August 2005
IMF Country Report No. 05/314

Georgia: Second Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Requests for Waiver of Performance Criterion and Conversion of an Indicative Target into a Performance Criterion—Staff Report; Staff Statement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Georgia

In the context of the second review under the three-year arrangement under the Poverty Reduction and Growth Facility and requests for a waiver of a performance criterion and conversion of an indicative target into a performance criterion with Georgia, the following documents have been released and are included in this package:

- the staff report for the Second Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Requests for Waiver of a Performance Criterion and Conversion of an Indicative Target into a Performance Criterion, prepared by a staff team of the IMF, following discussions that ended on June 7, 2005 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 July 6, 2005. 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 July 20, 2005 updating information on recent developments.
- a Press Release summarizing the views of the Executive Board as expressed during its July 20, 2005 discussion of the staff report that completed the review.
- a statement by the Executive Director for Georgia.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Georgia*
Memorandum of Economic and Financial Policies by the authorities of Georgia*
Technical Memorandum of Understanding by the authorities of Georgia*

*May also be included in Staff Report

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

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

GEORGIA

Second Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Requests for Waiver of Performance Criterion and Conversion of an Indicative Target into a Performance Criterion

Prepared by the Middle East and Central Asia Department

Approved by Amor Tahari and Carlos Muñiz

July 6, 2005

- Georgia's three-year PRGF arrangement in the amount equivalent to SDR 98 million (65 percent of quota) was approved on June 4, 2004. The first review was completed on December 20, 2004.

- Discussions for the second review under the arrangement were held in Tbilisi during February 23–March 8 and June 1–7, 2005. Staff met with Prime Minister Nogaideli, the speaker of parliament; the ministers of finance, economic development, and energy; the president of the National Bank of Georgia; other senior government officials; civil society organizations; and members of parliament. The staff team was headed by Mr. Neuhaus during the first mission and by Mr. Berengaut during the second mission and it comprised Messrs. van Selm and Billmeier (both MCD) and Mr. Hajdenberg (FAD). Messrs. Staines (PDR) and Fedorov (EP, MCD) participated in the February mission, and Messrs. Neuhaus, Ding (both MCD) and Zeuner (PDR) in the June mission. Mr. Christiansen, Resident Representative, assisted both missions. The team cooperated with overlapping World Bank missions.

- The attached letter of intent and Memorandum of Economic and Financial Policies (attachments I and II) set out the authorities' economic program for the remainder of 2005. The authorities have requested completion of the second review, a waiver for nonobservance of an end-December 2004 structural performance criterion on amendments to the Budget Systems Law, and the conversion of the indicative target on reserve money into a performance criterion.

- The authorities have submitted a Poverty Reduction Strategy Paper (PRSP) progress report to the Executive Boards of the Fund and the World Bank. The report (Country Report No. 05/113) and the related Joint Staff Advisory Note (Country Report No. 05/210) have been posted on the Fund's external website.

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EXECUTIVE SUMMARY

- **The economy has continued to perform well.** Growth has remained robust and the exchange rate has stabilized around its end-2004 level. All quantitative performance criteria (PCs) for end-December 2004 were met, but the indicative target on reserve money growth was exceeded, mainly because of large unsterilized intervention in the foreign exchange market. The authorities are requesting a waiver for nonobservance of a December structural PC on upgrading the Budget Systems Law to the status of an organic law, since parliamentary approval was delayed owing to a crowded legislative agenda.

- **Policy discussions focused on the opportunities and macroeconomic challenges posed by the sizable increase in privatization-related external inflows since early 2005, which the authorities are planning to spend on priority programs.** While easing the fiscal stance, the authorities undertook to tighten monetary policy to keep inflation at single-digit rates. In this vein, the authorities' economic program for 2005 targets end-year inflation at 7 percent and real GDP growth at 8½ percent, while keeping reserve coverage relative to imports broadly unchanged. In the attached MEFP, the authorities set out their macroeconomic policy and reform agenda, as well as quantitative PCs for end-September, indicative targets for end-June and end-December, and a matrix of structural PCs and benchmarks. Mirroring the shift in the policy mix, and to strengthen the monitoring under the program, the authorities are requesting a change in the key monetary performance criterion, from net domestic assets of the central bank to reserve money.

- **The structural reform agenda focuses on consolidating the fiscal gains, removing key obstacles to growth, and enhancing social protection and the provision of basic services.** An overhaul of the power sector to improve its physical and financial performance is a key priority for the government.

- **Following last year's Paris Club rescheduling,** the government would be well-advised to bring the pending negotiations with certain bilateral creditors—including non-Paris Club creditors—to a swift conclusion.

- **The main risks in the outlook** stem from political pressures to target the exchange rate (at the expense of monetary control) or to further increase spending,which could exacerbate inflationary pressures and compromise fiscal sustainability. In this regard, staff welcomes the government's assurances that discretionary spending will be managed carefully, and it urges the central bank to tighten the monetary stance beyond the programmed limits if inflationary pressures were to persist in the second half of the year. Georgia also remains vulnerable to external shocks, including a rekindling of tensions over its breakaway regions. Nevertheless, the authorities' strong track record and their commitment to take corrective measures as needed bode well for the successful implementation of the program.

I. Background

1. **The Saakashvili administration has achieved a remarkable turnaround in the Georgian economy during its first 18 months in office.** The fiscal position, in particular, has strengthened significantly, thanks to impressive gains in tax receipts sparked by the anti-corruption drive, and the privatization process has gained momentum. As a result, the government has cleared the bulk of the domestic arrears incurred by the previous administration, while increasing pensions from their low levels, beginning to rehabilitate transport infrastructure and the power sector, and upgrading the country's defense capabilities.

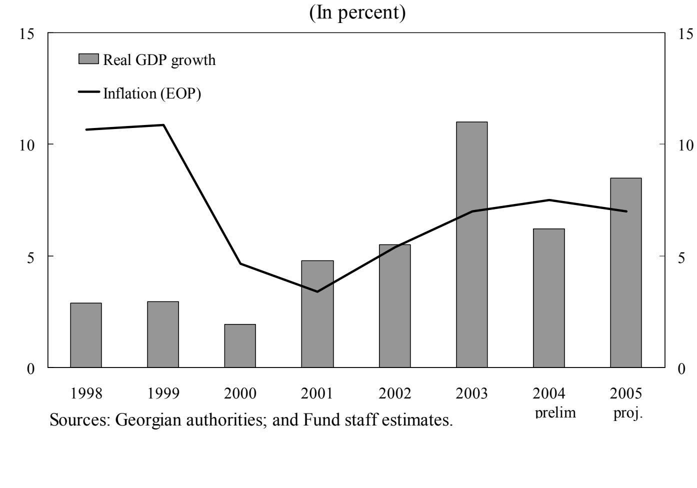
2. **The government has also launched comprehensive reforms** to streamline the tax code and enhance fiscal management on the revenue and expenditure sides; downsize and overhaul the civil service; reduce government intervention in the economy; and improve the business climate. These efforts have elicited strong international support, including a restructuring of Georgia's debt to the Paris Club and large aid pledges at a donors' conference in mid-2004.

3. **The improvement in the fundamentals and the stimulus from pipeline construction have been reflected in a robust recovery of activity, significant capital inflows, and a decline in risk premia on government securities.** These developments have contributed to a strengthening of the currency, but also complicated the conduct of monetary policy as the central bank engaged in sizable intervention in the foreign exchange market. The easing of liquidity associated with these operations, combined with a number of one-off factors, have contributed to a rise in inflation over the past several months, which the authorities are seeking to address.

II. Recent Developments and Performance Under the Program

4. **Economic activity continues to be strong** (Table 1 and Figure 1). Real GDP in 2004 grew by 6.2 percent and by an estimated 7.3 percent year-on-year during the first quarter of 2005, although these results also reflect the ongoing inclusion of previously unrecorded activities. Construction of the *Baku-Tbilisi-Ceyhan* oil pipeline and the *South Caucasus* gas pipeline have been an important source of growth. Twelve-month inflation increased from 7.5 percent at end-2004 to 8.9 percent in May 2005, resulting from an accommodating monetary policy, as well as one-off factors including a spike in foodstuff prices, increases in excise tax rates on cigarettes and liquor, and higher international oil prices.

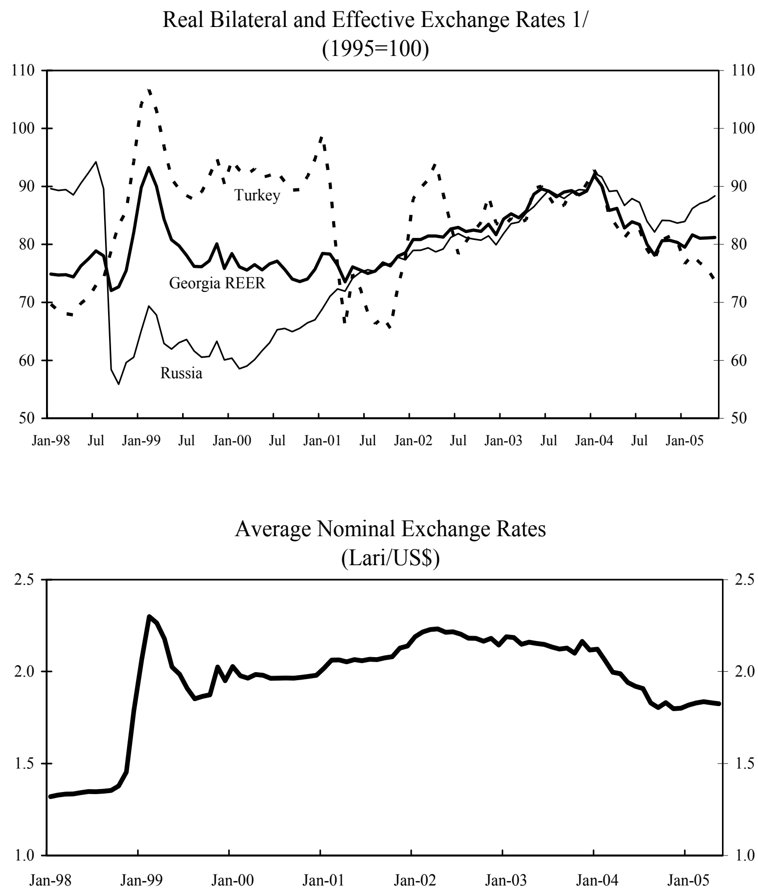
Figure 1. Georgia: Inflation and Real GDP Growth, 1998-2005
(In percent)



Sources: Georgian authorities; and Fund staff estimates.

5. **All end-December 2004 quantitative performance criteria were met, in most cases by wide margins.** However, the indicative target for reserve money was exceeded, largely reflecting significant unsterilized intervention by the National Bank of Georgia (NBG) (Table 2). Fiscal performance in 2004 was impressive. Thanks to a drive to curb evasion and improve administration, tax revenue increased by 4 percentage points of GDP, allowing two supplementary increases in spending appropriations (including for faster-than-planned clearance of arrears on wages and pensions) and a build-up of deposits at the central bank. Despite large unsterilized foreign exchange intervention, the lari appreciated by 13½ percent both against the U.S. dollar and in real effective terms during 2004. The currency has remained broadly stable during the first half of 2005 (Figure 2). Gross international reserves doubled to US$383 million at end-2004, well above the program target, and as of mid-June 2005, they amounted to US$442 million (or 1.8 months of projected 2005 non-pipeline imports) (Figure 3).

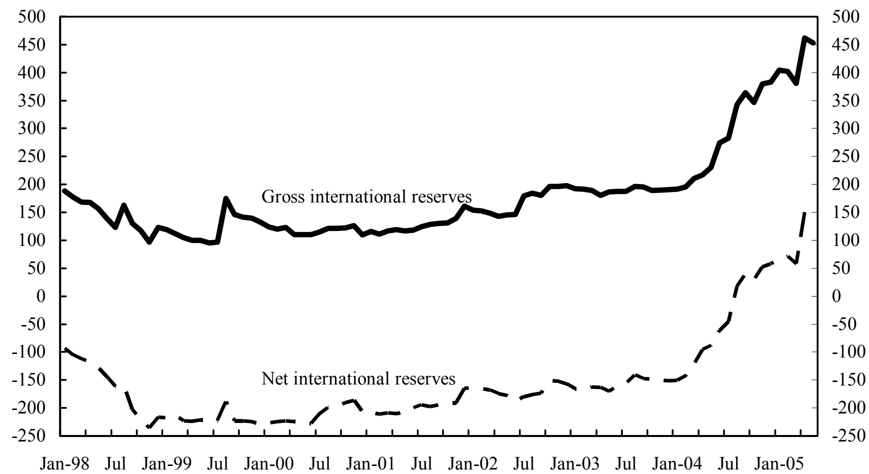
Figure 2. Georgia: Exchange Rate Developments, 1998-2005



Sources: Georgian authorities; and Fund staff estimates.

1/ Based on INS exchange rates and CPI. An increase in the rate indicates a depreciation of the lari.

Figure 3. Georgia: International Reserves, 1998 - 2005
(In US$ million)

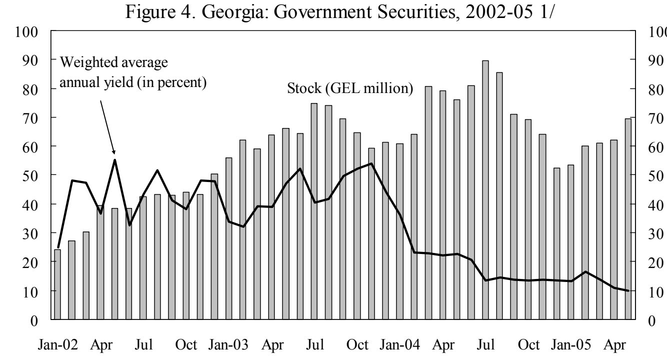


Sources: Georgian authorities; and Fund staff estimates.

6. **Some progress has been made in the area of structural reforms (Table 3).** In the fiscal area, the authorities have built on their major achievements in 2004 (Country Report No. 05/1), and they completed the transition to a single treasury revenue account in April 2005. Owing to a heavy legislative agenda, parliamentary approval of envisaged constitutional amendments to upgrade the status of the Budget Systems Law into an "organic law" in line with FAD recommendations—an end-December 2004 structural performance criterion—has, however, been delayed and is now expected by September 2005. The authorities are requesting a waiver for nonobservance of this PC and they have indicated that the delay will not compromise the integrity of the 2006 budget. Under the terms of Georgia's WTO accession, the number of tariff bands was reduced from 21 in 2004 to 16 as of January 2005. However, the authorities did not comply with the end-2004 structural benchmark on trade liberalization, which called for cutting the number of bands to three and reducing the unweighted average tariff by 8 percentage points (instead of the actual reduction by 1 percentage point). The benchmark on auditing the stock of domestic expenditure arrears by end-December 2004 was also missed.

7. **Fiscal performance has continued to be strong in 2005.** Tax collections have remained in line with expectations (showing a 13 percent year-on-year increase through May) and expenditure has been less than targeted. A comprehensive tax reform package was implemented in January 2005 (Box 1). On the expenditure side, minimum pensions were doubled to GEL 28 per month (about US$15) from

Figure 4. Georgia: Government Securities, 2002-05 1/



Sources: Georgian authorities; and Fund staff estimates.
1/ End-period stock of T-bills at settlement prices.

January 2005, and the government has continued to clear arrears accumulated under the previous administration. Treasury bill yields have declined to 10 percent in May 2005 from extremely high levels in 2003 (Figure 4).

Box 1. Georgia: Streamlining the Tax Code

A comprehensive tax reform took effect on January 1, 2005, aimed at improving the business climate by simplifying the tax system, broadening the tax base, and lowering tax rates. The main elements of the reform are:

- the number of taxes was reduced from 21 to 7;
- personal income tax marginal rates ranging from 12 to 20 percent were replaced by a single flat rate of 12 percent; the VAT rate is being reduced from 20 to 18 percent on July 1, 2005; the payroll tax rate was reduced from 33 to 20 percent; and excise tax rates were increased; and
- the bases of the value-added and profit taxes were broadened by eliminating certain exemptions and special regimes.

Collections in the year to date have been largely in line with expectations. However, the increase in excise rates has encouraged cigarette smuggling, which the government is trying to curb by strengthening border controls and banning cigarette sales in street markets. A system of private arbitration for resolution of tax disputes introduced by the new code was abolished in April; parliament is expected to discuss a revised mechanism later this year. As anticipated, some energy companies are having difficulties in meeting their obligations under the new rules of the VAT, which require payment of taxes on invoiced amounts rather than on actual collections.

8. **As attempts to reinvigorate the privatization process started to pay off in early 2005 (Box 2), the government secured passage of two supplementary budgets in April and May 2005, authorizing a large increase in expenditure that would be financed mainly by privatization receipts (Table 4).** Additional outlays are mainly on defense (as part of Georgia's bid to join NATO) and on rehabilitation of roads and the dilapidated energy sector. The two supplementary budgets raised the projected 2005 deficit to 4.8 percent of GDP on a cash basis and to 3.5 percent on a commitment basis (the difference reflects the clearance of the bulk of the remaining arrears accumulated during the previous administration).

Box 2. Georgia: The 2004–05 Privatization Program

Since taking office in early 2004, the government has revitalized the privatization of more than 1800 state-owned enterprises and other public assets, including farm land. More than 100 agreements have been reached in 2004 and early 2005 (see www.privatization.ge).

The 2005 supplementary budgets are premised on an increase in 2005 privatization receipts to 3½ percent of GDP, on the back of the sale of the Ocean Shipping Company (US$93 million), as well as the envisaged divestiture of an industrial complex in Western Georgia, including the Vartsikhe hydro power station and the Chiatura manganese mine (valued around US$130 million).

Moreover, the government has recently invited bids for additional privatizations (the proceeds of which will likely begin to materialize in 2006), including:

- Several energy sector companies, comprising the main provincial distribution companies (the United Distribution Company and the Adjara region distributor) and a number of smaller hydro power plants; and
- The large Rustavi and Madneuli metallurgical plants and the Batumi crude oil storage complex.

9. **The monetary stance was broadly accommodating during the first half of 2005, reflecting sizable unsterilized intervention by the NBG** (Tables 5 and 6). More recently, reserve money growth has slowed somewhat to 31 percent year-on-year by mid-June, from 44 percent in December 2004. Dollarization has stabilized at about three-fourths of total bank deposits in 2005, following a sharp decline in 2004 sparked by a strengthening of the lari and a rebound in confidence in the wake of the November 2003 regime change. The ratio of nonperforming to total commercial bank loans has dropped to 5 percent at end-April 2005 (Table 7).

10. **International support for Georgia's economic reform program has been strong** (Tables 8–11). Following the July 2004 Paris Club rescheduling of Georgia's debt, bilateral agreements have been reached with a number of creditors. Discussions with other bilateral creditors have advanced and the authorities have asked the Paris Club to extend the deadline for concluding these discussions to end-September 2005. Indicators of external indebtedness have improved, as evidenced by a decline in the external public debt-to-GDP ratio from 46 percent at end-2003 to about 36 percent at end-2004. The U.S. Millennium Challenge Corporation is expected to decide in the coming months on Georgia's request for a sizable grant, the bulk of which would be aimed at upgrading road and energy infrastructure. The authorities' 2003 Poverty Reduction Strategy has been an important vehicle for donor coordination, and donors were closely involved in the preparation of the first Annual

Progress Report of the strategy, which was completed in January 2005 (Country Report No. 05/113).

11. **Some progress has been made in improving the technical and financial viability of the energy sector, but much remains to be done.** Quasi-fiscal losses in the sector declined to an estimated 4½ percent of GDP in 2004, from 5 percent in 2003 (Table 12). While the steady increase in the cash collection rate of the major provincial distribution company (which partly reflects the ongoing extension of communal metering) is encouraging, the nonpayment for the use of electricity outside Tbilisi remains the largest source of quasi-fiscal losses. Moreover, payments discipline in the gas sector has not improved as programmed.

