)											
B. Net external non-project flows to the budget 6/											
Projection				-29.2		-63.58				-77.5	-107.9
Outturn				-24.7		-46.7				n.a.	n.a.
Adjustment to NDA and NCG targets				-4.5		-16.8				n.a.	n.a.
C. External project financing minus non-project grants plus external interest											
Projection				42.7		78.0				130.0	181.1
Outturn				44.9		87.5				n.a.	n.a.
Adjustment to cash deficit target				2.2		9.5				n.a.	n.a.
3. Deposits of the government of Adjara at commercial banks reflecting tax revenues withheld from the central government 8/											
				8.5		17.8					

Sources: Georgian authorities; and Fund staff estimates.

1/ Section 1 of this table shows quantitative indicative targets for 2003 based on cumulative changes from end-December 2002. Some ceilings and floors are subject to possible adjustment, as indicated in footnotes 5, 6, and 7, based on deviations from projections of external financing, reported in Section 3 of the table. Continuous performance criteria are defined in paragraph 53 of the MEEP (EBS/00/258).

2/ Year-to-date flows for tax revenues, cash deficit, expenditure arrears, and cigarette and oil revenues.

3/ Quantitative targets for 2003 are based upon accounting exchange rates of 2.15 lari/US\$, 1.28 US\$/SDR, and 0.90 US\$/euro.

4/ Special state funds include the Pension, Employment, and Road Funds. Privatization receipts are excluded.

5/ The program target on the cash deficit is adjusted for deviations from projected disbursements of external project finance minus non-project grants plus external interest payments (Section 2C) as specified in the TMU agreed with the authorities in 2003, subject to a cap on cumulative upward adjustment of lari 100 million.

6/ Program targets on NCG and NDA are adjusted for deviations from projected net external non-project flows to the budget (Section 2B) as specified in the TMU agreed with the authorities in 2003, and subject to a cap as specified in the TMU agreed with the authorities in 2003, subject to a cap on cumulative upward adjustment of lari 25 million.

7/ The program target on NIR is adjusted for deviations from projected net foreign-currency non-project flows (Section 2A) as specified in the TMU agreed with the authorities in 2003, subject to a cap on downward adjustment of US\$20 million.

8/ As specified in the TMU agreed with the authorities in 2003, until the Adjara revenue issue has been resolved, deposits by the government of Adjara at commercial banks that reflect tax revenues withheld from the central government will be excluded from net financing to the government. The cumulative lari amount equivalent to the non-transferred revenues will be added to the end-period outcomes for the cash deficit and net banking system credit to the government.

Table 4. Georgia: General Government Operations, 2002-2003

	2002 Actual		Budget 2003		Rev. Proj. 2003		2003 Revised Quarterly Projections			
	million	% of	million	% of	million	% of	Q1 Act.	Q2 Act.	Q3 Proj.	Q4 Proj.
	lari	GDP	lari	GDP	lari	GDP				
Total revenue and grants (excl. privatization)	1,177.2	15.8	1,442.5	17.8	1,390.1	17.1	306.6	317.1	383.2	383.3
Total revenue	1,156.3	15.5	1,347.1	16.6	1,362.4	16.8	298.8	314.1	369.4	380.1
Tax revenue 1/	1,076.0	14.4	1,270.0	15.6	1,284.0	15.8	273.4	302.7	347.9	360.0
Taxes on income	143.0	1.9	163.6	2.0	163.6	2.0	30.3	37.8	46.8	48.7
Taxes on profits	82.5	1.1	96.5	1.2	99.5	1.2	22.7	29.2	24.0	23.6
VAT	413.7	5.5	471.5	5.8	472.5	5.8	111.3	104.6	126.5	130.1
Customs duties	63.9	0.9	76.6	0.9	78.6	1.0	15.7	22.2	20.9	19.8
Excises	91.3	1.2	115.5	1.4	121.0	1.5	17.6	24.9	34.2	44.3
Other taxes	111.6	1.5	116.2	1.4	118.7	1.5	24.0	31.8	31.8	31.1
Nontax revenue	80.3	1.1	77.1	0.9	78.4	1.0	25.4	11.5	21.4	20.1
NBG profit transfers	35.0	0.5	15.0	0.2	15.0	0.2	15.0	0.0	0.0	0.0
Extrabudgetary revenue 2/	169.9	2.3	230.1	2.8	230.1	2.8	51.8	52.2	63.7	62.5
Medical and pension funds 3/	127.9	1.7	180.5	2.2	180.5	2.2	42.1	41.4	49.5	47.5
Road fund	42.0	0.6	49.6	0.6	49.6	0.6	9.6	10.8	14.2	15.0
<i>Of which: Gasoline excise</i>	13.7	0.2	17.3	0.2	17.3	0.2	2.1	2.4	5.3	7.5
Grants	20.9	0.3	95.4	1.2	27.7	0.3	7.8	3.0	13.9	3.1
Total expenditure and net lending	1,324.2	17.8	1,543.6	19.0	1,501.5	18.5	364.3	345.6	391.8	399.7
Current expenditure	1,172.8	15.7	1,388.2	17.1	1,351.9	16.6	327.7	310.3	351.2	362.7
Wages and salaries 2/	176.9	2.4	235.0	2.9	232.0	2.9	55.9	55.1	58.8	62.1
Goods and services	158.3	2.1	177.6	2.2	137.4	1.7	37.4	35.4	32.6	32.0
Transfers and subsidies 2/	132.5	1.8	165.4	2.0	157.1	1.9	38.7	30.3	42.0	46.1
<i>Of which: Energy commitments</i>	0.0	0.0	32.3	0.4	29.8	0.4	...	...	...	...
Interest payments	145.9	2.0	154.4	1.9	172.4	2.1	48.8	35.2	46.8	41.5
Domestic	80.2	1.1	84.6	1.0	95.5	1.2	23.2	22.8	24.4	25.2
External	65.7	0.9	69.8	0.9	76.9	0.9	25.6	12.4	22.4	16.3
Extrabudgetary expenditures 3/	243.6	3.3	320.5	3.9	332.6	4.1	81.5	82.7	84.4	84.0
Medical and pension funds 4/	201.6	2.7	273.8	3.4	287.5	3.5	71.9	71.9	71.9	71.9
Road fund	42.0	0.6	46.7	0.6	45.1	0.6	9.6	10.8	12.5	12.1
Local government expenditures 5/	315.6	4.2	335.3	4.1	320.4	3.9	65.4	71.6	86.6	96.9
Capital expenditure	78.6	1.1	108.5	1.3	102.7	1.3	17.6	17.0	32.6	35.6
<i>Of which: Foreign financed</i>	76.3	1.0	75.0	0.9	75.0	0.9	17.2	16.5	23.3	18.0
Net lending	72.8	1.0	46.9	0.6	46.9	0.6	19.1	18.3	8.0	1.5
<i>Of which: Foreign financed</i>	56.8	0.8	62.9	0.8	62.9	0.8	11.6	14.3	19.0	17.9
Budget contingency	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance (commitments)	-147.1	-2.0	-101.1	-1.2	-111.4	-1.4	-57.7	-28.5	-8.5	-16.5
Adjustment to cash basis	8.1	0.1	-54.4	-0.7	-24.7	-0.3	46.1	-2.1	-49.0	-19.7
Net change in expenditure arrears (-, reduction)	-29.8	-0.4	-54.4	-0.7	-24.7	-0.3	29.9	-2.3	-38.9	-13.4
Domestic expenditure	-29.8	-0.4	-54.4	-0.7	-24.7	-0.3	29.9	-2.3	-38.9	-13.4
TMU definition 6/	-29.8	-0.4	-45.7	-0.6	-16.0	-0.2	34.9	-2.1	-38.9	-10.0
Statistical discrepancy	37.9	0.5	0.0	0.0	0.0	0.0	16.1	0.3	-10.1	-6.3
Overall balance (cash)	-139.0	-1.9	-171.9	-2.1	-136.0	-1.7	-11.6	-30.5	-57.6	-36.2
Total financing	139.0	1.9	171.9	2.1	136.0	1.7	11.6	30.5	57.6	36.2
Privatization	15.3	0.2	46.5	0.6	30.0	0.4	5.2	2.3	11.3	11.3
Domestic	-7.8	-0.1	70.5	0.9	62.1	0.8	-9.2	19.5	32.7	19.0
NBG credit (loans and t-bills) net of deposits	16.8	0.2	40.0	0.5	40.0	0.5	-12.4	13.4	23.4	15.7
Commercial banks (t-bills and deposits)	-27.7	-0.4	30.5	0.4	15.1	0.2	8.5	-0.4	-2.5	9.5
Nonbank (t-bills and other)	3.1	0.0	0.0	0.0	7.0	0.1	-5.3	6.5	11.9	-6.1
External	131.5	1.8	54.9	0.7	83.9	1.0	24.2	18.0	24.5	17.2
Disbursements	170.3	2.3	127.8	1.6	132.5	1.6	28.7	28.4	41.5	33.9
Amortization	-115.7	-1.6	-72.9	-0.9	-155.8	-1.9	-28.1	-36.9	-41.1	-49.7
Changes in arrears (-, reduction)	0.0	0.0	0.0	0.0	107.2	1.3	23.6	26.5	24.1	33.0
Macroeconomic support	77.0	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Adjustment for net withheld Adjara transfers 7/	...	...	0.0	0.0	-40.0	-0.5	-8.5	-9.3	-10.9	-11.3
Memorandum items:										
Cigarette and petroleum tax revenue	124.9	1.7	139.3	1.7	146.3	1.8	23.9	29.9	42.8	49.7
Social spending (commitment basis)	591.8	7.9	655.0	8.1	651.7	8.0	138.9	180.0	...	...
Social spending (cash basis)	616.9	8.3	700.7	8.6	667.6	8.2	103.9	182.1	...	...
Nominal GDP (millions of lari)	7,457.0	100.0	8,126.2	100.0	8,126.2	100.0	1,846.9	2,027.9	...	...

Sources: Georgian authorities and Fund staff estimates.

1/ Program definition for tax revenue includes extrabudgetary revenue.

2/ Excludes employment programs (2002).

3/ Includes transfers from Central Budget. Excludes employment programs (2002).

4/ The previously off-budget state medical fund was consolidated with the state pension fund in January 2003.

5/ Includes transfers and payroll from Central Budgets and payroll from Local Budgets.

6/ TMU arrears includes social expenditure items, such as wages, pensions, food in-kind, refugee allowances and a part of local spending dedicated for health and education.

7/ Beginning in 2003 financing is adjusted by the amount of Adjara deposits attributable to the withheld tax revenue that Adjara collects on behalf of the central government.

