April 2011
IMF Country Report No. 11/87

Georgia: 2011 Article IV Consultation—Staff Report; Staff Supplements; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Georgia

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2011 Article IV consultation with Georgia, the following documents have been released and are included in this package:

- The staff report for the 2011 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on February 17, 2011, 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 March 7, 2011. 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.

- Two staff supplements completed on March 7, 2011: an Informational Annex; and an Ex Post Assessment of Longer-Term Program Engagement—An Update.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its March 23, 2011 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for Georgia.

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

GEORGIA

Staff Report for the 2011 Article IV Consultation

Prepared by the Staff Representatives for the 2011 Consultation with Georgia

Approved by David Owen and Dominique Desruelle

March 7, 2011

- Discussions for the 2011 Article IV consultation with Georgia took place in Tbilisi from February 2–17, 2011. The staff team comprised E. Gardner (head and Senior Resident Representative), E. Martin, A. Luca (all MCD), L. Eyraud (FAD), I. Halikias (SPR), and N. Sharashidze (Resident Representative Office). The mission met with the Prime Minister, the Ministers of Finance, Agriculture, Health and Social Affairs, and Infrastructure and Regional Development, the Governor of the National Bank of Georgia (NBG), and other senior government officials. It also met with representatives of the commercial banks, the private sector, and the donor community. The mission held a press conference and issued a concluding statement.
- Georgia is on the 24-month consultation cycle. The last Article IV consultation was concluded on March 23, 2009. On that occasion, Executive Directors observed that the Georgian economy had been seriously affected by the August 2008 armed conflict and the global downturn. They supported the authorities' plans to contain the economic slowdown through a donor-financed fiscal stimulus and a reorientation of expenditures. Directors took note of the staff assessment that the real effective exchange rate was overvalued and observed that the authorities' commitment to exchange rate flexibility and structural reforms to enhance competitiveness should help correct the overvaluation. Directors recommended that all instruments of monetary policy be deployed in support of the authorities' adjustment strategy to preserve external stability.
- Georgia accepted the obligations of Article VIII, Sections 2, 3, and 4, effective December 20, 1996. Georgia's exchange rate regime is classified as "floating." Georgia maintains a multiple currency practice (MCP), which preceded the program, arising from the fact that the official exchange rate used by the government may differ by more than 2 percent from freely determined market rates. In practice, the official and market rates have never differed by more than 2 percent since the introduction of foreign exchange auctions in March 2009, when the market rate became more flexible. Staff does not recommend approval of this MCP.
- Economic data are broadly adequate for surveillance and program monitoring. Georgia participates in the GDDS and subscribed to the SDDS in May 2010.
- The authorities indicated that they would consent to the publication of the staff report.

Contents Page

Executive Summary

The policy response to the crisis has succeeded in stabilizing the economy and restoring confidence. The economy is recovering at a solid pace, with real GDP growth expected to have exceeded 6 percent in 2010 and projected at 5½ percent in 2011. Supported by the cyclical upturn, the fiscal position has improved sizably and the 2011 budget implies substantial additional adjustment, with the deficit projected to decline from 9.2 percent of GDP in 2009 to 3.9 percent of GDP in 2011. Inflation has risen to 12 percent on the back of rising commodity prices, but core inflation remains subdued. While the recovery of FDI has been slower than initially anticipated, the overall external position has continued to improve, as reflected in stable foreign exchange rate market conditions.

In the short term, the authorities' main challenge is to limit the impact of the recent commodity-price shock on the most vulnerable and to contain inflationary risks. To alleviate the social impact of higher food and energy prices, the authorities have issued transferable electricity vouchers and are considering increases in social spending. With regard to inflation, the monetary tightening to date should help stabilize inflation expectations. Staff and the authorities agreed that further tightening should be contingent on evidence that inflation is not abating as projected or credit is growing too fast.

Turning to the medium term, the main challenge is to transition from recovery to durable growth by addressing remaining adjustment needs—both fiscal and external—against an external environment that remains unsettled. The authorities have taken a more proactive approach to economic growth, with emphasis on structural reforms in agriculture and targeted public investment to improve productivity and attract private investment. Staff stressed the need to ensure that the new strategy is consistent with fiscal policy's goal of bringing the deficit to a sustainable position over the medium term (1½ percent of GDP by 2016). Despite the significant external adjustment already achieved since 2008, the current account deficit remains, by most measures, unsustainably high. The cyclical recovery in partner countries and, as noted by the authorities, productivity gains from structural reforms should help narrow the deficit over the medium term. The authorities agreed with staff that exchange rate flexibility should also remain a central instrument of adjustment. In the event of continued instability in international financial markets, balance-of-payments gaps could reemerge in 2012–14 on account of debt rollover needs.

I. The Policy Response to the Twin Crises and Recent Developments

1. **The government moved forcefully to counter the economic impact of the August 2008 conflict with Russia and global financial crisis** (Figures 1 and 2). Access to a large package of international financial support, combined with Georgia's relatively low public debt at the outset of the crisis, allowed the government to put in place a strong countercyclical fiscal policy response—the total fiscal stimulus injected into the economy in 2008 and in 2009 was equivalent to nearly 10 percent of GDP.

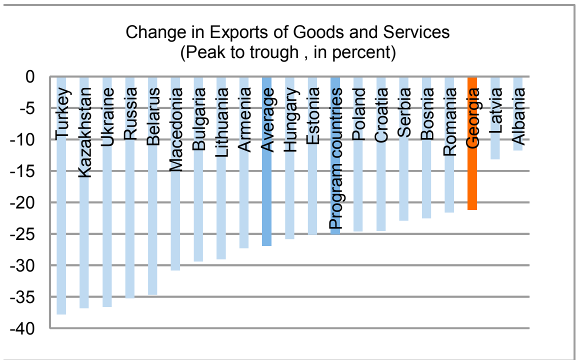
2. **Monetary and prudential policy easing was, however, unable to prevent a sharp credit squeeze.** The confidence shock triggered by the war and subsequent political instability led to a 29 percent loss of deposits (exchange rate adjusted), much larger than in comparable countries. In a context of volatile domestic and external funding, banks moved to increased liquidity buffers. The authorities sought to boost liquidity and restore credit growth through cuts in policy rates and reserve requirements, direct liquidity support, and a loosening of prudential regulations. However, in the highly dollarized financial system, these policies had a limited impact on on-shore dollar market interest rates and could not prevent a sizable contraction in credit.

3. **Although the loss of private external and domestic financing was generally larger than in comparable crisis economies, official financial support and the policy response led to a much lower overall output contraction.** They also helped avert a large overshooting of the exchange rate, which, in a dollarized context, would have led to even larger economic and financial dislocation.

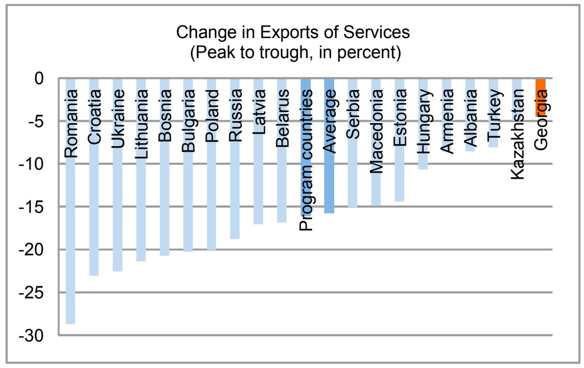
4. **The external financing gap opened by the twin crises was closed by a combination of current account adjustment and official financing.** Current account adjustment was in large part driven by the fall in private demand and of import-intensive FDI, but also by real exchange rate depreciation (18 percent peak to trough). The current account adjustment was large but consistent with bringing it closer to a sustainable position. Reliance on official financing (including from the Fund) to cover the remaining private sector financing gap through intervention was deemed appropriate on the expectation that private financial inflows would rebound.

Figure 1. Georgia: Direct Impact of the Crisis

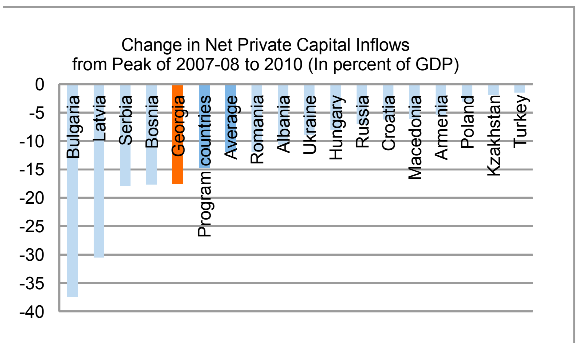
The fall in exports was less marked than in most comparator countries...



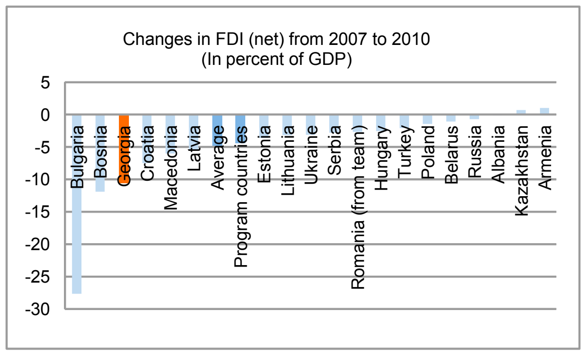
...due to the resilience of exports of services.



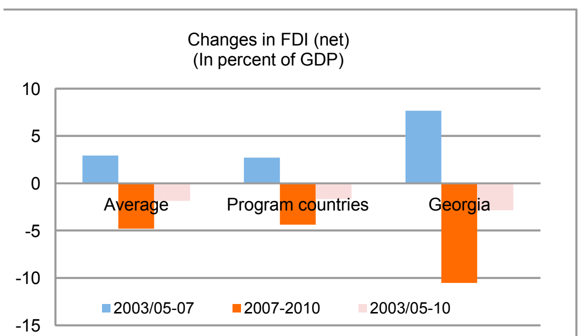
The decline in private capital flows in Georgia was slightly above average...



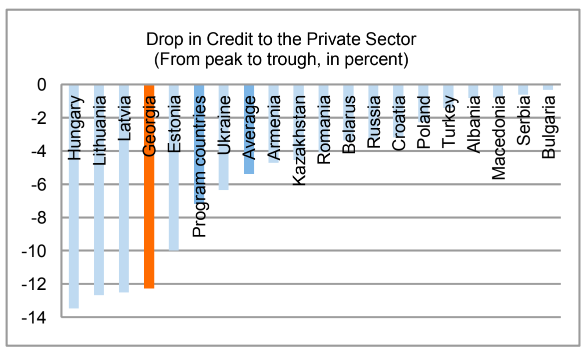
...reflecting to a large extent the fall in FDI,...



...which more than reversed the sharp increase in the run-up to the crisis.



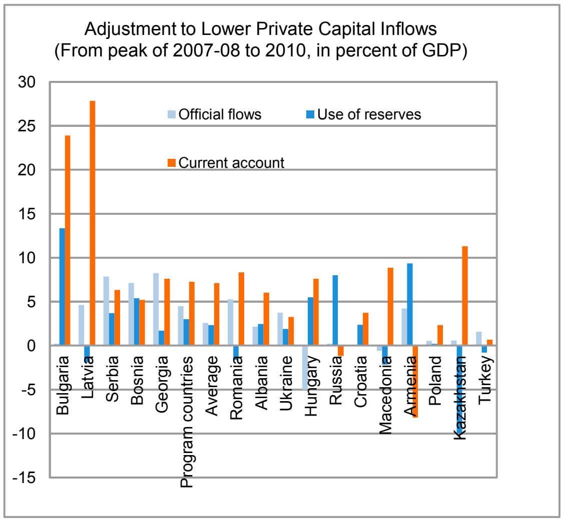
The contraction in credit to the private sector was also high relative to peer countries.



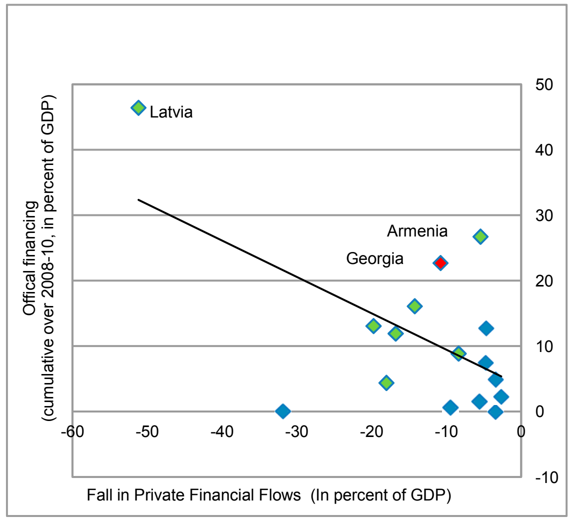
Sources: Fall 2010 WEO, IFS; and Fund staff estimates.

Figure 2. Georgia: Policy Response and Outcome

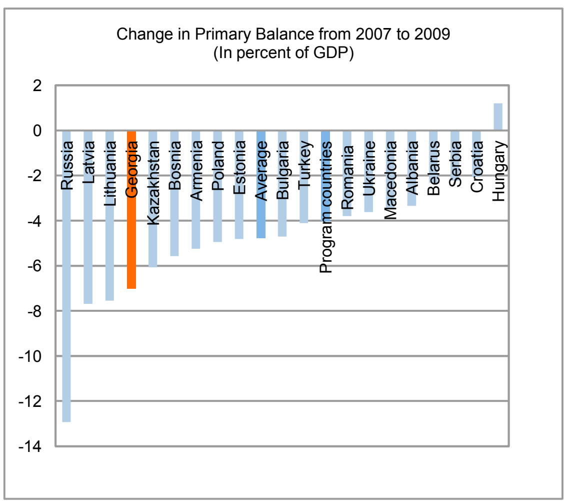
To fill the gap opened by the fall in net private capital inflows, Georgia relied about equally on official inflows and current account adjustment.



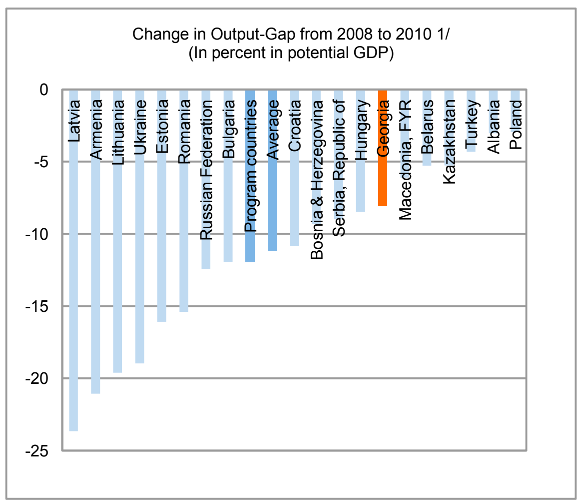
Official financial support to Georgia was higher than to peers, when calibrated by the fall in net private capital inflows.



This financing allowed for a stronger fiscal response than in most peer countries...



...which, in turn, contributed to limit the impact of the crisis on growth.



Sources: Fall 2010 WEO, IFS; and Fund staff estimates.

1/ To ensure a consistent treatment between countries, the output gaps were compiled by using an HP-filter.

5. **The economy is recovering at a solid pace, with real GDP growth expected to exceed 6 percent in 2010.** Encouragingly, growth was broad based across all economic sectors, driven by a rebound of credit to the private sector and strong export demand. The recovery of private sector growth enabled the government to begin withdrawing the fiscal stimulus, with a resulting narrowing of the fiscal deficit to 6.6 percent of GDP in 2010 from 9.2 percent in 2009—driven essentially by a tightening of current spending. The recovery of FDI has been slower than initially anticipated. However, the private sector external position has improved since mid-2010, reflecting an increase in other private financial inflows and a narrowing of the current account deficit. The resulting abatement of exchange rate pressures has allowed the central bank to reduce intervention and strengthen its net international reserve position. While FDI inflows continue to disappoint relative to the levels prevailing prior to the crisis, at 5 percent of GDP in 2010 they remain quite respectable by international standards.

II. Strengthening the Exit Strategy and the Foundations for Sustained Growth

6. **The policy response to the twin crises of 2008–09 succeeded in averting a much deeper economic contraction, but vulnerabilities remain.** The countercyclical fiscal response led to significant increases in the government deficit and public debt (from 22 percent of GDP in 2007 to 39 percent in 2010). Private sector balance sheets have also been weakened by the crisis, as evidenced by higher loan dollarization and indebtedness and, for the banks, a deteriorated loan portfolio, although the increase in nonperforming loans (NPLs) also reflects vulnerabilities built up prior to the crisis. Meanwhile, the external environment is likely to remain volatile and the much expected rebound of FDI appears increasingly uncertain.

7. **The main economic policy challenges going forward are to**:

- create the conditions for solid economic growth even in the absence of a strong rebound of FDI, while preserving a viable external position;
- strengthen public balance sheets;
- maintain price stability; and
- prevent the emergence of new imbalances and systemic risks in the private sector as credit and external borrowing resume.

8. **As a basis for the discussions, staff developed a medium-term scenario which relies on a set of consistent policies that address the above challenges** (Box 1). The main drivers of the scenario are: a moderate recovery of private capital inflows, which necessitates convergence of the current account deficit to 5.5 percent of GDP over the medium term; and

convergence of the government deficit to a level consistent with a steady decline in the public debt-to-GDP ratio.

Box 1. Georgia: Medium-term Scenario: Assumptions and Underlying Policies

GDP and inflation

The scenario projects real GDP growth of 5½ percent in 2011, higher than under the previous scenario (Seventh and Eighth reviews under the SBA), reflecting a higher carry-over from 2010. Growth is projected to stabilize at 4¾ percent thereafter, in line with regional peers. End-2011 inflation has been revised up to 8 percent, owing to higher commodity price inflation, but would decline to 6.5 percent in 2012 and then gradually to 5 percent.

Balance of payments

FDI increases from 5 to 6 percent of GDP over the medium term, compared to nearly 8 percent under the staff's previous scenario. Gross international reserves increase to $2.9 million by end-2016, consistent with keeping reserve coverage at roughly the same level as end-2010. The external financing and gross international reserve assumptions require that the current account deficit decline from 12.5 percent of GDP in 2011 to 5.5 percent of GDP in 2016 (compared with 9.1 percent of GDP in 2015 under the previous scenario). The cyclical recovery of trading partners and exchange rate adjustment contribute about equally to the narrowing of the current account deficit over the medium term. The (moderate) real exchange rate adjustment implied by these assumptions would eliminate the current estimated misalignment.

Fiscal policy

Debt sustainability analysis points to the need for slightly more fiscal adjustment than under the staff's previous scenario, with the deficit converging to 1.3 percent of GDP by 2016, rather than 2 percent of GDP under the previous scenario. Assuming an unchanged tax-to-GDP ratio, the adjustment would come from a 9 percent decline in real primary spending over the first two years (2011–12), followed by real growth of primary spending of around 3 percent on average per year through 2016. The compression of real spending in 2011–12 is concentrated in the capital budget, which in real terms declines by 17 percent as post-crisis spending winds down.

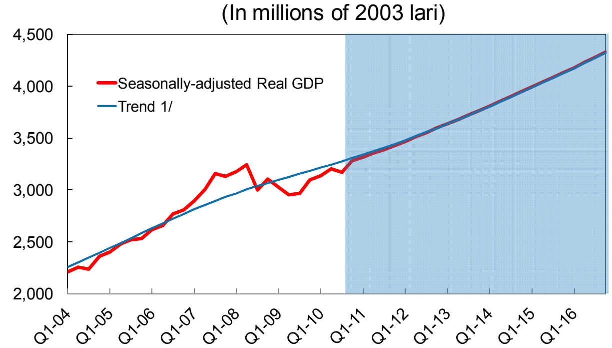
Money and credit

Consistent with an implied increase in domestic private saving, broad money growth is projected to exceed nominal GDP growth by about 7 percentage points a year over the medium term. Banks are assumed to finance part of their loan portfolio through external borrowing, all the while keeping the loan-to-deposit ratio on a downward path in line with prudential considerations. As a result, private credit growth would average 18 percent per year, and the credit-to-GDP ratio would rise moderately from 31 percent in 2010 to 43 percent in 2016, consistent with prudential considerations.

A. Sustaining Growth and a Viable External Position

9. **The authorities considered that sole reliance on a large rebound of FDI to unlock the economy's growth potential may no longer be realistic in the post crisis environment, and that a more proactive strategy is necessary.** They noted that by channeling countercyclical spending during the crisis to infrastructure rather than current expenditure they had enhanced the productivity of the economy. However, more could be done to raise productivity and attract private investment in high potential sectors such as agriculture and energy, following similar efforts in the tourism sector. In the absence of any productivity improvement, agricultural GDP has contracted by nearly 20 percent since 2005 and the supply response to higher agricultural commodity prices appears low. To promote growth in the sector, the authorities are preparing a three-year plan of structural reforms and investment focused on logistics (distribution and storage), irrigation, access to training and new technologies, as well as land consolidation. They also saw scope for targeted public investment in selected other sectors (such as energy), possibly through public-private partnerships. Based on this revised strategy, they considered that the economy had the potential to grow much faster than the 4¾-percent growth rate assumed in the staff's medium-term scenario, but accepted this assumption as a conservative base on which to build policies.

Georgia: Seasonally-adjusted Real GDP, 2004-16
(In millions of 2003 lari)



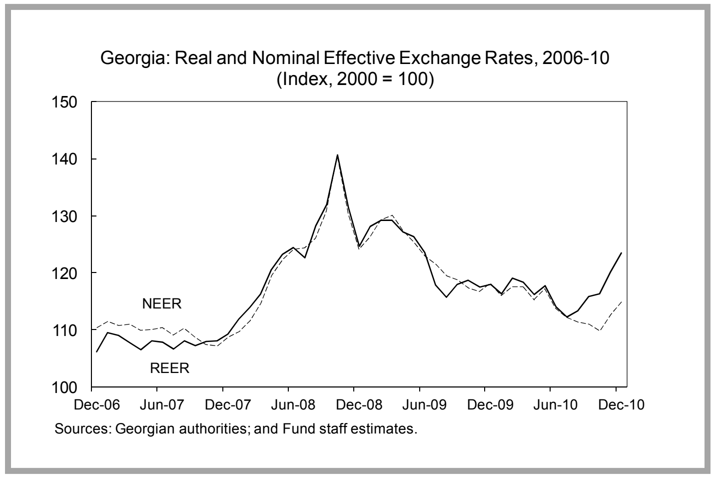
1/ Trend is calculated using the Hodrick-Prescott filter applied to 2004-16 data.

Sources: Georgian authorities; and Fund staff estimates.

10. **Staff underscored the importance of fitting the revised strategy within existing fiscal constraints.** This would require a reallocation of expenditure priorities, consistent with the deficit reduction strategy endorsed by the authorities (see below). Staff also cautioned that public-private partnerships or public enterprise investments should be considered with caution in view of the large direct and contingent fiscal costs which they may generate.

11. **Improving external competitiveness is also fundamental to sustained growth and, in this regard, the staff's analysis suggests that the crisis-related real exchange rate depreciation has moved the lari exchange rate closer to equilibrium** (see Selected Issue Paper on Exchange Rate Assessment and Competitiveness). Standard equilibrium exchange rate assessments suggest that the real effective exchange rate remains moderately overvalued by 7–9 percent. The current account deficit (10 percent of GDP in 2010) remains large by most measures, including by comparison with other emerging market

economies in the region. In line with a more conservative view of FDI inflows, staff considers that policies should aim at reducing the current account deficit to 5–6 percent of GDP over the medium term—as reflected in the medium-term scenario. This adjustment would come from the expected growth recovery of trading partners and domestic productivity gains, but would also require some moderate real exchange rate depreciation over the medium term. Real exchange rate adjustment would be facilitated by fiscal consolidation.

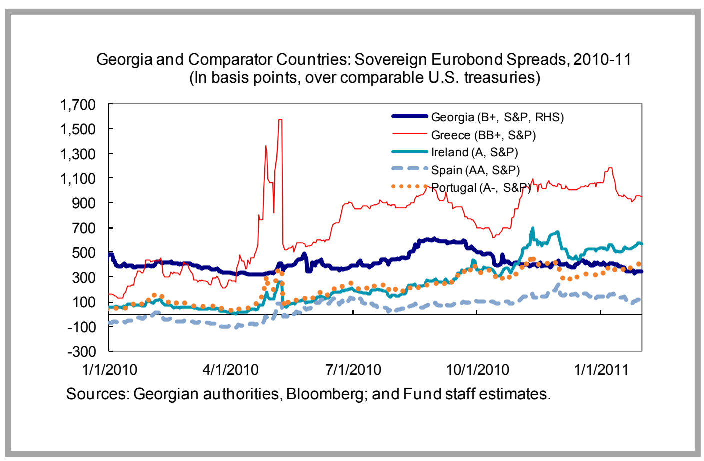


Georgia: Real and Nominal Effective Exchange Rates, 2006-10
(Index, 2000 = 100)

Sources: Georgian authorities; and Fund staff estimates.