12. **President Saakashvili's administration continues to enjoy a solid parliamentary majority.** The government has recently reached agreement with Russia on the closure of the two remaining Russian military bases on Georgian territory by end-2008. Moreover, Georgia continues to seek a peaceful reintegration of the breakaway regions of Abkhazia and South Ossetia.

13. **Poverty still remains widespread** (Table 13). The share of the population living under the minimum subsistence level (about US$30 a month) declined slightly in 2004, to 52½ percent, partly reflecting the recovery in economic activity, timely payment of wages and social transfers, and a significant clearance of domestic arrears. Extensive layoffs in the public sector in 2004 helped to create a leaner, more efficient government, but they also appear to have contributed to a rise in the unemployment rate by 2 percentage points to 13 percent.

III. Policy Discussions and the 2005 Program

14. **Discussions with the authorities focused on the opportunities and macroeconomic challenges posed by the sizable increase in privatization-related external inflows since early 2005.** The authorities took the view that the jump in these government receipts over the next two-to-three years should be largely spent on urgent infrastructure and social programs, and on upgrading Georgia's defense capabilities as it seeks greater external political and economic integration. The officials added that two-thirds of the additional 2005 spending covered by these extraordinary resources would be in imported goods and services, thereby limiting demand pressures and a real appreciation of the currency. Moreover, they stressed their commitment to keeping inflation at single-digit rates, which will be underpinned by a tightening of monetary policy in the remainder of 2005. The government will also submit a Medium-Term Expenditure Framework (MTEF) to parliament this fall (together with the 2006 budget bill), which will be geared at ensuring fiscal sustainability.

A. Objectives of the Program

15. **The authorities' economic program for 2005 targets real GDP growth at 8½ percent and end-year inflation at 7 percent**. The external current account deficit would widen to 12 percent of GDP, mainly because of an increase in energy sector and defense equipment imports and higher world oil prices, and it would be financed mostly by privatization-related and other private capital inflows. Gross reserves would remain at 2 months of non-pipeline imports of goods and services. The authorities have set quantitative and structural PCs for September 2005 as specified in Attachments III and IV, and they have also specified indicative targets and structural benchmarks for end-December 2005. Mirroring the shift in the policy mix, and to strengthen the monitoring of monetary developments under the program, the authorities are requesting a change in the key monetary performance criterion, from net domestic assets of the NBG to reserve money.

B. Fiscal Policy

16. **The macroeconomic program for 2005 features an increase in the cash budget deficit from 0.2 percent of GDP in 2004 to 4.8 percent, driven by higher spending, and financed mainly by privatization proceeds.** On the revenue side, the tax effort would remain unchanged at around 18 percent of GDP, with improved administration and higher excise rates offsetting losses from the reduction in other tax rates. In addition to the repayment of arrears, social expenditures in the original 2005 budget include the increase in minimum pensions mentioned above and the introduction in late 2005 of a streamlined, means-tested poverty benefit targeted to the 600,000 most needy, which would cost about 0.9 percent of GDP a year when it becomes fully operational (paragraph 32 of the Memorandum of Economic and Financial Policies (MEFP). The authorities indicated that the stock of domestic arrears incurred during the previous government had been revised upward by some GEL 60 million (0.5 percent of GDP) as a result of recent audits, and they underscored their intention to fully eliminate domestic arrears by end-2006.

17. **The authorities noted that the large increase in expenditure authorized by the two 2005 supplementary budgets (see paragraph 5) poses a manageable risk to short-term macroeconomic stability and will not jeopardize medium-term fiscal sustainability**. The supplementary budgets do not include major increases in recurrent expenditure, and their financing does not increase debt. The authorities pointed out that two-thirds of the additional outlays will be spent on imported goods and services, limiting the effects on short-term macroeconomic stability. They also stressed that continuing accumulation of government deposits at the central bank is not politically sustainable against the backdrop of pervasive social and other priority needs. In addition, they pointed to their excellent track record in managing the economy since taking office, with fiscal performance in 2004 much stronger than projected. Staff acknowledged these arguments and the authorities' strong program ownership, but noted that the shift to a more expansionary fiscal policy would require a tightening of monetary policy, so as to safeguard the single-digit inflation objective. The authorities concurred that the fiscal stance would need to be kept

under review (e.g., by saving any overperformance in tax revenue) in light of inflation developments in the coming months.

C. Monetary and Financial Sector Policies

18. **The authorities' monetary program targets 12-month CPI inflation at 7 percent by end-2005.** The monetary program limits reserve money growth to 26 percent during the year and keeps gross reserve coverage relative to imports broadly unchanged (see Tables 5 and 6 and paragraph 22 of the MEFP). While additional capital repatriation may be expected as confidence rebounds and legalization of the informal economy continues, the NBG plans to limit its foreign exchange intervention to smoothing fluctuations. Staff noted that the transmission lag of monetary policy in Georgia was relatively short, owing in part to the highly dollarized economy. Against this backdrop, it urged the authorities to tighten the monetary stance beyond the programmed limits if inflationary pressures were to persist in the second half of the year.

19. **The NBG will further strengthen monetary control instruments with assistance from the Fund's Monetary and Financial Systems Department (MFD)**. The authorities endorsed the recommendations of a recent MFD mission, (e.g., fostering primary and secondary markets for treasury bills by increasing the stock of treasury bills, developing benchmark issues, and seeking to establish a treasury yield curve). This would allow the NBG to begin phasing out credit auctions and to start relying instead on repurchase operations for short-term liquidity management. The authorities agreed that reserve requirements on local and foreign currency deposits should be equalized over the medium term, with a view to improving monetary management. In the area of banking supervision, the NBG will continue to implement its action plan geared at enhancing compliance with the Basel core principles (MEFP, paragraph 23). The NBG will continue to work with donors in preparing a deposit insurance scheme, and it will also seek agreement with the fiscal authorities on an increase in the NBG's capital base.

D. Structural Reforms

20. **The overarching goals of structural reforms under the program are to consolidate the fiscal position, as well as to enhance growth prospects, social protection, and the provision of basic services.** In addition to the 2004–05 privatization program mentioned above, major efforts to streamline the regulatory environment are key elements of this endeavor (see Box 2 and paragraph 26 of the MEFP). The government has embarked on discussions with the World Bank on a Poverty Reduction Support Credit (PRSC), focusing on governance and public sector operations; reforms in the energy sector; human development and social protection; and private sector development (Appendix II). Consideration of the proposed PRSC by the World Bank's Executive Board is tentatively planned for fall 2005, together with the new Country Assistance Strategy.

21. **Decaying transport infrastructure, as well as dilapidated power generation and distribution, are key obstacles to growth** (paragraph 30 of the MEFP). The government has

launched a multi-year effort to rehabilitate roads, which will be covered mostly by external grants and privatization proceeds. The authorities also aim to mitigate the customary power rationing in the coming winter season, and to provide stable and reliable power supplies to all paying customers by end-2006. Several rehabilitation projects are being completed, and accelerated privatization of various units should help improve the incentive structure of the power sector. A review of the tariff methodology under way with World Bank assistance should eventually permit introduction of an updated tariff structure at cost-recovery levels by mid-2006.

E. External Sector Policies

22. **The authorities confirmed their commitment to a further liberalization of the foreign trade regime** (paragraph 31 of the MEFP), but indicated that the government had changed the sequencing of reforms somewhat in light of other pressing issues that required immediate attention. A strategy paper aimed at reducing the number of tariff bands and the maximum import tariff rate is expected to be discussed in the government shortly. The authorities will submit draft legislation to parliament by end-September 2005, and parliamentary approval will be sought to introduce these measures in January 2006. In the discussions with the authorities, staff emphasized that accelerated trade liberalization would help mitigate the pressures for currency appreciation mentioned above.

23. **Staff encouraged the authorities to bring discussions with bilateral external creditors to a swift conclusion**, noting that an orderly and rapid resolution could provide a significant boost to Georgia's international credibility. Discussions with four Paris Club and four non-Paris Club creditors are pending, for a variety of reasons.[1]

F. Program Risks

24. **The challenge of reconciling an expansionary fiscal policy with the inflation and competitiveness objectives poses the main risk to the success of the program**. Political pressures to contain an appreciation of the lari and further increase spending (using higher-than-anticipated tax revenues or additional privatization receipts) could jeopardize fiscal sustainability and exacerbate inflation. A rekindling of tensions over Georgia's breakaway regions could also hinder the reform program. These risks could be mitigated by more systematic efforts by the government to explain the importance of keeping inflation low to the public, thereby helping forge a strong domestic consensus on the way forward, as well as by continued international efforts toward peaceful resolution of regional territorial disputes.

[1] Discussions with Paris Club creditors (Austria, Germany, Turkey and the United States) have been delayed partly due to technical disagreements, e.g., on the amount of interest accrued and on equal treatment of creditors. Regarding non-Paris club creditors (Armenia, Azerbaijan, China, and Kazakhstan), an agreement with Armenia awaits signature. China is reportedly considering a conversion of its claims to a grant. Negotiations with Azerbaijan and Kazakhstan are slated to continue in the coming months.

IV. Staff Appraisal

25. **The new administration that came into power in early 2004, following the Rose Revolution, has demonstrated its resolve to invigorate reforms and make a decisive break with deeply ingrained corruption.** The most tangible progress has taken place in the fiscal accounts, especially an impressive rise in tax revenue sparked by improvements in tax administration. These gains have been sustained in 2005, despite a tax reform that came into effect in January featuring significant tax cuts.

26. **The economy has continued to perform well, while the economic program for 2004 has been implemented largely as envisaged.** All quantitative performance criteria for end-December 2004 were met. Moreover, the NBG pursued a largely accommodating monetary stance, allowing the indicative target for reserve money to be exceeded as strong capital inflows complicated the conduct of monetary policy. Although progress was made in the structural area, some of the programmed measures were delayed, including parliamentary approval of amendments to the Budget System Law.

27. **Staff has reached understandings with the authorities on a macroeconomic framework and structural reforms for 2005, including quarterly targets through end-2005.** In the wake of the impressive revenue gains, the government has framed its expenditure priorities for 2005 with a view to addressing long-standing obstacles to growth. Accordingly, additional privatization receipts are being directed toward infrastructure and energy rehabilitation, promoting political and economic integration with the international community, and further reducing expenditure arrears. Staff supports these priorities and notes that the domestic borrowing requirements of the government are modest, as the bulk of the deficit is being financed by privatization proceeds and concessional aid flows. Staff also notes that longer-term fiscal sustainability is being protected, since most of the additional outlays are of a nonrecurrent nature.

28. **Nevertheless, higher government spending will likely complicate the conduct of macroeconomic policies, especially with regard to inflation.** Depending on the pace of capital inflows and the fiscal stance, the burden of keeping inflation below 10 percent would fall mainly on the central bank. In this context, staff welcomes the assurances by the government that discretionary spending will be managed carefully, based on an assessment of inflationary trends.

29. **Staff expects the central bank to ensure low inflation, based on its commitment to adhere strictly to the agreed path for reserve money growth by allowing greater exchange rate flexibility and mopping up liquidity as needed.** However, if inflationary pressures do not abate as expected during the second half of the year, the authorities should be prepared to tighten the monetary stance beyond the limits envisaged in the program. The NBG is to be commended for its ongoing efforts to develop a broad menu of indirect monetary instruments. The fiscal cost of sterilization operations will need to be monitored closely and factored into the authorities' plans to recapitalize the central bank from 2006.

30. **Georgia's relatively underdeveloped financial system limits its ability to finance small- and medium-sized enterprises and expand retail banking.** Staff welcomes the NBG's ongoing program of gradually increasing minimum capital requirements and allowing the entry of foreign banks in order to consolidate and strengthen the system. As macroeconomic stability becomes entrenched and the structure of the banking system is rationalized, further progress in reducing dollarization and remonetizing the economy can be expected.

31. **Beyond the initiatives underway to strengthen the public finances and the financial system, the authorities' structural reform agenda is appropriately focused on fostering the revival of private investment.** One prong of the strategy targets removing fundamental obstacles to growth in transport infrastructure and ensuring reliable energy supplies, both of which are essential to improving the business climate. Staff particularly welcomes the authorities' commitment to eliminate the quasi-fiscal deficit in the energy sector by end-2006. The second prong of the strategy is intensifying efforts to improve the business climate. Staff agrees with the emphasis on accelerated privatizations; streamlining requirements for licenses, permits, and certificates; and creation of a professional and well-remunerated civil service. The third prong is trade liberalization. Staff regrets the delay in implementing the programmed measures, but it is encouraged by the ongoing formulation of a trade reform strategy. In this regard, staff recommends the acceleration of the reduction of maximum tariffs and the number of tariff bands.

32. **Staff endorses the government's continued efforts to alleviate poverty, which will be greatly aided by enhancing the environment for rapid and sustained growth.** More immediately, poverty is being addressed by increasing minimum pensions, which are low by international standards, and by eliminating wage and pension arrears. Introducing a targeted, means-tested poverty program geared at eliminating extreme poverty is a highly commendable initiative.

33. **The road ahead for Georgia will require continued efforts to maintain macroeconomic stability and implement structural reforms.** The main risk to macroeconomic stability is the challenge posed by the shift in the policy mix toward greater reliance on a restrictive monetary stance as an anchor of single-digit inflation, in an environment of potentially large capital inflows. In this regard, the third review under the arrangement will focus on progress in lowering inflation, as well as in observing the fiscal targets of the general government and reducing energy sector quasi-fiscal deficits. The main risk in the structural area comes from opposition of vested interests to reform efforts, but the authorities have demonstrated their determination to resist these pressures, as evidenced by their success in fighting corruption, which many thought to be intractable.

34. **Overall, Georgia's performance under the PRGF arrangement has been strong.** Based on this track record, the policy commitments set out in the attached MEFP, and the government's assurances to take corrective measures if inflationary pressures are exacerbated, staff supports the authorities' request for completion of the second review under the arrangement and a waiver for nonobservance of a structural performance criterion.

Table 1. Georgia: Selected Macroeconomic Indicators, 2000–05
(Quota: SDR 150.30 million)
(Population: 4.3 million)
(Per capita GDP: US$1,201)

	2000	2001	2002	2003	2004	2005	
					Revised Est.	Country Rep. No. 05/1	Proj. 3/
(Annual percentage change, unless otherwise indicated)							
National accounts							
Nominal GDP (millions of lari)	6,013	6,638	7,448	8,565	9,951	10,809	11,660
Nominal GDP (US$ million)	3,043	3,202	3,392	3,984	5,183	5,843	6,303
Real GDP	1.9	4.7	5.5	11.1	6.2	6.0	8.5
Consumer price index, period average	4.0	4.7	5.6	4.8	5.7	4.8	9.4
Consumer price index, end-of-period	4.6	3.4	5.4	7.0	7.5	...	7.0
Poverty rate (in percent)	51.8	51.1	52.1	54.5	52.7	...	...
(In percent of GDP, unless otherwise indicated)							
Investment and savings							
Investment	21.6	21.9	22.0	24.5	26.6	28.9	28.9
Public	1.0	1.8	2.0	1.8	2.4	2.8	5.5
Private	20.6	20.1	20.0	22.7	24.2	26.1	23.4
Gross Domestic Saving	17.3	15.5	16.2	17.2	19.0	20.8	17.1
Public	-3.0	-0.2	0.1	-0.7	4.7	2.5	2.0
Private	20.3	15.7	16.2	17.9	14.3	18.3	15.1
Savings-Investment balance	-4.3	-6.4	-5.8	-7.2	-7.6	-8.1	-11.8
Budgetary operations							
Total revenue and grants	15.2	16.3	15.8	16.2	21.8	20.4	21.7
o/w Tax revenue	14.2	14.3	14.4	14.5	18.2	18.0	18.1
Total expenditure and net lending	19.2	18.3	17.8	18.7	19.5	20.7	25.2
o/w Current expenditure	18.2	16.5	15.7	17.0	17.1	17.9	19.7
Primary balance	-1.0	-0.2	0.0	-0.4	3.5	0.8	-2.4
Fiscal balance, commitment basis	-4.0	-2.0	-2.0	-2.5	2.3	-0.3	-3.5
Net change in expenditure arrears	1.4	0.2	-0.4	1.4	-2.6	-1.6	-1.3
Statistical discrepancy	0.1	0.1	0.5	-0.3	0.1	...	...
Fiscal balance, cash basis	-2.6	-1.6	-1.9	-1.3	-0.2	-1.9	-4.8
Financing	2.6	1.6	1.9	1.3	0.2	1.9	4.8
Privatization	0.3	0.1	0.2	0.3	0.9	1.1	3.4
External 1/	0.0	1.9	1.8	1.0	0.2	0.4	0.8
Domestic	2.2	-0.4	-0.1	0.6	-0.9	0.4	0.6
Adjustment for net withheld Adjara transfers 2/	0.0	0.0	0.0	-0.7	0.0	0.0	0.0
(Annual percentage change, unless otherwise indicated)							
Monetary sector							
Reserve money	26.8	9.9	18.4	13.9	44.2	18.0	26.0
Broad money (including foreign exch. deposits)	39.0	18.5	17.9	22.8	42.6	21.0	31.8
Velocity of broad money, level	9.7	9.1	8.6	8.1	6.6	6.6	5.8
(In millions of US dollars, unless otherwise indicated)							
External Sector							
Exports of goods and services (percent of GDP)	36.0	30.4	30.2	33.2	37.8	31.9	34.0
annual percentage change	48.2	-11.1	5.5	28.9	48.1	7.5	9.3
Imports of goods and services (percent of GDP)	45.3	42.5	40.1	45.6	51.2	46.7	52.6
annual percentage change	9.3	-1.2	-0.2	33.7	46.0	14.1	25.1
Net imports of oil	104	123	131	180	239	278	304
Current account balance	-132	-205	-196	-286	-394	-475	-743
In percent of GDP	-4.3	-6.4	-5.8	-7.2	-7.6	-8.1	-11.8
External public and publicly guaranteed debt (percent of GDP)	51.3	51.7	52.4	46.4	35.8	30.3	29.4
Gross international reserves	109	161	198	191	383	366	493
In months of imports of goods and services (excl. pipeline imports)	1.0	1.4	1.8	1.5	2.0	1.9	2.0
Average exchange rate (lari per dollar)	1.98	2.07	2.20	2.15	1.92	...	...

Sources: Georgian authorities; and Fund staff estimates.

1/ External financing for 2004 includes debt relief from the Paris Club.
2/ For 2003, Adjaran claims on commercial banks that reflect withheld tax revenues are excluded from net financing to the government.
3/ 2005 projections reflect the supplementary budget approved in May.