Table 5. Georgia: Accounts of the National Bank of Georgia, 2001-2003

	2001			2002									2003								
	Dec.	Mar.		Jun.			Sep.			Dec.			Mar.		Jun.			Sep.	Dec.		
	Actual (2)	Target	Adj.Target	Actual	Target	Adj.Target	Actual	Target	Adj.Target	Actual	Target	Adj.Target	Actual	Target	Adj.Target	Actual	Target	Actual	Target		
	(Annual percentage change)																				
Net foreign assets 1/ 3/	13.8	17.7	17.4	17.8	21.1	14.2	15.5	18.1	11.0	13.7	2.8	7.4	16.7	14.1	15.7	15.8	14.1	15.7	22.2	23.2	3.2
Net domestic assets 3/	-2.5	0.3	-0.4	-1.0	-1.9	-0.3	-1.9	0.7	1.8	-0.1	5.5	2.2	2.2	1.8	1.3	-0.3	3.5	1.4	-2.1	3.6	5.9
Net claims on general government	-5.5	0.6	-0.1	-0.7	-1.4	0.4	-1.0	-0.5	0.6	-0.7	5.4	1.9	2.3	5.4	4.8	1.8	4.8	2.5	1.4	3.6	5.3
Claims on rest of economy	0.3	14.1	14.1	12.7	13.9	13.9	13.6	13.6	13.6	13.8	0.0	0.0	0.5	1.9	1.9	-1.5	0.9	0.9	1.1	0.4	0.1
Reserve money (RM)	9.9	23.3	...	20.4	20.7	...	14.1	19.9	...	13.8	12.5	...	18.4	15.8	...	13.3	18.8	...	15.5	24.4	11.3
Currency in circulation (M0)	11.1	21.4	...	16.7	22.4	...	13.8	21.0	...	12.5	11.1	...	14.1	16.8	...	10.2	20.6	...	12.0	26.9	14.1
Required reserves	37.0	42.5	...	41.0	27.9	...	25.6	29.7	...	33.0	27.0	...	35.5	19.4	...	28.6	16.2	...	38.7	15.7	9.9
Balances on banks' correspondent accounts	-52.9	-1.8	...	59.9	-40.7	...	-15.8	-37.5	...	-22.0	-11.2	...	79.7	-27.5	...	31.6	-19.6	...	1.8	-4.9	-42.1
	(In percent of lagged reserve money)																				
Net foreign assets 1/ 3/	15.1	22.7	22.3	22.8	24.8	16.7	18.3	18.5	11.2	14.0	2.4	6.3	14.3	12.3	13.7	13.8	12.3	13.7	19.4	17.9	1.9
Net domestic assets	-5.2	0.6	-0.8	-2.4	-4.1	-0.7	-4.2	1.4	3.5	-0.2	10.1	4.1	4.2	3.4	2.4	-0.5	6.5	2.7	-3.9	6.5	9.4
Of which: Net claims on general government	-11.0	1.2	-0.2	-1.3	-2.7	0.8	-1.9	-1.0	1.2	-1.4	9.3	3.3	3.9	9.2	8.1	3.0	8.1	4.3	2.4	5.8	7.9
Reserve money (RM)	9.9	23.3	...	20.4	20.7	...	14.1	19.9	...	13.8	12.5	...	18.4	15.8	...	13.3	18.8	...	15.5	24.4	11.3
Of which: Currency in circulation (M0)	9.3	18.5	...	14.4	18.7	...	11.5	17.5	...	10.4	9.4	...	12.0	14.0	...	8.5	17.1	...	10.0	22.2	11.5
	(In millions of lari)																				
Net foreign assets 1/ 3/	-367	-378	-380	-378	-357	-388	-382	-338	-367	-356	-356	-339	-305	-324	-319	-318	-328	-322	-297	-273	-296
Gold	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1
Foreign exchange reserves (including BIS account) 2/	348	318	316	322	388	357	305	392	363	378	414	431	407	374	380	380	403	409	372	382	330
Use of Fund resources	-629	-615	-615	-615	-663	-663	-601	-649	-649	-649	-689	-689	-628	-614	-614	-614	-646	-646	-584	-570	-541
Other foreign liabilities (net)	-86	-82	-82	-86	-82	-82	-86	-82	-82	-86	-82	-82	-86	-86	-86	-86	-86	-86	-86	-86	-86
Net domestic assets 3/	796	821	816	811	819	833	819	823	832	817	840	814	814	825	821	809	848	831	802	846	862
Net claims on general government	739	740	735	731	744	757	747	755	764	753	779	753	756	770	766	743	782	765	757	780	796
Loans	768	768	763	768	770	783	782	781	790	790	803	777	777	792	787	792	803	787	791	806	817
Deposits	-28	-28	-28	-37	-26	-26	-36	-26	-26	-37	-24	-24	-21	-21	-21	-48	-21	-21	-34	-25	-21
Claims on rest of economy	83	83	83	82	83	83	83	83	83	83	83	83	84	84	84	81	84	84	84	84	84
Claims on banks	1	1	1	1	2	2	0	3	3	0	4	4	0	-5	-5	-5	0	0	0	5	10
Other items, net	-27	-3	-3	-3	-10	-10	-11	-19	-19	-20	-27	-27	-25	-23	-23	-11	-18	-18	-39	-23	-28
Reserve money (RM)	430	443	...	433	463	...	438	485	...	461	484	...	509	501	...	491	520	...	505	573	566
Currency in circulation (M0)	366	376	...	362	392	...	364	409	...	381	406	...	417	422	...	399	439	...	408	483	476
Required reserves	53	58	...	58	62	...	61	67	...	68	68	...	72	69	...	74	71	...	85	79	79
Balances on banks' correspondent accounts	11	8	...	14	9	...	13	10	...	12	10	...	20	10	...	18	10	...	13	11	11
Memorandum items:																					
Growth of reserve money (in percent, relative to end of previous year)	9.9	3.0	...	0.7	7.6	...	1.8	12.9	...	7.2	12.5	...	18.4	-1.6	...	-3.6	2.2	...	-0.7	12.6	11.3
Foreign exchange reserves (in mlns of U.S. dollars) 2/	161.8	147.9	147	150	180	166	142	183	169	176	193	...	189	174	...	177	188	...	173	178	154

Sources: National Bank of Georgia; and Fund staff estimates.

1/ Net foreign assets are valued at the program rate of 2.15 lari/US\$, US\$/SDR of 1.28 and US\$/Euro of 0.90. Quarterly patterns reflect the expected timing of World Bank and EU disbursements. Small differences between data reported in this table on net foreign assets and those reported by the NBS stem from different accounting treatment of these amounts.

2/ Includes SDR holdings and foreign currency account with BIS which is used for debt service payments.

3/ The program floor on net international reserves is adjusted to reflect cumulative deviations from program assumptions on net foreign-currency non-project flows. The program ceilings on net domestic assets of the NBS and net credit of the banking system to the government are adjusted to take into account cumulative deviations from program assumptions on net external non-project financing. Both adjusters are specified in the TMU (EBS/02/117).

Table 6. Georgia: Monetary Survey, 2001-2003

	2001			2002									2003								
	Dec.	Mar.		Jun.			Sep.			Dec.			Mar.			Jun.			Sep.	Dec.	
	Actual	Target	Adj.Target	Actual	Target	Adj.Target	Actual	Target	Adj.Target	Actual	Target	Adj.Target	Actual	Target	Adj.Target	Actual	Target	Adj.Target	Actual	Target	Target
	(Annual percentage change)																				
Net foreign assets 1/	17.1	19.2	18.8	15.0	20.8	13.8	11.8	19.5	12.4	20.3	2.8	7.5	22.9	24.1	25.6	23.4	23.1	24.6	27.5	27.6	6.3
Net domestic assets	3.6	8.2	7.7	8.8	8.0	9.3	7.3	8.5	9.3	2.3	11.7	9.3	4.4	3.4	3.0	3.2	4.5	3.1	4.4	10.1	10.2
Domestic credit	-0.2	7.6	7.2	6.0	6.7	7.7	5.1	5.5	6.1	1.4	9.7	7.7	8.5	11.5	11.1	10.7	10.3	9.1	12.9	12.5	8.3
Net claims on general government 5/	-5.4	1.1	0.4	0.2	0.4	2.2	-1.4	1.0	2.2	-5.3	6.9	3.3	-1.5	1.6	1.0	-1.5	3.3	1.0	-0.1	5.9	7.7
Credit to the rest of the economy	7.6	16.3	16.3	13.9	15.1	15.1	13.7	11.1	11.1	9.7	13.0	13.0	20.8	23.2	23.2	25.1	18.3	18.3	27.8	19.6	8.9
Broad money (M3)	18.5	29.5	...	27.3	28.2	...	20.7	25.5	...	15.9	18.8	...	17.9	17.7	...	17.0	18.7	...	20.8	25.6	15.5
Broad money, excl. forex deposits (M2)	5.7	21.7	...	17.6	23.2	...	11.7	24.0	...	9.4	19.7	...	14.5	16.8	...	10.3	18.5	...	11.3	24.5	11.6
Currency held by the public	10.7	20.3	...	17.4	23.3	...	14.9	20.7	...	10.6	10.9	...	12.0	15.5	...	7.7	16.9	...	8.6	23.4	10.2
Total deposit liabilities	26.5	38.6	...	36.9	32.6	...	26.0	29.6	...	20.7	26.1	...	23.2	19.5	...	24.9	20.1	...	30.7	27.5	19.9
	(In percent of lagged broad money)																				
Net foreign assets 1/	12.2	14.9	14.7	11.7	14.6	9.7	8.3	11.8	7.5	12.2	1.4	-45.8	11.4	12.6	13.3	12.1	11.8	12.6	14.1	11.4	2.0
Net domestic assets	6.3	14.6	13.7	15.6	13.7	15.8	12.4	13.7	14.9	3.7	17.4	163.4	6.6	5.1	4.5	4.9	6.9	4.7	6.7	14.2	13.5
Domestic credit	-0.4	15.9	15.1	12.6	13.6	15.7	10.4	10.7	12.0	2.8	17.4	194.0	15.4	20.0	19.5	18.6	18.2	16.0	22.8	21.4	13.8
Net claims on general government 5/	-6.7	1.3	0.5	0.2	0.4	2.5	-1.6	1.1	2.4	-5.7	6.8	102.2	-1.5	1.5	0.9	-1.4	3.1	1.0	-0.1	5.2	6.4
Credit to the rest of the economy	6.4	14.6	14.6	12.4	13.2	13.2	12.0	9.6	9.6	8.4	10.6	91.8	16.9	18.5	18.5	20.1	15.1	15.1	22.9	16.2	7.4
Other items, net	6.6	-1.4	-1.4	3.0	0.1	0.1	2.0	3.0	3.0	1.0	0.0	-30.6	-8.8	-14.9	-14.9	-13.8	-11.4	-11.4	-16.1	-7.1	-0.3
Broad money (M3)	18.5	29.5	...	27.3	28.2	...	20.7	25.5	...	15.9	18.8	...	17.9	17.7	...	17.0	18.7	...	20.8	25.6	15.5
Currency held by the public	5.5	10.0	...	8.6	11.0	...	7.0	9.7	...	4.9	5.2	...	5.7	7.1	...	3.5	7.6	...	3.9	10.4	4.6
Total deposit liabilities	13.0	19.5	...	18.6	17.2	...	13.7	15.8	...	11.0	13.6	...	12.2	10.6	...	13.5	11.1	...	16.9	15.2	10.9
	(In millions of lari)																				
Net foreign assets 1/	-363	-374	-376	-394	-353	-384	-393	-334	-363	-331	-352	-335	-279	-299	-293	-302	-302	-296	-285	-240	-262
Net domestic assets	1095	1145	1140	1151	1167	1180	1159	1197	1206	1129	1223	1197	1143	1190	1185	1188	1212	1195	1211	1242	1260
Domestic credit	1320	1345	1340	1325	1374	1388	1354	1414	1422	1359	1447	1421	1432	1477	1473	1467	1494	1477	1529	1529	1551
Net claims on general government 5/	725	727	722	720	736	749	723	749	757	702	775	749	714	732	727	710	747	731	723	744	769
Public borrowing from DMBs	0	0	...	0	0	...	0	0	...	0	0	...	0	3	...	0	7	...	0	11	15
Credit to the rest of the economy	595	618	618	605	638	638	631	665	665	657	672	672	719	745	745	757	746	746	806	786	783
Other items, net	-225	-200	-200	-174	-207	-207	-195	-216	-216	-230	-224	-224	-289	-287	-287	-279	-282	-282	-318	-287	-292
Broad money (M3)	732	771	...	757	814	...	767	864	...	798	870	...	864	891	...	886	910	...	926	1003	998
Broad money, excl. forex deposits (M2)	404	420	...	406	447	...	405	477	...	421	484	...	462	474	...	448	480	...	450	524	516
Currency held by the public	349	355	...	346	371	...	345	388	...	356	387	...	391	400	...	373	403	...	375	439	431
Total deposit liabilities	384	416	...	411	444	...	422	475	...	442	484	...	473	491	...	513	507	...	551	564	567
Memorandum items:																					
Growth of broad money (in percent, relative to end of previous year)	18.5	5.2	...	3.4	11.2	...	4.7	17.9	...	9.0	18.8	...	17.9	3.2	...	2.6	5.4	...	7.2	16.1	15.5
Growth of credit to the rest of the economy (in percent)	15.3	3.9	...	1.7	7.3	...	6.0	11.8	...	10.4	13.0	...	20.8	3.7	...	5.3	3.9	...	12.2	9.3	8.9
M3 multiplier 3/	1.7	1.7	...	1.7	1.8	...	1.8	1.8	...	1.7	1.8	...	1.7	1.8	...	1.8	1.8	...	1.8	1.8	1.8
M3 velocity 4/	9.1	...	...	...	...	...	...	...	...	...	9.0	...	8.4	...	...	8.5	...	...	8.8	...	8.1
Foreign exchange deposits in percent of total deposits	85.7	84.2	...	85.5	82.8	...	85.9	81.4	...	85.3	80.0	...	84.9	84.9	...	85.3	84.9	...	86.3	85.0	85.0

Sources: National Bank of Georgia; and Fund staff estimates.