12. **The authorities broadly agreed with staff's assessment, but considered that the required external adjustment over the medium term could be fully achieved through productivity gains, consistent with their revised growth strategy.** They also underscored the high degree of uncertainty surrounding equilibrium real exchange rate assessments. Nonetheless, they restated their commitment to exchange rate flexibility as an essential instrument of adjustment.

13. **The external debt repayment profile constitutes an important vulnerability, with the government and the central bank facing large external debt service obligations in 2012–14 (including to the Fund), peaking at just over $1 billion in 2013 (equivalent to 8 percent of GDP).** The authorities intend to minimize these risks by tapping the Eurobond market as soon as market conditions permit. Under the baseline scenario, the government's obligations to the Fund are assumed to be paid through a mix of external borrowing and issuance of domestic government paper. The central bank's obligations are met through the accumulation of international reserves. In view of the volatile conditions of international financial markets, staff presented the implications of an alternative refinancing strategy involving greater issuance of domestic government paper (Box 2), which would involve faster external adjustment. To ensure against the risk of adverse market developments, staff recommended that issuance of domestic government paper be raised gradually to cover this possibility. The authorities indicated that they were indeed considering alternative financing options, based on developments in international financial markets through the rest of the year. However,



Georgia and Comparator Countries: Sovereign Eurobond Spreads, 2010-11
(In basis points, over comparable U.S. treasuries)

Sources: Georgian authorities, Bloomberg; and Fund staff estimates.

they noted that accumulating deposits in anticipation of future debt service would create political pressures to increase spending.

Box 2. Georgia: Alternative Financing Scenario

Under the baseline scenario, the government's main external debt repayment obligations would be financed primarily through the issuance of a $800-million Eurobond in 2013. This issuance would allow the government to repay the maturing $500-million Eurobond and about three quarters of its obligations to the Fund over 2013–15.

To reduce exposure to changes in external market conditions, the authorities could rely more on domestic financing. The alternative financing scenario assumes a Eurobond issue of only $500 million and additional issuance of domestic government paper of $300 million to refinance the government's component of the debt to the Fund. To avoid unduly crowding out credit to the private sector, the additional issuance of domestic government paper is assumed to start in 2011 and span over 4 years.

However, because the domestic paper issuance would be in lari, additional external adjustment would be needed to generate the needed foreign exchange. In order to avoid a decline in international reserves, the central bank would have to increase sterilized purchases of foreign exchange in the market. This would lead to further (temporary) depreciation of the lari and improvement of the current account. The current account adjustment would replace the foregone external borrowing.

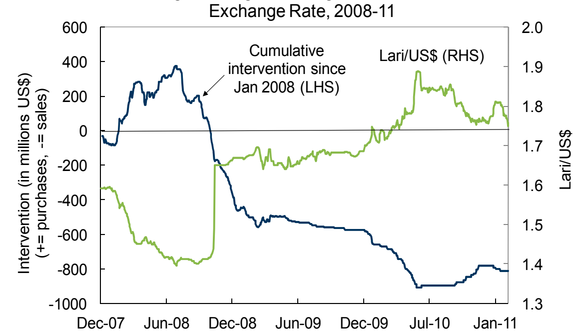
Georgia: Alternative Financing Scenario, 2011-16

	2011	2012	2013	2014	2015	2016
	(In USD million, unless otherwise indicated)					
Differences compared with the baseline scenario						
Eurobond issuance	0	0	-300	0	0	0
T-bill issuance	75	75	75	75	0	0
Sterilized intervention	50	100	150	0	0	0
Current Account balance (in percent of GDP)	0.4	0.7	1.1	0.0	0.0	0.0
Exchange rate (in percent, - = depreciation)	-1.4	-2.7	-3.8	0.0	0.0	0.0
Credit growth (exchange rate-adjusted, in percent)	-1.5	-2.5	-3.0	0.7	0.6	0.9
Gross international reserves	50	150	0	0	0	0

Sources: Staff projections.

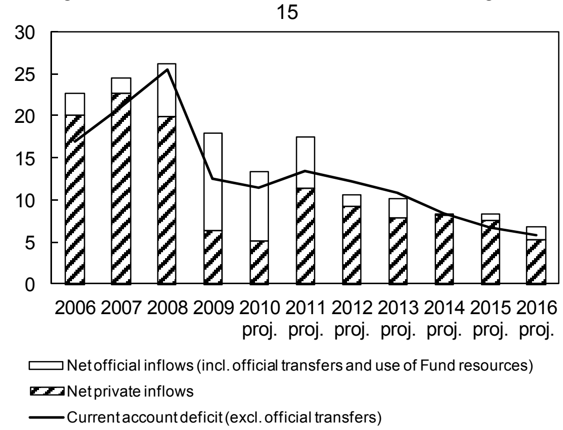
14. **The authorities consider the present level of gross international reserves ($2.3 billion) to be appropriate, given perceived risks.** This conclusion is backed by staff's analysis, which shows that GIR presently meets nearly all of the standard and composite reserve adequacy thresholds (see Selected Issue Paper on International Reserve Adequacy). Maintaining these ratios roughly unchanged over the medium term, would require a gradual increase of GIR to $2.9 billion by 2016. Meeting this objective, all the while repaying the Fund, will limit the room for central bank sales of foreign exchange in the market over the medium term. The authorities noted that intervention in response to temporary pressures will continue to be needed in Georgia's thin foreign exchange market to avoid abrupt exchange rate movements, which could have destabilizing effects in an economy prone to sudden currency conversions. Staff noted that such intervention should be systematically financed by purchases of foreign exchange in the market during quiet times so as to avoid a ratcheting down of GIR relative to its target.

Georgia: Foreign Exchange Intervention and Exchange Rate, 2008-11



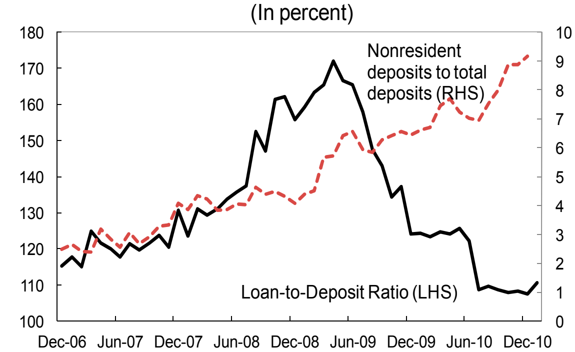
Sources: Georgian authorities; and Fund staff estimates.

Georgia: Current Account Balance and its Financing, 2006-15



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

Georgia: Sources of Bank Funding, 2006-10
(In percent)



Sources: Georgian authorities; and Fund staff estimates.

15. **The projected rebound of private capital inflows has been revised down relative to the previous scenario, but it remains a risk factor for the balance of payments.** The large improvement projected for 2011 rests essentially on two factors: inflows from banks to meet the increase in reserve requirements and the repatriation of the proceeds of the Eurobond issued by Georgian Railway in 2010.[1] Beyond 2011, the increase in private capital inflows reflects moderate increases in both FDI and other private inflows. Nonresident deposits have grown quite sizably (by roughly 1½ percent of GDP

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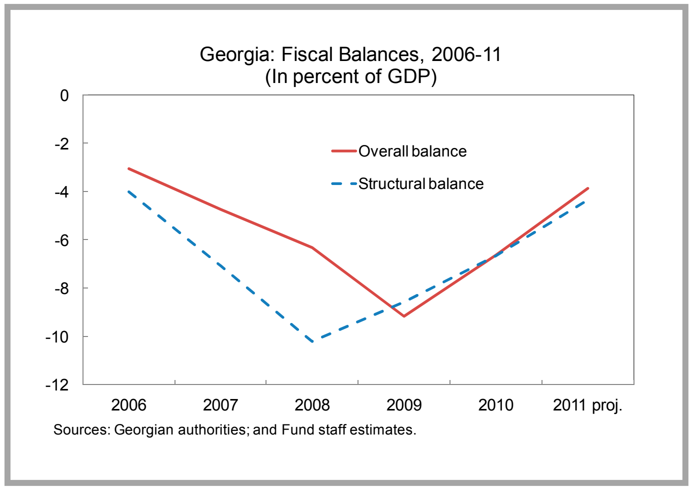
[1] Reserve requirements on foreign exchange liabilities of banks were increased from 5 to 10 percent on January 20, 2011, and to 15 percent on February 17, 2011. The net inflows generated in 2011 by this measure are estimated at around $264 million.

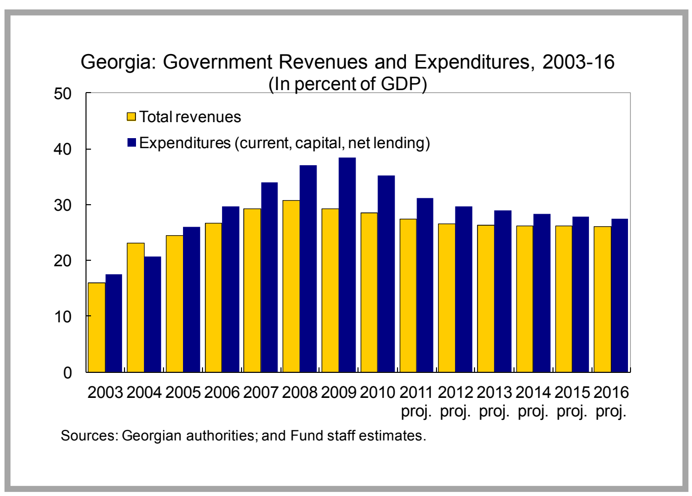
from mid-2008 to end-2010), because of the attractive yields offered. Staff and the authorities agreed that risks of overheating from these inflows appear negligible at present, and staff pointed out that in fact these inflows may prove useful given continuing uncertainty about more traditional types of external financing such as FDI. The authorities highlighted, nonetheless, financial stability concerns related to these inflows (discussed in Section II.D. below).

B. Restoring a Sound Fiscal Position

16. **The authorities restated their commitment to durable fiscal adjustment over the medium term, as contained in their 2010 medium-term fiscal framework.** Furthermore, they underscored their intention of reducing the deficit to under 4 percent of GDP in 2011, below the 4.3 percent target under the Stand-By Agreement (SBA), by sticking to the budgeted expenditure envelope. This would correspond to an improvement in the structural fiscal balance of 2.3 percent of GDP relative to 2010—implying that nearly half of the adjustment targeted from 2010 to 2016 would take place in 2011. The adjustment strategy is based on expenditure containment, notably by scaling back the capital budget in which they had concentrated their countercyclical spending. To a large extent capital spending would reflect the phasing out of external project support. The authorities considered that reducing government spending over the medium term would be more growth enhancing than raising taxes.



17. **Staff welcomed the authorities' deficit reduction objectives, but also noted some of the challenges inherent to the adjustment strategy.** Elections in 2012 and 2013 will generate new pressures, and expenditure compression will require some tough decisions, especially in view of the need to rationalize public capital spending around fewer projects and to strengthen social safety nets. The authorities consider that the economic recovery would lessen demand for social assistance, but also acknowledged that pressures are emerging for broad increases,



particularly in pensions, owing to the steep rise in food and fuel prices. Some limited measures have already been taken in the form of electricity vouchers, which are by nature not very well targeted. Staff agreed that a real increase in social spending will need to be considered in the 2012 budget. It also noted that, while the overall impact of pensions in mitigating poverty is larger due to their universal coverage and the larger funding, targeted social assistance (TSA) is much more efficient. Accordingly, it would be important to direct the largest portion of any increase in the social budget to targeted rather than untargeted programs (Box 3).

Box 3: Social Programs in Georgia

The social safety net system mostly relies on three pillars: a targeted social assistance program (TSA), pensions, and health programs.

Georgia: Social Expenditures (General Government), 2008-11

	2008	2009	2010	2011
	(In percent of GDP)			
Health programs	1.2	1.5	1.6	1.4
Pensions	4.0	4.5	4.3	3.9
Social assistance 1/	1.1	1.3	1.2	1.1
Other	0.9	0.7	0.7	0.6
Total 2/	7.2	7.9	7.8	7.0

Sources: Ministry of Finance; and Fund staff estimates.

1/ Includes assistance to internally displaced persons (IDPs).

2/ The 2009 increase reflects both the 5.7 percent decline in nominal GDP and the nominal increase in spending stemming from two minimum pension hikes, the introduction of health insurance for the most vulnerable, and the increase in the number of social assistance beneficiaries after the 2008 conflict. The subsequent decine mainly reflects the fact that pensions were frozen in 2010 and 2011.

The TSA program was introduced in 2006, based on proxy means tests (PMT) including over 100 indicators. The benefit amounts to GEL 30 per month for the household head, plus GEL 24 for each additional household member. There are approximately 400,000 beneficiaries.

Minimum pensions consist of a universal GEL 80 monthly benefit for men above 65 and women above 60. In comparison, the monthly pension was only GEL 14 in 2003. Pensions account for about three-fourths of the social protection budget, and above half of social spending of the public sector. Owing to the high rate of inter-generational living, about half of the population lives in a household-receiving pension income.

The medical insurance program (MIP) targeted to the poor was introduced in 2008. The target group is identified on the basis of the same proxy means tests as the TSA program, but comprises a significantly higher number of beneficiaries (about 900,000). The MIP entails a transfer from the public budget to private insurers in exchange for their services as purchasers of health care for the poor. In 2009, the program accounted for nearly half the total health budget (the remainder going to disease-specific health programs).

Source: World Bank.

18. **Staff also noted that the expenditure-based consolidation strategy narrows considerably the room for contingency measures in the event of adverse shocks, raising the importance of preserving sufficient flexibility on the revenue front.** Staff analysis points to the fact that the tax system is already quite efficient, leaving little room for increasing revenues through administrative improvements or base broadening (see Selected Issue Paper on The Challenge of Enhancing Tax Productivity in Georgia). By the recent constitutional amendment, tax increases will be subject to a referendum requirement starting in 2013. The underlying rationale, from the authorities' perspective, is to preserve Georgia's favorable investment climate and avoid a ratcheting up of the tax burden over time. Nonetheless, the authorities confirmed that an escape clause would be specified through separate legislation. Staff recommended that the escape clause cover a sufficiently wide range of contingencies: in addition to linking it to a deficit and debt threshold, it could also be based on prospective debt dynamics, so as to capture adverse shocks that are not immediately reflected in the fiscal deficit, such as those illustrated in the DSA (Figure 4). The authorities said they would welcome staff advice on the subject.

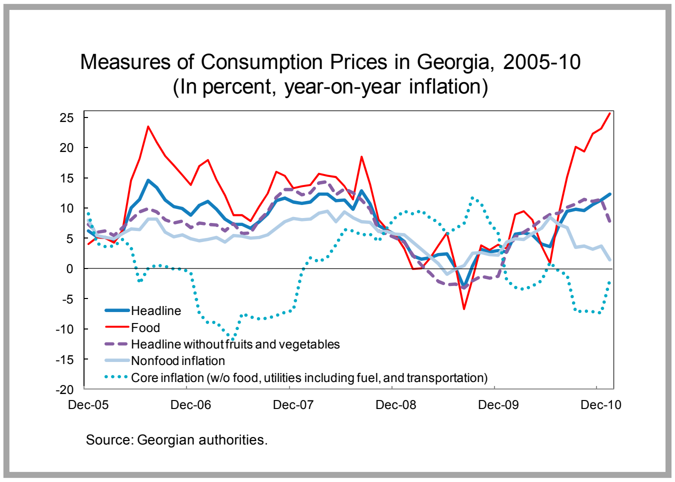
Box 4. Staff Suggestions on a Possible Escape Clause to the Referendum Requirement for Tax Increases

The escape clause should be triggered under exceptional circumstances, but before fiscal indicators start signaling severe fiscal stress. It would suspend the referendum requirement temporarily to restore fiscal flexibility. The escape clause should be forward-looking and restore full tax autonomy when fiscal indicators are projected to exceed certain thresholds under unchanged policies.

The authorities expressed a preference for an escape clause based on objective criteria rather than on political consensus, such as a parliamentary supermajority. Based on international experience, the thresholds could include: a 3-percent-of-GDP ceiling on the general government deficit (as initially envisaged by the authorities); a 2-percent-of-GDP ceiling on the primary gap (i.e. the difference between the primary deficit and its debt stabilizing level); and a 40-percent ceiling on the debt-to-GDP ratio. These criteria would have to be based on well-defined definitions, such as provided by the GFS 2001 Manual.

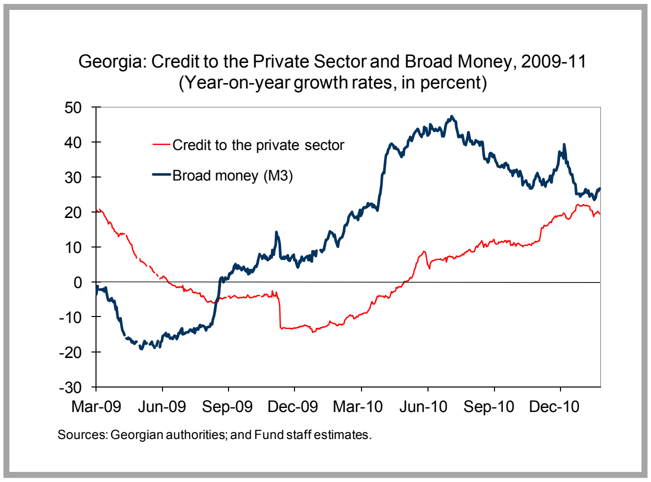
C. Maintaining Price Stability

19. **As in most other countries, consumer price inflation has risen unexpectedly since mid-2010, reaching 12 percent in January 2011.** Nearly all of this inflation originates from hikes in the international prices of food and energy. Currently, staff does not see any evidence of second-round effects, but the available price measures are, admittedly, subject to



data limitations. In the absence of additional external shocks, or second round effects, inflation is projected to decline by year-end to around 8 percent (see Selected Issue Paper on Inflation Trends and Monetary Policy Options). However, the uncertainty around this projection has increased recently on account of the spike in oil prices stemming from the Middle East turmoil.

20. **The main challenge ahead for monetary policy is to avoid the emergence of second-round effects that would entrench inflation at this higher level, undermining confidence in the lari.** The NBG has tightened its monetary stance sizably since June 2010, in response to exchange rate pressures first and, increasingly, to concerns about rising inflation. The policy rate has been raised by a cumulative 300 basis points—with the last 50 basis points increase taking place on February 16—and central bank CD rates have moved in parallel. Reserve requirements on dollar liabilities (both external and internal) have been increased in two steps from 5 to 15 percent (effective February 17) so as to balance monetary tightening across currencies. The authorities considered that, while higher reserve requirements on dollars may encourage larger firms to finance themselves directly abroad, in effect few companies have access to international financial markets at this stage. The increases in liquidity requirements (on October 1, 2010) and in regulatory capital requirements (on January 1, 2011) add to the general tightening of policies. Nonetheless, the NBG has communicated that it stands ready to tighten monetary conditions further. Staff suggested that further increases be linked to deviations of inflation from current projections or credit growth markedly in excess of the projected level.



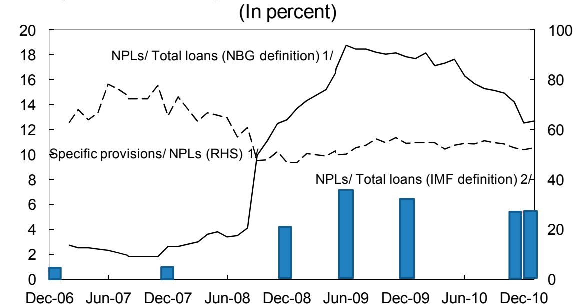
21. **The planned transition to an inflation-targeting framework should eventually anchor expectations around the inflation target rather than the exchange rate, thus allowing the exchange rate to move more flexibly.** The path toward an effective inflation-targeting framework is hampered by a number of constraints: structural (imperfect interest rate transmission), informational (inadequate understanding of the inflation process and

monetary policy transmission mechanisms), and statistical (insufficient price and economic activity indicators to assess underlying inflation and output trends). One of the preconditions to effective inflation targeting is the ability to affect market interest rates and, through that, credit aggregates and expectations. In this regard, the reforms undertaken by the NBG since 2009 to improve monetary policy effectiveness and to move to a market-determined exchange rate system have begun to bear fruit, and policy interest rate signals are now more effectively transmitted to market interest rates (see selected Issue Paper on Inflation Trends and Monetary Policy Options). Staff encouraged the authorities to continue preparing the ground for an inflation-targeting framework by building up their inflation forecasting and modeling capacity with technical assistance from the Fund.

D. Preventing the Emergence of New Private Sector Imbalances

22. **With the stabilization of financial conditions, in 2010, the supervisory authority began to restore liquidity and capital requirements back toward pre-crisis levels.** At the same time, the supervisor is progressing toward risk-based supervision, which should increase the efficiency of supervision and allow risk to be better reflected in the intermediation margins of banks. The authorities noted that, based on a relatively low credit-to-GDP ratio, there should be scope for continued financial deepening, but also stressed the importance of monitoring risks based on debt-service-to-income ratios (which remain high) and loan-penetration ratios (which remain low), reflecting conditions typical of developing and emerging market economies. Although banks were severely affected by the crisis, financial stability concerns from the balance sheet impact of the crisis have abated reflecting the decline of NPLs (from 8.6 percent of the loan portfolio in mid-2009 to 5.4 percent currently) and adequate provisioning. Currency-induced credit risk (from loan dollarization) remains a vulnerability. While credit dollarization increased at end-2010, the risk of a large depreciation appears to be lower, reflecting the modest estimated misalignment relative to the equilibrium exchange rate.

Georgia: Nonperforming Loans and Provisions Ratios, 2006-11
(In percent)



1/ NPLs are defined as loans in substandard, doubtful, and loss loan categories.
2/ NPLs are defined as loans with overdue payments (principle and/or interest) over 90 days.
Sources: Georgian authorities; and Fund staff estimates.

23. **On the funding side, the Georgian banking sector has succeeded in reducing considerably its exposure to foreign borrowing, which proved to be a major systemic vulnerability during the financing crisis.** The central bank considers that nonresident deposits can provide diversification benefits but also create new financial stability risks, owing to the potentially volatile nature of these inflows. To limit reliance on nonresident deposits as a funding base for domestic lending, the authorities are planning to introduce a 100-percent marginal liquidity requirement on nonresident deposits in excess of 10 percent of

the deposit base. The mission welcomed the authorities' alertness to new risks and the decision to monitor these deposits closely. It noted, however, that the empirical evidence of higher volatility of nonresident deposits was inconclusive—while they declined more rapidly than domestic deposits in the immediate aftermath of the 2008 conflict, they proved to be a more resilient source of funding during the subsequent domestic political unrest in April-May 2009. It also noted that financial stability risks should be weighed against other risks, including that of curtailing a useful source of balance of payments financing. It therefore encouraged the authorities to review the need for such a measure on a regular basis as more information on the nature and volatility of the nonresidents' deposits become available.

E. Relations with the Fund

24. **An Ex Post Assessment Update (EPA) was conducted to review Georgia's economic performance during its long-term involvement with the Fund.** The report covered the country's performance during 2004–10 under two Fund-supported programs: the 2004–07 Poverty Reduction and Growth Facility (PRGF) and the 2008–11 SBA. The EPA concluded that the cooperation with the Fund was fruitful, and the objectives of the two programs were broadly met. The PRGF helped remove the main impediments to effective economic policy and promote private sector activity, with a resulting impressive acceleration of growth. Yet, the program could have been more forceful in addressing risks associated with overheating and increasing financial vulnerabilities. The SBA was effective in restoring confidence and macroeconomic stability in the aftermath of the crises, but it remains to be seen whether the program objectives toward the exit strategy will be fully met, in view of Georgia's still large current account deficit.

25. **Macroeconomic policies were generally aligned with previous Fund recommendations.** While staff had recommended that additional tax revenue measures be considered to bolster the fiscal consolidation strategy, the authorities preferred to implement an expenditure-based strategy, which proved successful in meeting their objectives. On the exchange rate, while agreeing with staff's recommendation that the exchange rate remains flexible, the authorities considered that intervention was occasionally needed to avoid excessive volatility.

26. **The authorities confirmed their interest in a successor arrangement** to reinforce confidence and provide a safety net against possible shocks during the challenging debt rollover period ahead. Its modalities will be discussed at the time of the final review of the current SBA.

III. Staff Appraisal

27. **The policy response to the crisis has succeeded in stabilizing the economy and restoring confidence**. The challenge is now to transition from recovery to durable growth. Managing this transition will require further adjustment in an external environment that remains unsettled.

28. **The authorities' more proactive growth strategy is a welcome sign of policy flexibility in response to the weak rebound of FDI.** Structural reforms in agriculture could unlock the sector's growth potential. Selective use of public investment to attract private sector involvement is potentially fruitful, but will need to be designed carefully and integrated in the broader fiscal strategy to avoid risks of undermining fiscal adjustment.