Table 2. Georgia: 2004 Quantitative Performance Criteria and Indicative Targets 1/

	Stocks 2/ End-Dec. 2003	Cumulative Change from End-2003 3/ Mar. 2004			Jun. 2004			Sep. 2004			Dec. 2004			
	Actual	Program estimates	Adj. prog. estimate	Actual	Performance Criteria	Adjusted target	Actual	Indicative targets	Adjusted target	Actual	Performance criteria	Rev. perf. criteria	Adjusted Target	Prelim.
							(In millions of lari)							
1. Quantitative targets 4/														
Floor on general govt. tax revenue (including special funds) 5/	1207.7	312.9		335.4	685.2		774.0	1101.0		1267.5	1538.5	1720.9		1811.1
Ceiling on cash deficit of the general government 6/ 7/	109.5	81.2	55.7	64.1	151.6	79.5	19.8	179.5	77.8	17.8	240.4	178.8	147.1	69.2
Ceiling on domestic expenditure arrears of the general govt.	123.5	-6.3		-28.6	-25.8		-87.8	-52.2		-147.7	-93.4	-249.5		-258.8
Floor on tobacco and petroleum revenues	133.9	39.0		40.9	92.8		101.6	174.5		189.7	259.2	259.2		329.7
Ceiling on net credit of the banking system to the general government (NCG)	766.1	18.2		7.1	27.7		-25.6	27.4		-75.0	31.4	57.1		-26.9
Ceiling on net domestic assets (NDA) of the NBG	909.0	18.4		-51.2	24.3		-116.2	21.5		-242.3	19.6	-169.1		-206.2
							(In millions of U.S. dollars)							
Floor on total net international reserves (NIR) of the NBG	-153.1	-3.6		30.4	-0.2		89.3	11.9		190.6	28.8	146.1		215.3
Ceiling on contracting or guaranteeing of														
A. 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
B. 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
Ceiling on accumulation of external arrears	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	579.9	10.7		14.1	23.8		75.8	47.0		167.5	81.3	145.0		256.6
							(In percent)							
Average monthly cash collection rates (CCR)														
A. Electricity sector														
CCR from Direct Customers of the Georgian Wholesale Electricity Market	88.0	85.0		70.7	90.0		97.9	90.0		85.7	95.0	95.0		95.0
CCR from the General Government	51.0	95.0		72.2	95.0		112.5	100.0		126.9	100.0	100.0		117.6
CCR from customers of the major provincial distribution company (UDC)	19.0	18.0		23.3	20.0		26.8	27.0		34.9	35.0	35.0		39.1
B. Gas sector														
CCR from customers of Tbilgazi	22.8	25.0		21.8	29.0		60.8	34.0		56.2	40.0	40.0		29.6
							(In millions of lari)							
3. Baseline assumption on external project financing 6/	127.7	77.5		52.0	159.4		87.3	229.0		127.2	289.1	212.6		181.0

Sources: Georgian authorities; and Fund staff estimates.

1/ Section 1 of this table shows quantitative targets for 2004 based on cumulative changes from end-December 2003. The ceiling for the cash deficit of the government is adjusted, as indicated in footnote 6, for deviations from projected external financing, reported in Section 3 of the table. Indicative targets are shown in Section 2. The continuous performance criterion on accumulation of new external payments arrears is defined in paragraph 23 of the February 2004 TMU.
2/ Year-to-date flows for tax revenues, cash deficit, expenditure arrears, and tobacco and petroleum revenues. Monetary outcomes reflect revaluations due to changed program exchange rate assumptions. Collection rates are for the fourth quarter of 2003.
3/ Year-to-date flows for tax revenues, cash deficit, expenditure arrears, and tobacco and petroleum revenues. Monetary outcomes reflect revaluations due to changed program exchange rate assumptions.
4/ Quantitative targets for 2004 are based on accounting exchange rates of GEL 2.15/US$, US$ 1.49/SDR, and US$ 1.27/EUR.
5/ Special state funds include the Pension, Employment, and Road Funds. Privatization receipts are excluded.
6/ The program target on the cash deficit is adjusted for deviations from projected disbursements of external project finance (Section 3) as specified in the February 2004 TMU, subject to a cap on the cumulative upward adjustment of GEL 100 million for 2004.
7/ In March 2004, the license of Maritime Bank was withdrawn, and the bank's assets and liabilities (including GEL 45.55 million in deposits of the Adjaran local government) were removed from the monetary survey. This led to an unanticipated increase in net banking system credit to the general government (NCG) and a higher-than-projected cash deficit as measured from "below-the-line." In assessing program performance in the first two quarters of 2004, NCG and the cash deficit as measured under TMU definitions have not been corrected for the effect of the closure of Maritime Bank.

Table 3. Georgia: Status of 2004 Structural Performance Criteria (*) and Structural Benchmarks

Action	Status	Comments
1. Select a consultant to conduct the review of the electricity tariff methodology. **End-June (*)**	Observed	
2. Issue a strategy paper to deal with internal electricity sector legacy debts. **End-June (*)**	Not observed	A draft was prepared in September 2004, but work on a final strategy paper by the DMA is ongoing.
3. Establish full commitment control for all payments by the Treasury for state ministries and line agencies; close all revenue transit accounts (thereby making the Treasury Single Account fully effective); and move the VAT refund accounting and payment to the Treasury (the tax administration services of the Ministry of Finance will remain in full control of verifying and approving VAT refunds). **End-June**	Partially observed	By end-June 2004, full commitment control was in place for all state ministries and line agencies, but not for the Social Security and Road Funds. Full commitment control was extended to these extrabudgetary agencies in September 2004. In April 2005, the authorities closed all revenue transit accounts in commercial banks and the NBG, and established a treasury single revenue account. Legal provisions to transfer the administration of the VAT refund mechanism are complete and refunds have begun.
4. Appoint new supervisory boards for the Madneuli mining and Elektrokavshiri state enterprises that will be guided by performance-based contracts, which will require them to exercise effective oversight of management to ensure improved transparency in the operations of these enterprises. **End-June**	Partially observed	Supervisory boards have been appointed for Madneuli and Elektrokavshiri. Performance-based contracts for the supervisory boards of both companies have not been issued.
5. Move the collection systems for payments to electricity distributors in major towns outside Tbilisi to banks or service centers. **End-June**	Observed	
6. Submit to parliament legislation enabling the NBG to disqualify auditors from performing bank audits and require auditors to disclose violations of laws, regulations, or significant misrepresentation of financial data to the NBG. **End-June**	Observed	Legislation was submitted to parliament in May 2004.

Table 3. Georgia: Status of 2004 Structural Performance Criteria (*) and Structural Benchmarks

Action	Status	Comments
7. Post the results of the audits of the 2002 accounts of Poti Port, Georgian Railways and Madneuli Mining Company, including the management letters in the official websites of the Ministry of Finance and the Ministry of Economy. **End-August**	Not observed	The audit of the Railways was posted on the website of the Ministry of Economy in November. The audit for Madneuli will not be finalized until agreement is reached on payment of the auditor. The audit for Poti Port will be finalized shortly.
8. Secure parliamentary approval of enabling legislation to allow for provisional measures (i.e., freezing and seizure) and confiscation related to the anti-money laundering legislation. **End-September**	Not observed	The amendments to the criminal code and to the criminal procedure code were submitted to parliament in December 2004 but no decision has been taken.
9. Initiate international audits of the Tbilisi Airport Authority and the state telecommunications company (Elektrokavshiri) by issuing tenders and selecting auditors. **End-September**	Observed	
10. Secure parliamentary approval of amendments to the Budget System Law to align it with recent constitutional amendments and to implement the recommendations of the October 2003 FAD TA mission. **End-December (*)**	Not observed	Amendments to the Budget System Law are expected to be considered in parliament in September 2005.
11. Secure parliamentary approval of a Tax Reform, as specified in paragraph 15 of the MEFP dated May 12, 2004. **End-December (*)**	Observed	A tax reform bill was approved by parliament in December 2004.
12. Audit the stock of domestic expenditure arrears by verifying all claims on the state budget. **End-December**	Not observed	Audits of arrears are ongoing.
13. Reverse the changes in foreign trade tariffs that were introduced in December 2002. **End-December**	Not observed	The authorities are preparing a trade liberalization strategy for discussion in parliament by end-September 2005.
14. Refrain from issuing government guarantees on domestic loans. **Continuous (*)**	Observed to date	
15. Refrain from engaging in offset transactions to settle tax obligations or government electricity bills. Continuous	Observed to date	

Table 4. Georgia: General Government Operations, 2003−05

	2003		2004		2005							
					Initial Budget		Program		2005 Quarterly Profile			
	million lari	% of GDP	million lari	% of GDP	million lari	% of GDP	million lari	% of GDP	Q1 Prel.	Q2 Proj.	Q3 Proj.	Q4 Proj.
Total revenue and grants	1,391	16.2	2,166	21.8	2,297	19.7	2,532	21.7	555	559	658	760
Total revenue	1,343	15.7	2,042	20.5	2,164	18.6	2,395	20.5	545	545	637	668
Tax revenue 1/	1,245	14.5	1,811	18.2	1,995	17.1	2,107	18.1	448	516	602	541
Taxes on income	179	2.1	269	2.7	226	1.9	263	2.3	66	64	65	68
Taxes on profits	111	1.3	162	1.6	229	2.0	221	1.9	43	52	80	46
Social tax 2/	...	...	...	...	212	1.8	228	2.0	51	68	54	55
VAT	386	4.5	628	6.3	816	7.0	875	7.5	195	210	248	223
STD	195	2.3	263	2.6	346	3.0	354	3.0	81	87	96	91
SCD	191	2.2	366	3.7	470	4.0	521	4.5	114	123	152	132
Customs duties	84	1.0	123	1.2	119	1.0	135	1.2	24	27	47	38
Excises	110	1.3	181	1.8	319	2.7	319	2.7	54	80	90	95
STD	29	0.3	63	0.6	120	1.0	120	1.0	12	31	38	40
SCD	81	0.9	93	0.9	199	1.7	199	1.7	42	49	52	55
Other taxes	123	1.4	111	1.1	75	0.6	66	0.6	14	16	18	18
Nontax revenue 1/	98	1.1	231	2.3	169	1.4	289	2.5	97	29	36	127
of which: NBG profit transfers	15	0.2	12	0.1	30	0.3	40	0.3	40	0	0	0
Extrabudgetary revenue	254	3.0	337	3.4	...	...	...	...	...	...	...	...
Medical and pension funds 1/	199	2.3	281	2.8	...	...	...	...	...	...	...	...
Road fund 2/	55	0.6	56	0.6	...	...	...	...	...	...	...	...
Of which: Gasoline excise	16	0.2	19	0.2	...	...	...					
Grants	48	0.6	124	1.2	134	1.1	137	1.2	10	14	21	92
Total expenditure and net lending	1,601	18.7	1,937	19.5	2,398	20.6	2,939	25.2	529	746	832	833
Current expenditure	1,453	17.0	1,702	17.1	2,042	17.5	2,292	19.7	469	567	625	631
Wages and salaries	269	3.1	312	3.1	425	3.6	447	3.8	103	115	115	115
Goods and services	173	2.0	264	2.7	488	4.2	602	5.2	77	155	190	182
Transfers and subsidies 3/ 4/	138	1.6	237	2.4	523	4.5	598	5.1	180	138	138	139
Interest payments	178	2.1	120	1.2	121	1.0	122	1.0	32	28	29	32
Domestic	95	1.1	71	0.7	78	0.7	78	0.7	21	19	20	17
External	84	1.0	49	0.5	44	0.4	44	0.4	11	9	9	14
Extrabudgetary expenditures	341	4.0	388	3.9	...	...	...	...	...	...	...	...
Medical and pension funds 4/	288	3.4	336	3.4	...	...	...	...	...	...	...	...
Road fund 5/	53	0.6	52	0.5	...	...	...	...	...	...	...	...
Local government expenditures 6/	354	4.1	380	3.8	484	4.2	524	4.5	77	131	153	164
Capital expenditure 5/	70	0.8	208	2.1	292	2.5	584	5.0	59	163	185	177
Of which: Foreign financed	69	0.8	107	1.1	190	1.6	192	1.6	22	50	55	65
Net lending	78	0.9	27	0.3	63	0.5	63	0.5	0	16	22	25
Of which: Foreign financed	59	0.7	56	0.6	78	0.7	78	0.7	4	20	25	29
Overall balance (commitments)	-210	-2.5	229	2.3	-101	-0.9	-407	-3.5	27	-187	-174	-73
Adjustment to cash basis	101	1.2	-252	-2.5	-140	-1.2	-149	-1.3	7	-44	-47	-65
Net change in expenditure arrears (-, reduction)	124	1.4	-259	-2.6	-140	-1.2	-149	-1.3	-29	-32	-35	-54
Statistical discrepancy	-23	-0.3	6.5	0.1	0	0.0	0	0.0	35	-12	-12	-12
Overall balance (cash)	-109	-1.3	-24	-0.2	-241	-2.1	-556	-4.8	34	-231	-221	-138
Total financing	109	1.3	24	0.2	241	2.1	556	4.8	-34	231	221	138
Privatization	30	0.3	87	0.9	99.8	0.9	393	3.4	36	181	145	31
Domestic	48	0.6	-86	-0.9	47	0.4	67	0.6	-55	52	18	52
Net NBG credit	27	0.3	-61	-0.6	27	0.2	47	0.4	-56	41	16	45
Net commercial banks credit	26	0.3	-12	-0.1	20	0.2	20	0.2	3	10	2	5
Nonbank	-2	0.0	-14	-0.1	0	0.0	0	0.0	-2	1	1	1
External	88	1.0	23	0.2	94	0.8	97	0.8	-15	-2	58	55
Disbursements	137	1.6	173	1.7	268	2.3	270	2.3	16	77	82	95
Amortization	-159	-1.9	-150	-1.5	-174	-1.5	-174	-1.5	-31	-79	-24	-40
Changes in arrears (-, reduction)	109	1.3	...	...	...	...	...	...	...	...	...	...
Adjustment for net withheld Adjara transfers 7/	-56	-0.7	...	...	...	...	...	...	...	...	...	...
Memorandum items:												
Overall balance excluding grants (commitments)	-258	-3.0	105	1.1	-235	-2.0	-544	-4.7	16	-201	-195	-164
Cigarette and petroleum tax revenue	138	1.6	330	3.3	461	4.0	466	4.0	72	118	135	141
Defense spending (cash basis)	61	0.7	160	1.6	128	1.1	361	3.1	...	...	...	...
Social spending (commitment basis)	652	7.6	835	8.4	996	8.5	1,076	9.2	203	...	...	...
Social spending (cash basis)	607	7.1	974	9.8	1,051	9.0	1,131	9.7	243	...	...	...
Domestic public debt	1,290	15.1	1,054	10.6	949	8.1	925	7.9	1,087	1,065	1,032	985
Domestic arrears	400	4.7	209	2.1	60	0.5	60	0.5	181	149	114	60
T-bills and debt to the NBG	890	10.4	905	9.1	949	8.1	925	7.9	906	917	919	925
Nominal GDP (millions of lari)	8,566	100.0	9,951	100.0	11,660	100.0	11,660	100.0	2,477	2,884	3,014	3,285

Sources: Georgian authorities and Fund staff estimates.

1/ 2005 tax revenue and nontax revenue include arrears of GEL 25 million and GEL 108 million respectively, collected in relation to the privatization process.
2/ The Road Fund and Social Security Fund were eliminated in 2005. Revenue reported in previous years under medical and pension funds is being reported in 2005 as social tax.
3/ Excludes transfers from Central Budgets to local budgets.
4/ 2005 transfers and subsidies incorporate spending on health and pensions previously recorded under medical and pension funds.
5/ Starting in 2005 capital spending includes expenditure previously undertaken by the Road Fund and recorded as current spending.
6/ Includes transfers from Central Budget.
7/ In 2003 financing is adjusted by the sum of Adjaran 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, 2003–05

	2003 1/	2004					2005 2/							
	Dec.	Mar. 1/	Jun. 1/	Sep. 1/	Dec.		Jan.	Feb.	Mar.	Apr.	May	Jun.	Sep.	Dec.
	Actual	Actual	Actual	Actual	Actual 1/	Actual 2/	Actual	Actual	Actual	Actual	Actual	Proj.	Proj.	Proj.
							(Annual percentage change)							
Net foreign assets	17.0	35.4	64.1	123.2	140.6	142.9	-148.1	-154.1	-151.7	-258.2	-241.4	-232.0	232.7	159.9
Net domestic assets	0.4	-4.6	-10.6	-25.7	-22.7	-15.9	-22.6	-21.3	-14.4	-25.9	-31.8	-5.5	7.7	4.1
Net claims on general government	3.5	-0.4	-7.1	-12.8	-7.8	-7.8	-14.9	-12.3	-10.0	-24.2	-25.7	0.6	7.8	6.5
Claims on rest of economy	0.4	2.7	0.0	0.4	0.4	0.4	0.5	0.4	0.4	0.4	-17.4	0.5	-0.1	-0.1
Reserve money (RM)	13.9	21.1	29.8	35.8	44.3	44.3	38.7	38.2	36.2	47.4	35.2	32.7	29.9	26.0
Currency in circulation (M0)	13.4	17.0	23.7	34.8	42.9	42.9	42.1	46.9	41.2	48.9	41.0	39.8	30.5	25.1
Required reserves	12.7	21.4	-12.3	-9.7	13.4	13.4	7.5	5.1	8.6	9.0	9.9	38.6	48.9	28.6
Balances on banks' correspondent accounts 3/	29.1	112.3	502.3	233.6	169.3	169.3	75.6	15.6	40.6	213.6	27.6	-19.1	5.9	31.8
							(In percent of lagged reserve money)							
Net foreign assets	13.2	29.5	48.4	77.8	79.8	67.7	72.4	69.0	56.0	81.5	77.2	39.1	23.0	22.5
Net domestic assets	0.7	-8.4	-18.6	-41.9	-35.6	-23.4	-33.6	-30.8	-19.8	-34.1	-41.9	-6.4	6.9	3.5
Of which: Net claims on general government	5.2	-0.7	-10.7	-18.0	-10.5	-10.5	-20.5	-16.5	-12.5	-29.2	-29.8	0.7	7.0	5.6
Reserve money (RM)	13.9	21.1	29.8	35.8	44.3	44.3	38.7	38.2	36.2	47.4	35.2	32.7	29.9	26.0
Of which: Currency in circulation (M0)	11.0	13.8	19.1	28.2	35.0	35.0	33.5	36.3	32.3	39.4	32.0	30.6	24.5	20.3
							(In millions of lari)							
Net foreign assets	-329	-264	-137	81	134	118	131	140	113	287	278	146	246	306
Gold	2	2	2	2	2	2	2	2	1	2	1	1	1	1
Foreign exchange reserves (including BIS account) 4/	413	461	598	791	802	679	730	722	688	839	830	698	806	881
Use of Fund resources	-622	-605	-615	-590	-549	-463	-500	-484	-476	-454	-454	-454	-462	-477
Other foreign liabilities (net)	-122	-122	-122	-122	-122	-100	-100	-100	-100	-100	-100	-100	-100	-100
Net domestic assets	909	858	793	667	703	719	643	658	696	560	554	724	725	748
Net claims on general government	783	740	703	671	722	722	656	681	666	526	529	707	723	769
Loans	817	816	811	817	841	841	841	841	842	842	842	842	842	842
Deposits	-35	-75	-108	-146	-120	-120	-185	-161	-176	-316	-313	-134	-118	-73
Claims on rest of economy	118	118	118	118	118	97	97	97	97	97	97	97	97	97
Claims on banks	6	8	0	-42	-41	-41	-43	-46	-30	-20	-15	-30	-40	-55
Other items, net	2	-8	-28	-81	-96	-59	-67	-74	-37	-43	-58	-50	-55	-63
Reserve money (RM)	580	594	656	747	837	837	774	797	809	847	832	870	971	1,054
Currency in circulation (M0)	473	466	504	600	676	676	630	656	658	690	676	705	783	846
Required reserves	81	90	74	75	92	92	90	94	98	102	109	103	112	119
Balances on banks' correspondent accounts 3/	25	38	77	72	68	68	53	47	53	55	47	62	76	90
Memorandum items:														
Growth of reserve money (in percent, relative to end of previous year)	13.9	2.4	13.1	28.9	44.3	44.3	-7.5	-4.7	-3.3	1.2	-0.5	4.0	16.1	26.0
Growth of reserve money (in percent, relative to same period of previous year)	...	21.1	29.8	35.8	44.3	44.3	38.7	38.2	36.2	47.4	35.2	32.7	29.9	26.0
Growth of currency in circulation (in percent, relative to same period of previous year)	...	17.0	23.7	34.8	42.9	42.9	42.1	46.9	41.2	48.9	41.0	39.8	30.5	25.1
Foreign exchange reserves (in mlns of U.S. dollars) 4/	192	214	278	368	373	367	394	390	372	454	449	377	436	476

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 1.49 and US$/Euro of 1.27.
2/ Net foreign assets are valued at the program rate of 1.85 lari/US$, US$/SDR of 1.46 and US$/Euro of 1.21.
3/ Including overnight deposits from banks.
4/ Includes SDR holdings and foreign currency account with BIS which is used for debt service payments.