1/ Net foreign assets are valued at the program rate of 2.15 lari/US\$, US\$/SDR of 1.28 and US\$/Euro of 0.90. Quarterly patterns reflect the expected timing of World Bank and EU disbursements. Small differences between data reported in this table on net foreign assets and those reported by the NBG stem from different accounting treatment of these amounts.

2/ Includes SDR holdings and foreign currency account with BIS which is used for debt service payments.

3/ M3 divided by reserve money (RM).

4/ Annual GDP divided by end-period M3. Estimated for 2002 and 2003.

5/ The program floor on net international reserves is adjusted to reflect cumulative deviations from program assumptions on net foreign-currency non-project flows. The program ceilings on net domestic assets of the NBG and net credit of the banking system to the government are adjusted to take into account cumulative deviations from program assumptions on net external non-project financing. Both adjusters are specified in the TMU (EBS/02/117).

Table 7. Georgia: Macroeconomic Framework, 1999-2008

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
	Actuals				Projections 1/					
	(Percent change)									
Output, prices, money, and external trade										
Real GDP	3.0	1.9	4.7	5.6	4.8	4.5	4.0	4.0	4.0	3.5
Consumer price index (average)	19.1	4.0	4.7	5.6	4.4	5.0	5.0	5.0	5.0	5.0
Broad money (M3, lari)	20.7	39.0	18.5	17.9	15.5	14.7	15.1	15.4	15.8	15.7
Exports (US\$)	-0.3	10.6	-10.4	-0.9	11.2	6.7	6.7	6.7	7.1	7.0
Imports (US\$) 2/	-13.0	-7.5	-0.2	1.0	31.4	5.8	5.6	5.6	-8.6	6.3
	(In percent of GDP)									
General government										
Total revenues and grants	15.4	15.2	16.3	15.8	17.1	18.5	19.5	20.8	22.0	23.1
Tax revenues	13.8	14.2	14.3	14.4	15.8	16.6	17.4	18.2	19.0	19.8
Non-tax revenues	0.8	0.8	1.3	1.1	1.0	1.1	1.2	1.5	1.8	2.0
Grants	0.9	0.3	0.7	0.3	0.3	0.9	1.0	1.2	1.3	1.3
Expenditures and net lending	22.1	19.2	18.3	17.8	18.5	18.3	19.0	20.9	22.5	24.0
Current expenditure (incl. budget contingency)	20.0	18.2	16.5	15.7	16.6	15.9	16.4	18.2	19.9	21.3
non-interest	17.2	15.2	14.7	13.8	14.5	13.5	14.4	16.5	18.4	20.1
interest	2.8	3.0	1.8	2.0	2.1	2.4	2.0	1.7	1.4	1.3
Capital expenditure and net lending	2.1	1.0	1.8	2.0	1.8	2.4	2.6	2.7	2.7	2.7
Overall balance (commitment basis)	-6.7	-4.0	-2.0	-2.0	-1.4	0.2	0.5	-0.1	-0.5	-0.9
Net change in expenditure arrears	...	1.4	0.2	-0.4	-0.3	-1.1	-1.0	-0.9	-0.3	-0.3
Overall balance (cash basis)	-5.0	-2.6	-1.6	-1.9	-1.7	-1.0	-0.6	-1.0	-0.8	-1.1
Financing	5.0	2.6	1.6	1.9	1.7	1.0	0.6	1.0	0.8	1.1
Privatization	0.9	0.3	0.1	0.2	0.4	0.4	0.4	0.3	0.3	0.3
Domestic financing	2.3	2.2	-0.4	-0.1	0.8	0.7	0.2	0.3	0.1	0.2
External financing (net)	1.7	0.0	1.9	1.8	1.0	-0.1	0.0	0.4	0.3	0.6
Disbursements (incl. in-kind)	2.9	1.1	2.4	2.3	1.6	1.6	1.7	1.9	1.8	1.7
Amortization	-1.2	-1.1	-4.1	-1.6	-0.6	-1.7	-1.8	-1.5	-1.4	-1.1
Debt rescheduling	...	...	3.6	1.0	0.0	0.0	0.0	0.0	0.0	0.0
Adjustment for Net Withheld Adjara Transfers	...	...	...	...	0.5	...	...	...	...	...
Saving and investment										
Investment	19.2	18.2	18.5	18.4	22.9	23.0	22.8	23.0	17.7	18.3
Non-government sector 2/	17.1	17.1	16.7	16.4	21.1	20.6	20.1	20.3	15.1	15.6
Of which: FDI	2.2	5.0	2.5	3.8	8.4	8.5	8.2	8.2	2.7	2.9
Gross domestic saving	11.5	12.4	12.9	12.4	11.8	12.2	12.3	13.4	13.8	14.8
General government	-4.6	-3.0	-0.2	0.1	0.5	2.5	3.1	2.6	2.1	1.8
Non-government sector	16.1	15.4	13.1	12.3	11.4	9.7	9.2	10.8	11.7	13.0
Current account deficit 2/	7.8	5.8	5.6	6.0	11.1	10.8	10.4	9.5	3.9	3.5
	(In millions of U.S. dollars; unless otherwise indicated)									
Gross official reserves of the NBG	132	109	161	198	159	187	213	241	271	311
(In months of imports of goods and services)	1.3	1.0	1.4	1.8	1.3	1.5	1.5	1.7	1.8	1.9
Balance of payments gap	0	0	0	0	0	192	147	105	96	53
External debt, public and guaranteed										
External debt stock	1,676	1,590	1,655	1,776	1,812	1,783	1,797	1,819	1,857	1,912
NPV of external debt	...	...	...	1,473	1,449	1,401	1,394	1,372	1,368	1,388
As percent of 3-year av. exports of goods & services	...	...	...	147.9	144.6	133.0	123.3	113.6	105.8	100.3
As percent of central govt. revenues, excl. grants	...	...	...	500.9	404.2	353.7	323.1	282.9	253.1	231.3
External debt service, total	...	...	...	227	166	177	185	171	160	147
As percent of exports of goods and services	...	...	...	23.4	15.6	15.7	15.3	13.2	11.6	9.9
As percent of central government revenues, excl. grants	...	...	...	77.2	46.2	44.7	42.8	35.3	29.6	24.4
As percent of official reserves	...	...	...	114.9	104.3	94.7	86.8	70.9	59.3	47.1
Memorandum items:										
Nominal GDP (in millions of lari)	5,665	6,013	6,638	7,457	8,126	8,916	9,737	10,632	11,610	12,618
Nominal GDP (in millions of US\$)	2,803	3,042	3,201	3,382	3,771	3,990	4,147	4,391	4,649	4,900
External debt stock (public and guaranteed)/ GDP	59.8	52.3	51.7	52.5	48.0	44.7	43.3	41.4	39.9	39.0
Exchange rate, average (Lari/US\$)	2.02	1.98	2.07	2.21	...	...	...	...	...	...
M3-velocity	n.a.	9.7	9.1	8.6	8.1	7.8	7.4	7.0	6.6	6.2
Social sector expenditures (percent of GDP)	n.a.	8.3	8.3	8.0	8.4	8.8	9.2	9.6	10.0	10.7
Social sector spending, cash basis (percent of GDP)	n.a.	6.9	8.1	8.3	8.6	9.9	10.2	10.5	10.3	11.0

Sources: Georgian authorities; and Fund staff estimates.

1/ The projections assume net repayment of budgetary arrears of lari GEL million during 2003-08 and continued access to concessional external financing.

2/ Large oil and gas pipeline projects are projected to increase investment and the current account deficit substantially in 2003-2006.

Table 8. Georgia: Summary Medium-Term Balance of Payments, 1998-2008
(In million of U.S. dollars)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
	Act. 1/	Act. 1/	Act. 1/	Act. 1/	Est. 1/	Projections					
Current account balance (including transfers) 1/	-370	-218	-176	-179	-202	-418	-430	-432	-417	-183	-169
Trade balance	-685	-536	-409	-462	-476	-719	-756	-792	-829	-658	-696
Exports (total)	478	477	528	473	469	521	556	594	633	678	726
<i>Of which: extractive products</i>	63	88	150	128	94	120	129	137	145	153	161
Imports (total)	1164	1013	937	935	944	1240	1312	1386	1463	1337	1421
<i>Of which gas and oil pipeline</i>	139	0	0	0	12	217	219	213	213	0	0
Services and income (net)	86	135	115	124	143	136	140	148	177	220	253
<i>Of which: interest (gross)</i>	42	48	57	49	42	48	52	57	57	56	56
Transfers	229	183	119	159	130	164	185	212	235	256	273
Official transfers	92	69	51	81	58	42	57	78	95	109	120
Private transfers	137	114	68	78	72	122	128	134	140	147	153
Capital account	254	102	88	94	119	374	366	361	387	152	187
Medium- and long-term loans	36	25	-95	-11	-25	57	19	11	17	17	37
Disbursements	118	107	15	117	139	153	130	134	140	146	158
World Bank	74	58	0	64	61	60	60	50	50	50	50
EBRD	14	15	0	2	28	44	22	30	30	30	35
IFAD	1	1	1	1	2	2	2	2	2	2	2
Bilateral	29	13	9	12	13	18	21	22	23	24	26
Other (including commercial & uncommitted)	0	20	4	38	34	28	25	30	35	40	45
Amortization	82	82	110	128	164	96	111	123	123	130	121
Foreign direct investment	221	62	153	80	130	315	338	340	360	125	140
<i>Of which gas and oil pipeline</i>	174	0	0	0	15	255	258	250	250	0	0
Other (incl. commercial banks)	-3	16	31	25	15	2	10	10	10	10	10
Errors and omissions	-7	39	23	-12	-7	0	0	0	0	0	0
Overall Balance	-124	-76	-65	-97	-91	-44	-64	-71	-30	-31	18
Financing	124	76	65	97	91	44	-128	-77	-75	-65	-71
Use of Fund resources, net	36	24	-26	24	0	-44	-51	-51	-46	-36	-30
<i>Of which: purchases/disbursements</i>	37	45	0	37	30	0	0	0	0	0	0
<i>Of which: repurchases/repayments</i>	1	21	26	13	30	44	51	51	46	36	30
Increase in reserves (-)	55	-14	23	-52	-37	39	-28	-26	-29	-29	-40
Change in arrears (+, increase)	-94	55	68	5	0	49	-49	0	0	0	0
Debt and arrears rescheduling 2/	5	0	0	114	128	0	0	0	0	0	0
Rescheduling based on March 2001 Paris Club	...	...	...	114	128	0	0	0	0	0	0
Rescheduling of arrears	...	...	...	0	0	0	0	0	0	0	0
Macroeconomic support from the EU	122.7	12	0	5	0	0	0	0	0	0	0
Financing gap	0	0	0	0	0	0	192	147	105	96	53
Memorandum items											
Current account deficit, including transfers (In percent of GDP)	10.2	7.8	5.8	5.6	6.0	11.1	10.8	10.4	9.5	3.9	3.5
Current account deficit, excluding pipeline-related imports	6.4	7.8	5.8	5.6	5.6	5.3	5.3	5.3	4.7	3.9	3.5
Export growth (percent)		-0.3	10.6	-10.4	-0.9	11.2	6.7	6.7	6.7	7.1	7.0
Import growth (percent)		-13.0	-7.5	-0.2	1.0	31.4	5.8	5.6	5.6	-8.6	6.3
Gross international reserves 3/ (In months of imports of goods and services)	118.4	132.4	109.4	161.1	197.7	159.1	186.9	212.6	241.3	270.7	311.1
(In months of imports of non-pipeline goods and services)	1.0	1.3	1.0	1.4	1.8	1.1	1.3	1.4	1.5	1.8	1.9
Debt service due (In percent of GNFS exports)	125.0	151.5	193.0	190.5	236.1	187.6	214.9	230.7	226.3	221.6	207.6
Total external debt (nominal) (In percent of GDP)	1,634	1,706	1,613	1,712	1,858	1,958	1,941	1,964	1,982	2,014	2,070
Public and publicly guaranteed external debt (nominal) (In percent of GDP)	45.1	60.9	53.0	53.5	54.9	47.7	48.6	48.3	46.1	44.3	42.2
Public and publicly guaranteed external debt (nominal) (In percent of GDP)	1,629	1,676	1,590	1,655	1,776	1,812	1,783	1,797	1,819	1,857	1,912
(In percent of GDP)	45.0	59.8	52.2	51.7	52.5	48.0	44.7	43.3	41.4	39.9	39.0

Sources: Georgian Statistics Department; National Bank of Georgia; and Fund staff estimates.