29. **Despite significant external adjustment already achieved since 2008, the current account deficit remains, by most measures, unsustainably high**. Policies over the medium term should support its narrowing to 5–6 percent of GDP. Fiscal adjustment—necessary on its own merits—should contribute to this process. Real exchange rate adjustment would also be needed over the medium term, consistent with closing the remaining (moderate) exchange rate misalignment.

30. **Balance-of-payments gaps could reemerge in 2012–14 on account of debt rollover risks.** Georgia's sound policy performance and overall macroeconomic conditions and prospects place it in a good position to tap international financial markets. However, in the event of continued instability in international financial markets, an alternative refinancing strategy could involve greater issuance of domestic government paper, accompanied by faster external adjustment. The authorities are encouraged to raise issuance of domestic government paper and lengthen maturities gradually to cover this possibility.

31. **Accordingly, exchange rate flexibility should remain a fundamental pillar of growth and adjustment.** The foreign exchange auction system introduced in March 2009 has already enhanced flexibility (see Box 1 of the EPA). Greater exchange rate volatility should be increasingly tolerated. If temporary exchange rate pressures need to be resisted, it is important that sales of foreign exchange in support of the lari be offset by purchases in quieter times, consistent with the need to rebuild net international reserves and exit from Fund support.

32. **Fiscal policy should be anchored on the need to bring the deficit to a sustainable position over the medium term, implying an adjustment need of approximately 5 percent of GDP relative to 2010.** Through a sizable deficit reduction in 2010, the authorities have started to make good progress toward this objective. The 2011 budget maintains the front-loaded nature of the adjustment, ahead of the 2012–13 elections. Keeping spending in 2011 within the budget envelope is key to safeguarding the structural improvement of the deficit, in the event of a stronger cyclical upturn.

33. **Over the medium term, the expenditure-based fiscal adjustment strategy chosen by the authorities will require some difficult decisions among competing priorities.** It will be important to carve out sufficient fiscal space to enhance social safety nets and to avoid an unsustainable compression of other current spending, which would leave the government hostage to large catch-up increases down the road. These constraints, as well as the need to respond to unforeseen contingencies, highlight the importance of rationalizing the

capital budget, and of preserving adequate flexibility on the revenue side. Revenue measures should also be considered if expenditure pressures cannot be contained and the escape clause to the referendum requirement on tax increases should be sufficiently broad.

34. **The immediate challenge for the monetary authorities is to prevent the entrenchment of the commodity-price shock into permanent inflation.** While core inflation remains subdued, the large increase in headline CPI raises the risk of second-round effects. The preemptive tightening to date should help stabilize inflation expectations. In view of the uncertain lags and transmission channels of monetary policy, the full impact of recent policy rate and reserve requirement increases should now be allowed to play out, and further monetary policy tightening should be contingent on evidence that inflation is not abating as projected or credit is growing too fast. The authorities' message that they stand ready to tighten further if needed is welcome.

35. **The medium-term challenge for the central bank is to manage the transition to inflation targeting.** Over the last two years, the authorities have successfully implemented a number of reforms to introduce market-based policy instruments and to develop financial markets. These reforms have begun to pay off by increasing the traction of monetary policy. Building on these achievements, the authorities are invited to continue building up their inflation forecasting and modeling capacity and improving underlying statistics.

36. **Given the relatively low level of financial intermediation, the authorities will continue to face challenges in balancing financial development considerations against prudential ones, so as to limit systemic risks.** Financial stability concerns stemming from the crisis-related increase in NPLs have abated. With credit growth picking up, the supervisory authority has moved decisively and appropriately to contain the emergence of new risks by tightening prudential regulations. Increases in its risk monitoring and assessment capacity, and the move to risk-based supervision, are commendable. The authorities have also shown the ability to act preemptively in response to the emergence of new risks, such as financial stability concerns created by the growth in nonresident deposits. The authorities are encouraged to review on a regular basis whether the recently introduced liquidity requirement to limit such inflows remains necessary, given the limited evidence about the added risks and these inflows' potential usefulness for balance of payments financing.

37. **It is expected that the next Article IV consultation be held in accordance with Decision No. 14747-(10/96), 9/28/2010, as amended.**

Table 1. Georgia: Selected Macroeconomic Indicators, 2008–16

	2008 Act.	2009 Act.	2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.
	(Annual percentage change, unless otherwise indicated)								
National accounts									
Nominal GDP (in million lari)	19,075	17,986	20,566	23,332	26,028	28,833	31,788	35,046	38,638
Real GDP growth	2.3	-3.8	6.3	5.5	4.7	4.8	4.7	4.8	4.8
Population (in million) 1/	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4
GDP deflator, period average	9.7	-2.0	7.6	7.5	6.5	5.8	5.3	5.3	5.3
Consumer price index, period average	10.0	1.7	7.1	10.2	7.3	6.3	5.8	5.5	5.4
Consumer price index, end-of-period	5.5	3.0	11.2	8.0	6.5	6.0	5.5	5.5	5.3
GDP per capita (in US$)	2,937	2,455	2,629	2,920	3,066	3,171	3,292	3,434	3,628
Unemployment rate (in percent)	16.5	16.9	...	...	...	...	...	...	...
	(In percent of GDP)								
Investment and saving									
Investment 2/	21.5	15.3	15.0	17.2	18.9	20.3	21.2	21.3	21.4
Public	4.3	6.9	7.2	6.0	5.8	5.9	5.8	5.6	5.4
Private	17.2	8.5	7.8	11.2	13.1	14.4	15.4	15.7	16.0
Gross national saving	-1.1	4.1	5.1	4.7	7.4	9.8	13.2	15.0	15.9
Public	2.2	-0.8	2.3	3.7	3.8	4.0	4.1	4.1	4.1
Private	-3.4	4.9	2.8	1.1	3.6	5.8	9.1	10.9	11.9
Saving-investment balance	-22.6	-11.2	-9.9	-12.5	-11.5	-10.5	-8.0	-6.3	-5.5
Consolidated government operations									
Total government debt	25.0	37.3	39.5	41.1	40.5	40.8	39.0	37.9	36.9
Of which : foreign-currency denominated	20.9	31.7	33.9	35.9	35.4	35.8	34.1	33.1	32.3
Revenue 3/	30.7	29.3	28.5	27.3	26.5	26.3	26.2	26.1	26.1
Current expenditures	28.5	30.1	26.3	23.7	22.8	22.4	22.1	22.1	22.0
Operating balance	2.2	-0.8	2.3	3.7	3.8	4.0	4.1	4.1	4.1
Capital spending and net lending	8.6	8.4	8.9	7.6	6.9	6.6	6.2	5.7	5.4
Overall balance	-6.3	-9.2	-6.6	-3.9	-3.1	-2.6	-2.2	-1.7	-1.3
Total financing	6.3	9.2	6.6	3.9	3.1	2.6	2.2	1.7	1.3
Domestic	-2.3	3.3	0.0	0.4	0.6	-0.2	0.8	0.8	0.0
External	5.0	3.9	5.6	2.6	2.2	2.7	1.2	0.8	1.3
Privatization receipts	3.7	2.0	1.1	0.9	0.4	0.2	0.2	0.0	0.0
	(Annual percentage change, unless otherwise indicated)								
Monetary sector									
Reserve money	-4.5	21.8	4.5	7.1	7.0	7.0	7.0	7.5	7.5
Broad money (including fx deposits) 4/	7.0	8.1	28.5	16.0	19.0	19.0	18.5	18.5	18.5
Bank credit to the private sector	28.2	-13.5	20.5	13.2	19.1	22.8	15.1	14.9	19.9
Deposit interest rate (annual weighted average on flows)	9.5	9.4	7.9	…	…	…	…	…	…
Lending interest rate (annual weighted average on flows)	22.7	20.8	17.7	…	…	…	…	…	…
External sector									
Exports of goods and services (percent of GDP)	28.7	29.8	35.2	36.9	38.1	39.2	40.3	41.6	42.8
Annual percentage change	15.9	-13.0	26.6	16.6	8.5	6.4	6.9	7.8	8.9
Imports of goods and services (percent of GDP)	58.3	48.9	52.9	55.6	55.4	55.1	54.2	54.1	54.7
Annual percentage change	26.8	-29.8	15.9	16.8	4.9	2.9	2.2	4.2	6.9
Net imports of oil (in US$)	762	555	642	780	820	849	874	898	940
Current account balance (in millions of US$)	-2,912	-1,210	-1,147	-1,597	-1,554	-1,464	-1,164	-956	-872
In percent of GDP	-22.6	-11.2	-9.9	-12.5	-11.5	-10.5	-8.0	-6.3	-5.5
Gross international reserves (in millions of US$)	1,480	2,111	2,263	2,780	2,590	2,488	2,462	2,730	2,902
In months of next year's imports of goods and services	3.4	4.2	3.8	4.5	4.0	3.8	3.6	3.7	3.7
Foreign direct investment (percent of GDP)	12.2	6.1	5.0	5.5	6.0	6.0	6.0	6.0	6.0
Average exchange rate (lari per US$)	1.48	1.67	1.78	…	…	…	…	…	…

Sources: Georgian authorities; and Fund staff estimates.

1/ Excludes Abkhazia residents.

2/ Investment is measured on a net basis (acquisitions minus disposals of nonfinancial assets).

3/ Includes grants.

4/ The proceeds of the Georgian Railway eurobond issuance from July 2010, which were deposited in accounts with Georgian commercial banks that placed them abroad are not included in broad money.

Table 2. Georgia: Annual General Government Operations, 2009-16 1/

	2009	2010		2011		2012	2013	2014	2015	2016
		7/8 Rev.	Act.	7/8 Rev.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	(In millions of lari)									
Revenues	5,264	5,809	5,866	6,315	6,381	6,907	7,595	8,314	9,156	10,083
Taxes	4,389	4,860	4,867	5,571	5,589	6,235	6,907	7,615	8,395	9,256
Other revenues	487	440	526	440	440	508	533	556	613	676
Grants	389	510	473	304	351	164.2	155	143	148	151
Current expenditures	5,407	5,413	5,399	5,550	5,519	5,926	6,445	7,020	7,732	8,516
Compensation of employees	1,048	1,151	1,138	1,208	1,150	1,280	1,410	1,540	1,698	1,872
Use of goods and services	1,105	1,062	1,086	1,016	1,050	1,130	1,220	1,350	1,488	1,641
Subsidies	420	384	372	380	379	380	390	430	474	523
Grants	14	12	13	12	14	20	22	24	26	29
Social expenses	1,506	1,611	1,612	1,631	1,630	1,820	2,020	2,220	2,448	2,698
Other expenses	1,142	969	972	1,013	1,000	970	940	1,030	1,136	1,252
Interest	171	224	206	292	296	326	443	426	462	501
To nonresidents	113	160	133	191	191	174	277	262	285	312
To residents	58	64	74	101	105	152	166	165	177	190
Operating balance	-143	397	467	765	862	981	1,150	1,293	1,424	1,567
Capital spending and net lending	1,506	1,794	1,834	1,748	1,763	1,798	1,913	1,982	2,003	2,086
Capital	1,444	1,674	1,706	1,630	1,599	1,622	1,741	1,886	1,963	2,086
Net lending	62	120	128	118	164	176	172	96	40	0
Overall balance	-1,648	-1,397	-1,366	-983	-901	-817	-762	-688	-578	-520
Statistical discrepancy	0	0	0	0	0	0	0	0	0	0
Total financing	1,648	1,397	1,366	983	901	817	762	688	578	520
Domestic	596	42	-6	209	93	155	-58	257	286	0
Net T-bill issuance	260	171	172	100	99	150	150	150	150	150
Amortization 2/	-37	-39	-42	-35	-35	-35	-35	-35	-35	-35
Use of deposits at the NBG and banks	373	-91	-136	144	29	40	-173	142	171	-115
External	694	1,155	1,152	624	607	562	771	382	292	519
Borrowing	787	1,291	1,275	761	744	666	2,363	738	785	824
of which: IMF	170	523	523	0	0	0	0	0	0	0
Amortization	-133	-136	-123	-137	-137	-105	-1,593	-357	-492	-305
of which: IMF	0	0	0	0	0	-12	-428	-175	-242	0
Use of Sovereign Wealth Fund resources	40	0	0	0	0	0	0	0	0	0
Privatization receipts	358	200	220	150	200	100	50	50	0	0
Memorandum items:										
Nominal GDP	17,986	20,490	20,566	23,018	23,332	26,028	28,833	31,788	35,046	38,638
Fiscal deficit excluding grants	2,037	1,907	1,839	1,287	1,252	981	917	831	726	671
Total expenditures (current prices) 3/	6,913	7,206	7,232	7,298	7,281	7,724	8,358	9,002	9,735	10,603
Total expenditures (constant 2008 prices)	7,055	6,859	6,858	6,461	6,423	6,397	6,546	6,699	6,883	7,123

	2009	2010		2011		2012	2013	2014	2015	2016
		7/8 Rev.	Act.	7/8 Rev.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	(In percent of GDP)									
Revenues	29.3	28.4	28.5	27.4	27.3	26.5	26.3	26.2	26.1	26.1
Taxes	24.4	23.7	23.7	24.2	24.0	24.0	24.0	24.0	24.0	24.0
Other revenues	2.7	2.1	2.6	1.9	1.9	1.9	1.8	1.7	1.7	1.7
Grants	2.2	2.5	2.3	1.3	1.5	0.6	0.5	0.4	0.4	0.4
Current expenditures	30.1	26.4	26.3	24.1	23.7	22.8	22.4	22.1	22.1	22.0
Compensation of employees	5.8	5.6	5.5	5.2	4.9	4.9	4.9	4.8	4.8	4.8
Use of goods and services	6.1	5.2	5.3	4.4	4.5	4.3	4.2	4.2	4.2	4.2
Subsidies	2.3	1.9	1.8	1.6	1.6	1.5	1.4	1.4	1.4	1.4
Grants	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Social expenses	8.4	7.9	7.8	7.1	7.0	7.0	7.0	7.0	7.0	7.0
Other expenses	6.3	4.7	4.7	4.4	4.3	3.7	3.3	3.2	3.2	3.2
Interest	1.0	1.1	1.0	1.3	1.3	1.3	1.5	1.3	1.3	1.3
To nonresidents	0.6	0.8	0.6	0.8	0.8	0.7	1.0	0.8	0.8	0.8
To residents	0.3	0.3	0.4	0.4	0.5	0.6	0.6	0.5	0.5	0.5
Operating balance	-0.8	1.9	2.3	3.3	3.7	3.8	4.0	4.1	4.1	4.1
Capital spending and net lending	8.4	8.8	8.9	7.6	7.6	6.9	6.6	6.2	5.7	5.4
Capital	8.0	8.2	8.3	7.1	6.9	6.2	6.0	5.9	5.6	5.4
Net lending	0.3	0.6	0.6	0.5	0.7	0.7	0.6	0.3	0.1	0.0
Overall balance	-9.2	-6.8	-6.6	-4.3	-3.9	-3.1	-2.6	-2.2	-1.7	-1.3
Statistical discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total financing	9.2	6.8	6.6	4.3	3.9	3.1	2.6	2.2	1.7	1.3
Domestic	3.3	0.2	0.0	0.9	0.4	0.6	-0.2	0.8	0.8	0.0
Net T-bill issuance	1.4	0.8	0.8	0.4	0.4	0.6	0.5	0.5	0.4	0.4
Amortization 2/	-0.2	-0.2	-0.2	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1
Use of deposits at the NBG and banks	2.1	-0.4	-0.7	0.6	0.1	0.2	-0.6	0.4	0.5	-0.3
External	3.9	5.6	5.6	2.7	2.6	2.2	2.7	1.2	0.8	1.3
Borrowing	4.4	6.3	6.2	3.3	3.2	2.6	8.2	2.3	2.2	2.1
of which: IMF	0.9	2.6	2.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Amortization	-0.7	-0.7	-0.6	-0.6	-0.6	-0.4	-5.5	-1.1	-1.4	-0.8
of which: IMF	0.0	0.0	0.0	0.0	0.0	0.0	-1.5	-0.6	-0.7	0.0
Use of Sovereign Wealth Fund resources	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Privatization receipts	2.0	1.0	1.1	0.7	0.9	0.4	0.2	0.2	0.0	0.0
Memorandum items:										
Nominal GDP										
Fiscal deficit excluding grants	11.3	9.3	8.9	5.6	5.4	3.8	3.2	2.6	2.1	1.7
Total expenditures (current prices) 3/	38.4	35.2	35.2	31.7	31.2	29.7	29.0	28.3	27.8	27.4
Total expenditures (constant 2008 prices)										

Sources: Ministry of Finance; and Fund staff estimates.

1/ General government includes central and local governments and the Sovereign Wealth Funds.
2/ Excluding arrears clearance, provisions and T-bill repayment.
3/ Including net lending.

Table 3. Georgia: Summary Balance of Payments, 2008–16

(In millions of U.S. dollars)

	2008	2009	2010	2011	2012	2013	2014	2015	2016
			Proj.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Current account balance	-2,912	-1,210	-1,147	-1,597	-1,554	-1,464	-1,164	-956	-872
Trade balance	-3,833	-2,399	-2,566	-3,048	-3,084	-3,063	-2,961	-2,972	-3,100
Exports	2,428	1,894	2,454	2,848	3,086	3,271	3,480	3,739	4,087
Imports	-6,261	-4,293	-5,020	-5,896	-6,169	-6,333	-6,441	-6,711	-7,186
Services	21	340	525	656	747	841	946	1,083	1,205
Services: credit	1,260	1,314	1,606	1,885	2,049	2,195	2,360	2,555	2,766
Services: debit	-1,239	-974	-1,081	-1,229	-1,302	-1,353	-1,414	-1,472	-1,561
Income (net)	-161	-118	-183	-287	-288	-325	-277	-238	-192
Of which: interest payments	-249	-247	-284	-386	-395	-435	-395	-377	-332
Transfers (net)	1,060	967	1,077	1,081	1,070	1,082	1,127	1,171	1,214
Of which: public sector	365	140	175	128	81	56	55	54	53
Capital account	112	183	196	138	93	85	76	77	76
General government	87	170	179	116	60	50	40	39	38
Other sectors	25	13	17	22	33	35	36	38	38
Financial account	2,784	1,428	824	1,773	1,517	1,662	1,402	1,357	1,029
Direct investment (net)	1,494	659	575	706	809	837	869	908	960
Monetary authorities, net 1/	22	247	1	0	0	0	0	0	0
General government	651	386	331	333	297	580	254	231	215
Portfolio investment (net)	501	0	0	0	0	800	0	0	0
of which: liabilities	508	0	0	0	0	800	0	0	0
Long-term loans received	191	359	331	333	297	-220	254	231	215
Drawing	227	428	399	408	345	343	336	339	341
Repayment	-36	-69	-68	-75	-48	-563	-83	-108	-126
Other, net	-41	27	0	0	0	0	0	0	0
Private Sector, excl. FDI	617	136	-83	734	411	245	279	218	-145
Banks	403	-65	-170	571	211	271	314	445	443
Portfolio investment, net	109	8	21	5	2	13	12	12	13
Of which: equity liabilities	101	8	19	5	7	10	12	13	14
Loans received (net)	596	-243	28	-28	59	150	200	305	303
Other, net (currency and deposits)	-302	171	-219	593	150	108	102	128	127
Other sectors	214	201	87	164	200	-26	-35	-227	-588
Portfolio investment, net	17	4	255	0	0	5	25	27	-221
Long-term loans received (net)	61	152	-28	106	161	117	19	-73	-209
Other, net	137	45	-139	58	40	-148	-79	-180	-158
Errors and omissions	-36	51	88	0	0	0	0	0	0
Overall balance	-52	451	-39	314	55	282	314	478	233
Financing	52	-451	39	-314	-55	-282	-314	-478	-233
Gross International Reserves (-increase)	-131	-616	-223	-517	190	102	26	-268	-172
Use of Fund Resources	222	313	276	203	-245	-385	-340	-210	-61
Purchases (SBA)	257	340	297	262	0	0	0	0	0
Of which: augmentation	…	…	305	262	…	…	…	…	…
Repayments (SBA and ECF 2/)	-35	-28	-22	-59	-245	-385	-340	-210	-61
Exceptional financing	-39	-148	-13	0	0	0	0	0	0
Memorandum items:									
Nominal GDP	12,870	10,768	11,539	12,826	13,476	13,946	14,490	15,129	15,993
Current account balance (percent of GDP)	-22.6	-11.2	-9.9	-12.5	-11.5	-10.5	-8.0	-6.3	-5.5
excluding official transfers (percent of GDP)	-25.5	-12.5	-11.5	-13.5	-12.1	-10.9	-8.4	-6.7	-5.8
Trade balance (in percent of GDP)	-29.8	-22.3	-22.2	-23.8	-22.9	-22.0	-20.4	-19.6	-19.4
GNFS exports growth (percent)	15.9	-13.0	26.6	16.6	8.5	6.4	6.9	7.8	8.9
GNFS exports volume growth (percent)	-1.3	0.4	8.6	6.5	8.8	8.4	8.5	8.6	7.2
GNFS imports growth (percent)	26.8	-29.8	15.9	16.8	4.9	2.9	2.2	4.2	6.9
GNFS imports volume growth (percent)	8.4	-17.6	2.1	4.0	5.6	3.7	4.0	4.4	5.7
Net capital inflows to private sector	2,111	796	492	1,440	1,220	1,082	1,148	1,126	815
(in percent of GDP)	16.4	7.4	4.3	11.2	9.1	7.8	7.9	7.4	5.1
Gross international reserves (end of period)	1,480	2,111	2,263	2,780	2,590	2,488	2,462	2,730	2,902
(in months of next year GNFS imports)	3.4	4.2	3.8	4.5	4.0	3.8	3.6	3.7	3.7
External debt (nominal)	5,664	6,254	7,148	7,948	8,221	8,420	8,137	8,078	7,712
(in percent of GDP)	44.0	58.1	61.9	62.0	61.0	60.4	56.2	53.4	48.2
MLT External debt service	591	758	676	885	1,245	1,855	1,136	988	815
(in percent of exports)	16.0	23.6	16.6	18.7	24.2	33.9	19.5	15.7	11.9
External public sector debt (nominal)	2,691	3,382	3,937	4,506	4,606	4,840	4,802	4,880	5,080
(in percent of GDP)	20.9	31.4	34.1	35.1	34.2	34.7	33.1	32.3	31.8
External public debt service	126	168	177	250	399	1,097	557	463	346
(in percent of exports)	3.4	5.2	4.4	5.3	7.8	20.1	9.5	7.4	5.0

Sources: National Bank of Georgia, Ministry of Finance, and Fund staff estimates.

1/ SDR allocation included under monetary authorities' long-term liabilities.

2/ Following the Low Income Countries (LIC) reforms, effective January 7 2010, the PRGF arrangements were renamed Extended Credit Facility (ECF) arrangements.