Table 6. Georgia: Monetary Survey, 2003–05

	2003 1/	2004					2005 2/						
	Dec	Mar. 1/	Jun. 1/	Sep. 1/	Dec.		Jan.	Feb.	March	April	Jun.	Sep.	Dec.
	Actual	Actual	Actual	Actual	Actual 1/	Actual 2/	Actual	Actual	Actual	Actual	Proj.	Proj.	Proj.
	(Annual percentage change)												
Net foreign assets	23.1	56.1	83.1	138.7	169.5	173.1	-176.9	-183.1	-196.0	-339.3	-461.0	186.2	89.0
Net domestic assets	9.0	0.9	-3.8	-7.8	-2.4	3.2	-0.9	4.2	8.4	2.5	18.2	26.7	24.4
Domestic credit	14.1	10.3	7.7	11.9	16.6	15.5	13.8	17.2	19.4	16.4	24.6	24.0	20.7
Net claims on general government	7.3	8.9	2.4	-5.2	-3.5	-3.5	-10.3	-6.7	-11.2	-26.4	-0.4	9.3	9.1
Credit to the rest of the economy	20.4	11.5	12.2	26.1	33.7	34.1	37.0	40.2	50.3	56.3	47.2	34.6	28.9
Broad money (M3)	22.8	26.1	27.9	25.3	42.6	42.6	31.9	35.5	34.0	44.1	36.9	38.0	31.8
Broad money, excl. forex deposits (M2)	14.1	22.0	32.1	40.9	60.4	60.4	52.5	48.6	48.6	57.7	51.0	44.8	35.6
Currency held by the public	13.0	15.6	24.8	30.6	39.5	39.5	37.9	42.1	41.1	47.7	39.5	35.0	27.5
Total deposit liabilities	30.9	33.6	30.0	21.9	44.8	44.8	28.2	31.2	29.5	41.9	35.3	40.0	34.8
	(In percent of lagged broad money)												
Net foreign assets	9.9	24.8	33.2	35.1	45.6	38.6	33.0	30.5	24.6	41.3	18.0	13.2	10.2
Net domestic assets	12.9	1.2	-5.3	-9.8	-3.0	3.9	-1.1	4.9	9.4	2.8	18.9	24.8	21.6
Domestic credit	23.9	17.4	13.0	18.1	26.2	22.8	19.5	24.4	26.8	22.6	32.4	30.1	24.6
Net claims on general government	6.1	7.2	1.9	-3.6	-2.5	-2.5	-7.2	-4.6	-7.8	-17.6	-0.2	4.9	4.4
Credit to the rest of the economy	17.8	10.2	11.1	21.7	28.8	25.3	26.7	29.1	34.5	40.3	32.7	25.2	20.2
Other items, net	-11.0	-16.1	-18.3	-27.9	-29.2	-18.8	-20.6	-19.5	-17.4	-19.8	-13.5	-5.2	-3.0
Broad money (M3)	22.8	26.1	27.9	25.3	42.6	42.6	31.9	35.5	34.0	44.1	36.9	38.0	31.8
Currency held by the public	5.9	6.6	10.0	11.9	16.5	16.5	14.6	16.4	15.9	18.8	15.6	14.3	11.2
Total deposit liabilities	16.9	19.5	17.9	13.4	26.1	26.1	17.4	19.1	18.1	25.4	21.3	23.7	20.6
	(In millions of lari)												
Net foreign assets	-285	-172	-62	103	198	173	156	151	135	321	167	267	327
Net domestic assets	1345	1289	1247	1218	1314	1339	1274	1322	1362	1266	1455	1556	1666
Domestic credit	1672	1654	1683	1798	1950	1796	1744	1807	1839	1772	1944	2050	2168
Net claims on general government	766	773	741	691	739	739	674	704	687	542	738	755	806
Credit to the rest of the economy	906	881	943	1106	1211	1057	1069	1103	1152	1231	1206	1295	1362
Other items, net	-327	-365	-437	-580	-636	-457	-470	-485	-476	-506	-489	-494	-502
Broad money (M3)	1060	1117	1184	1321	1512	1512	1430	1473	1497	1586	1622	1823	1993
Broad money, excl. forex deposits (M2)	527	547	595	711	846	846	783	807	812	857	898	1029	1148
Currency held by the public	442	431	468	538	616	616	574	601	609	641	653	726	785
Total deposit liabilities	619	686	717	784	896	896	856	872	888	946	969	1097	1208
Memorandum items:													
Growth of broad money (in percent, relative to end of previous year)	22.8	5.3	11.7	24.6	42.6	42.6	-5.4	-2.6	-1.0	4.9	7.3	20.6	31.8
Growth of broad money (in percent, relative to same period of previous year)	...	26.1	27.9	25.3	42.6	42.6	31.9	35.5	34.0	44.1	36.9	38.0	31.8
Growth of credit to the rest of the economy (in percent, relative to end of previous year)	20.4	-2.7	4.1	22.1	33.7	34.1	1.2	4.3	9.0	16.4	14.1	22.5	28.9
Growth of credit to the rest of the economy (in percent, relative to same period of previous year)	...	11.5	12.2	26.1	33.7	34.1	37.0	40.2	50.3	56.3	47.2	34.6	28.9
Growth of credit to the rest of the economy													
(in percent, relative to same period of previous year, at actual exchange rates)	...	7.3	3.9	12.5	20.6	...	20.7	28.6	39.6	45.6	...	...	...
M3 multiplier 3/	1.8	1.9	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.9	1.9	1.9	1.9
M3 velocity 4/	8.1	...	...	...	6.6	6.6	...	...	...	...	...	...	5.8
Foreign exchange deposits in percent of total deposits	86.1	83.2	82.3	77.9	74.3	74.3	75.6	76.3	77.1	77.2	74.7	72.4	70.0

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 1.49 and US$/Euro of 1.27.
2/ Net foreign assets are valued at the program rate of 1.85 lari/US$, US$/SDR of 1.46 and US$/Euro of 1.21.
3/ M3 divided by reserve money.
4/ Annual GDP divided by end-period M3.

Table 7. Georgia: Prudential Indicators of Commercial Banks, 2000–05
(End-of-period)

	2000	2001	2002	2003	2004	Apr-05
Capital adequacy ratio (in percent)	36.7	33.1	21.9	20.3	18.8	17.4
Leverage ratio1/	44.2	39.9	36.1	33.5	27.9	27.5
Nonperforming loans (in percent of total loans)	7.1	11.6	7.9	7.5	6.2	5.3
Specific provisions (in precent of total loans)	4.7	7.5	4.4	4.5	4.3	3.7
Loans collateralized by real estate (in percent of total lo	…	30.2	33.3	31.9	33.5	33.6
Loans in foreign exchange in percent of total loans	81.4	81.4	83.8	87.7	86.7	81.4
Net foreign assets (in millions of lari)	-12.7	3.7	25.0	42.5	54.6	33.1
Net foreign assets (in percent of total assets)	-1.7	0.4	2.2	3.2	3.2	1.8
Net open foreign exchange position 2/	15.7	6.9	9.3	8.5	7.4	5.9
Liquidity ratio (in percent)	36.8	38.5	45.4	43.3	45.0	38.0

Source: National Bank of Georgia.

1/ Definied as the ratio of total capital to total liabilities; an increase in the ratio indicates an improvement.
2/ Percent of Total Regulatory Capital.

Table 8. Georgia: Macroeconomic Framework, 1999–2008

	1999	2000	2001	2002	2003	2004		2005		2006	2007	2008	2009	2010
	Actuals					Rev.Prog.	Est.	Country Rep. No. 05/1	Proj.	Proj.				
	(Percent change)													
Output, prices, money, and external trade														
Real GDP	3.0	1.9	4.7	5.5	11.1	8.5	6.2	6.0	8.5	5.0	5.0	5.0	4.0	4.0
Consumer price index (average)	19.1	4.0	4.7	5.6	4.8	5.8	5.7	4.8	9.4	6.0	4.0	4.0	4.0	4.0
Broad money (M3, lari)	20.7	39.0	18.5	17.9	22.8	27.0	42.6	21.0	31.8	21.7	18.0	16.2	14.3	22.0
Exports (US$)	-0.3	22.5	-19.1	16.9	32.1	45.5	73.1	9.0	9.6	8.9	8.0	6.0	-25.5	6.6
Imports (US$) 1/	-13.0	-3.1	-2.3	3.5	33.9	34.3	51.8	15.1	30.0	-2.7	-1.3	6.3	-18.5	6.3
	(In percent of GDP)													
General government 2/														
Total revenues and grants	15.4	15.2	16.3	15.8	16.2	20.8	21.8	20.4	21.7	22.6	23.3	23.9	25.8	26.4
Tax revenues	13.8	14.2	14.3	14.4	14.5	17.6	18.2	18.0	18.1	18.6	19.1	19.6	20.1	20.6
Nontax revenues 3/	0.8	0.8	1.3	1.1	1.1	2.2	2.3	1.3	2.5	2.7	3.0	3.1	3.2	3.4
Grants	0.9	0.3	0.7	0.3	0.6	1.0	1.2	1.1	1.2	1.4	1.2	1.2	2.5	2.4
Expenditures and net lending	22.1	19.2	18.3	17.8	18.7	20.0	19.5	20.7	25.2	25.9	24.5	24.8	28.3	27.6
Current expenditure	20.0	18.2	16.5	15.7	17.0	17.6	17.1	17.9	19.7	20.9	21.6	22.2	24.5	24.0
non-interest	17.2	15.2	14.7	13.8	14.9	16.1	15.9	16.8	18.6	19.9	20.5	21.2	23.4	22.9
interest	2.8	3.0	1.8	2.0	2.1	1.5	1.2	1.1	1.0	1.0	1.1	1.0	1.1	1.1
Capital expenditure and net lending	2.1	1.0	1.8	2.0	1.7	2.4	2.4	2.8	5.5	5.0	2.9	2.6	3.8	3.6
Primary balance	-3.9	-1.1	-0.2	0.0	-0.4	2.3	3.5	0.8	-2.4	-2.2	-0.1	0.1	-1.4	-0.1
Overall balance (commitment basis)	-6.7	-4.0	-2.0	-2.0	-2.5	0.7	2.3	-0.3	-3.5	-3.3	-1.2	-0.9	-2.4	-1.2
Net change in expenditure arrears	...	1.4	0.2	-0.4	1.4	-2.6	-2.6	-1.6	-1.3	-0.5	0.0	0.0	0.0	0.0
Overall balance (cash basis)	-5.0	-2.6	-1.6	-1.9	-1.3	-1.8	-0.2	-1.9	-4.8	-3.7	-1.2	-0.9	-2.4	-1.2
Financing	5.0	2.6	1.6	1.9	1.3	1.8	0.2	1.9	4.8	3.7	1.2	0.9	2.4	1.2
Privatization	0.9	0.3	0.1	0.2	0.3	0.9	0.9	1.1	3.4	3.0	0.7	0.1	0.1	0.1
Domestic financing	2.3	2.2	-0.4	-0.1	0.6	0.1	-0.9	0.4	0.6	0.1	0.1	0.1	2.0	0.8
External financing (net)	1.7	0.0	1.9	1.8	1.0	0.8	0.2	0.4	0.8	0.6	0.4	0.7	0.3	0.3
Disbursements (incl. in-kind)	2.9	1.1	2.4	2.3	1.6	2.3	1.7	2.0	2.3	1.7	1.6	1.6	1.3	1.2
Amortization	-1.2	-1.1	-0.5	-0.5	-0.6	-1.4	-1.5	-1.6	-1.5	-0.9	-1.0	-0.7	-0.8	-0.7
Adjustment for Net Withheld Adjara Transfers 4/	…	…	…	…	-0.7	…	…	…	…	…	…	…	…	…
Saving and investment														
Investment	22.0	21.6	21.9	22.0	24.4	29.0	26.6	28.9	28.9	26.3	24.6	24.6	25.1	25.6
General government	2.1	1.0	1.8	2.0	1.7	2.4	2.4	2.8	5.5	5.0	2.9	2.6	3.8	3.6
Nongovernment sector 1/	19.9	20.6	20.1	20.0	22.7	26.6	24.2	26.1	23.4	21.3	21.7	22.0	21.4	22.0
Of which: FDI	2.2	5.0	2.5	3.8	8.4	9.0	9.7	7.9	11.6	5.0	2.3	2.3	2.4	2.5
Gross domestic saving	14.2	17.3	15.5	16.2	17.2	21.4	19.0	20.8	17.1	19.1	21.0	21.3	22.2	22.7
General government	-4.6	-3.0	-0.2	0.1	-0.7	3.1	4.7	2.5	2.0	1.7	1.7	1.7	1.3	2.4
Nongovernment sector	18.8	20.3	15.7	16.2	17.9	18.3	14.3	18.3	15.1	17.4	19.4	19.6	20.9	20.3
Current account deficit 1/	7.8	4.3	6.4	5.8	7.2	7.5	7.6	8.1	11.8	7.2	3.5	3.4	2.9	2.9
	(In millions of U.S. dollars; unless otherwise indicated)													
Gross official reserves of the NBG 5/	132	109	161	198	191	320	383	366	493	525	580	645	488	548
(In months of imports of non-pipeline goods and services)	1.3	1.0	1.4	1.8	1.5	1.9	2.0	1.9	2.0	2.1	2.2	2.3	2.0	2.1
(In months of imports of goods and services)	1.3	1.0	1.4	1.7	1.3	1.6	1.7	1.6	1.8	1.9	2.2	2.3	2.0	2.1
External debt, public and guaranteed														
External debt stock	1,691	1,560	1,655	1,776	1,849	1,796	1,858	1,769	1,852	1,840	1,841	1,844	1,824	1,726
External debt service, total	…	…	…	228	114	165	169	177	180	144	154	126	122	107
Memorandum items:														
Nominal GDP (in millions of lari)	5,665	6,013	6,638	7,448	8,565	9,758	9,951	10,809	11,660	12,978	14,172	15,475	16,738	18,104
Nominal GDP (in millions of US$)	2,803	3,042	3,201	3,392	3,984	4,879	5,183	5,843	6,303	7,002	7,494	8,021	7,211	7,644
External debt stock (public and guaranteed)/ GDP	60.3	51.3	51.7	52.4	46.4	36.8	35.8	30.3	29.4	26.3	24.6	23.0	25.3	22.6
Domestic public debt/GDP	16.7	18.5	16.7	15.1	15.3	11.0	11.2	8.8	8.4	7.5	7.1	6.7	8.4	8.6
Exchange rate, average (Lari/US$)	2.02	1.98	2.07	2.20	2.15	…	1.92	…	…	…	…	…	…	…
M3-velocity	n.a.	9.7	9.1	8.6	8.1	7.2	6.6	6.6	5.8	5.3	4.9	4.6	4.4	3.9
Social sector expenditures (percent of GDP)	n.a.	8.3	8.3	8.0	7.6	7.6	8.4	8.5	9.2	9.6	10.0	10.7	11.4	12.1
Social sector spending, cash basis (percent of GDP)	n.a.	6.9	8.2	8.3	7.1	9.5	9.8	9.0	9.7	10.1	10.0	10.7	11.4	12.1

Sources: Georgian authorities; and Fund staff estimates.

1/ Large oil and gas pipeline projects are projected to increase investment and the current account deficit substantially in 2003–06.
2/ For 2003, the classification of the new Budget Systems Law is used.
3/ The sustained increase in nontax revenues from 2006 onward reflects transit fees from the BTC oil pipeline and the South Caucasus gas pipeline.
4/ For 2003, deposits by the government of Adjara at commercial banks that reflect withheld tax revenues are excluded from net financing to the government.
5/ International reserves are reported at current exchange rates and may differ from reserves at program rates as reported in the monetary accounts.

Table 9. Georgia: Summary Medium-Term Balance of Payments, 2000–08 1/
(In million of U.S. dollars)

	2000	2001	2002	2003	2004		2005		2006	2007	2008
	Act.				Prog.	Prel.	Country Rep. No. 05/1	Proj.		Proj.	
Current account balance (including transfers) 1/	**-132**	**-205**	**-196**	**-286**	**-368**	**-394**	**-475**	**-742**	**-501**	**-266**	**-269**
Trade balance	-397	-486	-439	-598	-720	-751	-893	-1,235	-1,040	-886	-946
Exports (total)	584	473	553	730	1,063	1,264	1,159	1,386	1,509	1,630	1,728
Of which: extractive products	150	128	94	168	258	249	328	291	319	349	381
Imports (total)	-982	-959	-992	-1,328	-1,783	-2,016	-2,052	-2,620	-2,548	-2,516	-2,674
of which : Gas and oil pipeline	0	0	-12	-180	-250	-250	-259	-259	-156	0	0
Aid related imports	-20	-30	-61	-80	-90	-88	-166	-183	-179	-193	-198
Oil imports	-129	-150	-148	-204	-275	-271	-316	-347	-365	-375	-385
Other imports	-832	-778	-771	-864	-1168	-1406	-1310	-1831	-1849	-1948	-2091
Services and income (net)	58	54	53	42	8	-15	-19	9	15	62	95
Services (net)	114	97	106	103	62	58	27	58	103	149	170
Factor income (net)	-56	-43	-53	-61	-53	-73	-46	-49	-88	-87	-75
of which: Short-term workers compensation	14	18	21	21	20	18	21	19	20	22	23
of which: Interest (gross)	-50	-45	-42	-55	-41	-47	-38	-37	-39	-41	-42
Transfers (net)	207	226	190	269	344	372	437	483	523	558	582
Official transfers 2/	51	81	66	56	96	101	183	194	219	238	247
of which : General government	0	17	26	25	62	67	62	74	96	94	99
Other transfers	156	146	124	213	248	271	254	289	304	320	335
of which : Workers' remittances	77	78	72	166	197	205	209	218	230	241	252
Capital account	**67**	**115**	**106**	**276**	**456**	**566**	**476**	**788**	**490**	**339**	**368**
Public sector	-79	-47	-69	-36	-38	-43	-30	-4	17	47	73
Disbursements 2/	28	79	91	71	95	95	117	146	125	126	130
of which: World Bank	19	64	61	44	64	63	65	90	67	68	70
of which: Bilateral	3	12	17	21	28	29	46	43	50	49	51
Amortization	-107	-126	-160	-107	-133	-137	-146	-150	-108	-78	-58
Private sector	147	162	175	312	494	609	506	792	473	292	296
Foreign direct investment	153	80	122	335	438	503	464	731	350	171	188
of which : Gas and oil pipeline	0	0	15	240	280	280	324	324	195	0	0
Other private capital, net (incl. commercial banks) 3/	-6	83	53	-23	56	107	42	61	123	121	108
Overall Balance	**-65**	**-90**	**-90**	**-10**	**89**	**172**	**1**	**46**	**-11**	**73**	**99**
Financing	**65**	**90**	**90**	**10**	**-89**	**-172**	**-1**	**-45**	**11**	**-74**	**-99**
Use of Fund resources, net	-26	22	-1	-48	-13	-34	-13	8	-8	-18	-34
Purchases/disbursements	0	34	29	0	41	20	41	65	43	22	0
Repurchases/repayments	-26	-13	-30	-48	-54	-55	-54	-57	-51	-40	-34
Increase in reserves (-)	23	-52	-37	7	-130	-192	-45	-111	-31	-55	-65
Change in arrears (+, increase)	68	5	0	51	-52	-52	0	0	0	0	0
Debt relief 4/	0	114	128	0	106	106	57	57	50	0	0
Paris Club rescheduling	…	114	128	0	43	43	57	57	50	0	0
Rescheduling of arrears	…	0	0	0	63	63	0	0	0	0	0
Financing gap	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
Memorandum items											
Nominal GDP	3,044	3,201	3,392	3,984	4,879	5,183	5,843	6,303	7,002	7,494	8,021
Trade deficit, (percent of GDP)	13.0	15.2	12.9	15.0	14.8	14.5	15.3	19.6	14.8	11.8	11.8
Trade deficit, excl. pipeline-related imports, (percent pf GDP)	4.3	6.4	5.4	2.7	2.4	2.8	3.7	7.7	4.9	3.5	3.4
Current account deficit, incl transfers, (percent of GDP)	4.3	6.4	5.8	7.2	7.5	7.6	8.1	11.8	7.2	3.5	3.4
Current account deficit, excl. pipeline-related imports (percent of GDP)	4.3	6.4	5.4	2.7	2.4	2.8	3.7	7.7	4.9	3.5	3.4
Merchandise export growth (percent)	22.5	-19.1	16.9	32.1	45.5	73.1	9.0	9.6	8.9	8.0	6.0
of which : Volume growth	23.7	-15.2	15.3	29.5	42.9	70.1	6.8	7.6	8.2	7.4	5.4
Merchandise import growth (percent)	-3.1	-2.3	3.5	33.9	34.3	51.8	15.1	30.0	-2.7	-1.3	6.3
Nonpipeline-related merchandise import growth (percent)	-3.1	-2.3	2.2	17.2	35.1	53.8	16.9	33.7	1.3	5.2	6.3
of which : Volume growth	-3.9	1.2	-0.3	5.1	23.6	39.4	16.3	32.2	1.3	4.6	5.4
US dollars per barrel of oil	28.2	24.3	25.0	28.9	38.5	37.8	42.8	47.4	47.5	46.3	45.0
Net oil imports	104	123	131	180	242	239	278	304	320	329	338
Private transfers and labour income, receipts (percent of GDP)	5.9	5.5	4.8	6.6	5.5	6.4	4.7	5.6	5.3	5.2	5.1
Gross international reserves 5/	109	161	198	191	320	383	366	493	525	580	645
(In months of imports of goods and services)	1.0	1.4	1.7	1.3	1.6	1.7	1.6	1.8	1.9	2.1	2.2
(In months of imports of non-pipeline goods & services)	1.0	1.4	1.8	1.5	1.9	2.0	1.9	2.0	2.1	2.2	2.3
Public and publicly guaranteed external debt (nominal)	1,556	1,602	1,753	1,849	1,796	1,858	1,769	1,852	1,840	1,841	1,844
(In percent of GDP)	51.1	50.0	51.7	46.4	36.8	35.8	30.3	29.4	26.3	24.6	23.0
External assistance to general government	28	96	118	95	157	162	179	220	221	220	229
Debt service from the budget (cash)	148	48	37	59	102	105	118	118	88	110	88
(In percent of exports of goods and services)	13.5	4.9	3.6	4.5	5.9	5.4	6.3	5.5	3.8	4.4	3.3
Debt service PPG (cash)	181.3	185.3	73.8	114	165	169	177	180	144	154	126
Total external debt service (cash)	184.1	188.1	82.4	129	182	186	199	202	168	177	149