1/ From 2000 onwards, the current account is based on a new series estimated by the NBG, which is not consistent with the series used for the original program and not consistent with data prior to 2000.

2/ Paris Club creditors agreed in March 2001 to reschedule principal falling due in 2001 and 2002 over 20 years, with a 3-year grace period. The agreement includes a good will clause to extend the consolidation period to 2003 on at least comparable term

3/ The 2003 figure differs from that in the monetary accounts because it reflects the latest, rather than program, exchange rate projections.

Table 9. Georgia: External Financing Requirements and Sources, 1998-2008
(In millions of U.S. dollars)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	
							Projection					
Total requirements	464	321	311	320	397	557	593	606	586	348	321	
Current account deficit	370	218	176	179	202	418	430	432	417	183	169	
Capital outflows	93	104	136	141	194	139	163	174	169	165	152	
Scheduled public sector amortization 1/	83	104	136	141	194	139	163	174	169	165	152	
Private sector net outflows 2/	11	0	0	0	0	0	0	0	0	0	0	
Total sources	464	321	311	320	397	557	401	459	482	252	268	
Capital inflows	339	224	221	211	276	470	478	484	510	281	308	
Foreign direct investment	221	62	153	80	130	315	338	340	360	125	140	
Disbursements to public sector	118	107	15	117	139	153	130	134	140	146	158	
Private sector net inflows 2/	0	55	53	13	7	2	10	10	10	10	10	
Exceptional financing	70	112	68	161	158	49	-49	0	0	0	0	
IMF	37	45	0	37	30	0	0	0	0	0	0	
Macroeconomic support from the EU	123	12	0	5	0	0	0	0	0	0	0	
Change in arrears, net (- decrease)	-94	55	68	5	0	49	-49	0	0	0	0	
Debt rescheduling obtained	5	0	0	114	128	0	0	0	0	0	0	
Change in reserves (- increase)	55	-14	23	-52	-37	39	-28	-26	-29	-29	-40	
Financing gap	0	0	0	0	0	0	192	147	105	96	53	

Sources: Georgian Statistics Department; National Bank of Georgia; and Fund staff estimates.

1/ Includes principal payments to the IMF.

2/ Includes errors and omissions.

3/ Assumes extension to 2003 and 2004 of the 2001 agreement.

Table 10. Indicators of Financial Obligations to the Fund, 2002-2008
(In millions of SDR)

	2002	2003	2004	2005	2006	2007	2008
Obligations from existing drawings							
Principal (repayments/repurchases)	23.1	31.5	37.0	36.7	33.4	25.9	22.1
Charges and interest	1.8	1.6	1.4	1.1	0.8	0.7	0.5
Total debt service to the Fund	25.0	33.0	38.4	37.8	34.2	26.6	22.6
In percent of quota	16.6	22.0	25.5	25.1	22.8	17.7	15.0
In percent of exports of goods and non-factor services	3.3	4.3	4.7	4.4	3.7	2.7	2.1
Total Fund credit	228.0	196.6	159.6	122.9	89.5	63.6	41.5
In percent of quota	151.7	130.8	106.2	81.8	59.5	42.3	27.6
In percent of GDP	8.7	7.2	5.6	4.1	2.8	1.9	1.2

Sources: Fund Finance Department and staff estimates and projections.

Table 11. Georgia: External Debt Indicators Relative to Exports 1/
(In percent)

	2002	2003	2004	2005	2006	2007	2008
	Actual	Projections					
NPV of debt to exports ratio 2/							
Baseline	148	145	133	123	114	106	100
Stress tests 3/							
1. Export growth and non-interest current account (NICA) at historical averages	118	97	81	87	93
2. Export growth at historical average minus two standard deviations in 2004-05	148	167	195	203	193
3. NICA at historical average minus two standard deviations in 2004-045	137	132	121	111	104
4. Export growth and NICA at historical averages minus one standard deviation in 2004-05	125	115	108	127	142
5. Net official transfers at historical average minus two standard deviations in 2004-05	143	131	120	110	103
6. 10 percent of GDP increase in other debt-creating flows in 2004	173	155	138	123	110
Debt service to exports ratio 4/							
Baseline	23.4	15.6	15.7	15.3	13.2	11.6	9.9
Stress tests 3/							
1. Export growth and non-interest current account (NICA) at historical averages	15.0	11.3	7.0	4.0	5.1
2. Export growth at historical average minus two standard deviations in 2004-05	21.7	29.5	25.4	22.3	19.1
3. NICA at historical average minus two standard deviations in 2004-045	15.7	16.3	15.4	13.6	11.8
4. Export growth and NICA at historical averages minus one standard deviation in 2004-05	17.7	15.9	10.2	6.1	8.1
5. Net official transfers at historical average minus two standard deviations in 2004-05	15.7	17.6	15.4	13.6	11.8
6. 10 percent of GDP increase in other debt-creating flows in 2004	15.7	24.2	21.6	19.5	17.3

Source: Country authorities and staff estimates, projections and simulations.

1/ Includes public and publicly guaranteed debt only.

2/ Based on three-year backward-looking average of exports of goods and services.

3/ Historical averages are for period 1996-2002.

4/ Based on current-year exports of goods and services.

GEORGIA: FUND RELATIONS
(As of July 31, 2003)

I. **Membership Status:** Joined 05/05/1992; Article VIII

II. General Resources Account:	SDR Million	Percent of Quota
Quota	150.30	100.00
Fund holdings of currency	166.5	110.8
Reserve position in Fund	0.01	0.01

III. SDR Department:	SDR Million	Percent of Allocation
Holdings	3.18	N/A

IV. Outstanding Purchases and Loans:	SDR Million	Percent of Quota
Systemic transformation	16.2	10.77
ESAF/PRGF arrangements	193.80	128.94

V. **Financial Arrangements:**

<u>Type</u>	<u>Approval Date</u>	<u>Expiration Date</u>	<u>Amount Approved (SDR million)</u>	<u>Amount Drawn SDR Million)</u>
PRGF	1/12/01	1/11/04	108.00	49.50
ESAF	2/28/96	8/13/99	172.05	172.05
Stand-by	6/28/95	2/28/96	72.15	22.20

VI. **Projected Obligations to Fund:** (SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2003	2004	2005	2006	2007
Principal	15.7	37.0	36.7	33.4	25.9
Charges/interest	<u>0.7</u>	<u>1.1</u>	<u>0.7</u>	<u>0.5</u>	<u>0.4</u>
Total	16.4	38.1	37.4	33.9	26.3

VII. **Safeguards Assessments:**

The National Bank of Georgia was subject to a full safeguards assessment with respect to the current PRGF arrangement approved on January 12, 2001. The assessment found that NBG procedures may not be generally adequate to safeguard resources. The assessment proposed several recommendations to address the vulnerabilities, which continue to be implemented by the NBG. Staff will continue to monitor the safeguard procedures of the NBG.

VIII. Exchange Arrangements:

The currency of Georgia (the lari) became the sole legal tender in October 1995, replacing the coupon, which was introduced in April 1993. Since April 29, 1993, the Tbilisi Interbank Currency Exchange (TICEX), established by the NBG and a group of commercial banks, has conducted periodic auctions to determine the exchange rate of the domestic currency. The frequency of the TICEX auctions was increased from weekly to twice weekly in late September 1994, to thrice weekly in April 1995, and to daily from January 1, 1996. On June 14, 1993, the NBG authorized the establishment of foreign exchange bureaus that are allowed to buy and sell foreign currency bank notes.

From September 1994 until December 7, 1998 intervention was a major factor in the evolution of the exchange rate. However, the difference between the TICEX rates and those at foreign exchange bureaus has become smaller over time. Since December 7, 1998, the NBG has only intervened to purchase foreign exchange so as to bolster international reserves. Since May 1, 2001, foreign exchange transactions can be made electronically.

IX. Article IV Consultation:

The 2001 Article IV consultation was concluded on October 26, 2001.

X. FSAP Participation:

Two FSAP missions visited Tbilisi during May 1-15, and July 24-August 7, 2001.

XI. Technical Assistance:

See Table 1 of this Appendix.

XII. Resident Representative:

The fourth resident representative, Mr. Dunn, took up his post on August 16, 2001, replacing Mr. Lane.

XIII. National Bank of Georgia:

Ms. Vance, MAE peripatetic banking supervision advisor to the NBG, commenced a series of visits to Tbilisi in September 1997. Mr. Nielsen, an MAE advisor, provided technical assistance to the NBG in May 1998. Mr. Viksnins was an MAE peripatetic advisor to the NBG president starting in October 1999. Mr. Fish was resident advisor on banking supervision from August 10, 1999 to January 31, 2002. Mr. Bernard Thompson provided peripatetic technical assistance in accounting and internal audit in March and August 2000. Mr. Wellwood Mason has been providing technical assistance on payment system issues on a peripatetic basis since the spring of 2002.

XIV. Ministry of Finance Resident Advisors:

The late Mr. Sharma was an FAD resident advisor and assisted the authorities in the development of a Treasury beginning in May 1997. Mr. Sainsbury, an FAD advisor, assisted the Ministry of Finance from June 1998 to November 1999. Mr. Chaturvedi was FAD resident advisor in 2001 and 2002 to assist the authorities in continuing the development of the Treasury and the Treasury Single Account, in revising the legislative framework, expenditure control systems, and budgeting issues. Mr. Welling is FAD peripatetic advisor to assist the State Customs Department in preparing and introducing measures for the custom reform and modernization program. A series of two-month visits have been scheduled. Two visits took place in February-March and July-August 2001. The third one is expected in 2003, depending on progress achieved in introducing reforms.