Table 4. Georgia: Accounts of the National Bank of Georgia, 2009–16

	2009				2010				2011	2012	2013	2014	2015	2016
	Mar. Act.	Jun. Act.	Sep. Act.	Dec. Act.	Mar. Act.	Jun. Act.	Sep. Act.	Dec. Act.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	(In millions of lari)													
Net foreign exchange position	1,313	1,303	1,489	1,842	2,117	1,698	1,961	2,218	2,350	2,535	2,712	3,208	4,006	4,406
Gross International Reserves	2,493	2,517	3,371	3,558	3,847	3,438	3,812	4,013	5,171	5,188	5,304	5,553	6,491	7,123
Other foreign assets	35	14	15	5	6	5	5	8	8	9	9	10	10	11
Foreign currency liabilities	-1,215	-1,228	-1,896	-1,722	-1,736	-1,746	-1,856	-1,803	-2,829	-2,661	-2,601	-2,355	-2,496	-2,727
Of which: use of Fund resources	-1,040	-1,068	-1,330	-1,149	-1,143	-1,165	-1,186	-1,150	-1,587	-1,224	-923	-389	-160	-16
Of which: compulsory reserves in USD	-125	-109	-122	-127	-142	-148	-242	-245	-814	-977	-1,190	-1,449	-1,792	-2,151
Of which: swap liabilities	0	-30	-61	-61	-63	-33	0	0	0	0	0	0	0	0
Net domestic assets	-47	226	201	-98	-484	-37	-265	-396	-399	-448	-478	-818	-1,437	-1,644
Net claims on general government	-34	398	441	173	-194	52	-73	-95	-100	-95	-303	-196	-61	-210
Claims on general government (incl. T-bills)	777	778	764	758	746	733	718	714	680	645	610	575	540	505
Nontradable govt. debt	641	641	641	641	601	601	601	601	553	513	473	433	393	353
Securitized debt (marketable)	136	137	123	118	146	132	117	113	127	132	137	142	147	152
Deposits	-812	-380	-323	-585	-940	-681	-790	-809	-780	-740	-913	-772	-601	-715
Claims on rest of economy	4	4	4	3	3	3	2	2	2	2	2	2	2	2
Claims on banks	90	-17	-41	-114	-89	57	-7	-165	-27	149	524	261	-303	-232
Bank refinancing	204	102	45	45	45	217	185	190	185	249	624	361	100	100
Certificates of deposits and bonds	-114	-148	-146	-219	-194	-190	-192	-355	-212	-100	-100	-100	-403	-332
Other items, net	-106	-160	-203	-160	-204	-149	-188	-138	-275	-505	-702	-885	-1,075	-1,205
Reserve money	1,267	1,529	1,691	1,744	1,633	1,661	1,696	1,822	1,951	2,087	2,234	2,390	2,569	2,762
Currency in circulation	1,141	1,201	1,286	1,458	1,399	1,460	1,501	1,618	1,750	1,850	1,950	2,050	2,150	2,250
Bank lari reserves 1/	126	328	405	286	235	127	150	144	166	210	264	330	410	509
Overnight deposits	0	0	0	0	0	74	45	60	35	28	19	10	9	3
	(Percent contribution, compared to reserve money at the end of previous year)													
Net foreign exchange position	-15.0	-15.7	-2.7	21.9	15.8	-8.2	6.8	21.6	7.2	9.5	8.5	22.2	33.4	15.6
Net domestic assets	3.4	22.5	20.8	-0.1	-22.2	3.5	-9.6	-17.1	-0.2	-2.5	-1.5	-15.2	-25.9	-8.1
Net claims on general government	4.8	35.0	38.0	19.3	-21.1	-7.0	-14.1	-15.4	-0.3	0.2	-10.0	4.8	5.7	-5.8
Claims on rest of economy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Claims on banks	-2.9	-10.4	-12.1	-17.2	1.4	9.8	6.1	-2.9	7.6	9.0	17.9	-11.8	-23.6	2.8
Other items, net	1.6	-2.2	-5.1	-2.2	-2.5	0.7	-1.6	1.2	-7.5	-11.8	-9.4	-8.2	-8.0	-5.0
	(Percentage change, relative to end of previous year)													
Reserve money	-11.5	6.8	18.1	21.8	-6.3	-4.8	-2.8	4.5	7.1	7.0	7.0	7.0	7.5	7.5
Currency in circulation	-11.6	-6.9	-0.4	13.0	-4.1	0.2	2.9	11.0	8.1	5.7	5.4	5.1	4.9	4.7
Bank lari reserves 1/	-11.0	132.0	186.9	102.5	-18.0	-55.8	-47.7	-49.7	15.2	26.4	25.9	24.9	24.5	24.1
Memorandum items:														
Net international reserves														
(in millions of USD, at prog. exchange rates) 2/	777	775	876	987	897	647	708	882	885	906	1,131	1,374	1,757	1,896
Net domestic assets (in millions of lari, at prog. exchange rate) 2/	-66	189	228	95	135	579	513	349	473	575	344	95	-364	-404
Reserve money (in percent, 12-month growth)	-10.4	-4.5	-2.5	21.8	28.9	8.6	0.3	4.5	7.1	7.0	7.0	7.0	7.5	7.5

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

1/ Comprises required and excess reserves on lari-denominated deposits.

2/ Based on program definition as defined in the TMU.

Table 5. Georgia: Monetary Survey, 2009–16

	2009				2010				2011	2012	2013	2014	2015	2016
	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	Act.	Act.	Act.	Act.	Act.	Act.	Act.	Act.						
	(In millions of lari)													
Net foreign assets	-356	-357	240	789	1,067	800	1,249	1,394	1,599	1,710	1,663	1,842	2,106	2,002
NBG	1,438	1,442	1,672	2,030	2,323	1,880	2,203	2,463	3,164	3,513	3,902	4,658	5,798	6,558
Commercial banks 1/	-1,794	-1,800	-1,432	-1,241	-1,256	-1,079	-954	-1,069	-1,565	-1,802	-2,238	-2,816	-3,692	-4,555
Of which: liabilities	-2,760	-2,446	-2,319	-2,229	-2,197	-2,303	-2,157	-2,315	-2,377	-2,676	-3,168	-3,800	-4,729	-5,626
Net domestic assets	4,031	3,952	3,852	3,814	3,669	4,242	4,139	4,523	5,264	6,457	8,055	9,675	11,541	14,170
Domestic credit	5,644	5,733	5,676	5,539	5,418	6,041	6,125	6,512	7,423	8,900	10,743	12,587	14,669	17,435
Net claims on general government	-114	270	387	280	-5	230	206	173	247	354	244	500	786	787
Of which: government deposits at NBG	-812	-380	-323	-585	-940	-681	-790	-809	-780	-740	-913	-772	-601	-715
Of which: T-bills at commercial banks			70	270	335	397	457	456	581	708	831	981	1,131	1,281
Credit to the rest of the economy	5,758	5,462	5,289	5,259	5,423	5,811	5,919	6,339	7,176	8,546	10,499	12,086	13,883	16,649
Other items, net	-1,613	-1,781	-1,824	-1,725	-1,749	-1,799	-1,986	-1,989	-2,159	-2,443	-2,688	-2,912	-3,127	-3,265
Broad money (M3) 1/	3,675	3,594	4,092	4,603	4,736	5,042	5,388	5,916	6,863	8,167	9,719	11,517	13,647	16,172
Broad money, excl. forex deposits (M2)	1,634	1,709	1,914	2,133	2,215	2,347	2,458	2,731	3,163	3,701	4,345	5,101	6,008	7,097
Currency held by the public	960	1,020	1,093	1,229	1,187	1,269	1,307	1,373	1,505	1,605	1,705	1,805	1,905	2,005
Total deposit liabilities	2,715	2,574	2,999	3,373	3,549	3,773	4,081	4,543	5,358	6,562	8,014	9,712	11,742	14,167
	(Percent contribution, compared to broad money at the end of previous year)													
Net foreign assets	-10.2	-10.3	3.8	16.7	6.0	0.3	10.0	13.1	3.5	1.6	-0.6	1.8	2.3	-0.8
Net domestic assets	-3.5	-5.3	-7.7	-8.6	-3.1	9.3	7.1	15.4	12.5	17.4	19.6	16.7	16.2	19.3
Domestic credit	-6.5	-4.4	-5.8	-9.0	-2.6	10.9	12.7	21.1	15.4	21.5	22.6	19.0	18.1	20.3
Net claims on general government	1.0	10.0	12.7	10.2	-6.2	-1.1	-1.6	-2.3	1.3	1.6	-1.3	2.6	2.5	0.0
Credit to the rest of the economy	-7.5	-14.4	-18.5	-19.2	3.6	12.0	14.3	23.5	14.1	20.0	23.9	16.3	15.6	20.3
Other items, net	3.0	-0.9	-1.9	0.4	-0.5	-1.6	-5.7	-5.7	-2.9	-4.1	-3.0	-2.3	-1.9	-1.0
	(Percentage change, relative to end of previous year)													
Broad money (M3)	-13.7	-15.6	-3.9	8.1	2.9	9.6	17.1	28.5	16.0	19.0	19.0	18.5	18.5	18.5
Broad money, excl. forex deposits (M2)	-11.9	-7.8	3.2	15.0	3.9	10.1	15.3	28.1	15.8	17.0	17.4	17.4	17.8	18.1
Currency held by the public	-11.3	-5.7	1.0	13.6	-3.5	3.3	6.3	11.7	9.6	6.6	6.2	5.9	5.5	5.2
Total deposit liabilities	-14.5	-19.0	-5.6	6.2	5.2	11.8	21.0	34.7	17.9	22.5	22.1	21.2	20.9	20.6
Credit to the rest of the economy	-5.2	-10.1	-13.0	-13.5	3.1	10.5	12.5	20.5	13.2	19.1	22.8	15.1	14.9	19.9
Memorandum items:														
M3 (in percent, 12-month growth)	-8.7	-14.2	3.2	8.1	28.9	40.3	31.7	28.5	16.0	19.0	19.0	18.5	18.5	18.5
M2 (in percent, 12-month growth)	-27.7	-29.3	-15.2	15.0	35.6	37.3	28.5	28.1	15.8	17.0	17.4	17.4	17.8	18.1
Credit to the economy (in percent, 12-month growth)	13.6	-2.4	-4.0	-13.5	-5.8	6.4	11.9	20.5	13.2	19.1	22.8	15.1	14.9	19.9
Ratio of bank lari reserves to lari deposits 2/	18.6	47.6	49.4	31.7	22.8	18.6	16.9	15.0	12.1	11.3	10.7	10.3	10.2	10.0
M3 multiplier	2.64	2.19	2.26	2.46	2.67	2.79	2.89	2.98	2.73	2.96	3.19	3.43	3.67	3.92
M3 velocity	4.75	5.00	4.69	4.14	3.92	3.90	3.81	3.64	3.53	3.46	3.22	2.99	2.79	2.59
Foreign exchange deposits in percent of total deposits	75.2	73.2	72.6	73.2	71.0	71.4	71.8	70.1	69.1	68.1	67.1	66.1	65.1	64.1

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

1/ The proceeds of the Georgian Railway eurobond issuance from July 2010, which were deposited in accounts with Georgian commercial banks that placed them abroad, are subtracted from commercial banks' foreign assets and domestic fx deposits.

2/ Comprises required and excess reserves on lari-denominated deposits (excess reserves include overnight deposits with NBG).

Table 6: Selected Monetary and Financial Soundness Indicators, 2008-11

	2008				2009				2010				2011
	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Jan.
Deposit dollarization (in percent)	60.9	60.0	61.7	75.7	75.2	73.2	72.6	73.2	71.0	71.4	71.8	70.1	70.6
Loan-to-deposit ratio (in percent)	129.4	135.7	147.0	155.9	165.3	165.4	143.0	124.2	124.7	122.2	108.7	107.6	110.7
Credit-to-GDP ratio (in percent)	28.5	30.0	29.2	31.9	30.5	30.0	29.4	29.2	29.6	30.5	29.8	30.8	31.2
Capital adequacy ratio (in percent) 1/	17.5	15.7	17.0	13.9	15.2	17.6	20.2	19.1	18.3	17.4	18.2	17.4	16.3
Capital adequacy ratio (in percent) 2/				24.0	23.6	27.1	27.4	25.6	24.6	23.3	24.4	23.6	26.1
Liquidity ratio (in percent) 3/	36.8	33.3	30.4	28.3	30.8	31.4	40.6	39.1	41.6	37.5	37.3	38.7	38.9
Nonperforming loans (in percent of total loans) 4/	3.0	3.4	9.9	12.8	15.2	18.8	18.2	17.9	17.1	16.3	15.1	12.5	12.7
Nonperforming loans (in percent of total loans) 5/				4.1	5.4	7.1	8.3	6.3	6.6	6.9	7.8	5.4	5.4
Loans collateralized by real estate (in percent of total loans)	43.6	40.5	41.6	43.6	46.4	48.0	49.1	55.5	55.5	54.1	52.3	47.5	47.7
Loans in foreign exchange (in percent of total loans)	65.9	64.9	67.5	72.8	75.3	77.3	77.6	76.9	75.9	73.7	72.8	74.0	74.5
Specific provisions (in percent of total loans)	1.9	2.2	4.7	6.0	7.5	9.4	10.2	9.7	9.4	8.9	8.3	6.5	6.7
Net foreign assets (in percent of total assets)	-17.2	-20.2	-21.6	-19.6	-22.5	-24.4	-18.4	-14.9	-15.1	-12.4	-6.2	-8.2	-11.5
Net open foreign exchange position (in percent of regulatory capital)	3.5	1.5	1.5	1.7	9.1	8.8	10.4	1.8	4.3	5.3	3.3	8.1	6.4
Return on equity (cumulative through the year, annualized) 6/	10.2	8.9	-2.9	-12.6	-7.6	-8.4	-7.3	-4.3	4.0	4.8	8.0	9.6	8.2

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

1/ National definition. Risk weight to forex loans was reduced from 200 to 175 percent in September 2008, and to 150 percent in August 2009, and raised to 175 percent in January 2011.
2/ Basel I definition.
3/ Ratio of liquid assets to 6-month and shorter maturity liabilities.
4/ National definition: NPLs are defined as loans in substandard, doubtful, and loss loan categories.
5/ IMF definition.
6/ Pre tax.

Table 7. Georgia: External Vulnerability Indicators, 2008-16

	2008 Act.	2009 Act.	2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.
Value of exports of goods and services, percent change	15.9	-13.0	26.6	16.6	8.5	6.4	6.9	7.8	8.9
Value of imports of goods and services, percent change	26.8	-29.8	15.9	16.8	4.9	2.9	2.2	4.2	6.9
Terms of trade (deterioration -)	0.4	1.7	2.8	-2.5	0.3	-1.0	0.3	-0.6	0.4
Current account balance (percent of GDP)	-22.6	-11.2	-9.9	-12.5	-11.5	-10.5	-8.0	-6.3	-5.5
Capital and financial account (percent of GDP)	22.5	15.0	8.8	14.9	11.9	12.5	10.2	9.5	6.9
External public debt (percent of GDP)	20.9	31.4	34.1	35.1	34.2	34.7	33.1	32.3	31.8
in percent of exports of goods and services	73.0	105.4	97.0	95.2	89.7	88.6	82.2	77.5	74.1
Debt service on external public debt									
(in percent of exports of goods and services)	3.4	5.2	4.4	5.3	7.8	20.1	9.5	7.4	5.0
External debt (percent of GDP)	44.0	58.1	61.9	62.0	61.0	60.4	56.2	53.4	48.2
in percent of exports of goods and services	153.6	195.0	176.1	167.9	160.1	154.1	139.3	128.3	112.5
Debt service on MLT external debt									
(in percent of exports of goods and services)	16.0	23.6	16.6	18.7	24.2	33.9	19.5	15.7	11.9
Gross international reserves									
in millions of USD	1,480	2,111	2,263	2,780	2,590	2,488	2,462	2,730	2,902
in months of next year's imports of goods and servces	3.4	4.2	3.8	4.5	4.0	3.8	3.6	3.7	3.7
in percent of external debt	26.1	33.7	31.7	35.0	31.5	29.5	30.3	33.8	37.6
in percent of short-term external debt (remaining maturity)	101	169	160	152	110	153	164	197	179

Source: Fund staff estimates and projections.

Table 8. Georgia: External Financing Requirements and Sources, 2008–16

(In millions of U.S. dollars)

	2008	2009	2010	2011	2012	2013	2014	2015	2016
Total requirements	-3,275	-1,721	-1,553	-2,115	-2,423	-2,899	-1,919	-1,582	-1,369
Current account deficit	-2,912	-1,210	-1,147	-1,597	-1,554	-1,464	-1,164	-956	-872
Capital outflows: Repayments of MLT loans	-363	-511	-406	-518	-868	-1,436	-755	-626	-497
Total sources	3,275	1,721	1,553	2,115	2,423	2,899	1,919	1,582	1,369
Capital flows	3,188	2,145	1,492	2,370	2,233	2,797	1,894	1,850	1,542
Public sector	795	872	579	524	405	1,193	376	378	379
Project grants	87	170	179	116	60	50	40	39	38
Long-term loan disbursements to public sector	227	428	399	408	345	343	336	339	341
Other 1/	482	274	1	0	0	800	0	0	0
Private sector	2,392	1,273	913	1,846	1,828	1,604	1,518	1,473	1,163
Foreign direct investment in Georgia	1,564	658	575	706	809	837	869	908	960
Long-term loan disbursements to private sector	759	574	338	462	795	714	573	547	397
Other net inflows 2/	69	41	-1	678	225	53	75	18	-193
Financing	218	193	284	262	0	0	0	0	0
IMF 3/	257	340	297	262	0	0	0	0	0
Change in arrears, net (- decrease)	-9	27	6	0	0	0	0	0	0
Advance Repayments	-29	-186	-31	0	0	0	0	0	0
Change in reserves (- increase)	-131	-616	-223	-517	190	102	26	-268	-172
Memorandum items (in percent of GDP):									
Total financing requirements	-25.4	-16.0	-13.5	-16.5	-18.0	-20.8	-13.2	-10.5	-8.6
Total sources	25.4	16.0	13.5	16.5	18.0	20.8	13.2	10.5	8.6
Capital inflows	24.8	19.9	12.9	18.5	16.6	20.1	13.1	12.2	9.6
Exceptional financing	1.7	1.8	2.5	2.0	0.0	0.0	0.0	0.0	0.0
Change in reserves (- increase)	-1.0	-5.7	-1.9	-4.0	1.4	0.7	0.2	-1.8	-1.1

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

1/ Including the receipts and the repayment of the Eurobond-2013.

2/ Including errors and omissions.

3/ ECF (formerly known as PRGF) disbursements in 2006 and 2007, SBA purchases from 2008 on, including augmentation in 2010-11.

Table 9. Georgia: External Debt Sustainability Framework, 2006-2016
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Debt-stabilizing non-interest current account 6/
Baseline: External debt	37.8	38.5	44.0	58.1	61.9	**63.7**	**63.6**	**62.6**	**58.0**	**55.1**	**49.2**	**-7.1**
Change in external debt	5.1	0.7	5.5	14.1	3.9	1.8	-0.1	-1.0	-4.5	-2.9	-5.9	
Identified external debt-creating flows (4+8+9)	-6.2	-6.3	8.8	8.0	0.3	4.0	2.8	1.8	-0.8	-2.3	-3.0	
Current account deficit, excluding interest payments	14.3	18.2	20.4	8.3	7.0	9.3	8.6	7.3	5.1	3.6	3.1	
Deficit in balance of goods and services	24.0	26.7	29.6	19.1	17.7	19.2	18.1	16.5	14.4	12.9	12.1	
Exports	32.8	31.1	28.7	29.8	35.2	37.9	39.7	40.6	41.7	42.9	43.8	
Imports	56.8	57.9	58.3	48.9	52.9	57.1	57.8	57.1	56.0	55.8	55.9	
Net non-debt creating capital inflows (negative)	-15.2	-16.3	-11.6	-6.1	-5.0	-5.7	-6.3	-6.2	-6.2	-6.2	-6.1	
Automatic debt dynamics 1/	-5.3	-8.1	0.1	5.8	-1.8	0.3	0.5	0.7	0.3	0.3	0.0	
Contribution from nominal interest rate	0.8	1.5	2.7	2.7	2.9	3.5	3.4	3.6	3.2	2.9	2.4	
Contribution from real GDP growth	-2.5	-3.5	-0.8	1.8	-3.3	-3.2	-2.9	-2.9	-2.9	-2.6	-2.5	
Contribution from price and exchange rate changes 2/	-3.6	-6.1	-1.7	1.4	-1.3	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	11.3	7.0	-3.3	6.1	3.6	-2.2	-3.0	-2.8	-3.8	-0.6	-2.8	
External debt-to-exports ratio (in percent)	115.1	123.7	153.6	195.0	176.1	167.9	160.1	154.1	139.3	128.3	112.5	
Gross external financing need (in billions of US dollars) 4/	1.5	2.7	3.9	2.7	2.4	3.0	3.4	3.8	2.8	2.5	2.3	
in percent of GDP	19.9	26.6	30.3	24.9	20.8	24.1	26.2	28.4	19.9	16.8	14.4	
Scenario with key variables at their historical averages 5/						**63.7**	**55.7**	**49.4**	**43.3**	**40.6**	**37.5**	**-13.1**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	9.4	12.3	2.3	-3.8	6.3	5.5	4.7	4.8	4.7	4.8	4.8	
GDP deflator in US dollars (change in percent)	12.4	19.2	4.7	-3.1	2.3	2.5	-1.1	-0.7	-0.5	-0.2	2.0	
Nominal external interest rate (in percent)	3.1	5.2	7.4	5.6	5.4	6.1	5.6	5.9	5.3	5.3	4.7	
Growth of exports (US dollar terms, in percent)	16.6	24.7	15.9	-13.0	26.6	16.6	8.5	6.4	6.9	7.8	8.9	
Growth of imports (US dollar terms, in percent)	33.0	34.1	26.8	-29.8	15.9	16.8	4.9	2.9	2.2	4.2	6.9	
Current account balance, excluding interest payments	-14.3	-18.2	-20.4	-8.3	-7.0	-9.3	-8.6	-7.3	-5.1	-3.6	-3.1	
Net non-debt creating capital inflows	15.2	16.3	11.6	6.1	5.0	5.7	6.3	6.2	6.2	6.2	6.1	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

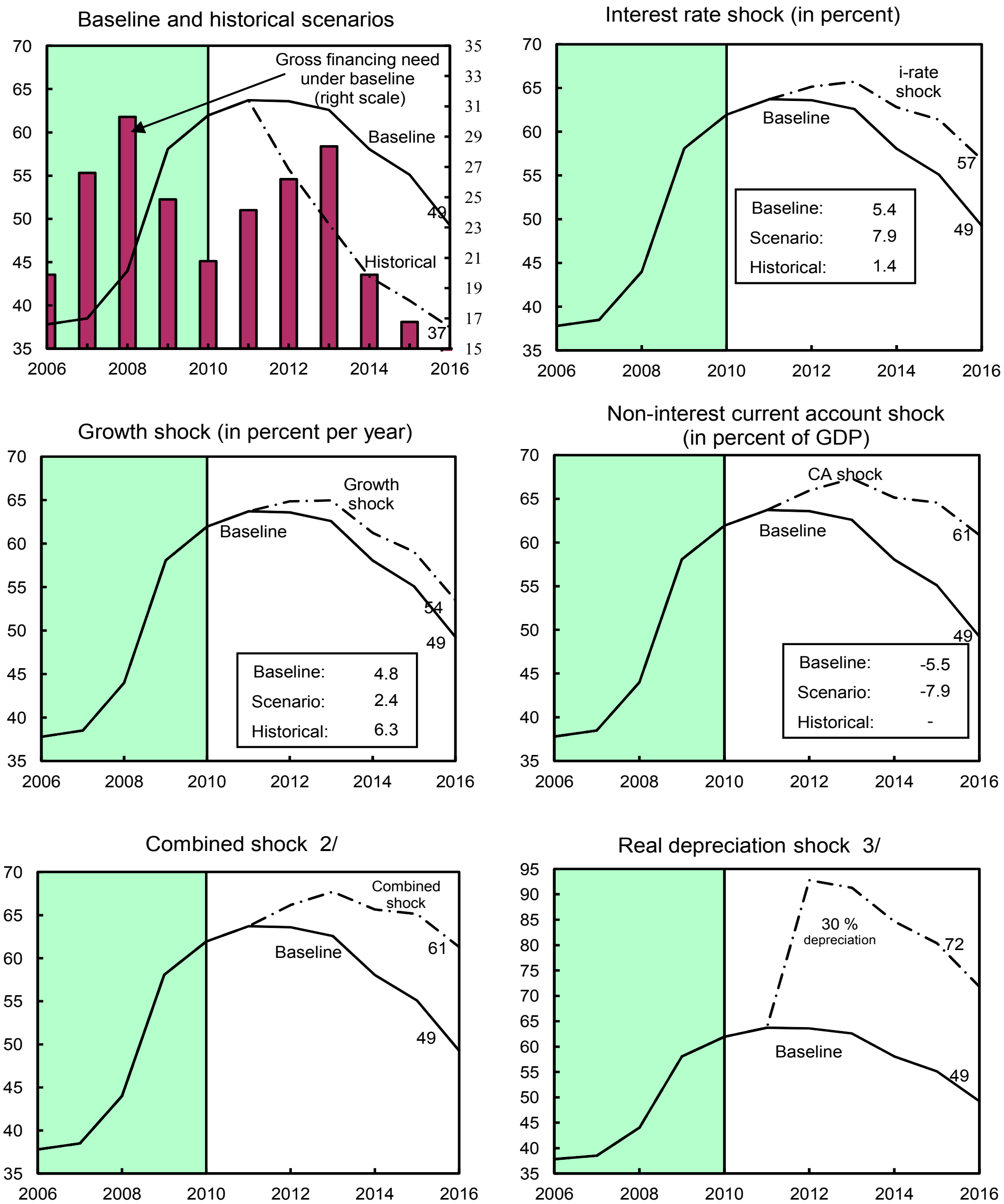
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table 10. Georgia: Public Sector Debt Sustainability Framework, 2006-2016
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	**Debt-stabilizing primary balance 9/**
Baseline: Public sector debt 1/	27.3	21.5	27.6	37.3	39.5	**41.1**	**40.5**	**40.8**	**39.0**	**37.9**	**36.9**	**-0.9**
o/w foreign-currency denominated	21.3	16.8	23.5	31.7	33.9	35.9	35.4	35.8	34.1	33.1	32.3	
Change in public sector debt	-6.8	-5.8	6.1	9.7	2.2	1.6	-0.6	0.3	-1.8	-1.1	-1.0	
Identified debt-creating flows (4+7+12)	-8.3	-7.0	1.0	9.1	2.4	-1.7	-1.5	-1.5	-1.8	-2.0	-2.2	
Primary deficit	2.3	4.2	5.7	8.2	5.6	2.6	1.9	1.1	0.8	0.3	0.0	
Revenue and grants	26.7	29.3	30.7	29.3	28.5	27.3	26.5	26.3	26.2	26.1	26.1	
Primary (noninterest) expenditure	29.0	33.4	36.4	37.5	34.2	29.9	28.4	27.5	27.0	26.5	26.1	
Automatic debt dynamics 2/	-5.4	-6.0	-1.0	2.9	-2.2	-3.4	-3.0	-2.4	-2.4	-2.3	-2.2	
Contribution from interest rate/growth differential 3/	-4.6	-4.6	-1.7	2.6	-3.7	-3.4	-3.0	-2.4	-2.4	-2.3	-2.2	
Of which contribution from real interest rate	-1.9	-1.8	-1.3	1.5	-1.6	-1.5	-1.3	-0.7	-0.7	-0.6	-0.6	
Of which contribution from real GDP growth	-2.7	-2.7	-0.4	1.1	-2.0	-1.9	-1.7	-1.7	-1.8	-1.7	-1.6	
Contribution from exchange rate depreciation 4/	-0.8	-1.4	0.7	0.3	1.5	...	...	...	...	...	...	
Other identified debt-creating flows	-5.2	-5.2	-3.7	-2.0	-1.1	-0.9	-0.4	-0.2	-0.2	0.0	0.0	
Privatization receipts (negative)	-5.2	-5.2	-3.7	-2.0	-1.1	-0.9	-0.4	-0.2	-0.2	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	1.5	1.3	5.1	0.5	-0.2	3.3	0.9	1.7	0.0	0.9	1.2	
Public sector debt-to-revenue ratio 1/	102.5	73.6	90.0	127.4	138.5	150.3	152.7	154.8	149.0	144.9	141.3	
Gross financing need 6/	5.2	5.7	6.9	10.1	8.7	6.4	5.7	10.6	6.0	6.0	5.2	
in billions of U.S. dollars	0.4	0.6	0.9	1.1	1.0	0.8	0.8	1.5	0.9	0.9	0.8	
Scenario with key variables at their historical averages 7/						**41.1**	**40.5**	**41.0**	**39.7**	**39.6**	**39.9**	**-2.4**
Scenario with no policy change (constant primary balance) in 2011-2016						**41.1**	**41.2**	**43.0**	**42.9**	**44.0**	**45.4**	**-1.1**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	9.4	12.3	2.3	-3.8	6.3	5.5	4.7	4.8	4.7	4.8	4.8	
Average nominal interest rate on public debt (in percent) 8/	2.6	2.6	3.3	3.2	3.1	3.6	3.4	4.2	3.6	3.7	3.8	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-5.9	-7.1	-6.4	5.3	-4.5	-3.9	-3.1	-1.6	-1.6	-1.5	-1.5	
Nominal appreciation (increase in US dollar value of local currency, in percent)	3.6	8.7	-4.5	-1.1	-4.9	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	8.5	9.7	9.7	-2.0	7.6	7.5	6.5	5.7	5.3	5.3	5.2	
Growth of real primary spending (deflated by GDP deflator, in percent)	26.7	29.6	11.4	-0.9	-3.2	-7.5	-0.6	1.2	2.9	2.7	3.5	
Primary deficit	2.3	4.2	5.7	8.2	5.6	2.6	1.9	1.1	0.8	0.3	0.0	