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 data prior to 2000.

2/ Incorporates projections of donor disbursements based on pledges at the donors' conference in Brussels, June 2004.

3/ Includes errors and omissions.

4/ Incorporates the agreement reached with the Paris Club creditors in July 2004 and assuming comparable treatment with non-Paris Club and commercial creditors. Under the agreement, half the external arrears accumulated to end-May and all current maturies from June 1 2004 to end-2006 are rescheduled on terms somewhat more generous than Houston terms. The remaining half of the accumulated arrears were also rescheduled, to be repaid over the 2004-2006.

5/ The figures differ from those in the monetary accounts because they reflect actual, rather than program, exchange rates.

Table 10. Georgia: External Financing Requirements and Sources, 2000–08

(In millions of U.S. dollars)

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Total requirements	**-265**	**-344**	**-387**	**-441**	**-586**	**-949**	**-660**	**-384**	**-361**
Current account deficit	-132	-205	-196	-286	-394	-742	-500	-265	-269
Capital outflows	-133	-139	-190	-155	-192	-207	-160	-119	-92
Scheduled public sector amortization 1/	-133	-139	-190	-155	-192	-207	-160	-119	-92
Total sources	**265**	**344**	**387**	**441**	**586**	**949**	**660**	**384**	**361**
Capital inflows	175	212	247	383	679	918	575	394	401
Foreign direct investment	153	80	122	335	503	731	350	171	188
Disbursements to public sector	28	49	72	71	70	126	102	102	106
Private sector net inflows 2/	-6	83	53	-23	107	61	123	121	108
Exceptional financing	**68**	**184**	**176**	**51**	**99**	**142**	**116**	**45**	**25**
IMF	0	34	29	0	20	65	43	22	0
World Bank	0	30	20	0	24	20	22	23	25
Macroeconomic support from the EU	0	0	0	0	0	0	0	0	0
Change in arrears, net (- decrease)	68	5	0	51	-52	0	0	0	0
Debt rescheduling obtained 3/	0	114	128	0	106	57	50	0	0
Change in reserves (- increase)	23	-52	-37	7	-192	-111	-31	-55	-65
Financing gap	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
Memorandum									
In percent of GDP									
Total requirements	-8.7	-10.7	-11.4	-11.1	-11.3	-15.1	-9.4	-5.1	-4.5
Total sources	8.7	10.7	11.4	11.1	11.3	15.1	9.4	5.1	4.5
Capital inflows	5.7	6.6	7.3	9.6	13.1	14.6	8.2	5.3	5.0
Exceptional financing	2.2	5.7	5.2	1.3	1.9	2.2	1.7	0.6	0.3
Change in reserves	0.8	-1.6	-1.1	0.2	-3.7	-1.8	-0.4	-0.7	-0.8

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 rescheduling of 2003 arrears in 2004 and of principal maturities falling due during 2004-06. Includes comparable treatment by non-Paris Club bilateral creditors.

Table 11. Indicators of Financial Obligations to the Fund, 2001–10
(In millions of SDR)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Total Fund credit outstanding	228.6	228.0	194.3	171.3	176.6	170.5	158.1	135.6	114.5	93.4
In percent of quota	152.1	151.7	129.3	114.0	117.5	113.4	105.2	90.2	76.2	62.2
In percent of GDP	9.1	8.7	6.8	4.9	4.3	3.8	3.3	2.6	2.1	1.6
In percent of exports of goods and non-factor services	23.5	22.2	14.7	8.7	8.2	7.3	6.3	5.1	4.0	3.1
Disbursements (PRGF)	27.0	22.5	0.0	14.0	42.0	28.0	14.0	0.0	0.0	0.0
Total obligations from existing and prospective drawings	14.8	25.0	35.3	38.1	37.6	35.2	27.5	23.4	21.9	21.8
Principal (repayments/repurchases)	12.0	23.1	33.8	37.0	36.7	34.1	26.4	22.5	21.0	21.1
Charges and interest	2.8	1.8	1.6	1.1	0.9	1.1	1.1	0.9	0.8	0.7
Total obligations to the Fund										
In percent of quota	9.9	16.6	23.5	25.4	25.0	23.4	18.3	15.6	14.5	14.5
In percent of GDP	0.5	0.7	0.9	0.7	0.6	0.5	0.4	0.3	0.3	0.2
In percent of exports of goods and non-factor services	1.9	3.2	3.7	2.9	2.7	2.3	1.7	1.3	1.2	1.1
Net credit from the Fund	15.0	-0.6	-33.8	-23.0	5.3	-6.1	-12.4	-22.5	-21.0	-21.1
Net resources from the Fund	12.2	-2.5	-35.3	-24.1	4.4	-7.2	-13.5	-23.4	-21.9	-21.8

Sources: Fund Finance Department and staff estimates and projections.

Table 12. Georgia: Energy Sector Quasi-Fiscal Losses, 2001–05

	2001	2002	2003	2004	2005 Proj.
Power sector					
Quantity delivered (million kWh) 1/	6085.5	6433.7	6669.8	7076.9	7761.9
Cost (US cents)	4.1	4.1	4.5	5.0	5.3
Tariff (US cents)	4.1	4.1	4.2	4.8	5.0
Collection rate (percent) 2/	19.7	35.0	52.4	48.0	64.8
Generation cost (US$ million)	247.7	263.5	298.6	357.0	408.9
Billed amount (US$ million)	247.7	263.5	277.9	339.0	387.2
Collected amount (US$ million)	48.8	92.2	145.6	162.7	250.8
Total losses (US$ million)	198.9	171.3	152.9	194.3	158.0
Of which: price effect (US$ million)	0.0	0.0	20.6	18.0	21.7
Of which: non-payment effect (US$ million)	198.9	171.3	132.3	176.3	136.3
Total losses (percent of GDP)	6.2	5.0	3.8	3.7	2.5
Gas sector					
Tbilgazi: total losses (US$ million)	...	15.6	24.9	28.8	33.4
Other consumers: total losses (US$ million)	...	15.0	16.8	19.4	21.2
Total losses (percent of GDP)	...	0.9	1.0	0.9	0.9
Energy sector (power + gas sector)					
Total losses (US$ million)	...	201.8	194.6	242.5	212.7
Total losses (percent of GDP)	...	6.0	4.9	4.7	3.4
GDP (US$ million)	3202	3392	3984	5183	6303

Source: Fund staff calculations and estimates, based on data provided by the authorities and energy-sector entities (GWEM, GSE, AES, Tbilgazi, and GGIC).

1/ Quantity produced domestically and net imports less normative losses (15 percent in 2002 and 2003, 9 percent in 2004 and 2005).
2/ UDC collection rate for 2002 are based on Fund staff estimates.

Table 13. Georgia: Millennium Development Goals, 1990–2003
(In percent, unless otherwise specified)

	1990	1995	2000	2003
1 Eradicate extreme poverty and hunger	2015 target = halve 1990 $1 a day poverty and malnutrition rate			
Population below US$1 a day	...	...	...	...
Poverty gap at US$1 a day	...	...	...	...
Share of income or consumption held by poorest 20 percent	...	...	6.4	...
Prevalence of child malnutrition (percent of children under 5)	...	...	3.1	...
Share of population below minimum level of dietary energy consumption	...	39	...	27
2 Achieve universal primary education	2015 target = net enrollment to 100			
Net primary enrollment ratio (percent of relevant age group)	97.1	...	95.2	88.7
Percentage of cohort reaching grade 5	...	...	...	...
Youth literacy rate (ages 15-24)	...	...	...	...
3 Promote gender equality	2005 target = education ratio to 100			
Ratio of girls to boys in primary and secondary education	98.2	99.4	100.9	99.7
Ratio of young literate females to males (ages 15-24)	...	...	...	...
Share of women employed in the nonagricultural sector	44.5	45.0	41.2	46.5
Proportion of seats held by women in national parliament	...	6	...	7
4 Reduce child mortality	2015 target = reduce 1990 under 5 mortality by two-thirds			
Under 5 mortality rate (per 1,000)	47	...	45	45
Infant mortality rate (per 1,000 live births)	43	41	41	41
Immunization, measles (percent of children under 12 months)	...	63	73	73
5 Improve maternal health	2015 target = reduce 1990 maternal mortality by three-fourths			
Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	22	32	...
Births attended by skilled health staff (percent of total)	...	...	96.4	...
6 Combat HIV/AIDS, malaria and other diseases	2015 target = halt, and begin to reverse, AIDS, etc.			
Prevalence of HIV, female (ages 15-24)	...	...	0.02	...
Contraceptive prevalence rate (of women ages 15-49)	...	...	40.5	...
Number of children orphaned by HIV/AIDS	...	...	...	...
Incidence of tuberculosis (per 100,000 people)	38.2	47.2	82.2	82.8
Tuberculosis cases detected under DOTS 1/	...	15	31	51.9
7 Ensure environmental sustainability	2015 target = various (see notes)			
Forest area (% of total land area)	43	...	...	...
Nationally protected areas (percent of total land area)	...	2.7	...	2.3
GDP per unit of energy use (PPP $ per kg oil equivalent)	1.2	1.6	3.4	4.4
CO2 emissions (metric tons per capita)	2.8	0.4	1.2	...
Access to an improved water source (percent of population)	...	...	...	76
Access to improved sanitation (percent of population)	...	...	...	83
Access to secure tenure (percent of population)	...	...	...	...
8 Develop a Global Partnership for Development	2015 target = various (see notes)			
Youth unemployment rate (percent of total labor force ages 15-24)	...	...	21.1	...
Fixed line and mobile telephones (per 1,000 people)	98.9	102.3	140.2	239.7
Personal computers (per 1,000 people)	...	...	22.3	31.6
General indicators				
Population (in millions)	5.4	5.1	4.5	4.4
Gross domestic product (US$ billion)	5.1	2.1	3.0	4.0
GDP per capita (US$)	940	410	692	927
Adult literacy rate (percent of people ages 15 and over)	...	...	...	...
Total fertility rate (births per woman)	2.2	1.4	1.1	1.1
Life expectancy at birth (years)	72.3	72.5	...	73.5
Public and publicly guaranteed external debt (percent of GDP)	...	64.1	51.3	46.4
Investment (percent of GDP)	29.1	23.9	21.6	24.4
Trade (percent of GDP) 2/	85.6	67.9	81.2	78.8

Sources: World Development Indicators database, April 2004; Georgian State Department for Statistics; and Fund staff estimates.

Note: In some cases the data are for earlier or later years than those stated. The goal targets are the following: Goal 1: Halve, between 1990 and 2015, the proportion of people whose income is less than US$1 a day. Halve, between 1990 and 2015, the proportion of people who suffer from hunger; Goal 2: Ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling; Goal 3: Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education no later than 2015; Goal 4: Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate; Goal 5 target: Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio; Goal 6: Have halted by 2015, and begun to reverse, the spread of HIV/AIDS. Have halted by 2015, and begun to reverse, the incidence of malaria and other major diseases; Goal 7: Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources. Halve, by 2015, the proportion of people without sustainable access to safe drinking water; Goal 8: Develop further an open, rule-based, predictable, non-discriminatory trading and financial system. Deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term. In cooperation with developing countries, develop and implement strategies for decent and productive work for youth. In cooperation with pharmaceutical companies, provide access to affordable, essential drugs in developing countries. In cooperation with the private sector, make available the benefits of new technologies, especially information and communications.

1/ Directly observed treatment, short-course case detection and treatment strategy (World Health Organization).

2/ Trade is calculated as the sum of imports and exports of goods and non-factor services relative to GDP.

GEORGIA: FUND RELATIONS

(As of May 31, 2005)

I. **Membership Status:** Georgia joined the Fund on May 5, 1992 and has Article VIII Status.

II. **General Resources Account:**	**SDR Million**	**Percent of Quota**
Quota	150.30	100.00
Fund holdings of currency	152.61	101.54
Reserve position in Fund	0.01	0.01

III. **SDR Department:**	**SDR Million**	**Percent of Allocation**
Holdings	1.02	N/A

IV. **Outstanding Purchases and Loans:**	**SDR Million**	**Percent of Quota**
PRGF Arrangements	165.75	110.28
Systemic transformation	2.31	1.54

V. **Latest Financial Arrangements:**

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn SDR Million)
PRGF	6/4/04	6/3/07	98.00	28.00
PRGF	1/12/01	1/11/04	108.00	49.50
PRGF	2/28/96	8/13/99	172.05	172.05

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

	Forthcoming				
	2005	**2006**	**2007**	**2008**	**2009**
Principal	19.52	33.44	25.94	22.11	17.96
Charges/interest	0.83	0.65	0.50	0.38	0.28
Total	20.35	34.08	26.43	22.49	18.24

VII. **Safeguards Assessments:**

Under the Fund's safeguards assessment policy, the National Bank of Georgia (NBG) is subject to an assessment with respect to the PRGF arrangement approved on June 4, 2004. The assessment was completed on December 10, 2004 and concluded that safeguards in place at the NBG appear generally adequate. However, certain vulnerabilities were identified in the internal audit and internal controls areas, and the safeguards assessment recommended measures to address them.

VIII. **Implementation of HIPC Initiative:**

Not applicable.

IX. **Exchange Arrangements:**

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 vis-à-vis the U.S. dollar. These auctions are conducted daily. Foreign exchange bureaus are allowed to buy and sell foreign currency bank notes. Georgia's exchange rate regime is classified as "managed floating."

X. **Article IV Consultation:**

The 2003 Article IV consultation was concluded on October 17, 2003.

XI. **FSAP Participation:**

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

XII. **Technical Assistance:**

See Table 1 of this Appendix.

XIII. **Resident Representative:**

The fifth resident representative, Mr. Christiansen, took up his post on August 1, 2004, replacing Mr. Dunn.

XIV. **National Bank of Georgia Resident Advisors:**

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 provided technical assistance on payment system issues on a peripatetic basis in 2002 and 2003. Mr. Howard C. Edmonds serves since September 2004 as a resident advisor on banking supervision issues.

XV. **Ministry of Finance Resident Advisors:**

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. A third, shorter visit took place in late 2003. In March 2005, Mr. Zohrab started advising the authorities on treasury-related reforms.

Table 1. Georgia: Fund Technical Assistance Missions, 2001–05

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
Public Expenditure Management	Assessment of Treasury System and implementation of Budget Systems Law	Sep. 29-Oct. 11, 2003	Ministry of Finance
Tax and Customs Administration	Assistance in taxation of excisable goods	Oct. 27-Nov. 13, 2003	Ministry of Finance
Tax Policy	Review of Tax Policy	June 8-21, 2004	Ministry of Finance
Public Expenditure Management	Assessment of Treasury system.	Nov. 8-23, 2004	Ministry of Finance
	Monetary and Financial Systems Department (MFD)		
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

Table 1. Georgia: Fund Technical Assistance Missions, 2001–05

Subject	Type of Mission	Timing	Counterpart
Accounting and Audit, Anti-Money Laundering, Bank Supervision, and Monetary Operations	Advisory	Sep. 24-Oct 9, 2002	National Bank of Georgia
Payment Systems	Advisory	June 16-20, 2003	National Bank of Georgia
Government Securities Market, Deposit Insurance, Anti-Money Laundering	Advisory	April 20-30, 2004	National Bank of Georgia
Monetary Operations, Banking Sector Competition	Advisory	Oct. 24-Nov. 5, 2004	National Bank of Georgia
Liquidity management; trends in securities and insurance sectors	Advisory	April 18-29, 2005	National Bank of Georgia
	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
Government Finance Statistics	Follow-up assistance	Nov. 5-18, 2003	State Department of Statistics, Ministry of Finance
National Accounts	Follow-up assistance	April 26-May 7, 2004	State Department of Statistics
National Accounts	Follow-up assistance	April 18-29, 2005	State Department of Statistics
Price Statistics	Follow-up assistance	May 23- June 3, 2005	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

A. Partnership in Georgia's Development Strategy

1. The government's PRSP was presented to the Boards of IDA and the IMF in October and November 2003. An interim lending and economic sector work program for FY04 and FY05 was presented to the IDA Board in the context of the Reform Support Credit (RSC) program document in June 2004. A Country Assistance Strategy for FY06-09 is expected to be discussed by the Board in May 2005.

2. The Fund 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) improving performance of the public sector; (iii) reducing corruption; (iv) deepening and diversifying sources of growth; (v) protecting the environment; and (vi) reducing poverty. Georgia is the second largest IDA borrower in the CIS, with borrowing of US$773 million for 37 operations. A range of instruments has been used to conduct the dialogue, including Structural Adjustment Credits. The most recent Adjustment Credit was the RSC which was approved last June, which supported urgent improvements in the areas of: (i) governance/ anti-corruption; (ii) public finance management; and (iii) energy sector bottlenecks. To deepen the assistance initiated with the RSC over the medium term, the first Poverty Reduction Support Credit (PRSC) is under preparation. Other support has come in the form of project support 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 Public Expenditure Review (PER) was prepared in 2002, and a Trade Study in 2003. The PER will be followed by a series of annual programmatic PERs, the first of which is under preparation. A Country Procurement Assessment Report (CPAR) was prepared in 2002 and a Country Financial Accountability Assessment (CFAA) in 2003.