Table 1. Georgia: Fund Technical Assistance Missions, 2001-03

Subject	Type of Mission	Timing	Counterpart
Fiscal Affairs Department (FAD)			
Public Expenditure Management	Assessment of Treasury system and preparing work plan for the resident advisor	Jun. 12-19, 2001	Ministry of Finance
Public Expenditure Management	Review of the draft Budget System Law	Mar. 14-Apr. 02, 2002	Ministry of Finance
Public Expenditure Management and Fiscal ROSC	Assessment of Treasury system and of observance of standards and codes	Jan. 16-30, 2003	Ministry of Finance
Monetary and Exchange Affairs Department (MAE)			
Banking, foreign exchange reserve management, monetary programming, and research	Advisory	Feb. 26-Mar. 8, 2001	National Bank of Georgia
Payment Systems, Bank Supervision and Resolution, Internal Audit, Foreign reserve Management, and Research	Advisory	Oct. 23-Nov. 6, 2001	National Bank of Georgia
Payment Systems and Bank Resolution	Advisory	Mar. 11-19, 2002	National Bank of Georgia
Accounting and Audit, Anti-Money Laundering, Bank Supervision, and Monetary Operations	Advisory	Sep. 24-Oct 9, 2002	National Bank of Georgia

Table 1. Georgia: Fund Technical Assistance Missions, 2001-03

Subject	Type of Mission	Timing	Counterpart
Statistics Department (STA)			
National Accounts	Follow-up assistance	Mar. 26-Apr. 6, 2001	State Department of Statistics
Balance of Payments Statistics	Follow-up Assistance	February 13-27, 2002	State Department of Statistics
Money and Banking	Follow-up Assistance	March 2-15, 2002	National Bank of Georgia
Data ROSC	Assessment of observance of standards and codes	July 15-31, 2002	State Department of Statistics, National Bank of Georgia, Ministry of Finance
Balance of Payments Statistics	Follow-up Assistance	May 20-June 3, 2003	State Department of Statistics
Legal Department (LEG)			
Tax Code	Follow-up Assistance	Jan. 28-Feb. 9, 2001	Ministry of Finance, Tax Inspectorate of Georgia
Tax Code	Follow-up Assistance	Jul. 13-24, 2001	Ministry of Finance, Tax Inspectorate of Georgia

GEORGIA: IMF-WORLD BANK RELATIONS

Partnership in Georgia's Development Strategy

1. The government's poverty reduction strategy, embodied in its first full PRSP, has recently been completed and will be presented to the Boards of IDA and IMF in the second half of 2003. A new Country Assistance Strategy will be presented to the IDA Board at the same time.
2. The IMF has taken the lead in assisting Georgia in improving macroeconomic stability and pursuing fiscal reforms. The World Bank has taken the lead in the policy dialogue on structural issues, focusing on: (i) strengthening public expenditure management; (ii) deepening and diversifying sources of growth, (iii) protecting the environment; and (iv) reducing poverty. Georgia has been the largest IDA borrower in the CIS, with borrowing of over US\$725 million for 34 operations. A range of instruments is used to conduct the dialogue, including Structural Adjustment and Structural Reform Support Credits. The most recent Adjustment Credits were SAC III and an Energy Sector Adjustment Credit (ESAC), both approved in FY99. SAC III supported the government's reform program, including strengthening fiscal performance, ensuring budgetary provisions for core social expenditures, improving the legal and regulatory framework for the private sector, and advancing the process of privatization and market liberalization. Key reform objectives supported by the ESAC included enhancing financial sustainability and management of the energy sector, privatization, and increasing the poverty benefit for the socially most vulnerable. Other support has come in the form of credits and Analytical and Advisory Assistance across a broad spectrum: education, health, social protection, energy, roads, water and sanitation, agriculture, agricultural research and extension, irrigation and drainage, forestry, environment, biodiversity, enterprise development, municipal development, judicial reform and cultural heritage. A Country Economic Memorandum (CEM) was completed in 2001, and a Public Expenditure Review (PER) in 2002. The PER is being followed by an annual process-based PER exercise. A combined Country Procurement Assessment Review (CPAR) and Country Financial Accountability Assessment (CFAA) is under preparation. In addition, a living Standards Assessment is underway.
3. Since Georgia joined IFC in 1995, it has approved eight projects with total commitment of US\$83.2 million. IFC has included Georgia in the list of countries covered by the Private Enterprise Partnership. In this connection, it is launching a new technical assistance project, which will include support to development of leasing and corporate governance. IFC provides advisory services to the government on (i) privatization of electricity distribution and generation outside Tbilisi, and (ii) hiring private firms to manage transmission network, system dispatch, and the wholesale electricity market. The Foreign Investment Advisory Service (FIAS), a joint facility of IFC and the World Bank, carried out an assessment of Georgia's investment climate in November 2001. It has also assisted the government with the legislation on foreign direct investment and establishment of an investment promotion agency.

4. Table 1 summarizes the division of responsibilities between the two institutions. In a number of areas—for example the social sectors, rural development, environment, and infrastructure—the Bank takes the lead in the dialogue and there is no related conditionality in the IMF-supported program. The Bank is also leading the dialogue on private sector reform, and Bank analysis serves as inputs into the Fund program. In other areas—energy, the financial sector, public expenditure management, civil service reform, and revenue and customs—both institutions have worked together. Finally, in areas like monetary policy, the IMF takes the lead with little Bank involvement.

IMF-World Bank Collaboration in Specific Areas

Areas in which the World Bank leads and there is no direct IMF involvement

5. Areas in which the Bank leads and there is no direct IMF involvement include the social sectors, infrastructure and environment.

6. In the **social sectors**, a main focus of the Bank's strategy has been to ensure that scarce public resources are used efficiently and effectively. Ongoing work under the annual process-based Public Expenditure Reviews is helping to underpin systemic changes in expenditure management, including improving the transparency and equity of transfers from the central to the local budgets (which have an important role in providing social services). Through the Social Investment Fund Credits, IDA is focusing in particular on high-poverty areas to provide basic infrastructure to the poorest communities. A recently approved Self-reliance Fund Grant will help the authorities address the complex issues related to internally displaced people. IDA is also supporting a dialogue with the government on social protection reform that may lead to an IDA-supported project.

7. In **education**, the Education Adaptable Program Credit aims at improving the learning outcomes of primary and secondary students, through curriculum reform, development of an examination system, training of teachers, provision of learning materials, and development of capacity to make better use of physical, financial and human resources. While the investment needs of school buildings are substantially higher than is currently affordable for Georgia, the Social Investment Fund projects continue to assist in financing urgent repairs to school facilities in many communities.

8. In **health**, IDA credits support the government in improving the health care financing system, exploring risk-pooling options, introducing a new system of primary health care and improving the focus of services funded through public funds on the poor and on priority public health interventions. In addition, hospital restructuring has been supported by SAC 3 and the Structural Reform Support Credit.

Table 1. Georgia: Bank-Fund Collaboration on Georgia

Area	Specialized Advice from Fund	Specialized Advice from Bank	Key Instruments
Economic Framework/Management	Monetary policy, exchange rate, fiscal, and trade policies, economic statistics	Economic growth, economic statistics	<i>IMF</i> : PRGF performance criteria and benchmarks on monetary and fiscal targets. <i>Bank</i> : SAC 3 conditionality.
Budget	Budget framework, tax policy and administration, customs, debt management, extra-budgetary funds	Budget management, Public Expenditure Review and Process-Based PER, Country Procurement Assessment, Country Financial Accountability Assessment	<i>IMF</i> : PRGF performance criteria on overall fiscal balance and revenue collection. <i>Bank</i> : SAC 3 conditions on fiscal performance and budgetary provisions for health, education and social protection.
Public Sector Reform	Public asset management, audit of 3 problematic state-owned enterprises	Civil service reform, anti-corruption agenda, decentralization	<i>IMF</i> : PRGF <i>Bank</i> : Structural Reform Support Credit.
Social/Poverty	Prioritization of expenditure cuts to protect social spending	Poverty analysis; reforms in education, health, social protection; support to community driven development	<i>IMF</i> : PRGF. <i>Bank</i> : Support through IDA Credits for Education, Health and Social Investment Funds, Social Protection study, SAC and ESAC conditions on payment of poverty benefits and on hospital restructuring.
Private Sector Development		<i>Costs of Doing Business</i> Surveys. Support for improved legislation and regulatory framework for private sector, and support for privatization and market liberalization	<i>IMF</i> : PRGF. <i>Bank</i> : SAC 3 conditions on business and regulatory framework and privatization, and on private sector participation in infrastructure.
Infrastructure		Private sector participation in infrastructure	<i>Bank</i> : Support though IDA Credits for Municipal Development, Roads, and Electricity Market Support.
Rural development		Reforms in agriculture, irrigation, forestry and, environment	<i>Bank</i> : SAC 3 conditions on land reform. Support though IDA Credits for Forestry, Agriculture Research, Extension and Training, Irrigation and Drainage Community Development.

9. In **infrastructure**, support is being provided through the Municipal Development and Decentralization Credit and the Social Investment Fund Credit. These projects finance critical infrastructure needs at the community level primarily for school and health facilities heating and repair, small hydropower schemes to provide electricity, drinking water and sanitation rehabilitation, as well as transportation infrastructure rehabilitation.

10. In **rural development**, IDA credits have supported development of private sector farming and agro-processing improvements, agricultural credit, irrigation and drainage, and agriculture research and extension. IDA has also been supporting the creation of local institutions, such as rural credit unions and water users associations through its credits.

Areas in which the World Bank leads and its analysis serves as input into the IMF program

11. The Bank has been leading the dialogue on structural reforms, especially through SAC 3, approved by the Bank's Board in June, 1999, and closed in October, 2002. Despite considerable delays, the core conditions of SAC 3 were met, but their impact was reduced by poor governance. Institution building and technical assistance have been supported through the Structural Reform Support Credit, also approved by the Bank Board on June 29, 1999. The Bank also leads in the areas of:

- a) **Privatization and Public Enterprise Reforms.** SAC V supported improvements in the environment for private sector development, focusing on: (i) simpler and more transparent licensing; (ii) more transparent government procurement; (iii) reduced cost of entry for businesses. IDA has also been supporting private sector participation in other areas such as energy, urban services and agriculture. The IMF has worked with the authorities to initiate audits of the 2002 accounts of three major state-owned enterprises.
- b) **Energy.** The energy system is in poor condition, with unreliable supply, massive non-payment and mounting debts. IDA has been working with other donors, including the IMF, to encourage more private management and ownership, and to implement a series of short-term action plans to improve the overall functioning of the sector. The IMF has also been focusing on improved payments for electricity and pursuit of tariff policies at cost-recovery levels.
- c) **Public Sector Management.** The Bank is supporting the development of a civil service reform program, while the Fund is providing technical assistance in support of tax and customs administration reform.

Areas of shared responsibility

12. The Bank and the Fund have been working jointly in the following main areas (supported by the Bank's SAC 3 and Structural Reform Support Credit, several investment operations and the Fund's PRGF):

- a) **Poverty Reduction Strategy.** Both institutions have been working closely with the government to support the development of the PRSP, through seminars and workshops, direct staff input, and a multi-donor Trust Fund to assist the work of the PRSP secretariat.
- b) **Budget Planning and Execution.** The annual process-based Public Expenditure Reviews will provide the underpinnings for systemic changes in expenditure management, with the immediate aim being improved budget formulation in 2004. The IMF is focusing on treasury reform within the Ministry of Finance.
- c) **Financial Sector Reforms.** The joint Financial Sector Assessment Program has supported: (i) strengthened banking and non-banking supervision; (ii) introduction of international accounting standards; (iii) and consolidation of banks through higher capital requirement ratios; and (iv) anti money-laundering legislation. The IMF has focused in particular on banking supervision and anti-money laundering legislation.

Areas in which the IMF leads and its analysis serves as input into the World Bank program

- a) **Fiscal Framework.** The IMF's focus on prudent fiscal policy has served as an important framework for IDA's work on public expenditure management.

Areas in which the IMF leads and there is no direct World Bank involvement

- a) **Monetary Framework.** The IMF closely collaborates with the NBG in the design and implementation of a monetary program that aims at remonetization of the economy, while keeping inflation low and rebuilding international reserves.
- b) **Economic Statistics.** IMF technical assistance has been conducive to improvements in national accounts, price, monetary and government financial statistics.

World Bank Group Strategy

13. The World Bank Group Strategy and future proposed lending operations will be presented to the Executive Directors in early FY04. The current draft of the strategy envisages a lower level of lending than in the past on account of poor governance, which is limiting the development impact of project lending. Lending will likely employ mechanisms that have in the past proven to produce development impact despite weak governance:

- The use of autonomous institutions, like the Social Investment Fund and the Municipal Development Fund that can be financially self-sustaining;
- Community-based efforts that do not rely heavily on central government institutions, such as the irrigation and drainage project that is helping to build local social capital;

- Private-sector led development that, again, does not rely heavily on resources from the central government;
- Empowerment of civil society organizations, which can press for real and effective reform in their respective spheres of influence.

14. New Adjustment Lending is not envisaged until governance improves significantly. Investment lending is currently planned to be about \$90m in FY04-06. This lending will, using the mechanisms outlined above, focus on the key constraints identified in the PRSP to sustained development and poverty reduction. This will likely mean lending to further the following objectives:

- Improving governance and institutional capacity;
- Attaining stronger and more broad-based growth, through the removal of policy, institutional and infrastructure obstacles to private sector development; and
- Developing and strengthening human capital, and providing some minimum social protection, both in the short term, as well as beginning to put in place longer-term programs to protect the most vulnerable.

15. The lending program will be complemented by a wide range of analytical and advisory work (AAA). The program of lending and AAA will, within the confines of these criteria, support those PRSP priorities where the Bank Group has a comparative advantage.