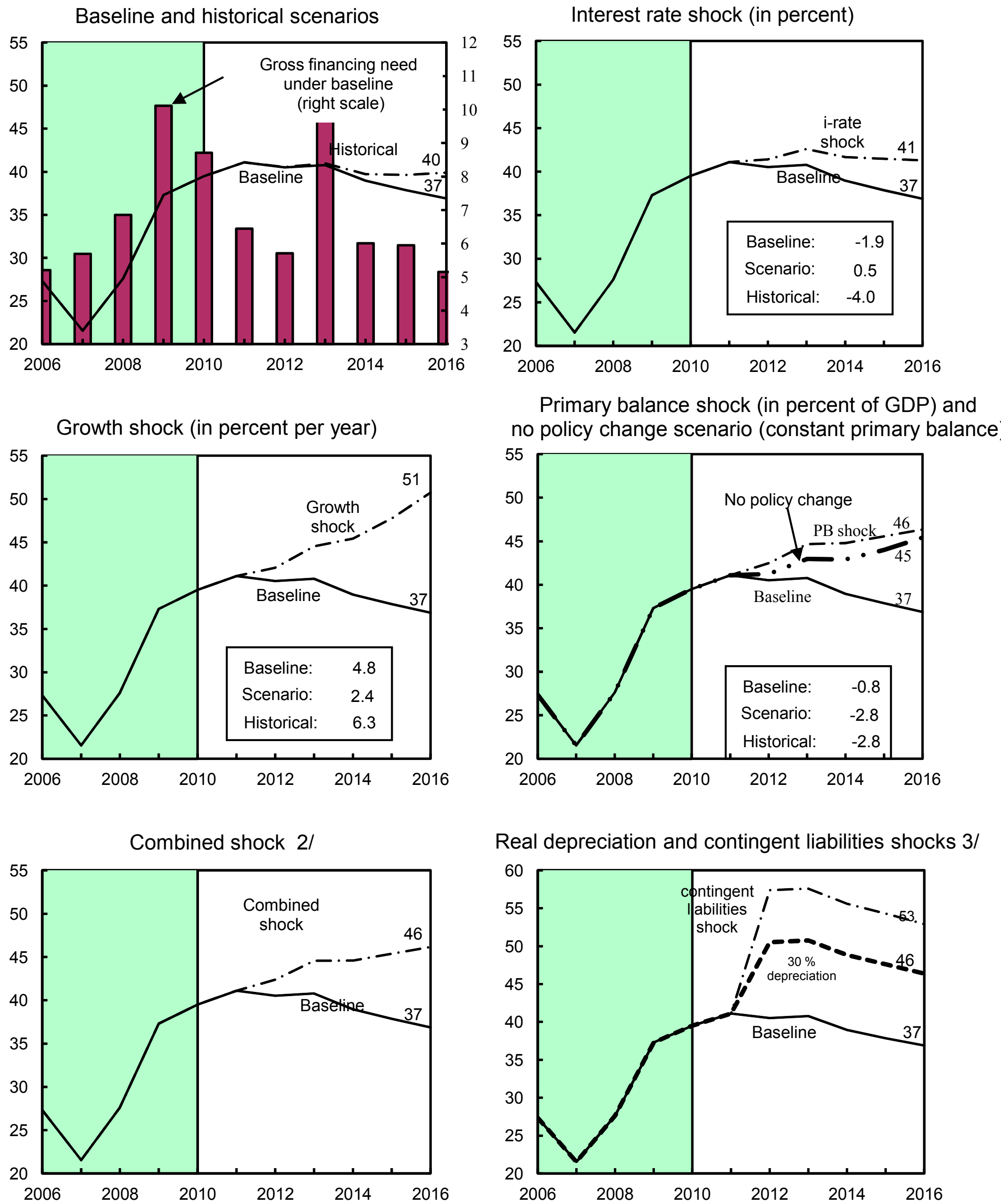
1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 3. Georgia: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2010.

Figure 4. Georgia: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2010, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

INTERNATIONAL MONETARY FUND

GEORGIA

Staff Report for the 2011 Article IV Consultation
Informational Annex

Prepared by the Middle East and Central Asia Department

March 7, 2011

Contents Page

ANNEX I. GEORGIA: RELATIONS WITH THE FUND

(As of January 31, 2011)

I. **Membership Status:** Georgia joined the Fund on May 5, 1992.

II. **General Resources Account:**	**SDR Million**	**Percent of Quota**
Quota	150.30	100.00
Fund holdings of currency	727.40	483.97
Reserve position in Fund	0.01	0.01

III. **SDR Department:**	**SDR Million**	**Percent of Allocation**
Holdings	148.37	103.07

IV. **Outstanding Purchases and Loans:**	**SDR Million**	**Percent of Quota**
Stand-by Arrangements	577.10	383.97
ECF [1]	100.45	66.83

V. **Latest Financial Arrangements:**

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn SDR Million)
Stand-By	9/15/08	6/14/11	747.10	577.10
ECF [1]	6/4/04	9/30/07	98.00	98.00
ECF [1]	1/12/01	1/11/04	108.00	49.50

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

	Forthcoming				
	2011	**2012**	**2013**	**2014**	**2015**
Principal	33.56	159.90	251.11	166.75	52.23
Charges/interest	10.63	9.38	5.35	2.03	0.28
Total	44.20	169.28	256.46	168.78	52.51

VII. **Safeguard Assessments:**

An update of the December 2008 safeguards assessment of the National Bank of Georgia (NBG) was completed on January 21, 2010 in conjunction with an augmentation of access

[1] Following the Low Income Countries (LIC) reforms, effective January 7, 2010, the PRGF arrangements were renamed the Extended Credit Facility (ECF) Arrangements.

under the SBA approved on August 6, 2009. The NBG continues to publish financial statements that comply with International Financial Reporting Standards, and are externally audited by an international firm in accordance with International Standards on Auditing. In response to the safeguards assessment, the authorities have agreed to a multi-year appointment of an external audit firm, beginning with financial year 2010.

VIII. **Implementation of Multilateral Debt Relief Initiative (MDRI):**

Not Applicable.

IX. **Implementation of HIPC Initiative:**

Not Applicable.

X. **Exchange Arrangements:**

(a) From 1993 to 2009, the National Bank of Georgia conducted foreign exchange market interventions through daily fixing sessions at the Tbilisi Interbank Currency Exchange (TICEX). A temporary de facto exchange rate peg to the U.S. dollar was introduced in the wake of the early August armed conflict. During the second week of November, the authorities allowed a 17 percent depreciation of the lari. In March 2009, the authorities introduced an auction-based system for the foreign exchange market. This mechanism is intended to allow more flexibility and give market forces a greater role in setting the price, with a view to reaching faster and smoother convergence toward equilibrium in the foreign exchange market and giving the market greater clarity about the authorities' policies. In end-May 2009, the authorities officially ended foreign exchange market interventions on TICEX.

(b) The government uses the official exchange rate for budget and tax accounting purposes as well as for all payments between the government and enterprises and other legal entities. The official rate may differ by more than two percent from freely determined market rates, which gives rise to a multiple currency practice. In practice, the official and market rates have never differed by more than 2 percent since the introduction of foreign exchange auctions in March 2009.

XI. **Article IV Consultation:**

The 2009 Article IV consultation was concluded on March 23, 2009.

XII. **FSAP Participation:**

Two FSAP missions visited Tbilisi during May 1–15, and July 24–August 7, 2001. An FSAP update mission visited Tbilisi during February 15–28, 2006.

XIII. **Technical Assistance:**

See Table 1 of this Annex.

XIV. **Resident Representative:**

The sixth resident representative, Mr. Edward Gardner, took up his post on March 15, 2009.

XV. **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 served from September 2004 to October 2007 as a resident advisor on banking supervision issues.

XVI. **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. Between 2001 and 2003, Mr. Welling was an FAD peripatetic advisor to assist the State Customs Department in preparing and introducing measures for the custom reform and modernization program. In March 2005, Mr. Zohrab started advising the authorities on treasury-related reforms, and his term ended in November 2006.

Table 1. Georgia: Fund Technical Assistance Missions, 2007–10

Subject	Type of Mission	Timing	Counterpart
		Fiscal Affairs Department (FAD)	
Tax Administration	Follow-up mission	Jan. 17–30, 2007	Ministry of Finance
Tax Administration	Expert assistance (Woodley)	Jan/Feb and Apr/May 2008	Ministry of Finance
Budget Classification and Accounting Reforms	Expert assistance (Swarap)	Jun. 11-22, 2007	Ministry of Finance
Budget Classification and Accounting Reforms	Expert assistance (Swarap)	Jun. 11-22, 2007	Ministry of Finance
Public Financial Management	Expert assistance	Apr. 6-19, 2010	Ministry of Finance
		Monetary and Capital Markets Department (MCM)	
Monetary Operations/Monetary Policy/Foreign Exchange	Advisory	Feb. 16–Mar. 2, 2007	National Bank of Georgia
Consolidated Supervision	Advisory	Dec. 4–14, 2007	National Bank of Georgia
Lender of Last Resort Framework	Advisory	Dec. 11-17, 2008	National Bank of Georgia
Stress Testing and Foreign Exchange Market	Advisory	Apr. 21-30, 2009	Financial Supervisory Agency; National Bank of Georgia
Macroeconomic Modeling for Monetary Policy Formulation	Advisory	June 2-10, 2010	National Bank of Georgia
Macroeconomic Modeling for Monetary Policy Formulation	Advisory	October 4-13, 2010	National Bank of Georgia
		Statistics Department (STA)	
Balance of Payments	Follow-up assistance	Jul. 9-20, 2007	National Bank of Georgia
Monetary and Financial Statistics	Advisory	Mar. 18-31, 2009	National Bank of Georgia
Evaluation of Technical Assistance	Follow-up assistance	Jul. 14–16, 2010	National Statistics Office, National Bank of Georgia, Ministry of Finance
External Sector Statistics	Follow-up assistance	Oct. 4–15, 2010	National Bank of Georgia
		Legal Department (LEG)	
Payment Systems	Advisory	May 25–Jun. 5, 2010	National Bank of Georgia
Payment Systems	Follow-up assistance	Nov. 8–14, 2010	National Bank of Georgia

ANNEX II. GEORGIA: RELATIONS WITH THE WORLD BANK

(As of March 1, 2011)

Title	Product	Tentative Timing of Mission	Expected Delivery of Report
Bank	*Operations*		
	DPO program, including ongoing policy dialogue on:	Quarterly	July 2011
	public investment management program budgeting social safety nets tax and customs reforms trade-related reforms		
	Public Sector Financial Management Project	Ongoing	Ongoing
	Analytical Work		
	Programmatic PER	Quarterly	End-2010/Mid-2011
	Trade Dialogue / Technical Assistance	Ongoing	Ongoing
	Programmatic Poverty Assessment	Periodic	Periodic
Fund	*Missions and Technical Assistance:*		
	Staff visit on 2011 budget and macroeconomic framework update	Sept.8-16, 2010	Sept 20, 2010
	SBA 7th and 8th Reviews	Oct.26-Nov.5, 2010	Nov.10 (draft)
	SBA 9th Review and Art.IV Consultation	Feb 1-11, 2011	Feb 16 (draft)
	SBA 10th Review	Mar.30-Apr.8, 2010	Apr.12 (draft)
	TA: payments system legal framework, follow up	January, 2011	February 2011
	TA: Payments system oversight	undecided	…
	TA: macroeconomic model for monetary policy analysis	Oct.4-14, 2010	November 2010
	Analytical work		
	DSGE model for monetary policy analysis Inflation process and forecast Potential output estimation Equilibrium exchange rate assessment International reserve adequacy assessment		
Joint Bank-Fund	Joint Debt Sustainability Analysis	Ongoing collaboration	May 2011

ANNEX III. GEORGIA: RELATIONS WITH THE EBRD

(As of December 15, 2010)

Since 1994, the EBRD has been active in supporting Georgia's transformation toward a market economy. The Bank's current country strategy for Georgia, approved in February 2010, outlines the following main strategic directions:

- Supporting stabilization and restructuring of the financial sector, strengthening risk and portfolio management practices and increasing the share of local currency operations;
- Helping rehabilitate and modernize the country's road, energy and municipal infrastructure to strengthen energy security and promote energy efficiency, help Georgia benefit from its potential as a transit country and improve efficiency and long-term financial sustainability of its municipal services;
- Provide financing to the enterprise sector with the view of supporting innovation, competition and export potential, in particular in manufacturing and agribusiness.

As of end-November 2010, the Bank had signed 131 investments in Georgia with the cumulative commitment totaling € 1 billion. Its outstanding portfolio stands at around € 700 million. The majority of the portfolio is in the financial sector (around 2/5th), energy sector and infrastructure (1/5th each). The ratio of private sector projects in the portfolio currently stands at 80 percent. The Bank will give preference to non-sovereign operations. Where sovereign guarantees are required, donor co-funding on a grant basis will be sought.

In 2008-9, the Bank played an important role in stabilizing Georgia's financial system that had suffered from the August 2008 conflict and the global financial crisis. Along with the IFC, the EBRD provided Bank of Georgia and TBC Bank, the two largest systemic banks, with equity, quasi equity and loan facilities aggregating $170 million.

In 2010, the EBRD's operations focused on the infrastructure sector. The Bank signed several large projects, including Tbilisi Railway By-Pass (€112 million), a sovereign guaranteed loan to finance the Black Sea Transmission Line (€80 million), the second stage of the rehabilitation of the Enghuri hydro power plant (€20 million) as well as a berth rehabilitation project at the Poti port (€8 million) and Adjara solid waste landfill project (€3million).

The Bank also signed a number of smaller projects in the financial and industrial sectors. The Bank increased its equity participation in Bank Republic and provided SME credit lines to TBC Bank and Bank of Georgia (€ 5.6 million and € 15 million, respectively). It enhanced its Medium size Co-Financing Facility (MCFF) and signed four sub-projects in the manufacturing, agriculture and health sectors (totaling € 16 million). MCFF has been working successfully for several years. The Bank also expanded the efforts in promoting its

Energy Efficiency Initiative by providing € 3.7 million facility for residential and industrial on-lending to Bank of Georgia.

Georgia is part of the 'Early Transition Countries' (ETC) initiative. Launched in April 2004, the initiative aims to increase investments in the Bank's then seven poorest countries. The initiative builds on international efforts to address poverty in these countries. Through this initiative, the EBRD focuses its efforts on private sector business development and selected public sector interventions. It aims to stimulate market activity by using a streamlined approach to financing, focusing on smaller projects, mobilizing more investment, and encouraging ongoing economic reform. The Bank will accept higher risk in the projects it finances in the ETCs, while respecting the principles of sound banking. Since the launch of the ETC initiative, the Bank's annual business volume in Georgia has increased five-fold.

Going forward, the EBRD is actively engaged in promoting local currency lending and de-dollarisation of the Georgian banking system. Georgia is one of the first countries to undergo a joint EBRD-IMF-World Bank assessment of the economic policy, regulatory and legal frameworks for development of the local currency capital markets. Next steps are expected to include a framework agreement with the authorities on policy reforms required to support de-dollarisation, expansion of EBRD lending in lari and technical assistance activities.

INTERNATIONAL MONETARY FUND

GEORGIA

Ex Post Assessment of Longer-Term Program Engagement—An Update

Prepared by an interdepartmental staff team[1]

Authorized for distribution by the Middle East and Central Asia and the Strategy, Policy, and Review Departments

March 7, 2011

Key Issues

- *During 2004-07, Georgia experienced an impressive economic transformation owing to enhanced macroeconomic policies and structural reforms supported by a Poverty Reduction and Growth Facility-arrangement.*

- *The double shock (the armed conflict and the global crisis) in 2008-09 put pressure on the capital account, which the country was able to counteract with a strong domestic policy response supported by a Stand-By Arrangement and donors' aid.*

- *Though Georgia navigated relatively well through the storm, risks remain—fiscal consolidation, greater exchange rate flexibility, and enhanced effectiveness of monetary policy should be central to the authorities' policy strategy.*

- *A successor arrangement with the Fund could help the country mitigate the risks ahead and facilitate access to international capital markets.*

[1] The team is comprised of Stefania Fabrizio (head) and Linda Kaltani (both SPR), Alina Luca (MCD), and Luc Eyraud (FAD).

Content Page

I. Introduction

1. **This Ex Post Assessment (EPA) Update reviews Georgia's performance under two Fund-supported programs between 2004 and 2010**: the 2004–07 Poverty Reduction and Growth Facility (PRGF) (total access of SDR 206 million or 147.5 percent of quota) and the 2008 Stand-By Arrangement (SBA) (total access of SDR 747 million or 497 percent of quota), which will expire in June 2011.

2. **The recommendations of the 2003 EPA provide the starting point for this update**. The 2003 EPA (Country Report No. 04/26) noted that Georgia made some progress toward macroeconomic stabilization during 1996–2003. However, the overall results fell short of expectations, owing to the pervasiveness of corruption, political fragmentation, and low institutional capacity (Appendix I summarizes the 2003 EPA recommendations and their implementation status).

3. **Since 2004, Georgia experienced radical political and economic changes.** The new political leadership that came to power after the Rose Revolution of November 2003 implemented an ambitious reform agenda during 2004–07 that turned Georgia into a business-friendly market economy and led to strong economic growth. In 2008–09, the economy was hit hard first by the conflict with Russia in August 2008 and subsequently by the global crisis. The economic recovery started in late 2009 and accelerated in 2010.

4. **This EPA Update is structured as follows.** First, it reports on macroeconomic and structural developments since 2004. Second, it assesses the objectives, design, and performance under the IMF-supported programs. Finally, it analyzes challenges and risks ahead, draws broad policy recommendations, and suggests possible future Fund engagement.

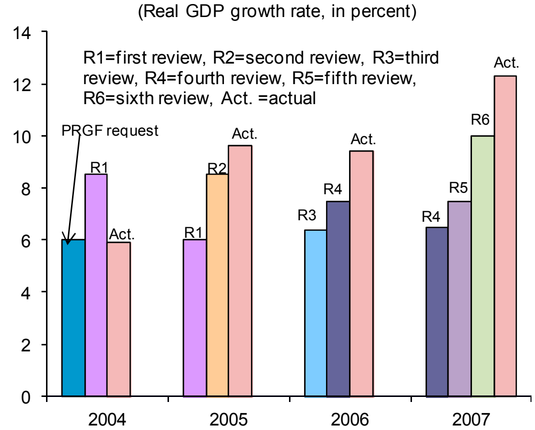
II. Macroeconomic and Structural Developments Since 2004

A. Macroeconomic Developments: From Fast Growth to Recession

Georgia enjoyed impressive economic growth over 2004–07, driven mostly by large external private inflows. This strong growth came to a halt in August 2008, when the conflict with Russia and the global crisis pushed the economy into recession. The recovery started in late-2009.

5. **During 2004–07, the Georgian economy performed beyond expectations**. Real GDP grew at an average rate of 9 percent, reaching a peak of 12.3 percent in 2007. Growth was generated mainly by large foreign capital inflows, in particular FDI, driven to a large extent by privatization. Significant

Economic growth was systematically underestimated.
(Real GDP growth rate, in percent)



Sources: World Economic Outlook (WEO), and Fund staff estimates.

homegrown structural reforms undertaken throughout the period facilitated the transition to a market-based economy and fostered capital inflows.

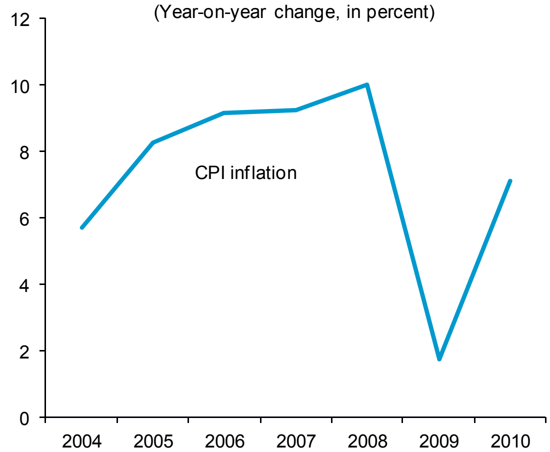
6. **As growth accelerated, new macroeconomic challenges emerged in the period leading to the double shock:**

- Inflation picked up in early 2005, remaining just below 10 percent throughout the period.

- While fiscal revenue performance was impressive and beyond expectations (the revenue-to-GDP ratio increased by more than 10 percentage points in four years) and expenditure arrears were eliminated, lingering difficulties to contain expenditures persisted, favoring a procyclical fiscal stance. Procyclicality continued in 2008, with the fiscal deficit partly financed by the issuance of a Eurobond to be repaid in 2013.

Inflation picked up in 2005, and remained just below 10 percent until the crisis hit.

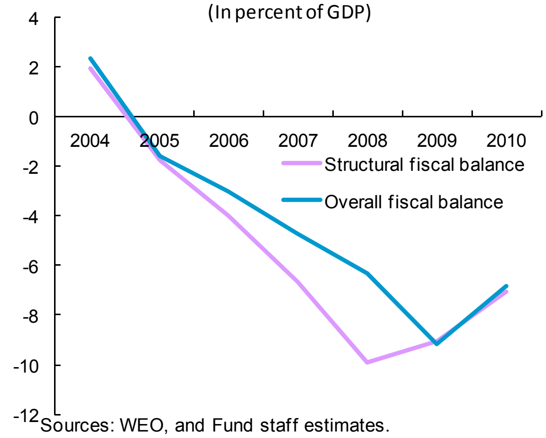
(Year-on-year change, in percent)



Sources: WEO, and Fund staff estimates.

Fiscal policy was procyclical during 2006–07 and most of 2008.