3. Since Georgia joined IFC in 1995, it has committed $117 million of investments for eight projects. IFC has provided equity and credit to local and international companies, including investments by British Petroleum and other sponsors in the construction of the *Baku-Supsa Early Oil Pipeline* and the *Baku-Tbilisi-Ceyhan Pipeline.* IFC has also provided equity and long-term credit lines to TBC Bank and helped establish Georgia Microfinance Bank (now Procredit Bank). In the housing finance sector, IFC provided credit lines to the Bank of Georgia and TBC Bank for mortgage lending to residences and small and medium enterprises (SMEs). Other investment projects have been in electricity distribution (AES-Telasi), mineral water, and glass bottle production. IFC's Private Enterprise Partnership is implementing a technical assistance project to develop financial leasing, strengthen corporate governance practices, and assess the business environment for SMEs. The Foreign Investment Advisory Service (FIAS), a joint facility of IFC and the World Bank, carried out an Assessment of Administrative Procedures for Doing Business in 2003. FIAS finalized an

advisory project in July 2004 to assist the Government in its efforts to remove administrative obstacles to investment to improve the business environment for private businesses.

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, infrastructure, and judicial reform—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 development and energy, and Bank analysis serves as inputs into the Fund program. In other areas—the financial sector, public expenditure management, and civil service reform—both institutions have worked together. Finally, in areas like monetary policy and domestic customs revenue, the IMF takes the lead.

B. IMF-World Bank Collaboration in Specific Areas

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

5. In the **social sectors**, IDA updates Georgia's Poverty Assessment based on quarterly household data. IDA's focus has been to improve execution of budgetary expenditures for health, education and poverty benefits and to raise the efficiency in the use of scarce public resources. Through the Social Investment Fund credits, IDA is focusing in particular on areas with high poverty levels to provide basic infrastructure to the poorest communities. IDA is also supporting a dialogue with the government on social protection reform (safety nets, pensions, labor market institutions and policies).

6. In **education,** the Adaptable Program Credit addresses a broad spectrum of educational reform issues, aimed at improving learning outcomes of primary and secondary students through curriculum reform, development of a national assessment and examination system, training of teachers, provision of learning materials, and development of capacity to make better use of physical, financial, and human resources. It also tackles key financing issues through the introduction of a per capita based formula for financing basic education. While the investment needs of school buildings are substantially higher than is currently affordable, the Social Investment Fund projects continue to assist in financing urgent repairs to school facilities in many communities.

7. In **health**, IDA credits support the government in improving health care financing, exploring risk-pooling options, introducing a new system of primary health care, and improving the focus of publicly-funded services to the poor and on priority public health interventions. SAC III and the SRS Credit have supported hospital restructuring. In addition, IDA will be engaged in policy work in health sector reform in the context of the Medium-Term Expenditure Framework (MTEF) and the upcoming PRSC.

8. In **infrastructure,** support is being provided through the Secondary and Local Roads Project, the Municipal Development and Decentralization Project and the Social Investment Fund Project. These projects provide financing at the community level for critical infrastructure needs, primarily for school and health facility heating and repair, small

hydropower schemes to provide electricity, drinking water and sanitation rehabilitation, as well as transportation infrastructure rehabilitation. IFC supported the privatization of Tbilisi electricity distribution through an investment in AES-Telasi, and IFC Advisory Services advised the Government on the management contract for UDC.

9. In **rural development**, IDA credits have supported development of private sector farming and agro-processing improvements, agricultural credit, irrigation and drainage, and agricultural research. IDA credits have also been supporting creation of local institutions, such as rural credit unions and water users associations. A Rural Development Project is under preparation.

10. A **Judicial Reform** Project has provided funds for development of new court administration and case management procedures, rehabilitation and construction of courthouses, a computerized network system, assistance for judicial training, and an extensive public information and education outreach effort to inform citizens of their rights and communicate the government's reform efforts.

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 III and the recent RSC. Institution building and technical assistance have been supported through the Structural Reform Support Project. The Bank also leads in the areas of:

a) **Energy**. The energy system is in poor condition, with unreliable supply, massive non-payment and unsustainable debts. IDA has been working with other donors, including the Fund, to introduce more private management and ownership, and to implement a series of short-term action plans and longer-term steps to improve the overall functioning of the sector. IDA has also provided additional funding to the power sector in 2004. The Fund has been focusing on reducing quasi-fiscal losses in the sector, especially through improved bill collections, while the pursuit of tariff policies at cost-recovery levels would be facilitated by a Bank-assisted review of the tariff policy methodology. The RSC supported a Strategic Action Plan for the Energy Sector.

b) **Public Sector Management**. The proposed PRSC would support, inter alia, administrative and civil service reform, improvements in public expenditure management and strengthening financial accountability. The proposed Public Sector Management Reform Project would provide technical assistance and capacity building in the first three areas. The Fund is providing technical assistance in support of tax and customs administration reform.

c) **Municipal Finance:** The Municipal Development and Decentralization Project II has been assisting the government to review the current intergovernmental fiscal relation, and to suggest an equalization transfer system to compensate for horizontal fiscal disparities across local governments.

Areas of shared responsibility

12. The Bank and the Fund have been working jointly in the following main areas (supported by the Bank's RSC, SAC III and SRS Credits, several investment operations, and the Fund's PRGF—further assistance is anticipated from IDA's PRSC):

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 donor coordination.

b) **Budget Planning and Execution.** The annual programmatic Public Expenditure Reviews and the proposed PRSC will provide the underpinnings for systemic changes in expenditure management and improvements in financial accountability. The Fund 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) consolidation of banks through higher capital requirement ratios; (iv) anti money-laundering legislation; (v) strengthening the regulatory environment and removing impediments for development of viable non-bank financial institutions; and (vi) strengthening the payment system. IFC has worked to strengthen the banking sector through investment and technical assistance, and has supported the development of the financial leasing market through technical assistance. The Fund has focused on banking supervision, anti-money laundering legislation, and improvements in monetary control instruments with extensive technical assistance from its Monetary and Financial Systems Department.

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

a) **Fiscal Framework and reforms in tax policy and tax and customs administration**. The Fund's focus on prudent fiscal policy has served as an important framework for IDA's work on public expenditure management. The Fund's Fiscal Affairs Department is now taking the lead in the areas of tax policy and tax and customs administration reform.

b) **Economic Statistics.** IMF technical assistance has been conducive to improvements in national accounts, price, monetary and government financial statistics. The Bank's grant on Statistical Capacity Building will build on the recommendations of Fund TA to strengthen the quality of national accounts statistics.

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

a) **Monetary Framework**. The IMF collaborates closely with the NBG in the design and implementation of a monetary program that aims at rebuilding international reserves while keeping inflation low and remonetizing the economy.

C. World Bank Group Strategy

13. The IDA Board recently approved a US$24 million Reform Support Credit, a US$20 million Secondary and Local Roads Project, and a US$3.6 million Electricity Market Support Project. The Bank continues its discussion with the government on a more comprehensive medium-term reform strategy that would be supported by a series of Poverty Reduction Support Credits and technical assistance operations such as the Public Sector Management Reform Program.

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	*IMF:* PRGF performance criteria and benchmarks on monetary and fiscal targets. *IDA:* Macromonitoring*;* Trade and Transport Facilitation Project; Financial Sector Advisory Work; Policy Options Report; Reform Support Credit
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	*IMF:* PRGF performance criteria on overall fiscal balance and revenue collection. *Bank:* Programmatic Public Expenditure Review; Support for PRSP Updates; Policy Options Report; Reform Support Credit
Public Sector Reform	Public asset management, audit of 3 problematic state-owned enterprises	Civil service reform (including pay and employment reform), anti-corruption agenda, decentralization	*IMF:* PRGF *IDA*: Public Sector Management Program; 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	*IMF:* PRGF *IDA*: Support through IDA Credits for Education, Health and Social Investment Funds, Programmatic Poverty Assessment, SRS support for hospital restructuring, Pensions and Social Assistance Note, Policy work in health sector reform under the MTEF and PRSC.
Private Sector Development		*Costs of Doing Business* Surveys. Support for improved legislation and regulatory framework for private sector	*IDA:* Business Environment Study, Integrated Trade Development Strategy, Labor Market Study,; Reform Support Credit. *IFC:* investments and technical assistance.
Infrastructure		Private sector participation in infrastructure	*IDA*: Support though ongoing and proposed IDA Credits for Municipal Development, Roads, and Transport. *IFC:* investments and advisory services.
Energy		Reforms and sector improvements	*IDA:* Support through ongoing credits for Power, Energy Transit, technical assistance, and joint donor policy

		dialogue.
Rural development	Reforms in agriculture, irrigation, forestry and, environment	*IDA:* Support though Rural Infra-structure and Water Resource studies; ongoing rural Credits, and proposed Credits for Rural Development, Rural Telecommunications, Community Based Tourism.

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 finance statistics, the quality of macroeconomic statistics remains poor, reflecting deficiencies in statistical methodologies, coverage, and availability of resources. Problems are particularly acute in the compilation of national accounts, balance of payments, foreign trade, and fiscal statistics. Nonetheless, the core statistical indicators compiled by the authorities are provided on a timely basis and are adequate to enable staff to monitor macroeconomic developments under the program. In July 2002, Georgia participated in the data module of the Report on the Observance of Standards and Codes (ROSC), which was conducted by the IMF's Statistics Department (STA). Although, in general, the authorities have indicated an interest in participating in the IMF's General Data Dissemination System (GDDS), no official notification expressing commitment to the GDDS has been received and no coordinator appointed as yet.

Real Sector

2. 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. The State Department of Statistics (SDS) is discontinuing the issuance of flash estimates one month after the observation period, which were considered as unreliable. Preliminary estimates are available after four months, and a final estimate after 13 months. The data ROSC mission found that data sources used for the compilation of national accounts statistics were inadequate. The coverage of the business register is not comprehensive because of the lack of economic census data. The coverage of units in terms of value added 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 nonobserved 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 are the compilation of the constant price estimates as well as the assessment and validation of source data. Given the sizeable infrastructure investment underway, technical assistance will need to focus on refining statistical coverage of such projects. A technical assistance mission in national accounts in April/May 2004 concluded that the SDS data are generally sound, but proposed a number of improvements in the estimation of national accounts from the expenditure side. A follow-up mission in April 2005 identified a problem related to the volume measure of taxes on products, and GDP data for 2004 were revised in light of the mission's recommendations.

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 National Bank of Georgia (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 data 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 broadly follows the analytic framework of *GFSM 1986*, but the concepts and definitions of revenue, expenditure, and financing differ from the international standard in 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 system. The single-entry system hampers the treasury's capacity to reconcile bank statements and hinders the reporting of information on accounts payable. Another statistical issue concerns the limited budget classifications available for expenditure. Discrepancies can 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 could improve once the treasury adopts internationally accepted accounting standards, including a unified treasury general ledger that is maintained on a double-entry cash basis. There are substantial differences in the classification systems of different government subsectors. Bridge tables linking national classification codes and *GFSM 2001* codes were established by a GFS mission in 2003 and were used in 2004 in reporting GFS for use in the GFS Yearbook. In accordance with recommendations of the 2003 GFS mission, a migration path leading more fully to data compilation in accordance with *GFSM 2001* needs to be approved soon.

Balance of Payments

5. The authorities have started to implement the recommendations of the previous technical assistance missions (February 2002 and May 2003) and of the 2002 data ROSC mission. In particular, the SDS is now using "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, SDS has made little progress, if any, on improving staffing arrangements since the Data ROSC mission. The May 2003 mission focused on identifying new data sources and made arrangements for the provision of additional information for compilation of the balance of payments. 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 reserve assets and other assets and liabilities of the NBG and recommended corrective actions. A follow-up mission arrived in Tbilisi on June 15, 2005.

Georgia: Table of Common Indicators Required for Surveillance

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]	Memo Items: Data Quality – Methodological soundness[7]	Memo Items: Data Quality – Accuracy and reliability[8]
Exchange Rates	6/9/05	6/13/05	D	W	M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	6/9/05	6/13/05	D	W	M		
Reserve/Base Money	5/05	6/6/05	M	M	M	O	O
Broad Money	4/05	5/15/05	M	M	M	O	O
Central Bank Balance Sheet	5/05	6/6/05	M	M	M	O	O
Consolidated Balance Sheet of the Banking System	4/05	5/15/05	M	M	M	O	O
Interest Rates[2]	4/16/05	5/15/05	W	W	M		
Consumer Price Index	5/05	6/6/05	M	M	M	O	LNO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	4/05	5/21/05	M	M	M	LO	LO
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	4/05	5/21/05	M	M	M	LNO	LO
Stocks of Central Government and Central Government-Guaranteed Debt[5]	5/05	6/6/05	M	M	M Domestic not disseminated		
External Current Account Balance	Q4/04	3/13/05	Q	Q	Q	LO	LNO
Exports and Imports of Goods and Services	4/05	6/13/05	M	M	M	LO	LNO
GDP/GNP	Q1/05	5/18/05	Q	Q	Q	LO	LNO
Gross External Debt	5/05	6/6/05	M	M	M		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).
[7] Reflects the assessment provided in the data ROSC (published on May 14. 2003, and based on the findings of the mission that took place during July 15 – 31, 2002) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[8] Same as footnote 8, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

July 2, 2005

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
700 19th Street N.W.
Washington, D.C. 20431

Dear Mr. de Rato:

The attached Memorandum of Economic and Financial Policies (MEFP) describes the 2005 policies supported by the International Monetary Fund as Trustee under a three-year Poverty Reduction and Growth Facility (PRGF) arrangement. The memorandum proposes performance criteria for end-September 2005 and outlines our broad macroeconomic objectives and policies for 2005. These policies are consistent with our Economic Development and Poverty Reduction Program (EDPRP), presented to the IMF and World Bank in October 2003. We completed an Annual Progress Report of our EDPRP in January 2005.

The Government of Georgia believes that the policies set forth in the attached memorandum are adequate to achieve the objectives of the program, but it will take any other measures that may become appropriate for this purpose. The government will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultation. We request hereby the completion of the second review under the PRGF arrangement and in this connection, we request a waiver for nonobservance of the end-December 2004 structural performance criterion on securing parliamentary approval for certain amendments to the Budget Systems Law, which was delayed owing to a particularly heavy legislative agenda. We also propose the conversion of reserve money from an indicative target into a performance criterion with effect from the third review, and the deletion of the performance criterion on net domestic assets of the National Bank of Georgia; for the future, we will measure net domestic assets as an indicative target. Georgia will conduct discussions with the Fund for the third review of its program under the PRGF arrangement before the end of 2005.

Sincerely yours,

/s/

Zurab Nogaideli
Prime Minister

/s/	/s/
Roman Gotsiridze	Aleksi Aleksishvili
President of the National Bank of Georgia	Minister of Finance

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

A. Introduction

1. The Government's economic program for 2004–2006, which is supported by the PRGF arrangement approved by the IMF Executive Board in June 2004, aims to achieve sustained, rapid, and equitable economic growth in an environment of low inflation. This Memorandum of Economic and Financial Policies reviews progress to date in the implementation of the program and describes our broad economic strategy through end-2005.

B. Recent Developments and Performance

2. The government's economic policies have strengthened macroeconomic fundamentals and improved growth prospects. Despite a bad harvest, real GDP increased by 6.2 percent in 2004, driven by buoyant activity in the manufacturing sector, as well as the inclusion of previously unrecorded activities. End period inflation for 2004 was 7.5 percent, compared with the program projection of around 5 percent, owing mainly to an overrun in liquidity growth. Other contributing factors included a weather-related increase in foodstuff prices, a rise in international oil prices, and anticipations of an increase in cigarette and liquor prices ahead of the hike in their excise tax rates from January 2005. As of end-May 2005, 12-month inflation increased further to 9 percent. Gross official foreign reserves increased to US$453 million as of end-May, equivalent to 2 months of non-pipeline imports.

3. All quantitative performance criteria for end-December 2004 were met. However, we missed the end-December indicative target for reserve money. Implementation of monetary policy was complicated by large capital inflows during the year, prompted by a rebound in investor confidence and significant strides towards legalization of the informal economy. In these circumstances, the National Bank of Georgia (NBG) conducted sizable, largely unsterilized intervention, while allowing greater exchange rate flexibility. During the year, the lari appreciated by 13½ percent against the U.S. dollar and in real effective terms. In the first quarter of this year, it appreciated a further 3 percent in real effective terms.

4. Owing to a particularly heavy legislative agenda towards the end of 2004, we were not able to secure timely parliamentary approval of all envisaged amendments to the Budget Systems Law. However, amendments to the Constitution according to which the Budget Systems Law will be upgraded to an organic law have been submitted to the Parliament for consideration, and a vote on these amendments is expected by September 2005. In light of progress made in tackling this issue, we request a waiver for nonobservance of this December 2004 performance criterion.

5. Fiscal consolidation, supported by decisive efforts to reduce tax evasion and improve expenditure management, is at the heart of our economic program. Thus far, the results have been particularly encouraging. Tax revenue of the general government increased by 49.9 percent year-on-year during 2004, well in excess of expectations. The supplementary budgets passed by parliament in August and December 2004 recognized these achievements. The

2004 commitments surplus amounted to 2.3 percent of GDP (compared with the original deficit target of 1.6 percent in the program) and the cash deficit to 0.2 percent (versus the original deficit of 2.6 percent). Tax receipts were 18.2 percent of GDP, up from our original projection of 16.3 percent. Much of this over-performance was used to accelerate clearance of arrears, with the result that we reduced domestic arrears by GEL 259 million (2.6 percent of GDP) versus the original objective of GEL 93 million.

6. A major drive to strengthen tax and customs administration played a key role in our improved fiscal performance. We bolstered tax administration by reorganizing the Tax Department, strengthening the Large Taxpayer Inspectorate, and establishing an Excise Tax Inspectorate and the Financial Police. In addition, customs administration has improved significantly as a result of efforts to curtail smuggling by modernizing border checkpoints and procedures, and reorganizing the central and regional structure of the customs department.

7. The tax reform approved by parliament in December 2004 represents an important step toward making the tax system more equitable and creating a more favorable business climate. The number of taxes was reduced from 21 to 8, the rates of the VAT (effective from July 1, 2005) and payroll taxes were cut, and the flat 12 percent personal income tax rate replaced marginal rates ranging from 12 to 20 percent. To offset the revenue loss from the tax cuts, excise tax rates were raised, several exemptions were abolished and efforts to improve revenue administration are being intensified. Moreover, a one-time write-off of any undeclared taxes outstanding as of January 1, 2004 was approved by parliament in December and should enhance tax compliance.

8. In the area of public expenditure management, significant progress has been made toward establishing a full treasury single account (TSA) system, including the introduction of a Treasury Single Revenue Account (TSRA). We have continued to improve budgetary design and execution under the Budget Systems Law that took effect in January 2004. In particular, we have taken important steps towards performance-oriented budgeting, increased transparency in the budget process and abolished two major extra-budgetary funds. We have also introduced a new system for tax refunds (especially for the VAT) that allows for timelier processing of claims. Moreover, we are improving the medium-term budgetary framework, with emphasis on full integration with our poverty alleviation goals and development of a Medium-Term Expenditure Framework (MTEF) in conjunction with our Basic Data and Directions (BDD) document that should help allocate expenditure to strategic priorities and underpin fiscal consolidation.