GEORGIA: RELATIONS WITH THE EBRD
(As of June 30, 2003)

1. As of June 30, 2003, the European Bank for Reconstruction and Development (EBRD) had signed 29 investments in Georgia with cumulative commitments totaling US\$215.9 million.¹ Current Portfolio Stock equals to US\$147.2 million. The EBRD's first operation, a power rehabilitation project, was signed in December 1994. Since then, the pace and composition of portfolio growth has varied significantly from year to year. Two large public sector projects were signed at the end of 1998, and fourteen private sector projects (of which four projects are regional) were signed in 1999-2002. The ratio of private sector projects in the portfolio now stands at 59.3 percent.
2. The latest projects in the **power sector** include a government-guaranteed loan, signed in December 1998, to rehabilitate hydropower generation and transmission capabilities, as well as a loan to Tbilisi's privatized electricity distribution company AES-Telasi, signed in December 1999, to help strengthen and expand the electricity distribution network, install power meters, and reduce power transmission losses.
3. In the **transport sector**, a government-guaranteed loan to Georgian National Railways was signed in December 1998, to finance a program of infrastructure improvements on the Georgian section of the South-Caucasian railway line. In March 2002 the Bank signed a loan of US\$11.6 million with the JSC Channel Energy Poti Port Ltd. The project consists of building and operating a new oil terminal in the Port of Poti which will be able to serve the growing demand for export of oil products and derivatives from Central Asia and Azerbaijan to Africa, Europe and United States.
4. The latest projects in the financial sector include US\$7 million convertible loan to Bank of Georgia for on-lending to small and medium-sized enterprises, and equity investment of US\$2 million and US\$9 million senior loan to Microfinance Bank of Georgia (MBG) to encourage development of micro and small enterprises in Georgia's private sector. The EBRD has also issued guarantees under its trade facilitation program.
5. In the **industrial sector**, the EBRD signed private-sector loan project the Georgian Wine & Spirits, and an investment to develop the offshore Chirag oil field in 1999.

The EBRD has provided **technical assistance** through 108 operations, with a total commitment of US\$11.2 million.

¹Evaluated at an exchange rate of US\$1.1492 per Euro.

Table 1. Georgia: EBRD Portfolio for Georgia
As of June 30, 2003 (US\$, million)

Project Name	Date of Agreement	Outstanding Amount
Public Sector Projects		
Power Rehabilitation Project	19-Dec-94	9.9
Georgia Enguri Hydro Power Plant	22-Dec-98	35.3
Georgia: Trans-Caucasian Rail Link Project	22-Dec-98	16.7
Tbilisi Airport Refurbishment	13-Jul-95	3.4
Private Sector Projects		
Bank of Georgia Equity and Convertible Loan	16-Jul-98	3.7
Commercial Bank of Greece (CBG) Georgia	11-Sep-96	0.5
Intellectbank (Sub Project of Georgia SME)	11-Nov-97	1.1
TBC Bank (Sub Project of Georgia SME)	12-Dec-96	1.4
TbilComBank (Sub Project of Georgia SME)	12-Dec-96	1.4
TbilcreditBank (Sub Project of Georgia SME)	12-Dec-96	1.1
Tbiluniversalbanki (Sub loan of Georgia SME)	18-Mar-97	0.6
United Georgian Bank	20-Nov-97	9.4
MicroFinance Bank of Georgia	30-Mar-00	4.5
MicroFinance Bank of Georgia (MBG)–Capital Increase	11-Oct-01	6.0
TFP: Bank of Georgia	2-Mar-01	6.3
TFP: TBC Bank	17-Aug-99	0.2
TFP: United Georgian Bank	31-Mar-01	0.2
TFP: Tbiluniversal Bank (TUB)	29-Sept-00	0.0
AES Telasi	30-Dec-99	28.4
JSC Channel Energy Poti Port	19-Mar-02	11.6
Georgian Wines	29-Sep-99	3.3
Regional Fund Investments		2.2
Total		147.2

1/ US\$ amounts calculated at an exchange rate of 1.1492 U.S. dollars per Euro, as of June 30, 2003.

GEORGIA: STATISTICAL ISSUES

1. The Fund has provided Georgia with substantial technical assistance in the compilation of macroeconomic statistics (Appendix I, Table 1). Despite improvements in the areas of national accounts, price, monetary, and government financial statistics, the quality of macroeconomic statistics remains poor, reflecting deficiencies in statistical methodologies, coverage, and inadequate resources. Problems are particularly acute in the compilation of national accounts, balance of payments, customs, and fiscal statistics. Nonetheless, the core statistical indicators compiled by the authorities are produced on a timely basis and are adequate to enable staff to monitor macroeconomic developments under the program. Georgia does not participate in the General Data Dissemination Standard (GDDS).

Real Sector

2. The quality of GDP estimates has improved, although the State Department of Statistics (SDS) still faces problems with compiling reliable national accounts. National accounts statistics follow the concepts and definitions of the *System of National Accounts 1993*, with GDP estimates by production and expenditure compiled annually and quarterly. Revisions of the national accounts by activity follow an established schedule; after the reference period, flash estimates are available after just a month, preliminary estimates after four months, and a final estimate after 13 months. The recent *Report on the Observance of Standards and Codes* prepared by the IMF's Statistics Department (STA) finds that data sources used for the compilation of national accounts statistics are inadequate. The coverage of the business register is not comprehensive because of the lack of economic census data. The coverage of value added data is relatively good for industry, satisfactory for transport and communications, and poor for agriculture, retail trade, construction, catering and services. Administrative sources used to estimate the non-observed economy are limited, and data for imports and exports of services (taken from the balance of payments) are inadequate. The main weakness of the statistical techniques used for national accounts statistics is that no assessment and validation of source data is undertaken by regional statistical offices and only limited efforts are made by the central office.

Money and Banking

3. A March 2002 STA mission found that the authorities had implemented many of the recommendations made by the December 2000 mission, but in a piecemeal manner that left a number of methodological problems unresolved. To address them, the mission advised the NBG (1) to break down resident data beyond the subsectors of "general government" and "the rest of the economy," in order to provide more disaggregated information about the sectoral distribution of credit; (2) to incorporate all Fund-related accounts transparently in the central bank survey; and (3) to distinguish restricted deposits of insolvent banks from the deposit liabilities that qualify for inclusion in broad money. The mission also reviewed implementation of the NBG's new chart of accounts (introduced January 1, 2001) and associated changes in procedures for compiling monetary statistics to ensure error-free data classification. In July 2002, an STA mission visited Georgia to conduct the statistical ROSC.

It found that most elements in the data quality assessment framework for monetary statistics were fully or largely observed, and recommended improvements in the statistical coverage of non-bank depository corporations and the provision of documentation on metadata. It also recommended increased transparency regarding access by governmental agencies to monetary statistics prior to their release to the public.

Government Finance

4. The fiscal accounts are presented on a cash basis for reporting purposes. Classification is generally consistent with the analytic framework of GSM 1986, although the concepts and definitions of revenue expenditure and financing differ from international standards in some significant respects. In addition, the central treasury and line departments employ differing accounting systems. Specifically, the treasury adopts a single-entry cash basis, whereas line departments and other budgetary organizations typically employ a Soviet-era accrual system. The single-entry system hampers the treasury's capacity to reconcile bank statements and hinders the reporting of information on accounts payable. A second statistical issue concerns the budget classification of expenditure. Discrepancies can easily arise when matching budget appropriations with the classified expenditure because the locally developed structure of expenditure codes changes frequently. Consequently, statistical performance and reliable budget reporting would improve once the treasury adopts internationally accepted accounting standards including a unified treasury general ledger that is maintained on a double-entry cash basis. The authorities have been very receptive to further technical assistance in this area.

Balance of Payments

5. An STA mission that visited Tbilisi in May-June 2003 found that the authorities have partially implemented the recommendations of the previous technical assistance mission (February 2002) and of the 2002 ROSC mission. In particular, the SDS has started to use "mirror statistics" to estimate trade flows as well as data from consumer expenditure surveys to estimate some major imports of goods. At the same time, the Customs Department of the Ministry of Finance has improved data collection on trade flows by computerizing clearance procedures in 60 percent of customs offices and initiating the compilation of trade statistics by its Goods Monitoring Division. However, the mission also found that SDS has not made efforts to improve staffing arrangements and prepare documentation on the sources and methods for balance of payments compilation since the ROSC mission. The mission focused on identifying new data sources and held meetings with officials from 13 ministries and departments and a few enterprises, who agreed to report balance of payments information. With the assistance of SDS staff, the mission prepared a first draft of the metadata, including a description of the data sources and the methods for data processing and estimation. The mission also identified several problems in the direct investment data collection system, made recommendations on its improvement and elaborated a new methodology to estimate reinvested earnings. It also identified errors in the presentation of data on reserves assets and other assets and liabilities of the NBG and recommended corrections.

Georgia: Core Statistical Indicators
(As of September 10, 2003)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Gov. Balance	GDP/ GNP	External Debt/Debt Service
Date of latest observation	9/5/03	8/31/03	8/31/03	8/31/03	7/31/03	7/31/03	8/03	7/03	3/03	7/03	Q2/03	7/03
Date received	9/8/03	9/9/03	9/9/03	9/9/03	8/14/03	8/15/03	9/7/03	7/30/03	3/03	8/21/03	7/22/03	8/7/03
Frequency of data	D	D	D	D	M	M	M	M	Q	M	Q	M
Frequency of reporting	D	W	W	W	M	M	M	M	Q	M	Q	M
Frequency of publication	D	M	M	M	M	M	M	M	Q	M	Q	M
Source of update	A	A	A	A	A	A	A	A	A	A	A	A
Mode of reporting	C,V,O (e-mail)	C,V,O (e-mail)	C,V,O (e-mail)	C,V,O (e-mail)	V,O (e-mail)	V,O (e-mail)	V,O (e-mail)	V,O (e-mail)	V, O (e-mail)	V,O (e-mail)	C,V,O (e-mail)	C,V
Confidentiality	C	C	C	C	C	C	C	C	C	C	C	C

Abbreviations:

Frequency of data/reporting	D	Daily
	W	Weekly
	M	Monthly
	Q	Quarterly
	A	Annually
	Other	(explained)
Source of Update	A	Direct reporting by central bank, Ministry of Finance, or other official agency
Mode of Reporting	C	Cable or fax
	V	Staff visits
	O	Other (explained)
Confidentiality	A	For use by the staff only
	B	For use by the staff and Executive Board
	C	Unrestricted use
	D	Embargoed for a specified period and thereafter unrestricted use
	E	Subject to other use restriction

GEORGIA: PUBLIC DEBT SUSTAINABILITY ANALYSIS

1. This appendix reviews indicators of public debt sustainability in Georgia.¹ It presents the staff's baseline scenario for net present value of general government debt for the period through 2008 and alternative scenarios based on shocks to various underlying variables. The shocks are expressed as temporary deviations from the baseline, and are defined relative to historical averages for the period 1996-2002 of key variables, without considering dynamic feedbacks. The assumptions behind the baseline scenario are consistent with the macroeconomic framework presented in Table 7 and staff views on average interest rates and access to new credit.
2. Real GDP growth rates averaging 3.8 percent and moderate, declining primary deficits have helped to reduce the net present value of the debt (NPV) relative to GDP from 62 percent in 1998 to 43 percent at end-2002. Georgia is expected to post a small primary surplus in 2003, contributing to a further reduction in the NPV/GDP ratio.
3. External public debt service has been a heavy burden after the rapid increase in external indebtedness in the early years of independence. Georgia has sought to ease this burden through several debt reschedulings. Slippages under the PRGF program, which precluded the consolidation of 2003 principal maturities owed to the Paris Club, have led to the accumulation of US\$23 million in "technical arrears" to bilateral creditors as of end-August 2003. After these arrears are regularized, Georgia would need to secure a restructuring of future obligations on concessional terms to keep the debt service burden manageable, as described in Box 3.
4. At the end of 2002, 75 percent of public debt was denominated in foreign currency, while general government debt to the NBG accounted for 16 percent, general government expenditure arrears for 8 percent, and treasury bills for the remaining 1 percent. The large share of foreign debt implies that the dynamics are to a large extent explained by developments of this component. The government is expected to diminish its reliance over time on domestic credit from the NBG to finance its activities. With technical assistance from FAD, the authorities plan to securitize expenditure arrears in early 2004, yielding a positive real remuneration. The domestic government securities market is expected to develop gradually in the coming years, but the impact on debt sustainability will be probably small in the medium term.
5. The stress tests focus on additional risks to public debt sustainability. They show that under adverse scenarios, Georgia's NPV of public debt relative to GDP would increase substantially, thereby exacerbating Georgia's difficulties in servicing its debts.