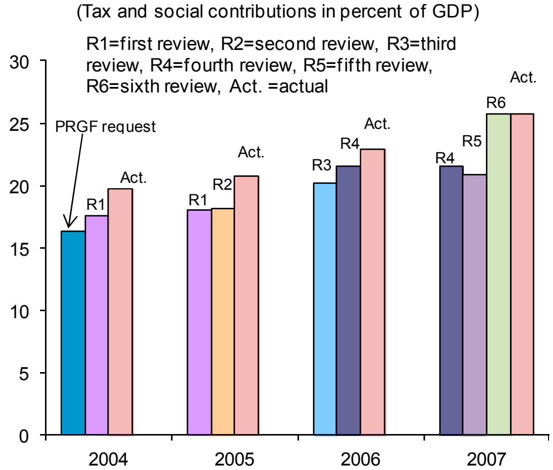
(In percent of GDP)



Sources: WEO, and Fund staff estimates.
Note: The structural balance removes the cyclical component of revenues and exogenous factors from the standard fiscal balance.

While tax revenues systematically overperformed...

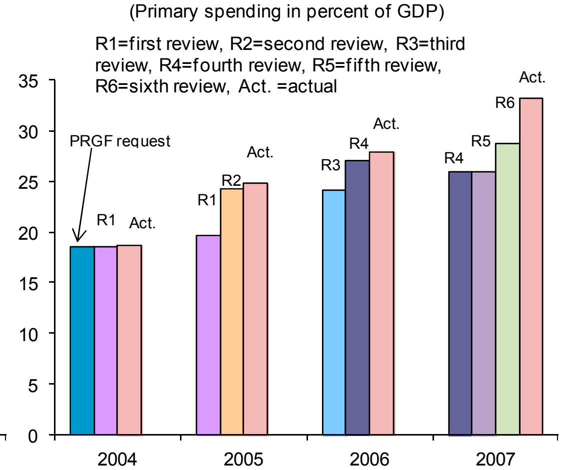
(Tax and social contributions in percent of GDP)



Sources: WEO, and Fund staff estimates.

...difficulties in containing spending persisted.

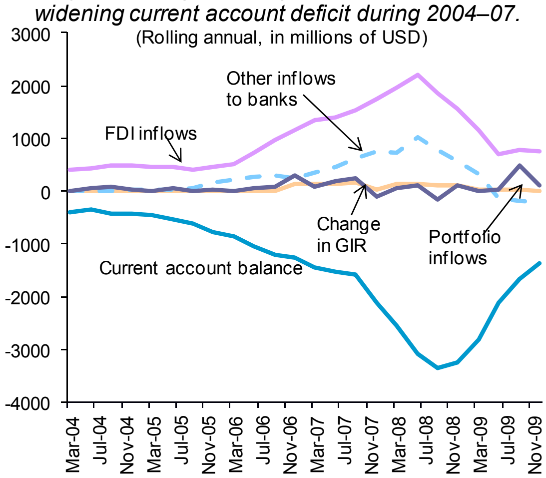
(Primary spending in percent of GDP)



Sources: WEO, and Fund staff estimates.

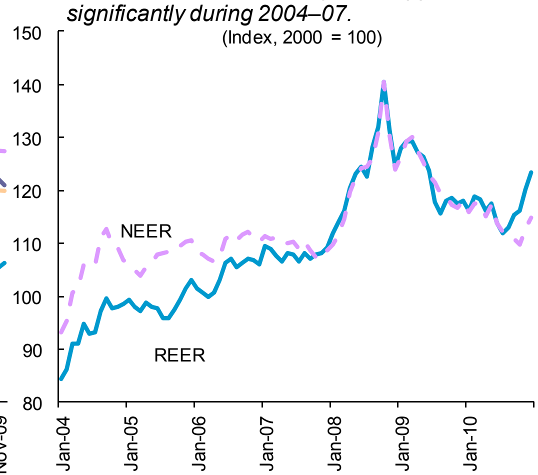
- External imbalances built up as reflected by a widening current account deficit. The central bank accumulated foreign exchange reserves rapidly to contain real appreciation pressures on the lari stemming from large capital inflows. Despite the relatively stable nominal effective exchange rate, the real rate appreciated by about 30 percent over the period on account of relative high inflation.

Large external private capital inflows financed the widening current account deficit during 2004–07.



Sources: WEO, and Fund staff estimates.

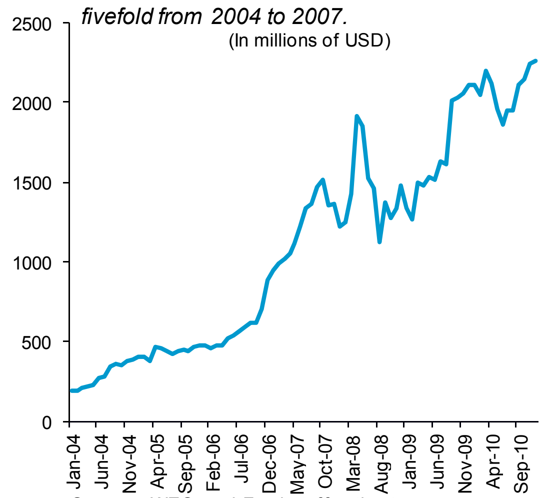
The real effective exchange rate appreciated significantly during 2004–07.



Source: Fund staff estimates.

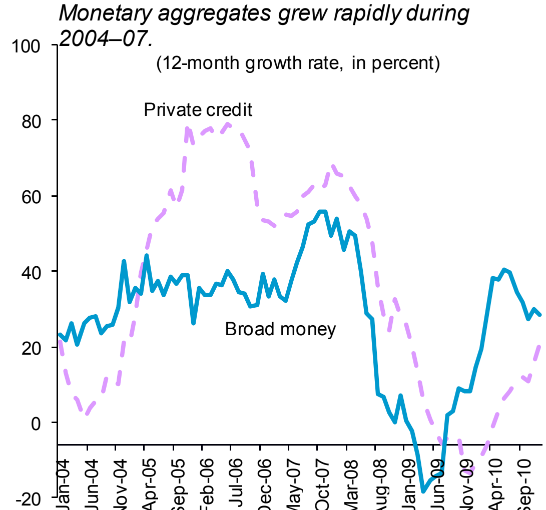
- Monetary and exchange rate policies were not very effective in fighting inflation and preventing the economy from overheating. The large accumulation of international reserves was only partially sterilized, and contributed to a significant expansion of monetary and credit aggregates, which was not contained by the increases in reserve requirements and the policy rate.

Gross international reserves increased fivefold from 2004 to 2007.



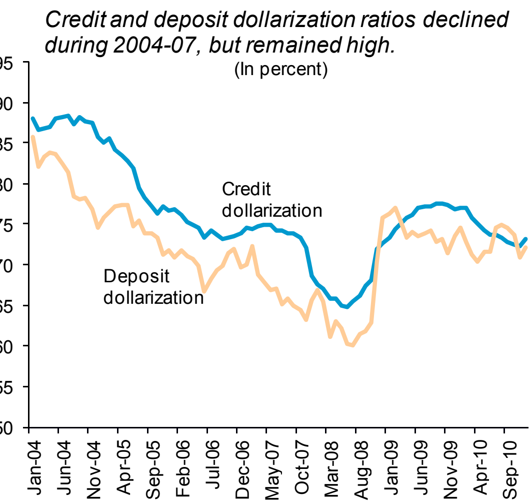
Sources: WEO, and Fund staff estimates.

Monetary aggregates grew rapidly during 2004–07.



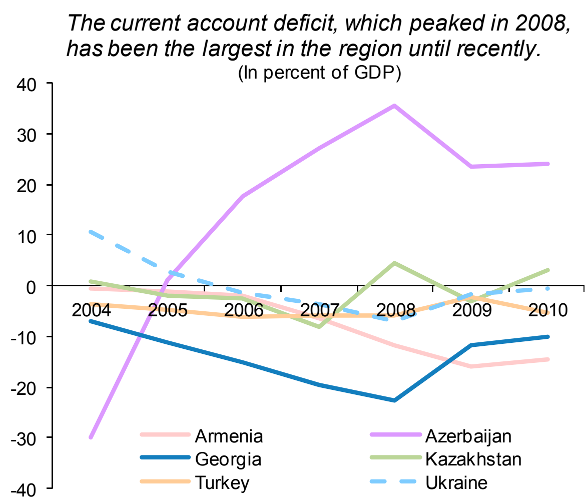
Sources: WEO, and Fund staff estimates.

- Vulnerabilities mounted in the financial sector as banks tapped external wholesale funding, and the exposure to currency-induced credit risk and real estate prices increased. Financial dollarization declined on the back of lari appreciation and strong demand for local currency driven by the effort to increase tax revenues (collected in lari), but it remained high. Capitalization, liquidity, and provisioning for most banks continued to be strong thanks to tight capital adequacy, provisioning, and liquidity requirements. Nevertheless, owing to the excessive credit expansion, two major banks were temporarily undercapitalized in 2006, and several banks experienced liquidity shortages in the first half of 2008.



Source: Georgian authorities.

7. **The dual crisis in 2008–09 hit the economy hard**. Pressures on the capital account stemming from the loss of investor confidence generated a large decline in international reserves and a substantial balance of payments financing gap. This gap, including banks' high repayment obligations in early-2009, was closed by Fund support and substantial loans and grants from official creditors and donors.[2] The decline in output—3.8 percent in 2009—was larger than initially anticipated but smaller than in other countries in the region. Average inflation fell below 2 percent in 2009 reflecting lower world commodity prices and depressed domestic demand. The current account deficit ballooned to 22.7 percent of GDP in 2008 (the largest in the region) as exports collapsed and imports declined less, but improved in the following year.



Sources: WEO, and Fund staff estimates.

8. **Fiscal policy played a supportive role during the crisis.** The fiscal deficit increased significantly in 2008, mostly due to higher current spending, and increased further in 2009—to 9.2 percent of GDP—owing to tax revenue shortfalls. Expenditures shifted from defense, which had increased sharply over the previous four years, to conflict-related reconstruction and social spending.

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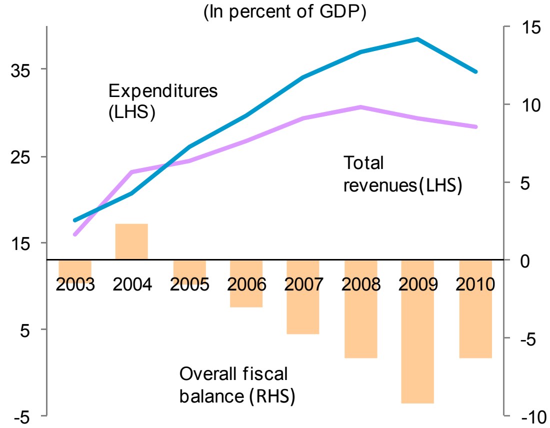
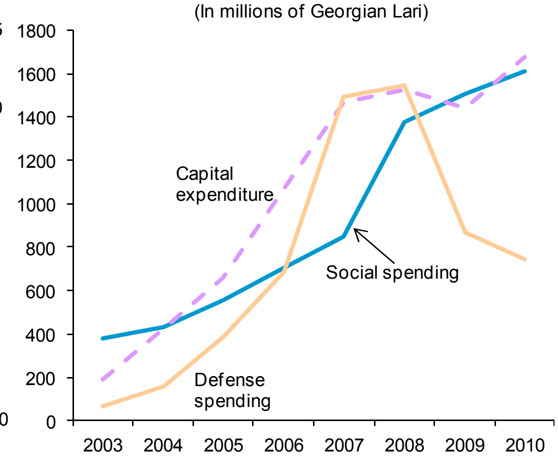
[2] In 2008, donors pledged $4.5 billion of financial assistance over 2008–11.

The overall fiscal balance deteriorated markedly in response to the crises in 2008–09.
(In percent of GDP)



Sources: WEO, and Fund staff estimates.

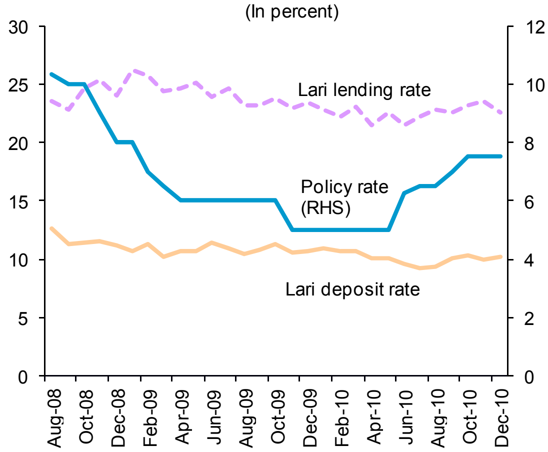
Spending composition has shifted after 2008 toward reconstruction and social spending.
(In millions of Georgian Lari)



Sources: WEO, and Fund staff estimates.

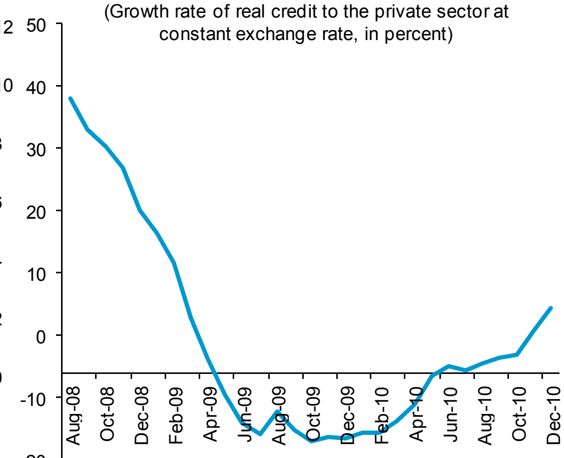
9. **While exchange rate flexibility increased somewhat during the crisis, monetary policy continued to be quite ineffective in supporting the economy.** Immediately after the conflict, facing large depreciation pressures, the National Bank of Georgia (NBG) pegged the lari to the U.S. dollar in an attempt to stabilize it. As pressures mounted and the reserve losses increased significantly, NBG allowed the exchange rate to depreciate substantially and has since moved gradually to a more flexible exchange rate regime (Box 1). However, when the lari came under pressure again in mid-2010, the NBG intervened aggressively. Regarding monetary policy, large policy rate cuts from mid-2008 to end-2009 had limited impact on the deposit and lending rates, while credit continued to contract. Limits on the loan-to-deposit ratios due to covenants with shareholders and factors that, as elsewhere, undermined the credit markets, such as elevated credit and funding risks and worsening bank balance sheets, exacerbated the inability of the monetary policy stimulus to ease credit conditions.

The policy rate cuts during 2008-09 failed to affect the lari deposit and lending rates.
(In percent)



Source: Georgian authorities.

After a sharp decline, credit to the private sector has been recovering since February 2010.
(Growth rate of real credit to the private sector at constant exchange rate, in percent)



Sources: WEO, and Fund staff estimates.

Box 1. Exchange Rate Flexibility: Some Progress, but the Extent of the Commitment Still to Be Fully Demonstrated

From 2005 to 2007, in an attempt to contain real exchange rate pressures stemming from large capital inflows, foreign exchange reserves increased rapidly. Tensions between the NBG's objectives of maintaining the external purchasing power of the lari and ensuring price stability arose in 2006, as the central bank was resisting exchange rate pressures at a time when inflation pressures intensified (figure below). As a consequence, toward the end of 2007 the NBG allowed the lari to appreciate significantly, and in March 2008 it declared that price stability was the main monetary objective.

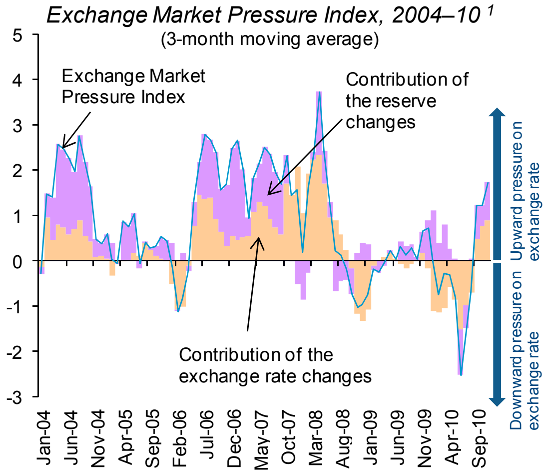
In response to large depreciation pressures in 2008, the authorities pegged the lari to the U.S. dollar. Immediately after the August 2008 conflict, the lari came under strong depreciation pressures owing to the confidence shock and the drying-up of foreign inflows**.** The NBG's strategy at the time—supported by the Fund—was to peg it to the U.S. dollar in an attempt to stabilize it.

As pressures on the exchange rate mounted and the reserve losses increased significantly at end-2008, the NBG allowed the exchange rate to depreciate. In October 2008, depreciation pressures re-emerged and NBG lost about 20 percent of reserves over a three-week period in an attempt to contain them. Subsequently, the NBG abandoned the peg and the exchange rate depreciated by 16 percent in the first ten days of November. The NBG has since moved to a more flexible exchange rate regime, though more gradually than recommended by the Fund. In this context, a multiple-price foreign exchange auction system was adopted in March 2009 and direct intervention in the interbank market was phased out by end-May 2009. The auctions led to improved functioning of the foreign exchange market (also evidenced by a lower share of NBG's transactions in the total foreign exchange market turnover (figure below)) and enhanced flexibility of the exchange rate. The frequency of the auctions was also reduced gradually from three a week to two and infrequent (ad-hoc) interventions later on.

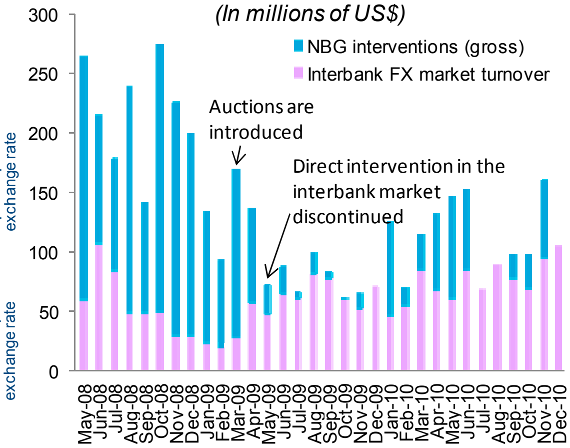
However, while intervention was limited from mid-2009 to early 2010 when exchange pressures were subdued, the authorities intervened heavily in mid-2010 as pressures reemerged. The uncertainty surrounding the municipal elections in May 2010 and expansionary monetary and fiscal policy from the first half of 2010 led to a bout of lari depreciation pressures, which the authorities resisted with, consequently, a significant loss in reserves.

As pressures on the exchange rate increased in mid-2010, heavy intervention resumed.

Exchange Market Pressure Index, 2004–10 [1]
(3-month moving average)



FX Market Turnover, 2008–10
(In millions of US$)

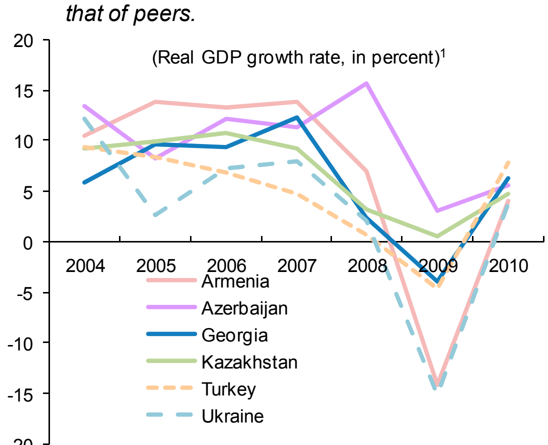


Sources: Georgian authorities, and Fund staff estimates.
[1] Calculated as the three-month moving weighted average of the monthly nominal rate of appreciation (vis-a-vis the U.S dollar) and the monthly change in foreign reserves (change in central bank's net foreign assets to previous period's reserve money).

10. **The banking sector weathered the crises relatively well, albeit with regulatory easing and large liquidity injections.** Systemic risks have abated, and lending has resumed since early-2010. Banks' balance sheets are cushioned by ample levels of capital and provisioning, but the elevated NPLs and the large exposure to the currency-induced credit risk remain important vulnerabilities. Deposit and credit dollarization ratios, which shot up during the conflict, have been declining recently but continue to be high. The authorities are reinforcing prudential regulations by tightening prudential norms back toward precrisis levels.

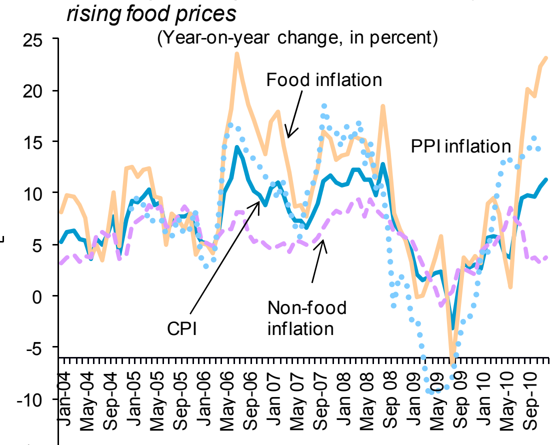
11. **As economic activity resumed, the authorities have started to tighten domestic policies in 2010.** The recovery began in the last quarter of 2009 and accelerated in the first half of 2010. Output growth in 2010—estimated at 6.3 percent, in line with growth in the region—was broad-based, driven by private sector demand. Inflation surged to around 10 percent, owing to rising food prices. The current account deficit narrowed, but remains high at about 10 percent of GDP. Fiscal consolidation started in mid-2010 along with the recovery, with the adjustment consisting mostly of expenditure compression, though overall spending was higher than originally budgeted as revenue windfalls were allocated to higher spending in mid-year. Monetary policy tightening also started in June 2010 in response to initial lari depreciation and recent inflationary pressures. In the second half of 2010, facing lari appreciation pressures, the NBG purchased dollars to reverse the crisis-induced decline in international reserves.

Growth in 2010 is estimated to be similar to that of peers.



Sources: WEO, and Fund staff estimates.
[1]Real non-oil GDP growth for Azerbaijan and Kazakhstan.

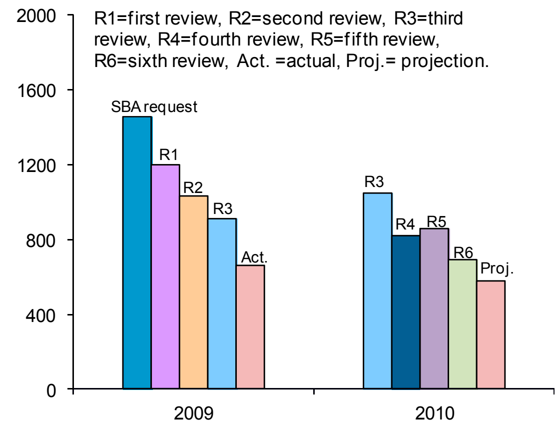
Inflation picked up in mid–2010, driven by rising food prices



Source: Georgian authorities.

12. **However, market confidence has not been fully restored, and FDI inflows are yet to rebound.** The recovery of FDI inflows has been slower than initially anticipated. While the banking sector has been experiencing outflows reflecting mostly debt prepayments, inflows to nonfinancial corporates have been strong, mostly due to the July Eurobond issued by the Georgian Railways.

FDI inflows have systematically underperformed.
(Net FDI in millions of US dollars)



Sources: Georgian authorities, and Fund staff estimates.

B. Structural Reforms: From a Transition to a Market-Based Economy

During 2004–07, structural reforms paved the way for the modernization of the economy with a more efficient public sector and an economic and legal environment more conducive to entrepreneurship. Since 2008, as the need to increase policy efficacy and flexibility became more pressing amid the crisis, the reform agenda has mainly focused on enhancing the effectiveness of macroeconomic policies.

13. **Until 2003 Georgia was perceived as a highly corrupt and inefficient country with a poor business environment**. In 2003, Georgia scored 124 out of 133 in the Corruption Perception Index published by Transparency International. Public frustration eventually led to a political upheaval, the Rose Revolution.

14. **As the new leadership came to power in 2004, it undertook forceful measures to fight corruption, increase public sector efficiency, improve governance, and create a business-friendly environment**. The authorities implemented comprehensive reforms that have borne long-lasting fruits. They effectively fought corruption (Box 2), reformed the civil service, reducing drastically public employment, restored the financial and technical viability of the electricity sector, and simplified regulations to facilitate business activity. An ambitious privatization program was also launched in 2004 (Appendix II).

15. **As a result, revenue collection increased beyond expectations**. The 2003 EPA indicated that revenue to GDP had the potential to increase by 4 percentage points over the subsequent five years. Owing to the reorganization of the revenue administration and the streamlining of tax policy (Appendix II), the tax-to-GDP ratio increase was almost twice higher than expected. Georgia's success is also striking among its peers.

Box 2. Significant Progress Has Been Made in Fighting Corruption

- Considerable progress has been made since 2004 in fighting corruption, as shown by the 2010 Transparency International survey that ranks Georgia 68 out of 178 countries in its Corruption Perception index.
- According to the 2010 Global Corruption Barometer, 77 percent of Tbilisi's residents feel that the Georgian government has been effective in fighting corruption, which is the highest percentage among the 86 countries surveyed.
- The latest World Bank Enterprise Survey (2008) echoes this perception from the perspective of the business community perspective. Georgian firms face less corruption than firms in the region: the Incidence of Graft Index, which is an indicator of the importance of bribery in dealing with government officials, is below the European and Central Asian region's average.