9. In 2004, the NBG continued strengthening supervision policy and rationalizing the banking sector. The licenses of three commercial banks were revoked, thereby reducing the number of banks from 24 to 21. The NBG's decision to increase the minimum capital requirement contributed to consolidation in the banking sector. There has been increased interest of foreign direct investment in Georgian banks.

10. The recent surge in international oil prices is estimated to have cost Georgia about 1.0 percent of GDP on a net basis in 2004 compared with the original program forecast. Nevertheless, the external current account deficit was 7.6 percent of GDP in 2004, versus the original forecast of 9.6 percent. This outturn reflects higher private transfers and a somewhat strengthened trade balance. Private capital inflows have been significantly higher than expected, mainly due to increased business confidence and legalization of the economy.

11. We have made good progress in the area of structural reform. Most structural performance criteria and benchmarks for 2004 envisaged in the program have been met. By strengthening payment discipline for key customers, especially outside Tbilisi, we have reduced the quasi-fiscal deficit in the energy sector to an estimated 4½ percent of GDP in 2004 from 5 percent in 2003. In the area of civil service reform, government employment was reduced by some 30,000 positions in 2004. The savings in the wage bill financed increased remuneration in the corresponding line ministries, including a phased increase in the civil service minimum wage to GEL 115 a month (about US$65) in the course of 2004. A Civil Service Council responsible for coordinating and overseeing civil service reform was established in August 2004 and regulations defining the mandate of the Council and its implementing arm (the Civil Service Bureau) were approved in October.

12. Georgia made important steps towards combating money laundering. In particular, we ratified the Strasbourg Convention, adopted the Law "On Facilitating the Prevention of Illicit Income Legalization" (in force since January 2004) and established the Financial Monitoring Service (FMS) at the NBG. The FMS became a member of the Egmont Group in June 2004. The Service conducts its activities in close cooperation with MONEYVAL and in accordance with Financial Action Task Force (FATF) recommendations and EU directives.

C. Economic Policies for 2005

13. The government is determined to enhance macroeconomic stability and intensify structural reforms aimed at improving living standards in a low-inflation environment. We view 2005 as a crucial window of opportunity to consolidate reforms and further enhance the effectiveness and efficiency of government, building on the important initiatives launched last year.

14. We have recently completed the Economic Development and Poverty Reduction Program (EDPRP) Progress Report in consultation with civil society and donors and submitted it to the Executive Boards of the IMF and the World Bank. We will continue to strengthen the links between our poverty reduction strategy and the budgetary process through the preparation of our BDD and MTEF, including individual strategies of line ministries. The EDPRP process inspired the government to begin compiling several strategic documents that have been developed for different purposes in recent years into one overarching strategy document called Government's Medium-Term Action Priorities. In this respect, such key papers as EDPRP, Individual Partnership Action Plan (IPAP) for joining NATO, and EU Neighborhood Policy Paper are being carefully analyzed and on their basis,

State Objectives and Priority Directions are outlined covering political, social and economic spheres.

15. The economic program for 2005 targets real GDP growth of 8.5 percent and end-period consumer price inflation of 7 percent, while gross reserves would remain at 2 months of non-pipeline imports. Reflecting the rise in imports associated with higher government spending and FDI as well as higher international oil prices, the external current account deficit is projected to rise from an estimated 7.6 percent of GDP in 2004 to 12 percent in 2005. We have set quantitative performance criteria for end-September 2005 and indicative targets for end-December 2005. We have also established structural performance criteria and benchmarks through December reflecting the government's reform priorities (Tables 1 and 2). In the structural area, we will take further significant steps to eliminate bottlenecks and secure efficiency gains in order to enhance growth prospects. Our immediate priorities are to (a) further strengthen the financial system and fiscal institutions; (b) improve the physical and financial performance of the energy sector; and (c) create an environment conducive to sustained, private-sector growth, including through regulatory and legal reforms, and an ambitious privatization program.

16. The availability of resources from asset sales and the U.S. Millennium Challenge Account (MCA) creates an opportunity to expand priority spending. Nonetheless, it also requires skilful fiscal and monetary management, combined with the elimination of structural rigidities, to keep inflation in check and maintain external competitiveness. Specifically, we have secured GEL 170 million (1.5 percent of GDP) in proceeds from the sale of a shipping company, and we expect to secure an additional GEL 230 million (2 percent of GDP) from the privatization of a mining complex and a hydroelectric plant. Further, we are actively embarked on divestiture of additional public assets that could fetch up to US$500 million in 2005-07. Agreement on the level of resources available from the MCA is expected by mid-2005 and any receipts under this program, as well as further privatization proceeds, will be incorporated into the macroeconomic framework to be formulated at the time of the third review under the PRGF arrangement.

17. Against this backdrop, the NBG has tightened monetary policy and will carefully manage liquidity while continuing to aim for greater exchange rate flexibility. Moreover, the fiscal authorities have cast the augmented spending envelope into the MTEF for 2006-2009, which is geared to fiscal sustainability and accompanied by a performance-oriented budget. The BDD and MTEF will help guide expenditures to formalized strategic priorities, including poverty alleviation, infrastructural needs, and defense.

D. Fiscal Policy

18. The 2005 budget law (including the first and second amendments) limits the commitments deficit of the general government to 3.5 percent of GDP and the cash deficit to 4.8 percent (the difference reflects the clearance of the bulk of expenditure arrears accumulated under the previous administration). These increased expenditures will be financed largely by privatization proceeds, and will only be executed as the anticipated

privatization proceeds are realized. Two-thirds of the additional outlays would finance imported goods and services. While we recognize that the fiscal deficit is high, we believe it is essential for both strategic and economic reasons. The increase in defense spending will allow us to achieve the critical foreign policy objective of joining NATO. Rehabilitation of the energy and road networks is an essential part of our strategy to improve the business climate. Medium-term fiscal sustainability will not be jeopardized, as the bulk of the additional spending is non-recurrent, and the financing would not increase debt.

19. We will continue to upgrade the legal and institutional framework for tax and customs administration, public financial management and treasury operations, building on the important innovations introduced in 2004. In addition, the Customs Department will continue with its administrative reorganization and will prepare for the introduction of the new customs code, which will be submitted to parliament by end-September 2005. The new customs code will achieve harmonization with international conventions and with EU and neighboring country legislation. The new code will consolidate all trade and customs legislation into a single code, thereby improving transparency. The code will cover, inter alia, customs powers; enforcement; offenses and penalties; exemptions; and appeals functions.

20. We are now working closely with our development partners to determine more precisely the timing and conditions for the disbursements of the funds pledged at the donors' meeting in June 2004. Discussions with both Paris Club and non-Paris Club creditors on bilateral debt rescheduling agreements, building on the July 2004 Paris Club debt rescheduling, are well underway. We plan to finalize agreements with bilateral creditors in 2005.

21. The establishment of the full TSA system will continue to be a dominating concern of the Ministry of Finance this year. With the introduction of the TSRA, the zero-balance transit accounts at the NBG have been closed and a new coding system has been launched for revenue collections. The next important components of the reform will be merging the central and regional treasuries expenditure accounts held at the NBG and at the commercial banks; and establishing the Single Treasury Account for both revenue and expenditure transactions. The Ministry of Finance intends to implement the full TSA by end-2005. We will introduce a new budget classification compliant with GSFM 2001. The new functional classification will be introduced for the purposes of the 2006 budget and the economic classification for the 2007 budget. Finally, we have started working on a public sector accounting reform with the ultimate goal of introducing international accounting standards.

E. Monetary Policy

22. A disciplined monetary program that features a flexible exchange rate regime is central to our macroeconomic strategy for 2005 and beyond. It is based on conservative assumptions on velocity and the money multiplier and targets end-year inflation at 7 percent. Reserve money growth would thus be limited to 26 percent, consistent with broad money growth of 32 percent and maintaining foreign reserves at about two months of imports. We

are well aware that inflationary pressures increased during the first five months of 2005. Accordingly, and recognizing the central role of monetary discipline in realizing our macroeconomic objectives, we propose the introduction of a performance criterion on reserve money. To enhance monetary control, the NBG will limit its foreign exchange intervention to smoothing fluctuations.

23. The NBG will intensify its efforts to strengthen banking supervision, foster competition in the financial system, and upgrade its banking supervisory policy and practices to the Basel Core Principles for Effective Banking Supervision. In this vein, it will align consolidated supervision and legal lending limits for insiders with international standards. Also, *Fit and Proper* criteria for banking will be brought up to international standards by submitting revisions to the Law on Activities of Commercial Banks and amending the Decree on the Fit and Proper Test. In addition, the NBG will improve financial sector transparency by publishing standardized quarterly bank financial statements on its website. Further, the NBG will fully implement the recommendations of the 2004 Safeguards Assessment Report of the IMF's Finance Department, particularly by formally documenting all its internal control processes, including key operating policies and procedures. The government and the NBG will work to secure a further increase in the capital of the NBG.

24. Georgia plans to strengthen its diligence towards combating money laundering and terrorism financing. More specifically, there will be accepted measures for further development of the FMS, improvement and harmonization of legislation with international standards, arrangement of advanced training programs for staff of the FMS, and other monitoring entities and supervisory bodies.

F. Structural Reform

25. Structural reforms under the program will be geared toward the overarching objectives of enhancing growth prospects and improving living standards. We will also continue to focus on key areas underpinning fiscal consolidation (such as energy sector reforms, further steps to strengthen tax administration and expenditure management, and civil service reforms), as well as on deepening financial sector reforms and trade liberalization.

Business Climate

26. To improve growth prospects and the business climate, the government will streamline its operations and reduce its intervention in the economy. To that end, it has started to implement economic reforms by (i) conducting significant SOE privatization and improvements in the efficiency and accountability of those enterprises remaining in the public domain; (ii) implementing institutional deregulation of economy; and (iii) creating a professional and well-remunerated civil service. We have also submitted draft legislation to parliament aimed at completing the privatization of arable, perennial and other agricultural lands. A main focal point for improving the business climate is simplifying the regulatory environment. Whereas previously the government issued more then 900 licenses and permits,

we have recently proposed legislation that will: (i) dramatically reduce the number of licenses and permits (at least by 80 percent); (ii) provide a "one-stop" and "silence is consent" system for individuals and businesses seeking licenses; (iii) create a new legal and institutional base for technical regulation; and (iv) liberalize the certification system.

27. As one of the important elements of the improvement of the business climate, the government is considering an opportunity to invite rating agencies to conduct first-time sovereign credit rating for Georgia. We are confident that this will facilitate further development of the banking, corporate and public sectors.

28. Enhanced transparency is an important tool to reduce opportunities for corruption. In 2005, we will actively participate in several international initiatives aimed at promoting transparency. Georgia already is a pilot country in the G-8 Transparency Initiative launched last year, which seeks to strengthen domestic institutions and enhance transparency and accountability in public financial management. In preparation for the significant increase in oil and gas transit fees we expect to receive after completion of the Baku-Tbilisi-Ceyhan and the South Caucasus Pipelines, we will join the Extractive Industries Transparency Initiative (EITI) and publish for 2004 oil and gas transit revenues, as a first step toward annual disclosure of this information. We are also striving to meet the requirements for subscription to the IMF's General Data Dissemination System in 2005.

29. An overview of decentralized reforms and staff retrenchments in 2004 prepared by the Civil Service Bureau will provide background information for a comprehensive, multi-year civil service reform to be developed with help from the World Bank and other donors. At the same time, and in conjunction with the MTEF mentioned above, line ministries will prepare mission statements and activity forecasts that will guide the design of optimal staffing levels and the corresponding retrenchments.

Energy sector

30. The overarching goal of energy sector reforms is to achieve reliable supplies of electricity and to eliminate the quasi-fiscal deficit in the energy sector by end-2006. The State Budget has allocated GEL 195 million to the energy sector in 2005. We intend to conduct the overdue repairs of the key Enguri power plant in spring 2006. Stricter enforcement of payments discipline, aided by a rapid extension of metering to rural areas, should reduce the sector's quasi-fiscal losses to 3½ percent in 2005, from an estimated 4½ percent last year. One of the main strategic tasks of the sector reforms is to carry out an effective privatization process in a transparent and competitive manner. In this regard it will be a priority to sell United Distribution Company (UDC) and JSC "Adjara Energy Company."

Trade liberalization

31. The government is committed to an open trade regime conducive to Georgia's integration in the world economy. Under the terms of accession agreed with the World Trade Organization, the number of tariff bands was reduced from 21 to 16 as of January 1, 2005. A draft strategy of the trade reform is being elaborated by the Ministry of Economic Development. The reform aims at reducing the number of import tariff bands and reducing the maximum import tariff rate, which is currently 30 percent. The draft will be submitted to the government agencies for further discussion by July, 2005. Draft enabling legislation needed to implement these changes is expected to be ready by end-September 2005, and parliamentary approval will be sought in time for making these measures effective from January 1, 2006.

G. Poverty alleviation

32. To assist households living in extreme poverty, we have increased the minimum pension to GEL 28 per month (equivalent to about US$15) beginning January 1, 2005. Additionally, we are preparing a targeted poverty alleviation program. The key principle of the reform is that social assistance will no longer be oriented to certain categories of the population (e.g., single pensioners, disabled, war veterans, and IDPs). Social assistance will give relief to all households living below the extreme poverty line. Cash benefits for households below the poverty line shall be determined in accordance to the current level of living conditions and family size. The state will complement the income of households at least to the level of the extreme poverty line. The main outcome indicator will be that at least 60 percent of those identified as extremely poor will be covered by the program. We are also continuing to work on the design of a long-term pension reform.

H. Program monitoring

33. Completion of the third review under the PRGF arrangement, scheduled for December 2005, will require observance of the performance criteria for end-September 2005 shown in Table 1. The review will focus on progress in lowering inflation without unduly sacrificing external competitiveness, observing the fiscal targets of the general government and reducing energy sector quasi-fiscal deficits. It will also take stock of ongoing and planned steps to add momentum to structural reforms, especially in the areas of energy, public sector operations, the business climate, and trade liberalization.

Table 1. Georgia: 2005 Quantitative Performance Criteria and Indicative Targets 1/

	Stocks 2/	Cumulative Change from End-December 2004			
	End-Dec. 2004	Mar. 2005	Jun. 2005	Sep. 2005	Dec. 2005
	Actuals	Prelim.	Program Estimates	Performance Criteria	Indicative Targets
			(In millions of lari)		
1. Quantitative targets 3/					
Floor on general govt. tax revenue	...	447.6	963.6	1565.2	2106.6
Ceiling on cash deficit of the general govt. 4/	...	-33.5	197.4	418.7	556.5
Ceiling on domestic expenditure arrears of the general govt.	...	-28.6	-60.6	-95.6	-149.2
Ceiling on net credit of the banking system to the general govt. (NCG)	739.2	-52.6	-1.5	16.1	67.0
Ceiling on reserve money	836.5	-27.4	33.7	134.7	217.5
			(In millions of U.S. dollars)		
Floor on total net international reserves (NIR) of the NBG	63.7	-2.4	15.3	69.3	101.8
Ceiling on contracting or guaranteeing of					
A. Nonconcessional medium- and long-term external debt	0.0	0.0	0.0	0.0	0.0
B. Short-term external debt (less than one year)	0.0	0.0	0.0	0.0	0.0
Ceiling on accumulation of external arrears	0.0	0.0	0.0	0.0	0.0
			(In millions of lari)		
2. Indicative target					
Ceiling on net domestic assets (NDA) of the NBG	718.7	-23.0	5.5	6.4	29.2
			(In millions of lari)		
3. Baseline assumption on external project financing 4/	...	25.7	95.7	175.6	270.1

Sources: Georgian authorities; and staff estimates.

1/ Section 1 of this table shows quantitative targets for 2005 based on cumulative changes from end-December 2004. The ceiling for the cash deficit of the government is adjusted, as indicated in footnote 4, for deviations from projected external financing, reported in Section 3 of the table. The indicative target is shown in Section 2. The continuous performance criterion for external arrears is defined in paragraph 21 of the July 2005 TMU.
2/ Outcomes reflect revaluations due to changed program exchange rate assumptions.
3/ Quantitative targets for 2005 are based on accounting exchange rates of GEL 1.85/US$, US$1.46/SDR, and US$1.21/EUR.
4/ The program target on the cash deficit is adjusted for deviations from projected disbursements of external project finance (Section 3) as specified in the July 2005 TMU, subject to a cap on the cumulative upward adjustment of GEL 100 million for 2005.

Table 2: Structural Performance Criteria (*) and Benchmarks for 2005

Measure	Date
1. Submit a new customs code to parliament, which incorporates FAD recommendations from November 2003 as described in paragraph 19 of the MEFP. (*)	End-September 2005
2. Prepare a Medium Term Expenditure Framework (MTEF) for 2006-09 as part of the Basic Data and Directions document as mandated under the Budget Systems Law. (*)	End-September 2005
3. Formulate an action plan to reduce significantly the number of regulatory bodies and licenses required by private firms, as described in paragraph 26 of MEFP.	End-September 2005
4. Publish 2004 oil and gas transit revenue according to international transparency standards, as a first step to annual publication of this data.	End-September 2005
5. Submit to parliament draft legislation aimed at reducing the number of import bands and the maximum tariff rate, effective January 1, 2006.	End-September 2005
6. Upgrade the *Fit and Proper* criteria for bank owners and managers to international standards, by submitting revisions to commercial banking law and related decrees.	End-December 2005
7. Complete the transition to a treasury single account for central government expenditures and revenues. (*)	End-December 2005
8. Complete electronic re-registration of existing taxpayers and registration of new taxpayers.	End-December 2005
9. Introduce a targeted poverty benefit to replace numerous in-kind benefits.	End-December 2005
10. Publish a strategy paper on pension reform to put the social security system on a sounder fiscal footing.	End-December 2005

GEORGIA: TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)

July 2, 2005

1. This memorandum sets out the understandings between the Georgian authorities and the IMF staff regarding the definitions of quantitative and structural performance criteria and indicative targets, as well as respective reporting requirements for the arrangement supported under the Poverty Reduction and Growth Facility (PRGF). These performance criteria and targets are reported in Tables 1 and 2 of the Memorandum of Economic and Financial Policies (MEFP), attached to the Letter dated July 2, 2005.

2. The quantitative performance criteria (ceilings and floors) and indicative targets listed in Table 1, Sections 1 and 2, of the MEFP are defined as cumulative changes from end-December 2004. The program allows for an automatic adjustment to the cash deficit target in case of deviations of external project financing from expectations, subject to a cap on the upward adjustment.

Quantitative Performance Criteria, Indicative Targets, and Continuous Performance Criteria: Definitions and Reporting Standards

A. Definition of the General Government and the Public Sector

3. The general government is defined as the central government, local government, and extra-budgetary funds. The public sector consists of the general government and the National Bank of Georgia (NBG).

B. Floor on Tax Revenues

4. **Definition:** Tax revenues are defined as total tax collections by the central government and local governments.

5. **Supporting material**: The ministry of finance (treasury) will provide data to the IMF showing a detailed breakdown of tax revenues paid into the NBG revenue account(s) on a monthly basis within two weeks of the end of each month. The local budget department in the ministry of finance will provide additional information to the IMF on revenue collections of local governments.

C. Ceiling on Domestic Expenditure Arrears

6. **Definition:** Domestic expenditure arrears are defined as arrears incurred by the general government on expenditure items, excluding external debt service payments. The measurement of central government expenditure arrears will be based on the following principles: (a) goods and services have been received; (b) the bill for payment has been received; and (c) the due-for-payment date has passed and the bill has remained unpaid beyond the normal or agreed period of credit. Expenditure arrears of local governments are

estimated as the difference between actual cash spending and the monthly cash limits issued prior to the beginning of the month.