¹ See the chapter on External Debt Sustainability Analysis in the companion Selected Issues paper.

Georgia: Public Sector Debt Sustainability Framework, 1999-2008
(In percent of GDP, unless otherwise indicated)

	Actual				Projections					
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
	I. Baseline Projections									
NPV of public sector debt 1/	61.8	60.5	52.2	43.3	42.0	38.6	35.0	32.0	29.8	28.3
<i>Of which: foreign-currency denominated</i>	45.1	40.4	33.9	26.9	26.5	24.9	23.2	21.9	20.6	19.8
Change in NPV	0.6	-1.3	-8.3	-9.0	-1.2	-3.4	-3.6	-3.0	-2.2	-1.5
Identified debt-creating flows	4.8	3.5	-3.2	-4.6	0.0	-0.9	0.5	1.8	3.3	4.5
Primary deficit	3.9	1.1	0.2	0.0	-0.7	-1.6	-2.4	-2.0	-1.4	-0.9
Revenue and grants	15.4	15.2	16.3	15.8	17.1	18.5	19.5	20.8	22.0	23.1
<i>Of which: grants</i>	0.9	0.3	0.7	0.3	0.3	0.9	1.0	1.2	1.3	1.3
Primary (noninterest) expenditure	19.3	16.3	16.5	15.8	16.4	16.9	17.0	18.8	20.7	22.3
Grant element of new concessional loans	0.8	2.3	-2.2	-1.8	0.3	1.3	3.5	4.3	5.1	5.7
Automatic debt dynamics	1.1	0.4	-1.2	-2.7	0.7	-0.2	-0.2	-0.2	-0.1	0.0
<i>Of which: contribution from discount rate on foreign-currency debt</i>	2.2	2.2	1.9	1.5	1.3	1.2	1.2	1.1	1.0	1.0
<i>Of which: contribution from real interest rate on domestic debt</i>	0.3	0.8	0.0	0.0	0.6	0.7	0.5	0.5	0.4	0.4
<i>Of which: contribution from real GDP growth</i>	-1.8	-1.2	-2.7	-2.8	-2.0	-1.8	-1.5	-1.3	-1.2	-1.0
<i>Of which: contribution from exchange rate depreciation in excess of inflation</i>	0.4	-1.4	-0.3	-1.5	0.9	-0.4	-0.4	-0.4	-0.4	-0.3
Other identified debt-creating flows	-0.9	-0.3	-0.1	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Privatization receipts (negative)	-0.9	-0.3	-0.1	-0.2	-0.4	-0.3	-0.3	-0.3	-0.3	-0.3
Residual, including asset changes	-4.3	-4.8	-5.1	-4.4	-1.2	-2.5	-4.1	-4.8	-5.5	-6.0
Other Sustainability Indicators										
Nominal value of public sector debt	75.2	70.2	68.5	65.1	64.7	60.6	56.6	52.6	49.8	47.9
Public sector debt-to-revenue and grants ratio (in percent)	488	462	420	412	379	328	290	253	226	207
Debt service-to-revenue and grants ratio (in percent)	39.1	42.8	35.2	24.7	27.8	28.8	25.2	21.7	20.0	17.7
Gross financing need	8.2	6.1	5.6	3.8	4.3	4.8	3.7	3.7	3.6	3.7
Key Macroeconomic and Fiscal Assumptions										
Real GDP growth (in percent)	3.0	1.9	4.7	5.6	4.8	4.5	4.0	4.0	4.0	3.5
Average nominal interest rate on forex debt (in percent)	2.7	2.7	1.7	2.0	2.1	2.2	1.9	1.6	1.4	1.2
Average real interest rate on domestic debt (in percent)	2.4	4.9	0.0	0.2	3.6	4.9	3.9	4.0	4.2	4.2
Nominal depreciation of local currency (percentage change in GEL per dollar)	9.5	0.8	4.3	1.5	7.2	3.2	3.1	3.1	3.1	3.1
Inflation rate (GDP deflator, in percent)	9.2	4.1	5.4	6.4	4.0	5.0	5.0	5.0	5.0	5.0
Growth of real primary spending (deflated by GDP deflator, in percent)	2.1	-14.2	6.2	1.2	8.4	7.8	5.1	14.8	14.1	11.6
	II. Stress Tests for NPV									
Alternative Scenarios										
A1. Real GDP growth and primary balance are at historical averages					45.2	46.3	48.4	51.1	54.5	58.6
A2. Primary balance is unchanged from 2002					42.8	41.8	42.1	43.5	45.8	49.4
Bounds Test										
B1. Real GDP growth is at baseline minus two standard deviations in 2004-2005					42.0	42.5	44.2	43.6	44.4	46.6
B2. Primary balance is at baseline minus two standard deviations in 2004-2005					42.0	43.1	44.6	42.6	41.0	40.2
B3. Combination of 1-2 using one standard deviation shocks					42.0	42.2	42.4	39.3	36.8	34.9
B4. Long-run real GDP growth is at baseline minus two standard deviations					43.6	42.4	41.5	41.9	44.2	48.8
B5. One time 30 percent real depreciation in 2004					42.0	50.1	44.9	40.4	36.4	33.0
B6. 10 percent of GDP increase in other debt-creating flows in 2004					42.0	48.4	43.6	39.1	35.2	32.0

Sources: Country authorities; and Fund staff estimates and projections.

1/ General government.

GEORGIA: MEDIUM AND LONG-TERM GROWTH PROSPECTS

1. **Efficiency gains resulting from structural changes are the main source of growth in transitional economies, but they have made only a limited contribution to growth in Georgia.** Growth decomposition for Georgia reveals that—under various assumptions about the initial capital stock to GDP ratio—total factor productivity (TFP) significantly increased only in 2002 (Table 1).¹ Given the low TFP growth, labor productivity growth was also modest.

Table 1. Georgia: Historical Growth Accounting, 1999-2002 1/

	GDP (% change)	Capital Stock (% change)	Employment (% change)	TFP (% change)	Investment to GDP Ratio (%)	Labor Productivity (GDP/Employment % change)
End 1998 Capital Stock / GDP ratio (%) = 50						
1999	3.0	33.1	0.1	-7.0	19.1	2.9
2000	1.9	22.3	0.9	-5.5	17.6	0.9
2001	4.7	17.9	7.4	-5.8	17.8	-2.7
2002	5.6	13.9	-2.1	2.9	16.5	7.7
End 1998 Capital Stock / GDP ratio (%) = 150						
1999	3.0	7.7	0.1	0.6	19.1	2.9
2000	1.9	6.2	0.9	-0.7	17.6	0.9
2001	4.7	5.9	7.4	-2.2	17.8	-2.7
2002	5.6	5.0	-2.1	5.5	16.5	7.7

Source: Fund staff estimates.

1/ The historical growth accounting is based on a Cobb-Douglas production function: $dQ/Q = 0.3*dK/K + 0.7*dL/L + dA/A$, where Q is output, K is capital, L is labor and A is total factor productivity (TFP). The initial (end 1998) capital/output ratios are staff assumptions. Depreciation is assumed to be 5 percent. Data on value added, employment and investment are from the Georgian State Department of Statistics.

2. **An increase in employment in low-value-added activities contributed to small productivity gains in 1999-2000.** The share of sectors with the highest labor productivity (industry, transport and communications, and real estate) in employment declined, partly offsetting the effect of gains within these sectors on aggregate productivity. At the same time, the share of agriculture—which exhibits the lowest labor productivity—increased, and the sector experienced a further reduction in productivity. The effect of an increase in the share of construction—a sector with relatively high labor productivity—was offset by the decline in productivity within the sector.

¹ The Georgian State Department of Statistics SDS started conducting a regular labor survey in 1998. Earlier data are not comparable, restricting the growth accounting analysis to the 1999-2002 period.

3. **Estimates of long-term per-capita income growth for Georgia are in the range of 1-5 percent per year.** Traditional growth regressions (Levine and Renelt, 1992) predict growth in the range of 3-5 percent, emphasizing the role of initial conditions in catching up with higher income countries and the role of human capital. Accounting for the effects of institutional development reduces long-term growth prospects to the 1-3 percent range (Crafts and Kaiser, 2001). Within this range, 3 percent growth can be achieved after attaining the level of institutional development comparable to the most successful transition countries.

4. **Medium-term growth prospects for Georgia depend on progress in economic liberalization.** Growth equations including variables specific to transition (Fridmuc, 2001) predict growth in the minus 2 to plus 5 percent range. A 5 percent growth rate could be achieved by accelerating structural reforms. Limited progress in liberalization could lead to negative growth rates in the medium-term.

5. **The growth accounting framework shows that achieving the upper limits of medium-term and long-term growth prospects is feasible (Table 2).** Assuming 2 percent TFP growth between 2004 and 2010, a 4 percent growth rate per year could be achieved with a moderate increase in the investment-GDP ratio. The higher rate of TFP growth—and consequently the upper limits of growth prospects—is attainable only with a significant acceleration of structural reforms and liberalization of the economy.

Table 2. Georgia: Growth Accounting Framework, 2003-10 1/

	Value Added (% change)	Capital Stock (% change)	Employment (% change)	TFP (% change)	Investment to GDP Ratio (%)
2003	4.8	9.0	0.0	2.1	23.0
Baseline 2004-2010	4.0	6.7	0.0	2.0	21.6
Downside 2004-2010	3.0	6.7	0.0	1.0	22.2
Upside 2004-2010	5.0	6.7	0.0	3.0	20.9

Source: Fund staff estimates

1/ The growth accounting framework is based on the same Cobb-Douglas production function as Table 1. The capital/output ratio in 2003 is calculated using SDS data on investment, assuming that the ratio was equal to 1.5 in 1999 and depreciation in the 1999-2002 period was 5 percent (the same depreciation rate is assumed for the rest of the simulation period). Projected population growth for Georgia is negative, and—with a modest decline in unemployment—employment is assumed to remain unchanged.

References

- Crafts, Nicholas, and Kai Kaiser (2000), *Long Term Growth Prospects in Transition Economies: A Reappraisal*, London School of Economics, mimeo.
- Levine, Ross and David Renelt (1992), "A Sensitivity Analysis of Cross-Country Growth Regressions," *American Economic Review* 82 (4), 942-963.
- Fidrmuc, Jan (2001), *Forecasting Growth in Transition Economies: A Reassessment*, mimeo.

**Statement by the IMF Staff Representative
October 17, 2003**

1. This statement provides an update on economic and policy developments since the issuance of the staff report. These developments do not change the thrust of the staff appraisal.

Macroeconomic developments

2. **Recent data confirm that macroeconomic performance in 2003 has been characterized by low inflation and exchange rate stability.** The twelve-month rate of inflation rose marginally in September, to 5.2 percent. The lari has remained broadly stable in nominal terms vis-à-vis the U.S. dollar; in real effective terms, the lari depreciated by almost 7 percent in the year ended August 2003. Arrears to official bilateral creditors increased to US\$34 million by end-September 2003. Despite a shortfall in external grants, gross official reserves remained practically unchanged in September, at US\$195 million.

3. **Preliminary data for end-September suggest that the indicative target for overall tax revenues was missed** by about GEL 11 million (0.1 percent of GDP). The target for reserve money was met. Data on the other end-September indicative targets will only become available within the next few weeks.

4. **The 2004 budget bill was sent to parliament on October 1 according to the statutory calendar,** but it will likely be discussed only after the new parliament convenes following the November 2 elections; a vote will probably take place in late 2003 or early 2004. The current budget bill reflects updated information compared with Table 4 of the staff report. In particular, the authorities have introduced downward revisions in external grants, capital outlays, and net lending. Given the limited availability of net foreign inflows and non-inflationary domestic financing, the authorities will probably need to further scale back their original spending plans. A staff team will visit Tbilisi October 23-29 to discuss the 2004 budget and review recent economic performance, and the authorities have indicated that the budget bill will be revised to take into account the mission's recommendations.