Georgia's tax performance stands out amongst peers.

(In percent of GDP)

	2003	2004	2005	2006	2007	Change 2003-2007
Georgia	**14.6**	**19.7**	**20.8**	**22.9**	**25.8**	**11.2**
Armenia	14.0	14.0	17.0	17.2	18.7	4.7
Azerbaijan	17.5	17.6	16.8	19.4	21.8	4.3
Kazakhstan	23.2	22.3	26.3	26.0	26.8	3.6
Turkey	18.2	23.8	24.2	25.2	24.3	6.1
Ukraine	32.6	31.3	36.2	37.6	36.5	3.9

Source: WEO.

Note: Revenues include taxes and social contributions of the general government (as a percentage of GDP).

16. **Progress in the monetary and financial areas was less even during 2004–07.** Despite substantial advances in improving the quality of banking supervision through the adoption of new regulations and staff training, a number of important 2001 FSAP recommendations—mainly inadequate assessment and supervision of credit concentration and connected lending, and limited supervisory powers related to governance—were yet to be implemented at the end of the PRGF (some of these recommendations were, however, undertaken after 2007). Reforms to enhance the conduct of monetary policy consisted mainly of strengthening the independence of NBG, and increasing the effectiveness and transparency of monetary policy (Appendix II).

17. **Since 2008, the structural reform agenda has mostly focused on enhancing the effectiveness and flexibility of macroeconomic policies.** This change in priorities was partly a natural shift to "second-generation" reforms and partly dictated by the crisis-related need to restore macroeconomic stability and, in turn, investor confidence, and to strengthen the financial sector. In this regard, significant progress has been achieved in public expenditure management, banking supervision, and exchange rate and liquidity management (Appendix II).

18. **Despite their aim to stimulate private sector growth, some tax policy initiatives were ill-timed, and recent proposals could reduce fiscal policy flexibility.** Precrisis

proposed tax cuts on income and dividends were implemented during the crisis, aggravating the 2009 tax shortfall. Also, in late 2009, the authorities proposed to put to referendum any increase in the rates or the base of existing taxes and prohibit the introduction of progressive taxes. This proposal (the Economic Freedom Act) would have introduced a great deal of rigidity in the budget and created risks for fiscal consolidation plans. Ultimately, following extensive discussions with the Fund and other donors, the authorities recognized the importance of preserving fiscal policy flexibility and thus limited the scope of the referendum to rate increases for selected taxes and introduced an escape clause to deal with adverse fiscal shocks. The triggers of the escape clause will be specified through separate legislation in 2011.

III. Assessment of Recent Fund Involvement

A. The 2004–07 PRGF—Program Objectives, Design, and Performance

The objectives and design of the PRGF focused on reforms to remove the main impediments to effective economic policy and foster private sector activity. The authorities' strong ownership of their reform agenda was key to the program's success.

19. **The objectives of the PRGF-supported program were in line with the main recommendations of the 2003 EPA.** They consisted in tackling corruption and governance issues so as to secure sizable gains in tax collections, streamlining government operations, reforming the civil service, and creating a business-friendly environment.

20. **Although overall the program design remained unchanged overtime, some targets were dropped or modified, reflecting progress toward program's objectives and new macroeconomic challenges.** Conditionality was very frontloaded and focused on measures that would help fiscal consolidation and the modernization of the public sector, and foster economic activity. In line with the 2003 EPA recommendations, conditionality was highly concentrated in the fiscal area, in particular on tax and customs collections, arrears clearance, and social and infrastructure spending increases. Other fiscal reforms were targeted toward the strengthening of budget execution, transparency, and monitoring. Performance criteria (PCs) were streamlined mostly in the context of the third review, since they were considered redundant given the new macroeconomic reality. As signs of overheating started to emerge, the indicative target on reserve money was converted to a PC to strengthen the monetary policy framework and better tackle inflation, and a new indicative target on net domestic assets was introduced. Georgia received extensive technical assistance from the Fund in the fiscal, monetary, financial, and statistical areas.

21. **Overall, the program was successful— it helped boost economic growth, fight corruption, strengthen revenue performance, and foster significant improvements in governance and the business environment.** All reviews were completed on time and nearly all program conditionality was met or exceeded, particularly on tax collections. Quantitative PCs were almost always met, in many cases by wide margins, while on the structural side various PCs and benchmarks were implemented, though often with delay. Key to the success of the program was the authorities' strong ownership and determination.

22. **However, in the later years, the program could have been more forceful in addressing risks associated with overheating and increasing banking sector vulnerabilities.** As the economy transformed, the country started to experience massive capital inflows, which, in particular in the later years, were channeled by banks mainly as foreign currency lending to unhedged domestic customers. The central bank had limited capacity to manage capital inflows, and the existing prudential framework failed to contain banks' exposure to excessive external borrowing. Risks of overheating and rising bank vulnerabilities were discussed only late in the program. More comprehensive action would have been warranted earlier on to address such vulnerabilities, in particular through a more prudent fiscal stance, more effective expenditure control, stronger focus on enhancing monetary policy effectiveness, and redirected conditionality towards strengthening banking prudential regulation.

While overall the program design remained unchanged overtime, it adapted to reflect progress and new macroeconomic challenges.

		Reviews					
	Program negotiation	First	Second	Third	Fourth	Fifth	Sixth
Quantitiative conditionality							
Performance criteria							
Tax revenue					Dropped	Dropped	Dropped
Deficit of government							
Domestic expenditure arrears					Dropped	Dropped	Dropped
Tobacco and petroleum revenues				Dropped	Dropped	Dropped	Dropped
Net credit of banking system to government							
Net domestic assets				Dropped	Dropped	Dropped	Dropped
Net international reserves							
Nonconcessional medium and long-term debt							
Short-term external debt							
External arrears							
Reserve money							
Indicative targets							
Reserve money				Dropped	Dropped	Dropped	Dropped
Cash collection rates on utitlities				Dropped	Dropped	Dropped	Dropped
Net domestic assets							
Structural conditionality							
Prior actions							
Prior action 1	Budget preparation						
Prior action 2	Revenue						
Prior action 3	Revenue						
Prior action 4	Revenue						
Performance criteria							
Performance criterion 1		Debt management	Debt management	Revenue	Central bank reform	Social sector	Fiscal transparency
Performance criterion 2		Public enterprises	Revenue	Expenditure	Fiscal transparency		Financial sector
Performance criterion 3		Public enterprises		Expenditure			
Performance criterion 4		Budget preparation					
Structural benchmarks							
Structural benchmark 1		Expenditure & Revenue	Expenditure & Revenue	Private sector regulation	Financial sector	Economic statistics	
Structural benchmark 2		Expenditure	Trade policy	Fiscal transparency	Financial sector	Revenue	
Structural benchmark 3		Public enterprises	Expenditure	Trade policy	Central bank operations		
Structural benchmark 4		Public enterprises		Financial sector	Economic statistics		
Structural benchmark 5		Financial sector		Revenue			
Structural benchmark 6		Fiscal transparency		Social sector			
Structural benchmark 7		Financial sector		Pension			
Structural benchmark 8		Expenditure					
Structural benchmark 9		Expenditure					
Notes:			Met		Not met or partially met but implemented later		Not met (pending or dropped)

Sources: Georgian authorities, and Fund staff estimates.

23. **The lack of reliable monitoring indicators limits the ability to assess progress in reducing poverty.** During 2004–07, household monetary incomes, in particular social transfers, increased in real terms. The minimum pension was raised to $35 per month in 2007, from $7 in 2003. In addition, non-income poverty indicators improved, including access to and quality of education and health care, and provision of public services. Since consumption aggregates are not comparable over time, it is not possible, however, to assess comprehensively developments in poverty reduction during the period. That being said, poverty remained entrenched in rural areas, which benefitted only marginally from rapid economic growth.

B. The 2008–11 SBA— Program Objectives, Design, and Performance

The SBA, approved right after the conflict-induced crisis, aimed at providing significant resources in order to replenish international reserves and help restore investor confidence. The program's design focused on measures to increase the flexibility and the efficacy of macroeconomic policies and strengthen banking sector soundness. The SBA was effective in restoring confidence and macroeconomic stability in the aftermath of the dual crisis, but the program's objectives toward an exit strategy are likely not to be fully met.

24. **The SBA intended to mitigate the impact of the shock on the balance of payments and to restore investor confidence.** After August 2008, a large financing gap emerged as new capital inflows came to a stop. The Fund-supported program was intended to provide the policy guidance to address the macroeconomic imbalances, to provide large (and quick) financing necessary to ensure the restoration of investor confidence, and to catalyze significant external support.

25. **Although Georgia is a PRGT-eligible country, an SBA arrangement was deemed appropriate.** The choice of facility was determined to a large extent by the amount of access needed, which could not have been granted under the PRGF, but also by the expectation of the short-term nature of the BOP needs (mainly created by a capital account crisis). In addition, the requirement of a Poverty Reduction Strategy (PRS) document for accessing concessional financing would have delayed Fund's support.

26. **The program's design focused initially on measures to stabilize the macroeconomic situation and support domestic demand.** The program envisaged quarterly reviews, and conditionality focused on accommodating a strong fiscal countercyclical response, protecting international reserves, and enhancing the banking sector's ability to mitigate potential vulnerabilities (Appendix II). The success of the reforms and the authorities' credibility on reform implementation built up since 2004 also provided a basis to limit structural conditionality.

27. **Since mid-2009, with a view to help the authorities prepare for an exit strategy, the program's focus rightly changed toward consolidation to help preserve investor confidence and restore access to international markets.** In the context of the third review,[3] the program was extended through mid-2011 and augmented (by about 180 percent of quota). The augmentation was intended to help contribute to a faster reserve accumulation and to fill a larger gap that had emerged due to lower capital inflows and the stronger-than-initially-planned fiscal stimulus. In the context of the augmentation and extension, the program was revised by rebalancing the fiscal strategy toward consolidation and by moving to more direct budget support. Throughout the program, collaboration with official creditors and donors, in particular with the World Bank and the European Bank for Reconstruction and Development (EBRD), has been close.

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[3] The third review was postponed to allow for additional discussions on the implications of a deeper-than-expected economic correction and a revision of government spending plans for the year.

Program's design aimed to increase flexibility/efficiency of domestic policies and strengthen banking sector soundness.

	Reviews					
	First	Second	Third	Fourth	Fifth	Sixth
Quantitiative conditionality						
Performance criteria						
Deficit of government 1/						
Nonconcessional external debt						Dropped
Net domestic assets						
Net international reserves						
External arrears						
Structural conditionality						
Performance criteria						
Performance criterion 1		Central bank operations				
Structural benchmarks						
Structural benchmark 1	Financial sector	Budget preparation	Central bank operations	Budget preparation		
Structural benchmark 2			Financial sector	Financial sector		
Structural benchmark 3			Financial sector	Expenditure auditing		
Structural benchmark 4				Budget preparation		
Notes:		Met		Not met or partially met but implemented later		Not met (pending or dropped)

Sources: Georgian authorities, and Fund staff estimates.

1/ This performance criterion (PC) could not be monitored at the sixth review because data were not available. A waiver of applicability was granted. The PC was eventually met.

28. **Performance under the program in 2008–10 was broadly satisfactory, but slippages have occurred in the fiscal and exchange rate areas.** Fund's endorsement of the authorities' decision to peg the currency immediately after the conflict was justified by the expected temporary nature of the pressures and the need to shield the economy from exchange rate risks. From the onset, the strategy envisaged a quick return to a flexible exchange rate to preserve reserves, which the authorities resisted until the peg became unsustainable at a large reserve cost. Quantitative PCs were met in most reviews, with the exception of the NIR target for end-June 2010 that was missed because of foreign exchange market pressures due to municipal elections. PCs related to the fiscal deficit were also frequently modified to rightly allow automatic stabilizers to operate and to accommodate countercyclical increases in spending during the 2008–09 downturn. However, against previous Fund advice, the authorities issued in April 2010 a budget supplement allocating most of the additional revenues from higher growth to new spending. In this context, a new PC on government spending was introduced at the time of the sixth review to contain the recurrence of supplementary spending revisions. Structural benchmarks were in some instances implemented with delay. Georgia received extensive technical assistance (TA) from the Fund in the fiscal, monetary, financial, and statistical areas.

29. **During the SBA, the government made efforts to support the poor by increasing social benefits.** The World Bank estimates that during the crisis the poverty headcount may have increased from 23.7 percent in 2007 to 27.1 in 2009 (due to weaknesses in the poverty monitoring system, it continues to be difficult to provide a comprehensive assessment of poverty). To alleviate the crisis impact, the government expanded the targeted social assistance and medical insurance to the poor.

30. **The SBA was effective in restoring confidence and macroeconomic stability in the aftermath of the dual crisis, but it remains to be seen whether the program objectives toward an exit strategy will be fully met.** Macroeconomic stability has been regained thanks to the supportive domestic policies that were implemented under the program. As the recovery took ground, fiscal consolidation and monetary tightening also started. However, fiscal consolidation in 2010 could have been more ambitious, if the

domestic capital budget had been contained and retrenched faster or additional more comprehensive tax measures had been adopted and revenue windfalls had been saved as recommended by staff, suggesting that the large budget financing by the Fund may have reduced incentives for faster adjustment. Monetary policy effectiveness remained weak, although some traction has been gained since April 2010, in the context of moving toward inflation targeting, as planned by the authorities. Also, exchange rate flexibility has improved, but the level of net international reserves (excluding Fund support) are yet to reach their precrisis levels, which was a main objective of the SBA. Finally, the program assumed a strong recovery of FDI inflows, which has not materialized as projected. Under the program, shortfalls in capital inflows were to be met by faster exchange rate adjustment, and indeed the exchange rate has depreciated during the program period. However, because the delayed response of FDI was viewed as temporary, reserves were used to counter exchange rate pressures in early 2009 and again in mid–2010 (Box 1). Additional exchange rate adjustment could have been desirable against the risk of permanently lower FDI.

IV. Challenges and Risks Ahead and Future Fund Engagement

A main challenge ahead is to prepare for facing the high debt obligations coming due in 2012–13. The main risk is a failure of FDI to rebound. Fiscal consolidation and increased exchange rate flexibility, combined with enhanced effectiveness of monetary policy, should be key components of the authorities' policy strategy ahead. A successor arrangement with the Fund can help anchor confidence and guide the design and implementation of such a strategy.

31. **The country is well positioned to refinance its large debt repayments due in 2012–13, but rollover risks cannot be ruled out.** While solvency risks on the sovereign debt appear manageable, as reflected in the DSA, debt repayment obligations in 2012–13 are high. Georgia's ongoing recovery and rating upgrades should facilitate rollover, but potential adverse spillovers from the instability in the Euro zone and Middle East and the sluggish rebound in investor confidence—as shown by the slow return of capital inflows—might impact the yields. Although the state-owned Georgian Railways successfully tapped the markets in July 2010, the yield on the issued Eurobond was considerably higher than similarly-rated sovereign Eurobonds.

32. **The main risk to the macroeconomic outlook and, in turn, to the authorities' policy strategy is protracted low capital inflows**. In the absence of a strong rebound in capital inflows (which, despite subdued geopolitical risks, have not yet recovered to expected levels), the policy adjustment would have to be stronger than currently planned, requiring larger fiscal consolidation to preserve debt sustainability and exchange rate adjustment to its equilibrium level. There would also be a need to refocus the current growth strategy in order to promote more actively domestically-originated growth and export diversification including through the expansion of sectors with significant growth potential, such as tourism and transportation, where progress has been made, and agriculture, where little action has been taken so far. On the contrary, were capital flows to rebound massively, there would be a need to develop strategies to manage them, while avoiding overheating pressures through enhanced exchange rate flexibility and monetary policy efficiency, and if needed, by adopting regulatory measures to discourage short-term capital inflows (hot money).

33. **In light of the elevated risks lying ahead, pursuing fiscal consolidation is crucial.** A successful fiscal adjustment could be based on reduced spending, consistent with the authorities' strategy. However, given the reduced room for further expenditure cuts, as well as inflation and electoral pressures, the credibility of the adjustment could be enhanced through the introduction of new tax measures. Therefore, preserving the ability to rapidly adopt revenue measures could be needed for a lasting consolidation. Increased budget flexibility would also help create the fiscal space to finance pro-growth and poverty-reduction spending.

34. **Fiscal consolidation should be complemented by enhancing exchange rate flexibility and building up international reserves.** Enhancing the exchange rate flexibility further by limiting foreign exchange intervention to smoothing extreme volatility would help protect the international reserve buffer, which, despite being recently on an upward trajectory, remains below its precrisis level and inadequate in light of high dollarization ratios. A higher reserve buffer would help ensure financial stability, mainly by enhancing NBG's role as a lender of last resort in foreign exchange in case of liquidity shortages.

35. **Preparing the ground for moving to inflation targeting can help monetary policy gain traction**. It is crucial to continue to implement the prerequisites for inflation targeting, including by improving price statistics, investigating and developing the transmission mechanism from the policy rate to inflation, improving the modeling capacity for inflation forecasting, and introducing a strong accountability framework. During the transition phase, NBG should stand ready to complement changes in the policy rate with other instruments (e.g., changes in reserve requirements), when needed. Gradual sustainable de-dollarization, achieved by pursuing sound policies and local currency and capital market development will contribute to enhanced monetary policy effectiveness.

36. **The resilience to shocks of the banking sector should be further enhanced.** In this context, it would be important to tighten regulation back towards precrisis levels, expand the central bank's supervisory capacity, and conduct regular stress tests. The merits of a deposit insurance scheme covering only lari-denominated term deposits should be re-considered. Risks stemming from elevated NPLs and large exposure to currency-induced credit risk are difficult to mitigate in the short run and need to be monitored carefully. An update of the 2001 FSAP in due course could help assess the health of the financial sector and remaining vulnerabilities.

37. **A successor arrangement with the Fund can help guide the conduct of macroeconomic policies needed to fully regain market confidence consistent with the authorities' exit strategy**. The key objectives of the program would be to support macroeconomic stability in order to anchor investor confidence and strengthen access to international financial markets. In this context, the program would need to design and implement a sound macroeconomic framework (built on more conservative FDI inflows assumptions), strengthen capacity for monetary policy, address fiscal consolidation buttressed by an explicit expenditure cap in order to strengthen expenditure control, and promote exchange rate flexibility and a higher international reserve buffer.

38. **The choice of Fund facility would depend on the existence of an actual or potential balance of payments need and could be in the form of a blended arrangement.** Georgia is eligible for Fund concessional support. As such, the authorities should consider a blended arrangement that, while offering the same access options as a stand-alone SBA, would provide more favorable financial terms than the latter. Also, given the role that the arrangement would play in guiding macroeconomic policy and providing insurance in light of high rollover risks, a precautionary (in the absence of actual balance of payments gap) SBA/SCF arrangement would appear to fit best the needs of the country over the next two years. In this case, a PRS document would not be required. Given the receding external risks relative to the current SBA, program monitoring could occur at a semiannual frequency. However, if risks materialize, a longer-term engagement with the Fund cannot be ruled out. Under such a scenario, there would be a need for greater policy adjustment, which could be partly generated by additional structural reforms. Should this turn out to be the case, a blended ECF/EFF, which would have a longer duration and also more advantageous financing terms than an SBA/SCF, should be considered. In this case, a PRS document would not be a delaying factor as it would have been when the current SBA was negotiated, since such a document would need to be circulated to the IMF Board only by the time of the second review.

Table 1. Georgia: Selected Macroeconomic Indicators, 2004–10

	2004 Act.	2005 Act.	2006 Act.	2007 Act.	2008 Act.	2009 Prel.	2010 Proj.
	(Annual percentage change, unless otherwise indicated)						
National accounts							
Nominal GDP (in million lari)	9,824	11,621	13,790	16,994	19,075	17,986	20,566
Real GDP growth	5.9	9.6	9.4	12.3	2.3	-3.8	6.3
Population (in million) 1/	4.3	4.3	4.3	4.4	4.4	4.4	4.4
GDP deflator, period average	8.4	7.9	8.5	9.7	9.7	-2.0	7.6
Consumer price index, period average	5.7	8.3	9.2	9.2	10.0	1.7	7.1
Consumer price index, end-of-period	7.5	6.2	8.8	11.0	5.5	3.0	11.2
GDP per capita (in US$)	1,188	1,484	1,765	2,326	2,937	2,455	2,629
Unemployment rate (in percent)	12.6	13.8	13.6	13.3	16.5	16.9	...
	(In percent of GDP)						
Investment and saving							
Investment 2/	27.5	28.1	25.6	25.7	21.5	15.3	15.0
Public	3.6	2.1	2.5	3.4	4.3	6.9	7.2
Private	23.9	26.0	23.0	22.3	17.2	8.5	7.8
Gross national saving	20.6	17.0	10.4	6.1	-1.1	4.1	5.1
Public	7.3	4.3	5.9	4.2	2.2	-0.8	2.3
Private	13.3	12.7	4.5	1.8	-3.4	4.9	2.8
Saving-investment balance	-6.9	-11.1	-15.1	-19.7	-22.6	-11.2	-9.9
Consolidated government operations							
Total government debt	45.3	34.4	27.9	22.3	25.0	37.3	39.5
Of which : foreign-currency denominated	36.2	27.1	21.9	17.5	20.9	31.7	33.9
Revenue 3/	23.1	24.4	26.7	29.3	30.7	29.3	28.5
Expenses	15.8	20.1	20.7	25.0	28.5	30.1	26.3
Operating balance	7.3	4.3	5.9	4.2	2.2	-0.8	2.3
Capital spending and net lending	4.9	5.9	9.0	9.0	8.6	8.4	8.9
Overall balance	2.4	-1.6	-3.0	-4.7	-6.3	-9.2	-6.6
Total financing	-2.4	1.6	3.0	4.6	6.3	9.2	6.6
Domestic	-3.4	-1.7	-1.7	-0.8	-2.3	3.3	0.0
External	0.3	-0.3	-0.4	0.2	5.0	3.9	5.6
Privatization receipts	0.7	3.6	5.2	5.2	3.7	2.0	1.1
	(Annual percentage change, unless otherwise indicated)						
Monetary sector							
Reserve money	44.3	19.7	19.2	25.6	-4.5	21.8	4.5
Broad money (including fx deposits) 4/	42.6	26.4	39.3	49.6	7.0	8.1	28.5
Bank credit to the private sector	21.2	73.2	53.4	68.9	28.2	-13.5	20.5
External sector							
Exports of goods and services (percent of GDP)	32.1	34.1	32.8	31.1	28.7	29.8	35.2
Annual percentage change	27.8	32.8	16.6	24.7	15.9	-13.0	26.6
Imports of goods and services (percent of GDP)	48.6	51.8	56.8	57.9	58.3	48.9	52.9
Annual percentage change	33.6	33.1	33.0	34.1	26.8	-29.8	15.9
Net imports of oil (in US$)	186	336	443	556	762	555	642
Current account balance (in millions of US$)	-354	-710	-1,175	-2,010	-2,912	-1,210	-1,147
In percent of GDP	-6.9	-11.1	-15.1	-19.7	-22.6	-11.2	-9.9
Gross international reserves (in millions of US$)	352	474	881	1,361	1,480	2,111	2,263
In months of next year's imports of goods and services	1.3	1.3	1.8	2.2	3.4	4.2	3.8
Foreign direct investment (percent of GDP)	9.6	7.1	15.1	17.1	12.2	6.1	5.0
Average exchange rate (lari per US$)	1.92	1.81	1.78	1.66	1.48	1.67	1.78

Sources: Georgian authorities; and Fund staff estimates.

1/ Excludes Abkhazia residents.

2/ Investment is measured on a net basis (acquisitions minus disposals of nonfinancial assets).

3/ Includes grants.

4/ The proceeds of the Georgian Railway eurobond issuance from July 2010, which were deposited in accounts with Georgian commercial banks that placed them abroad are not included in broad money.