7. **Supporting material:** The ministry of finance (treasury) will provide to the IMF monthly data, with a detailed breakdown by economic and organizational category, on cash spending and commitments made by the central government, and/or cash limits issued to the spending units. Information on cash limits and spending commitments will be provided to the IMF within two weeks from the beginning of each month. Information on cash spending will be provided to the Fund within four weeks of the end of each month. The local budget department in the ministry of finance will provide to the IMF information on monthly spending by the local budgets.

D. Ceiling on the Cash Deficit of the General Government

8. **Definition:** The cash deficit of the general government will be measured from the financing side, and will be defined as equal to the total financing (domestic and external plus privatization proceeds) received by the general government.[2] Privatization receipts consist of all gross proceeds received by the central and local governments. Domestic financing consists of all bank and nonbank financing to the general government. External financing is defined as the total of disbursements, macroeconomic support, net change in external arrears, minus amortization. Disbursements include all project financing (capital expenditure and net lending) and balance of payments support (excluding grants) received by the budget. Amortization includes all external debt-related payments of principal; amortization to external creditors via third parties is accounted for at the time and in the amount of payment by the budget to the third party, rather than at the time of recognition of amortization by the external creditor.

9. **Adjustment clauses:** The ceiling will be adjusted to reflect cumulative deviations from program assumptions on **external project financing** for capital expenditure or net lending. The ceiling at the end of a quarter will be adjusted upward (downward) by the full amount of the cumulative excess (shortfall) of external project financing. There will be a cap on cumulative upward adjustment of GEL 100 million for calendar year 2005.

10. **Supporting material:** Data on privatization receipts will be provided by the ministry of finance (treasury) to the IMF on a monthly basis within two weeks of the end of each month. The data will be consistent with the revenue account(s) in the NBG. Data on domestic bank and nonbank financing will be provided to the Fund by the NBG. A table on external project financing will be provided to the IMF monthly by the ministry of finance (specifying project by creditor) within two weeks of the end of each month.

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[2] Modest differences between the recorded financing and the cash deficit, calculated from "above the line" as expenditures plus net lending minus revenues and grants, can be attributed to check-float and smaller errors and omissions.

E. Ceiling on Reserve Money

11. **Definition:** Reserve money is defined as currency in circulation and required reserves of deposit money banks and balances on banks' correspondent accounts at the NBG.

12. **Supporting material:** The NBG balance sheet is to be transmitted to the IMF on a monthly basis, within two weeks of the end of the month.

F. Ceiling on Net Credit of the Banking System to the General Government

13. **Definition:** Net credit of the banking system to the general government includes net credit to the general government from the NBG and the deposit money banks. Credit to the government includes all loans to the general government and all treasury bills issued by the general government held by the banking system. Net credit to the government is defined as credit to the government less deposits of the general government in the banking system.

14. **Supporting material:** The NBG will provide the monetary survey to the IMF on a monthly basis within three weeks of the end of each month. The NBG will also provide to the IMF information on the activities of the treasury bill market.

G. Floor on Net International Reserves of the NBG

15. **Definition:** Net international reserves (NIR) of the NBG in U.S. dollars are defined as foreign assets minus foreign liabilities of the NBG, using program assumptions on bilateral exchange rates (GEL 1.85 per U.S. dollar, US$1.46 per SDR, and US$1.21 per euro).Foreign assets of the NBG include gold, gross foreign exchange reserves, SDR holdings, and the reserve position in the Fund. Gross foreign exchange reserves of the NBG are defined as liquid, convertible currency claims of the NBG on nonresidents that are readily available. Pledged or otherwise encumbered assets, including, but not limited to, assets used as collateral (or guarantee for third party external liabilities) are excluded from foreign assets. Foreign liabilities include the use of IMF resources and any other liabilities of the NBG.

16. **Supporting material:** Data on net international reserves and data on net foreign-currency nonproject financing will be provided to the IMF in a table on the NBG's foreign exchange flows (which includes details of inflows, outflows, and net international reserves) on a monthly basis within two weeks following the end of the month.

H. Ceiling on Contracting or Guaranteeing of New Nonconcessional Medium- and Long-Term External Debt by the Public Sector (with Original Maturity of One Year or More)

17. **Definition:** Nonconcessional external loans are defined as loans from lenders other than the IMF with a grant element of less than 35 percent of the value of the loan. The grant

element is to be calculated by using currency-specific discount rates reported by the OECD (CIRRs).[3] For maturities of less than 15 years, the grant element will be calculated based on six-month averages of commercial interest rates. For maturities longer than 15 years, the grant element will be calculated based on 10-year averages. This performance criterion applies not only to debt as defined in point No. 9 of the IMF's Guidelines on Performance Criteria with Respect to External Debt (Decision No. 12274-(00/85) August 24, 2000) but also to commitments contracted or guaranteed for which value has not been received.[4] Previously contracted nonconcessional external debt that has been rescheduled will be excluded from the definition of "new debt" for the purposes of this performance criterion.

18. **Supporting material:** Details of all new commitments and government guarantees for external borrowing, with detailed explanations, will be provided by the ministry of finance to the IMF on a monthly basis within two weeks of the end of each month.

I. Ceiling on Contracting or Guaranteeing Short-Term External Debt by the Public Sector (With Original Maturity of Less than One Year)

19. **Definition:** This performance criterion applies to debt as defined in point No. 9 of the IMF's Guidelines on Performance Criteria with Respect to External Debt (Decision No. 12274-(00/85) August 24, 2000), see footnote 5, as well as to commitments contracted or guaranteed for which value has not been received.

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[3] An electronic spreadsheet file that shows the relevant discount rates reported by the OECD (CIRRs) will be provided on a periodic basis by IMF staff.

[4] Point No. 9 of the IMF's guidelines reads as follows: "(a) For the purpose of this guideline, the term "debt" will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows: (i) loans, i.e., advances of money to obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans and buyers' credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements); (ii) suppliers' credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and (iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the leaser retains the title to the property. For the purpose of the Guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair, or maintenance of the property. (b) Under the definition of debt set out in point 9(a) above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt."

20. **Supporting material**: Details of all new commitments and government guarantees for external borrowing, with detailed explanations to be provided by the Ministry of Finance to the Fund on a monthly basis within two weeks of the end of each month.

J. Non-Accumulation of External Arrears

21. **Definition:** During the period of the arrangement, the general government and the NBG will not accumulate any new external payment arrears on debt service obligations to official creditors, including the IMF and the World Bank. Official external payment arrears are defined as unpaid debt service by the general government and the NBG beyond the due date. This definition excludes debt subject to rescheduling under the July 2004 Paris Club agreement or as agreed under a bilateral agreement with a creditor. The performance criterion on non-accumulation of external debt is continuous.

22. **Supporting material:** Details of official arrears accumulated on interest and principal payments to creditors will be reported to the IMF within one week from the date of the missed payment.

K. Indicative Target for the Ceiling on Net Domestic Assets of the NBG

23. **Definition:** Net domestic assets of the NBG are defined as the difference between its net foreign assets and reserve money. Net domestic assets are defined as the sum of net claims on the government (the sum of loans and treasury bills purchased by the NBG, less deposits of the government with the NBG), claims on banks, claims on the rest of the economy, and other items net (comprising the NBG capital accounts, net unclassified assets, counterpart funds and exchange rate revaluation).

24. **Supporting material**: The NBG will provide to the IMF its balance sheet, which includes data on its net domestic assets, on a monthly basis within one week of the end of each month.

Statement by the IMF Staff Representative
July 20, 2005

1. The following information has become available since the issuance of the staff report. These developments do not change the thrust of the staff appraisal.

2. Inflation remained at about 9 percent in the 12 months ended in June. The exchange rate has been stable around GEL 1.82 per U.S. dollar since end-2004. During that period, the lari depreciated by about 2 percent in real effective terms.

3. Preliminary data suggest that the program's end-June indicative targets appear to have been met, except for reserve money, which was exceeded by a small amount.

4. Preliminary half-year results indicate that tax receipts increased by 27 percent year-on-year, and that the program floor on general government tax receipts was met, despite a shortfall in tobacco excises stemming from smuggling. During that period, the government repaid some GEL 62 million in domestic arrears, slightly more than targeted under the program. The general government cash deficit during the first five months of 2005 amounted to 0.9 percent of GDP at an annualized rate, compared to a surplus of 0.7 percent during the corresponding period in 2004. On July 1, the VAT rate was reduced from 20 percent to 18 percent, as envisaged in the tax reform passed last year.

5. The government continues to hold intense discussions with investors interested in the privatization of the Chiatura mine and the associated Vartsikhe power plant complex, after the initial deal to sell these assets to a foreign investor for US$130 million fell through several weeks ago. The authorities have expressed confidence in the completion of this operation in the coming months. Other large enterprises slated for immediate privatization have been placed under a bankruptcy regime to simplify their divestiture.

6. Parliament has just passed legislation drastically simplifying the regulatory environment (an end-September structural benchmark). In particular, the reform cut the number of licenses and permits from about 900 to about 150, and introduced "one-stop-shop" procedures accompanied by "silence-means-consent" principles for licensing, thereby considerably easing the burden on applicants.

7. President Saakashvili has recently unveiled a national anti-corruption strategy that will be accompanied by the formulation of specific action plans for all major state agencies by September 1. The strategy includes preventive measures (e.g., improved state procurement procedures), as well as steps to enhance the business environment and to increase the effectiveness and accountability of the judiciary (e.g., increasing the remuneration of judges and other judiciary employees and introducing a witness protection program).

Press Release No. 05/165
FOR IMMEDIATE RELEASE
July 20, 2005

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Second Review of Georgia's PRGF Arrangement and Approves US$20.2 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) completed today the second review of Georgia's performance under the three-year program supported by the Poverty Reduction and Growth Facility (PRGF). In completing the review, the Board approved the authorities' request for a waiver for the nonobservance of an end-December 2004 structural performance criterion on amendments to the Budget Systems Law, and the conversion of the indicative target on reserve money into a performance criterion.

The Executive Board approved the PRGF arrangement on June 4, 2004 (see Press Release No. 04/107) for an amount equivalent to SDR 98 million (about US$141.6 million). Completion of the second review will release an SDR 14 million tranche, bringing total disbursements under the arrangement to SDR 42 million (about US$60.7 million).

Following the Executive Board discussion of Georgia's economic performance, Mr. Takatoshi Kato, Deputy Managing Director and Acting Chair, stated:

"Georgia's economy has continued to perform well under the Fund-supported program, buttressed by the impressive turnaround in the fiscal position that was underpinned by a decisive attack on corruption. The new administration has demonstrated strong ownership of the program and its resolve to invigorate reforms. The tax reform that took effect in January 2005 on the back of impressive revenue gains in 2004 has contributed to improving tax administration and the business climate, while receipts from an accelerated privatization drive have enabled the government to increase spending for priority programs without endangering fiscal sustainability.

"The government has made progress in structural reforms, including in revenue administration, the promotion of transparency in government operations, and a sweeping simplification of licenses and permits to facilitate private sector activities. It is important now to also make progress in areas where measures were delayed, including parliamentary approval of amendments to the Budget Systems Law and liberalization of the trade regime.

"The thrust of the authorities' economic program for the remainder of 2005 is to maintain macroeconomic stability and keep inflation at single-digit rates. The government will also continue to pursue reforms aimed at enhancing growth prospects and alleviating poverty, and it plans to institutionalize and further strengthen its anti-corruption strategy. Public spending priorities for 2005 seek to remove long-standing obstacles to growth, especially in infrastructure and the energy sector.

"Going forward, higher government spending against the backdrop of sizable capital inflows will require skillful coordination between the fiscal and monetary authorities. To ensure low inflation, the government has provided welcome assurances that discretionary spending will be managed carefully. If inflationary pressures intensify during the second half of the year, the central bank should stand ready to tighten the monetary stance beyond the limits envisaged in the program," Mr. Kato said.

The PRGF is the IMF's low-cost facility, which carries an annual interest rate of 0.5 percent, and is repayable over 10 years with a 5 ½-year grace period on principal payments. PRGF-supported programs are based on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners, and articulated in a Poverty Reduction Strategy Paper. This is intended to ensure that each PRGF-supported program is consistent with a comprehensive framework for macroeconomic, structural, and social policies, to foster growth and reduction of poverty. For additional information on Georgia's poverty reduction strategy visit the country-specific pages at www.imf.org. Georgia's annual progress report has been published as Country Report 05/113 and the related Joint Staff Advisory Note as Country Report 05/210).

Statement by Jeroen Kremers, Executive Director for Georgia and Elvira Eurlings, Advisor to Executive Director
July 20, 2005

The cooperation between the Georgian authorities and the Fund has been very fruitful. The authorities are pleased that all end-December quantitative performance criteria in the program supported by the Poverty Reduction and Growth Facility have been met, in most cases even with wide margins, in particular in the fiscal field. While the parliamentary approval of the envisaged upgrade of the Budget Systems Law has been delayed, this did not entail difficulties with planned amendments and parliamentary approval is now expected in September. Consequently, the authorities request a waiver for nonobservance of this structural performance criteria. For end-June, preliminary data indicate that the program's indicative targets have been met, with only the target for reserve money narrowly missed. Based on these results, the authorities request completion of the second review under the PRGF, which will signal to the international and business communities that Georgia is well on track on its ambitious reform agenda. As always, the authorities agree to publication of the staff report.

Fiscal policy

On the fiscal front, the authorities realized impressive consolidation. Efforts to strengthen tax administration, crack down on corruption, smuggling and tax evasion resulted in an increase of almost 30 percent of tax revenues in nominal terms in the first six months of 2005 compared to the same period last year. This trend will continue going forward, underpinned by ongoing efforts to strengthen tax and customs management. To this end, the authorities already reorganized the Tax Department, strengthened the Large Taxpayer Inspectorate, and established an Excise Tax Inspectorate and Financial Police. In addition, customs administration has improved significantly as a result of efforts to modernize border checkpoints and procedures, and reorganize the central and regional structure of the customs department.

Moreover, to promote an environment conducive to doing business, facilitate private sector development and at the same time avoid tax evasion and smuggling, a profound tax reform was approved by parliament and took effect on January 1 this year. This new tax code is intended to streamline and optimize the overall tax structure and tax rates. Anti-corruption measures were responsible for a surge in non-tax revenue, which includes, among others, the collection of administrative fees and penalties.

Buoyant revenue collection allowed additional spending for clearing pension and wage arrears, well ahead of schedule, and contributed to a build-up of deposits at the central bank. This year, the authorities continue to allocate expenditures to strategic priorities, with emphasis on the poverty alleviation goals as defined in the Economic Development and Poverty Reduction Program (EDPRP) and in line with the authorities Medium-Term Expenditure Framework. Regarding pro-poor spending, the authorities doubled the minimum pensions starting this year and are preparing a targeted poverty alleviation program aiming at providing social assistance to all households living below the extreme poverty line. During the EDPRP implementation, the authorities will continue their dialogue with civil society and international donors, also with an eye to safeguarding the high degree of donor coordination.

In addition, privatization is an important component of the economic reform process in Georgia, and will play a distinctive role in the economic development of the country. Nevertheless, the number of the remaining state-owned enterprises is still quite substantial and the authorities are committed to continue a transparent process. At the same time, the authorities are fully aware that the subsequent financial resources of these sales require skillful fiscal and monetary management to keep inflation under control and maintain external competitiveness. As mentioned in staff's paper, the increased expenditures will only be executed when privatization proceeds indeed materialize and will for two-thirds finance imported goods and services, thereby mitigating the possible negative impact on inflation and the exchange rate. Nevertheless, the proposed, non-debt creating, expenditures will allow the authorities to tackle the significant challenges ahead in the energy sector and infrastructural development, currently two major obstacles for sustainable growth.

The indicator for the level of indebtedness, reflected by the external public debt-to-GDP ratio, remains favorable and the Paris Club creditors have agreed to extend the deadline to Georgia for concluding discussions with other bilateral creditors.

Monetary policy

Sound monetary management has continued to underpin macroeconomic stability, aiming for price stability as the primary objective, while keeping the exchange rate at a competitive level. The real effective exchange rate appreciated by about 13.5 percent during 2004 and has broadly stabilized since then, and foreign exchange reserves have reached a level well above the program target. In the meantime, in the first six months of 2005, the National Bank of Georgia (NBG) made net sales in the foreign exchange market, thereby mopping up excess liquidity in the market.

Nevertheless, challenges continue to emerge in a dynamic environment. The NBG will carefully manage liquidity going forward and is fully committed to the objective of maintaining single-digit inflation. Inflationary pressures have indeed increased during the first five months of 2005, however in June, compared to May, there was a decline in the CPI of 1.4 percent. The NBG anticipates a further decline in the next two months as well. For the period ahead, while recognizing the central role of monetary discipline and to enhance monetary control, the NBG proposes the introduction of a performance criterion on reserve money growth, to be limited to 26 percent as per end 2005. In light of anticipated government spending in the period ahead, the NBG recently decided to increase interest rates on their main monetary instruments, such as their deposits, credits and repos, in order to absorb additional liquidity from the banking sector. The NBG will closely monitor the effect of this policy change and if necessary introduce further increases in the near future. In case this may prove not to be sufficient, the NBG stands ready to revise the required reserves ratios. In addition, the authorities are strongly committed to keeping expenditures under review and save any over-performance in tax revenue if warranted.

Furthermore, the NBG continued strengthening supervision policy, rationalizing the banking sector and upgrading its banking supervisory policy and practices to the Basel Core

Principles for Effective Banking Supervision. The authorities also plan to strengthen diligence towards combating money laundering and terrorism financing. In light of the significant changes in the financial sector over the past four years, the NBG has requested an update of the 2001 Financial Sector Assessment Program. The enhancement of effective liquidity management and improvement of the banking supervision would be topics to be included in the update. MFD already expressed willingness to work closely with the authorities on this issue in the near future.

Structural reform

In their first 18 months of office, the new administration under the leadership of President Saakashvili successfully focused on accelerating revenue collection, paying off outstanding arrears and starting up financing of priority programs, including in the areas of social protection, education and health. While safeguarding these achievements, the authorities subsequently intensified structural reform and rehabilitation in key sectors such as energy, public administration, all against the background of fighting corruption and improving public transparency and accountability. Looking ahead, the authorities have decided to streamline several strategic documents that have been developed for different purposes in recent years, such as the EDPRP and EU Neighborhood Policy Paper, into one overarching strategy document, the 'Government's Medium-Term Action Priorities'. The authorities will also ask each ministry to identify three top priorities for moving forward. The authorities do not foresee that this consolidation and harmonization initiative will result in a significant departure from the priority areas and structural reforms already identified in the EDPRP, but rather to provide them with an opportunity to reflect on progress so far and inform strategic thinking going forward. In the meantime, consultation with a broad range of stakeholders will take place, including representatives of civil society.

One of the ongoing priorities of the authorities' reform agenda is the improvement of the business climate. A main focal point in this regard is simplifying the regulatory environment. Whereas previously the government issued more than 900 different licenses and permits, recent adopted legislation has dramatically reduced the number of licenses and permits (at least by 80 percent), provided a 'one-stop shop' and liberalized the certification system. In addition, to reduce opportunities for corruption, the authorities seek to strengthen domestic institutions and enhance transparency and accountability in public financial management. In this light, they will join the Extractive Industries Transparency Initiative and publish 2004 oil and gas transit revenues, as a first step toward annual disclosure of this information.

The overarching goal of the energy sector reform agenda is to achieve reliable supplies of electricity and to eliminate the quasi-fiscal deficit in the energy sector by end-2006, which will not be an easy task. Stricter enforcement of payments discipline, aided by a rapid extension of metering to rural areas, should reduce the sector's quasi-fiscal losses to 3½ percent of GDP in 2005, from an estimated 4½ percent of GDP last year. A strategic task of the energy sector reform is also to carry out an effective privatization process in a transparent and competitive manner.

In closing, we would, on behalf on the authorities, like to once again thank staff and management for their dedicated work and sound policy advice to Georgia.