5. **The legislative changes designed to bolster the investigative and prosecutorial powers of the Ministry of Finance for economic crimes—including smuggling—became effective October 1.** A new investigative unit has been set up and is currently recruiting staff. The authorities anticipate significant improvements in the effectiveness of their anti-smuggling efforts and in the accountability of tax and customs department staff as a result of these legal and institutional changes. They hope this will contribute to improved revenue performance during 2004 in conjunction with other key components of the recently adopted tax reform (described in Box 1 of the staff report), which will become effective on January 1, 2004.

6. **The ratio of nonperforming loans to total bank assets fell from 7.5 percent in June to 7.1 percent in August 2003. In response to an acceleration in the growth rate of broad money to 28 percent in the year ended August (from 21 percent in June), the NBG has taken steps to tighten credit conditions.** These include a smaller-than-envisaged reduction in reserve requirements on lari deposits to 9 percent (versus the originally planned reduction to 8 percent reported in the staff report), and a cap on the amount of required reserves on lari deposits that can be met with current account balances at the NBG at 4 percent; as a result, banks will be allowed to meet just under half of the total required reserves on lari deposits (i.e., slightly less than indicated in the staff report) with their current account balances at the NBG. Required reserves on foreign currency deposits remain unchanged at 13 percent. The monetary authorities have informed staff that, if a further tightening is warranted over the next several weeks, they stand ready to mop up liquidity by resorting more actively to interbank credit/deposit auctions.

Other issues

7. **In the energy sector, recent data show that cash collection rates for both budgetary organizations and direct customers of the Wholesale Electricity Market (GWEM) now meet the 70 percent target set under the PRGF-supported program.** Cash collections from the GWEM's direct customers (mainly large SOEs) amounted to 80 percent in August, bringing the collection rate for the year to date up to 70 percent. The collection rate for budgetary organizations outside Tbilisi rose to 91 percent in August 2003. **By contrast, collections by the United Distribution Company (UDC) from households outside Tbilisi have not shown a significant improvement, owing in part to pressures from governors and other local officials to slow the UDC's drive to cut off non-paying customers, which had started in June 2003.** Transfers from UDC to GWEM stood at only about 6 percent of billing in July and August 2003, compared to the indicative floor of 30 percent for Q3 2003 set in the program.

8. **According to the latest *Corruption Perception Index* for 2003 just released by Transparency International, Georgia's ranking has fallen to 124th place** (out of 133 surveyed countries), compared to the 85th place it had scored last year (as noted in the staff report). Nevertheless, awareness of the challenges posed by governance problem seems to be increasing in Georgia, and in mid-September, the autonomous Anti-Corruption Bureau (ACB) and a number of resident NGOs forged a new coalition to strengthen anti-corruption efforts. The goal is to leverage the ACB's mandate and superior access to information with the independence and international experience of participating NGOs in an effort to design new, more specific anti-corruption measures and to strengthen enforcement.



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 03/133
FOR IMMEDIATE RELEASE
November 7, 2003

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2003 Article IV Consultation with Georgia

On October 17, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Georgia.¹

Background

Georgia has faced daunting challenges since independence given an environment rife with political tension, declining living standards, and severe economic dislocations, including dwindling tax revenue and loss of Soviet-era energy subsidies and market access. Weakened by civil war and de facto secession of two provinces, Georgia nonetheless has had to build basic national institutions and embark on fiscal consolidation and first-generation reforms, including privatization, land reform, and energy sector rehabilitation. Heavy energy-related foreign borrowing in the first years of independence saddled the country with debt, and the financial crises in Russia and Turkey—Georgia's two main trading partners—have further complicated economic management.

Against this backdrop, and with much left to be done, the authorities can point to several achievements. During the broader transition period, these include strides in structural reform and fiscal retrenchment during 1994-97; price and exchange rate stability after a hyper-inflation episode; accession to the World Trade Organization in 2000; and gradual harmonization of economic legislation with international best practice.

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

Since the last Article IV consultation in 2001, sustained activity in Russia and the onset of oil and gas pipeline construction have buoyed Georgia's output growth and inflation has remained subdued at around 5 percent and the exchange rate has been stable. The general government deficit remained below 2 percent in 2002 (reflecting reduced expenditure commitments and further improvement in tax revenues) allowing the authorities to reduce domestic arrears somewhat during the year. In the area of structural reforms, progress on banking sector reform has been substantial. Fiscal and energy sector reforms have also advanced, albeit with delays.

Developments in the first half of 2003 have been less favorable, particularly with respect to fiscal performance. Optimistic budget assumptions on external and privatization receipts, which did not materialize, and a slackening of the tax effort early in the year; led to non-observance of the March and June indicative arrears targets. Excise collections have been disappointing, as quarterly indicative targets for 2002-03 set as guideposts to curb evasion were missed. In addition, corruption has remained resilient, diverting scarce public resources, exacerbating income inequalities, adding to the cost of doing business, and weakening confidence.

Executive Board Assessment

Directors noted Georgia's impressive economic strides since independence, including laying the foundations for an open, market-based economy, achieving price and exchange rate stability, and embarking on major first-generation reforms. Directors expressed concern, however, that pervasive corruption and tax evasion remain the most serious obstacles to fiscal sustainability and private sector development. In view of indications that corruption has increased in 2003, and the grave economic and socio-political costs associated with such practices, they emphasized the need to place anti-corruption efforts at the center of the authorities' strategy to strengthen the macroeconomic situation and fulfill the objectives outlined in the Economic Development and Poverty Reduction Program (EDPRP). Directors hoped the recent alliance forged between the Anti-Corruption Bureau and resident Non-Governmental Organizations would add momentum to the ongoing efforts to fight corruption.

Directors welcomed the recent steps taken to strengthen fiscal performance—including passage of a budget systems law, a tax reform, and enhanced investigative and tax-enforcement powers of the Ministry of Finance. However, they considered that further efforts were required to rein in persistent tax evasion and improve budget planning. They saw action in these areas as essential in order to prevent the further buildup in domestic arrears and secure the resources for core spending required for sustained long-term growth and poverty reduction. Looking ahead, Directors urged the authorities to introduce supporting improvements in budgetary design and implementation, including making the single treasury account and commitment controls fully operational, and aligning cash management and accounting procedures with best practice. On the revenue side, Directors stressed the need for improved tax and customs administration, including through a strengthening of enforcement procedures, and the phasing out of tax exemptions.

In light of the findings of the latest debt sustainability analysis, Directors observed that any new external borrowing by the authorities will have to be restrained and on appropriately

concessional terms, and many Directors underlined that concessional treatment of bilateral debt obligations would help to achieve longer term debt sustainability. Continued fiscal efforts, complemented by progress on reforms, would also substantially enhance sustainability prospects.

Directors noted that the unresolved fiscal problems in 2003 had forestalled conclusion of the third review under the Poverty Reduction and Growth Facility arrangement. They encouraged the authorities to strengthen program ownership and adhere closely to the quarterly quantitative guideposts for the rest of 2003, as well as to formulate and secure timely approval of a 2004 budget based on plausible assumptions to avert the need for *ad hoc* sequestrations. In that regard, Directors found it disappointing that preliminary data on tax revenues through end-September 2003 point to a shortfall from the indicative target.

Directors commended the authorities for the prudent stance of monetary policy, which has played a crucial role in anchoring price stability. They encouraged the development of new operational tools for conducting monetary policy. Directors observed that new deposit reserve requirements, differentiated by currency denomination, could play a role in mitigating dollarization, but that long-term reversal of this phenomenon will hinge on sound economic fundamentals, good governance, and political stability. Directors also agreed that a further deepening of the treasury bill market will be helpful to enhance monetary policy implementation. Directors considered that the managed float of the lari had served the National Bank of Georgia (NBG) well, given the low level of foreign reserves and the economy's vulnerability to external shocks, but they advised the NBG to stand ready to allow the currency to float more freely if it came under pressure.

Directors welcomed the refinements introduced in financial sector regulation and supervision, including passage of new anti-money laundering legislation. They noted that these measures had contributed to an improvement in financial sector stability indicators since the 2001 financial system stability assessment was conducted. Directors encouraged the authorities to secure passage of enabling amendments to bring the anti-money laundering law into full compliance with international best practices, and to put in place an effective supervisory framework for microfinance institutions.

Directors stressed the importance of sustained progress in reforming the energy sector, so as to stem fiscal pressures and stabilize power supplies. They welcomed the reinstatement of the autonomy of the sector's regulatory body and the return to cost-recovery tariffs anticipated in December 2003, along with the improvement in collection rates from certain groups of customers achieved thus far. Looking ahead, Directors stressed the need to intensify these efforts, especially by disconnecting non-paying customers, and urged the government at all levels to support the disconnection program and the government's own strategy of transferring management of state-owned distribution, transmission, and dispatch to private companies. Directors also highlighted the importance of setting up a suitable institutional framework for verification and settlement of legacy domestic debts of the energy sector in a timely and orderly manner.

Directors noted the important initiatives now underway to improve public sector operations, including institutional changes in the oversight and divestiture of state property and audits of problematic state enterprises. They urged the authorities to follow up diligently on the recommendations from the audits, as well as to finalize promptly the strategy and costing of the envisaged civil service reform.

Directors observed that full exploitation of Georgia's development potential will require perseverance with the adjustment and reform effort, along with a substantial improvement in the business environment. In this vein, they emphasized the need for more effective and faster implementation of measures to combat corruption and powerful vested interests. These measures should aim to ensure a level playing field, and the uniform application of regulations. It was also suggested that these measures be complemented by stronger efforts to promote greater media attention, public debate, and educational programs targeted against corruption. Directors supported further liberalization of the trade regime to help foster rapid and outward-looking economic growth. In this regard, they welcomed the authorities' plans to study the feasibility of moving toward a low uniform tariff, supported by technical assistance from donors.

Directors considered that the finalization of Georgia's poverty reduction strategy paper is a significant achievement, both in its content and in the broad participation in its formulation, which provides a basis for addressing the main economic and social challenges facing Georgia. However, concern was expressed about some of the measures contemplated in the EDPRP, including the lack of project prioritization, and provision of subsidies and other support to certain industries and sectors. Directors emphasized that in the implementation stage, the authorities will need to articulate more fully the linkages between planned expenditures and the EDPRP, show leadership in improving governance and reducing corruption, and refine the specific targets to be used in assessing outcomes.

Directors noted that the provision of data by the authorities is adequate for surveillance and program monitoring purposes, but encouraged the authorities to undertake, with technical assistance from the Fund, further improvements in the statistical database, particularly in the compilation of national accounts, balance of payments, and fiscal statistics.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2003 Article IV Consultation with Georgia is also available.

Table 1. Georgia: Selected Economic and Financial Indicators, 1999-2002

	1999	2000	2001	2002
	(Percentage change relative to previous year, unless otherwise indicated)			
National income and prices				
GDP at constant prices	3.0	1.9	4.7	5.6
Consumer price index, end-of-period	10.9	4.6	3.4	5.4
Money and credit (end-of-period)				
Reserve money	18.8	26.8	9.9	18.4
Broad money (including foreign exch. deposits)	20.7	39.0	18.5	17.9
	(In percent of GDP, unless otherwise indicated)			
Public Finance				
Total revenue and grants	15.4	15.2	16.3	15.8
Tax revenue	13.8	14.2	14.3	14.4
Total expenditure and net lending	22.1	19.2	18.3	17.8
Fiscal balance, commitment basis	-6.7	-4.0	-2.0	-2.0
Fiscal balance, cash basis	-5.0	-2.6	-1.6	-1.9
External sector				
Trade balance	-19.1	-13.4	-14.4	-14.0
Current account balance	-7.8	-5.8	-5.6	-6.0
External debt	60.9	53.0	53.5	54.9
Gross international reserves in months of imports 1/	1.3	1.0	1.4	1.8
Exchange rate				
Exchange rate, lari/U.S. dollar, period average	2.02	1.98	2.07	2.20

Sources: Georgian authorities; and IMF staff estimates.

1/ Gross international reserves are calculated based on imports of goods and services, excluding pipeline imports.