Appendix I. Status of Key Recommendations from the 2003 Ex Post Assessment

2003 recommendation	Status
Achieve fiscal consolidation and unwind domestic arrears through an increase in the tax-to-GDP ratio	Tax-to-GDP ratio has increased by about 10 percentage points; expenditure arrears have been cleared
Improve public expenditure policy and management mainly by improving budget execution	Progress in the PFM area, but lingering difficulties to contain spending
Achieve sustainable growth by expanding opportunities for private sector activity, particularly to agriculture and tourism	Active promotion of tourism, but no defined strategy for agriculture
Reduce exposure to external shocks through a shift toward concessional financing, fiscal consolidation, and renewal of donor support	Shift toward concessional financing, but also increased exposure to external private capital flows as the economy was transformed
Improve business climate by effectively fighting petty and large-scale corruption	Effectively fought corruption and improved governance and the business climate (Box 2)
Improve management of budgetary resources and state property through a broad reform of the civil service	Civil service reform in 2004 (Appendix II)
Improve the management of public enterprises through mandatory auditing	Audits expended to cover all SOEs with a turnover higher than $5 million in 2004 (Appendix II)
Reform the energy sector by curtailing fraud and setting prices based on cost-recovery criteria	Cost-recovery mechanism for price setting and reforms to curtail fraud were mostly completed by 2006
Improve tax policy by moving to a low uniform import tariff	Tariff reform in 2006 reducing the number of rates from 16 to 3 and the top rates from 30 to 12 percent (Appendix II)
The Fund should continue to provide technical assistance, in particular in the fiscal, statistics, and money laundering areas	Extensive TA provided in all areas

Appendix II. Structural Reforms during 2004–10

1. During 2004–07 the authorities implemented a comprehensive reform agenda that helped address corruption, reduced government inefficiencies and fostered the business environment. In particular, reforms aimed at:

- **Improving governance in the public sector.** Measures included: (i) routine auditing of SOEs was widened in 2004 to all SOEs with a turnover higher than $5 million; (ii) management of these enterprises was strengthened by appointing supervisory boards guided by performance-based contracts; (iii) all public tenders were announced on the website of the State Procurement Agency; (iv) an ambitious privatization program was implemented; and (v) a large number of budgetary organizations were transformed into legal entities of public law with higher operational and financial autonomy (in particular, 2700 schools in 2005).

- **Reforming the civil service**. A new generation of policymakers was appointed to key government positions particularly vulnerable to corruption (including in the tax and customs departments of the ministry of finance and the ministry of interior). Public employment was reduced by 23 percent. The Police was modernized. State service became prestigious. The salary savings as well as some donor funds were used to increase the remuneration of the staff, reducing incentives to bribe-taking. Misconduct of state officials has been severely punished since then.

- **Streamlining the tax and customs codes.** The government passed a comprehensive tax reform in 2005: (i) The number of taxes was reduced from 21 to 7; (ii) The bases of the VAT and profit tax were broadened by eliminating certain exemptions and special regimes; (iii) The personal income tax rates were replaced by a single flat rate of 12 percent and was later merged in 2008 with the payroll tax rate (the rate of which was further decreased in 2009). The VAT rate was reduced from 20 to 18 percent. In addition, efforts were made to simplify the customs code (2007) and to liberalize the trade regime, with a notable revision of tariffs in 2006 reducing the number of rates from 16 to 3 and the top rates from 30 to 12 percent.

- **Curbing tax fraud and evasion**. A number of high-profile officials from the former administration and major state-owned enterprises suspected of corruption and tax fraud were fired and prosecuted; the prosecution measures were blunt and publically broadcasted (2004). The tax and customs departments were reorganized (then merged in 2007) with greater focus on large taxpayers. An excise tax inspectorate was established to bolster excise receipts by eliminating fragmentation in the control of excisable goods that occurred when the customs and tax departments shared responsibilities in this area (2004). A financial police with investigation authority was created under the ministry of finance, replacing economic crime units in the power ministries (2004). The authorities announced a one-off amnesty on undeclared tax arrears to regularize the informal sector (2004). The government established a revenue service to increase tax collection efficacy, improve taxpayer services, and develop risk-based customs controls and tax audits (2007).

- **Removing obstacles to growth in transport infrastructure and energy supply**. In the energy sector, reforms successfully restored the sector's technical and financial viability and expanded capacity, through modernization, privatization and resource diversification Regulations to start and operate a business were streamlined. The World Bank Doing Business Survey ranks Georgia 12 (out of 183 countries) for the ease of doing business in 2011.

2. **Advances were also made in monetary reforms during 2004–07**. These reforms aimed at strengthening the independence of NBG, and enhancing the effectiveness and transparency of monetary policy. The main reforms in this area included (i) prohibiting direct lending to the government and initiating the phased conversion of the government debt to NBG into tradable securities; (ii) clarifying NBG profit transfer procedures; (iii) creating a decision-making body in the form of the monetary policy committee; (iv) overhauling the reserve requirement system, (v) improving the quality of and access to key statistics; and (vi) launching the publication of periodical reports.

3. Since 2008 the structural reform agenda has focused on improving the effectiveness of domestic policies and strengthening the financial sector.

4. **Fiscal reforms**. The pace of reforms to improve budget planning, auditing, and cash management has gathered momentum under the SBA, with important steps in the following areas:

- **Adoption of a new budget system law.** The main PFM reform in 2009 was the adoption of a budget code, aimed at consolidating and simplifying budget legislation; unifying central and local budgets; and accelerating the budget approval and execution process. The budget code also introduced program budgeting.

- **Strengthening of the medium-term framework**. Since its first publication in 2005, the Basic Data and Directions (BDD)—a document that presents annually fiscal and macroeconomic projections and sectoral strategies for the following four years—has been underused, partly because the previous budget system law did not properly articulate the BDD calendar with the budget preparation cycle. In this regard, the new budget code brings several improvements: the elaboration of the BDD is better integrated in the budget cycle and will now be submitted to the Parliament along with the annual budget; the ceilings are included in the BDD; the list of spending agencies involved in the BDD preparation is extended.

- **Treasury reforms**. The authorities re-activated the T-bill market in 2009 and extended the term structure to two years in early 2010. Another important reform pertains to the design and implementation of an integrated PFM information system. The design of the IT system was finalized in 2009 and tenders were made in 2010. The new integrated PFM information system is now expected to be fully implemented in 2013–14. In addition, the Treasury is involved in accounting reforms to comply with the IPSAS norms by 2020 and to complete the transition to accrual GFS 2001.

- **Expansion of internal audit activities**. Several PFM reviews pointed to the need to develop internal control and audit systems in the public sector. In 2008, a unit was created in the MOF. In 2009, the Parliament adopted a law on internal audit that regulates the scope, principles, methodology, requirements of internal audit within the public sector. This law will precede the creation of internal audit units in line ministries.

- **Improvement of taxpayer services**, through a number of initiatives: development of e-filing systems; establishment of a dispute resolution office (2008); e-declaration service (2009); progress in the risk-based audit functions in the revenue service; adoption of a new tax code merging the existing customs and tax codes (2010); transformation of the revenue service into an independent entity with the aim of increasing efficiency and modernizing tax enforcement (2010); setting-up of customs clearance zones (2010).

5. **Monetary and exchange rate reforms.** Since 2008 NBG has significantly improved exchange rate and liquidity management, and started the transition to a soft inflation targeting regime. The main reforms have aimed at (i) strengthening the lender of last resort (LOLR) facility, (ii) increasing the exchange rate flexibility (mainly through the introduction of an auction-based system for the foreign exchange market, which replaced the daily fixing sessions in the inter-bank market), (iii) improving the liquidity framework to enhance liquidity forecasting, (iv) strengthening the transmission mechanism of policy rate changes through the re-activation of standing facilities and the introduction of guaranteed access to refinancing loans, (v) reforming the payment system, and (vi) improving the management of the international reserves. However, the creation of the Financial Supervision Agency as an independent legal entity in 2008 and its subsequent merger into the NBG has likely diverted attention from pressing banking-related issues and stretched scarce capacity.

6. **Financial sector reforms.** A series of measures were adopted to strengthen financial sector supervision: (i) enhanced monitoring of banks, notably by re-organizing the banking supervision department, and conducting regular stress tests; (ii) adoption of a contingent plan for dealing with crises scenarios and bank resolution, and (iii) expansion of central bank's powers over banks under temporary administration granted through the amendment of the NBG's organic law.

Annex I. The Authorities' Reaction

Discussions of the Ex Post Assessment (EPA) update were held in Tbilisi on February 23–4, 2011. The authorities broadly shared the conclusions and recommendations of the report and thought that, in most aspects, the report adequately reflected developments in Georgia during the period under review. Their comments are summarized below.

- The authorities viewed macroeconomic challenges in 2004–07—namely the widening of the current account deficit, and the increasing money and credit expansion—predominantly as effects of permanent upward shifts in the potential output and financial deepening rather than signs of overheating. They thought that monetary policy had played a crucial role in keeping inflation under control, and did not share the conclusion that monetary policy was not very effective during the PRGF period.

- The authorities considered that increased vulnerabilities in the banking sector during the precrisis period were due mainly to the lack of a macro-prudential and forward-looking regulatory framework, which limited the supervisors' ability to concentrate on the major sources of risk. Supervision was instead concentrated on micro-prudential risks, and the central bank resisted pressures to ease micro-prudential requirements, which remained conservative compared to peer countries. Moreover, the authorities did not share the view that concentration and connected lending were key areas in need of improvement, and believed that the focus should have been mainly on the aforementioned macro-prudential regulatory shortcomings.

- The authorities also pointed out that, in line with a countercyclical policy conduct and the recommendations in the EPA update, regulation has been recently tightened back toward precrisis levels. In addition, to address the shortcomings of the existing regulatory framework, the authorities are moving gradually toward risk-based supervision, including by taking into account systemic risks, introducing macro-prudential oversight, and conducting a more forward-looking supervisory assessment.

- The authorities indicated that, before the conflict and global crisis shocks, they were targeting fiscal balances, and that fiscal policy decisions were based on public debt considerations, which was on a downward trend in GDP terms over 2004–07. Also, they clarified that the 2008 Eurobond was not issued with the purpose of financing the fiscal budget, and that it was rather meant to establish Georgia's benchmark in international capital markets. Subsequently, the authorities created two sovereign reserve funds, in which they safeguarded the Eurobond proceeds. In the context of the fiscal stimulus in response to the crisis, the authorities deemed appropriate the tax policy initiatives to stimulate the economy despite their permanent nature. In their view, the countercyclical benefits of these measures outweighed the challenges that they would present to achieve medium-term fiscal consolidation. Also, the authorities viewed fiscal consolidation in 2010 as appropriately ambitious, emphasizing that capital spending was, to a large extent, financed by donor's highly concessional assistance. Regarding a possible successor IMF-supported program, the authorities noted that the recommendation of maintaining the expenditure cap is challenging in the context of rising food and fuel prices.

- The authorities emphasized their commitment to exchange rate flexibility and indicated that the decision to peg the currency in the aftermath of the August 2008 shock and subsequent interventions were dictated by the need to maintain public confidence in the financial sector. They pointed out that the peg was abandoned about two weeks after it was introduced and flexibility was restored thereafter. However, when the second shock hit the economy at end-September, exchange rate flexibility was again limited. In early November 2008, as it became clear that the shock was not of a temporary nature, the authorities abandoned the peg and allowed the lari to depreciate. The authorities also observed that greater exchange rate flexibility before moving to the auction system in early 2009 would have not been feasible, given the preparation time needed to introduce the auction system. Furthermore, the authorities deemed that the exchange rate pressures in mid-2010 were transitory, therefore justifying their heavy interventions to contain exchange rate volatility. The latter is viewed by the authorities as detrimental to the economy, given the high private sector dollar indebtedness and risks of additional conversions of lari holdings into US dollars. Also, they noted that, by end-2010, interventions were less than envisaged under the SBA-supported program and net international reserves higher than the end-year target. In the authorities' view, this over-performance was to a large extent attributable to their successful containment of exchange rate volatility.

- The authorities also made the point that the recent exchange rate assessment, conducted after the period covered by the EPA, suggests that the real effective exchange rate is overvalued by less than 10 percent, compared to previous findings of a larger overvaluation. In their views, these new results suggest that no additional exchange rate adjustment was necessary during the SBA.

- Regarding the Economic Freedom Act and the referendum requirements for new taxes and increases in the rates of existing taxes, the authorities pointed out that the requirements may be suspended through an escape clause, the conditions of which will be defined in a separate organic law. They stressed that this clause would maintain adequate tax policy flexibility to react quickly to possible adverse shocks.

- The authorities indicated that they did not see the refinancing of the 2013 Eurobond as a challenge. They emphasized that the Georgian Eurobond's secondary market performance is currently encouraging, and that they were confident that Georgia's credit history would allow debt refinancing at favorable conditions. They also pointed out that FDI inflows were not the only source of growth, and that sectors such as tourism and energy were also important contributors.

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IMF Executive Board Concludes 2011 Article IV Consultation with Georgia

On March 23, 2011, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Georgia.[1]

Background

The economic recovery is proceeding at a solid pace, with real GDP growth of above 6 percent in 2010. Growth was broad based across all economic sectors, driven by a rebound of credit to the private sector and strong export demand. Inflation rose to 13.7 percent in February on the back of increasing commodity prices, but core inflation remains low. Although foreign direct investment inflows remain subdued, the private sector external position has improved since mid-year, reflecting an increase in other private financial inflows and a narrowing of the current account deficit to 10 percent of GDP in 2010. The resulting abatement of exchange rate pressures has allowed the central bank to reduce intervention and strengthen its net international reserve position.

Riding on the rebound of the private sector, the government began withdrawing the fiscal stimulus, with a resulting narrowing of the fiscal deficit to 6.6 percent of GDP in 2010 from 9.2 percent in 2009, driven essentially by the containment of current spending. The central bank

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

has tightened its monetary stance steadily since June 2010, initially in response to exchange rate pressures and more recently worries about rising inflation.

Financial stability concerns from the balance sheet impact of the crisis have abated, reflecting the decline of non-performing loans and adequate bank capitalization and provisioning. Prudential requirements have been restored back toward pre-crisis levels, adding to the general tightening of policies.

An Ex Post Assessment Update (EPA) was conducted to review Georgia's economic performance during its long-term involvement with the Fund. The report covered the country's performance during 2004-10 under two Fund-supported programs: the 2004-07 Poverty Reduction and Growth Facility (PRGF) and the 2008-11 Stand-By Arrangement (SBA).

Executive Board Assessment

Executive Directors commended the authorities for their strong policy response to the crisis, which succeeded in stabilizing the economy and restoring confidence. The economy is recovering at a solid pace, the fiscal position has improved substantially, and core inflation remains subdued. Directors noted that fiscal consolidation, exchange rate flexibility, and effective monetary policy would help tackle the challenges ahead and lay the foundations for sustained growth.

Directors agreed that the short-term priority is to limit the impact of the recent commodity-price shock on the most vulnerable and to contain inflationary risks. They welcomed the recent increase in social spending and the authorities' readiness to tighten monetary policy further should inflation pressures persist or credit grow too fast.

For the medium term, Directors observed that the main challenge is to transition from recovery to durable growth by addressing remaining adjustment needs. They supported the authorities' more proactive approach to economic growth, with emphasis on structural reforms in agriculture and targeted public investment. At the same time, it will be important to further reduce the fiscal deficit to a sustainable level. To create sufficient fiscal space so as to enhance social safety nets and avoid an unsustainable compression of other current spending, Directors underscored the need for rationalizing the capital budget and preserving adequate flexibility on the revenue side.

Directors noted that further adjustment is needed to bring the fiscal and external positions to sustainable levels and encouraged the authorities to decisively implement their consolidation strategy. While the cyclical recovery in partner countries and productivity gains from structural reforms should help narrow the deficit, they stressed that exchange rate flexibility should remain a central instrument of adjustment. Directors also encouraged the authorities to increase the issuance of domestic government paper to contain potential external debt rollover risks.

Directors commended the authorities for the successful implementation of reforms to introduce market-based monetary policy instruments and to develop financial markets, which have contributed to increasing the traction of monetary policy. They looked forward to further progress in the transition to inflation targeting, by enhancing the inflation forecasting and modeling capacity, and improving underlying statistics. Directors welcomed the strengthening of financial sector supervision, and recommended continued vigilance in the face of emerging challenges.

Directors broadly agreed with the conclusions of the EPA update of Georgia's economic performance under the two Fund-supported programs. Structural reforms, implemented under the PRGF, have led to a private-sector driven economy. There was, however, some concern that the program in 2004–07 could have been more ambitious in addressing increasing vulnerabilities. The current SBA has been effective in restoring macroeconomic stability in the aftermath of the crisis, but the external and internal adjustment is likely to be incomplete. Directors agreed that addressing remaining vulnerabilities should be at the core of any future program engagement with the Fund.

Georgia: Selected Macroeconomic Indicators, 2008–11

	2008 Act.	2009 Act.	2010 Proj.	2011 Proj.
	(Annual percentage change, unless otherwise indicated)			
National accounts				
Nominal GDP (in million lari)	19,075	17,986	20,566	23,332
Real GDP growth	2.3	-3.8	6.3	5.5
Population (in million) 1/	4.4	4.4	4.4	4.4
GDP deflator, period average	9.7	-2.0	7.6	7.5
Consumer price index, period average	10.0	1.7	7.1	10.2
Consumer price index, end-of-period	5.5	3.0	11.2	8.0
GDP per capita (in US$)	2,937	2,455	2,629	2,920
Unemployment rate (in percent)	16.5	16.9	...	...
	(In percent of GDP)			
Investment and saving				
Investment 2/	21.5	15.3	15.0	17.2
Public	4.3	6.9	7.2	6.0
Private	17.2	8.5	7.8	11.2
Gross national saving	-1.1	4.1	5.1	4.7
Public	2.2	-0.8	2.3	3.7
Private	-3.4	4.9	2.8	1.1
Saving-investment balance	-22.6	-11.2	-9.9	-12.5
Consolidated government operations				
Total government debt	25.0	37.3	39.5	41.1
Of which: foreign-currency denominated	20.9	31.7	33.9	35.9
Revenue 3/	30.7	29.3	28.5	27.3
Current expenditures	28.5	30.1	26.3	23.7
Operating balance	2.2	-0.8	2.3	3.7
Capital spending and net lending	8.6	8.4	8.9	7.6
Overall balance	-6.3	-9.2	-6.6	-3.9
Total financing	6.3	9.2	6.6	3.9
Domestic	-2.3	3.3	0.0	0.4
External	5.0	3.9	5.6	2.6
Privatization receipts	3.7	2.0	1.1	0.9
	(Annual percentage change, unless otherwise indicated)			
Monetary sector				
Reserve money	-4.5	21.8	4.5	7.1
Broad money (including fx deposits) 4/	7.0	8.1	28.5	16.0
Bank credit to the private sector	28.2	-13.5	20.5	13.2
Deposit interest rate (annual weighted average on flows)	9.5	9.4	7.9	…
Lending interest rate (annual weighted average on flows)	22.7	20.8	17.7	…
External sector				
Exports of goods and services (percent of GDP)	28.7	29.8	35.2	36.9
Annual percentage change	15.9	-13.0	26.6	16.6
Imports of goods and services (percent of GDP)	58.3	48.9	52.9	55.6
Annual percentage change	26.8	-29.8	15.9	16.8
Net imports of oil (in US$)	762	555	642	780
Current account balance (in millions of US$)	-2,912	-1,210	-1,147	-1,597
In percent of GDP	-22.6	-11.2	-9.9	-12.5
Gross international reserves (in millions of US$)	1,480	2,111	2,263	2,780
In months of next year's imports of goods and services	3.4	4.2	3.8	4.5
Foreign direct investment (percent of GDP)	12.2	6.1	5.0	5.5
Average exchange rate (lari per US$)	1.48	1.67	1.78	…

Sources: Georgian authorities; and Fund staff estimates.
1/ Excludes Abkhazia residents.
2/ Investment is measured on a net basis (acquisitions minus disposals of nonfinancial assets).
3/ Includes grants.
4/ The proceeds of the Georgian Railway eurobond issuance from July 2010, which were deposited in accounts with Georgian commercial banks that placed them abroad are not included in broad money.

Statement by Mr. Bakker, Executive Director for Georgia
and Mr. Lezhava, Advisor to Executive Director
March 23, 2011

On behalf of my authorities, I would like to thank staff for the detailed and very objective report. Overall, the distributed set of documents in a clear and open manner describes economic developments, the policy consultation processes, and the authorities' views on both past and future developments. We would still like to draw the Board's attention to the main trends in current developments and the challenges ahead as seen by the authorities, including those widely discussed previously at the Board.

Economic Development Trends

After the contraction of 3.9 percent in 2009, the Georgian economy started to recover in 2010. In the course of the year, the growth forecast was adjusted upwards several times and it is now estimated to be between 6.3-6.5 percent at the end of 2010. The fiscal stimulus, made possible thanks to international support led by the IMF, was a decisive factor in avoiding a larger output drop and in the subsequent recovery.

Against the backdrop of a general economic rebound observed in 2010 and as a result of revenue and expenditure-side measures, the budget deficit declined to 6.6 percent of GDP (compared to 9.2 percent of GDP in 2009). The government aims at bringing the budget deficit below the 4.0 percent level in 2011.

Annual inflation has been steadily accelerating during the last few months. In the February 2010 it reached 13.7 percent. Withdrawal of the fiscal stimulus and reduced government spending was appropriate, having in mind both recent price developments and the closing GDP gap. The monetary authorities took several measures for tightening their policy.

As the staff report shows, overvaluation of the exchange rate in place during the crisis was eliminated or at least became less pronounced. Acceleration in economic activity and increased competitiveness were reflected in the balance of payments figures. In 2010 the current account is estimated to decline below 10.0 percent of GDP, down from 22.6% in 2008. Over the last two months the local currency has experienced appreciation pressure. Although some appreciation may have a positive effect on inflation, it may be harmful for the competitiveness of the country. To alleviate this pressure and accumulate reserves, the National Bank has intervened periodically by purchasing foreign exchange through auctions.

The situation in the financial sector has steadily stabilized. Financial stability indicators do not provide much cause for concern. The capital adequacy ratio is 16.8 percent in February 2011 and the liquidity ratio is 40.1 percent. The NPL ratio still remains slightly elevated at 5.3 percent, reflecting high risk taking by banks in the pre-crisis, boom period. Currently the authorities are moving gradually towards a more risk-based approach in supervision, including macro-prudential oversight that should prevent sharp deterioration in the banking sector in case of changing macroeconomic conditions.

Monetary and Fiscal Policy Efficiency Challenges

Inflation developments described above are raising concerns. We need to mention that the high figures of headline inflation are primarily explained by rising food prices. Monetary and fiscal tightening measures were taken in a timely manner and their effects still need to materialize. The authorities believe that second-round effects on prices will be contained. Even if further negative macroeconomic consequences are avoided, an unfavorable social impact has already materialized. In order to ease social conditions, the government has distributed power and food vouchers. Avoiding second-round effects of the rising prices and easing social conditions while staying within the margins of the fiscal framework, is the immediate challenge for the Georgian authorities.

Improving the transmission mechanism is the current objective of the monetary authorities in the path toward inflation targeting. The authorities remain committed to the flexible exchange rate. The monetary authorities are putting efforts to reduce dollarization of the banking sector, which should better serve the transmission channel, as well as reduce financial sector fragility.

Staff rightly identified "the challenge of enhancing tax productivity in Georgia" as an important issue. Supplemental analysis of tax productivity is an important tool that should be used more frequently by the staff in country reports. Indeed, tax collection in Georgia has improved significantly in recent years. Strong political will and a stream of measures aimed at improving tax compliance have contributed to the enhancement of the tax base and minimize tax fraud. Driven by the desire to implement a simple and business-friendly tax framework, the government seeks an appropriate balance between reasonable and context-specific containment measures on the expenditure side and thoughtful revenue-enhancing measures.

Concerns regarding a proposed referendum requirement for new taxes widely expressed here at the Board were duly noted by my authorities. The authorities are driven by dual objectives here: (a) send a strong signal that, despite the global economic context, Georgia will pursue its liberal private sector-led economic stance as it is in the best long-term interest of the country, and (b) retain, as appropriate, access to fiscal flexibility measures that we might wish to enact to counter the impact of adverse developments. The authorities are looking for the formulation of an escape clause for the referendum requirement that will allow an adequate margin of maneuver.

Economic Development Pillars

FDI in 2010 was US$ 553 million (about 5 percent of GDP), which is high compared to peer countries, but is below the expectations of the authorities. They have been conducting an aggressive policy to attract investors and try to eliminate political or economic barriers. The authorities realize that FDI is one of the main driver of growth. However, the authorities are not going to rely solely on FDI.

Agriculture, tourism, and energy are considered to be the main drivers for the economy in the coming years. The government is concerned about the developments in the agriculture sector; productivity of the sector is well below the desirable level. The government also considers that the potential of the energy and tourism sectors are not fully utilized and sees as its role to reform all three sectors and attract private investment. The government considers active, direct state intervention to be necessary for the development of these sectors.

Funds provided by the IMF and other donors were decisive for Georgia during the crisis. The country intends to decrease gradually the reliance on external support. Although Georgia faces large external debt payments in 2012-13, refinancing of the 2013 Eurobond should not be challenging. The current Georgian Eurobond's secondary market performance is encouraging and the authorities believe that Georgia's credit story will allow refinancing on good terms. Given the rebound in the economy, the authorities' capability to ensure phasing out of IMF support has been reinforced.

The Georgian authorities are thankful to the IMF Board members for their comments and suggestions expressed during the previous discussion. The authorities believe that the success achieved under the programs is one of the best examples of effective cooperation. Both programs discussed in the Ex Post Assessment of Longer-Term Engagement were of crucial importance for Georgia. The first one allowed implementation of structural reforms leading to a private sector-driven economy, while keeping high growth rates. Without the second - the Stand-By Arrangement - Georgia would still struggle with the negative consequences of the crisis. The recent upgrade of Georgia's credit rating by the major rating companies should be seen as a reward for the successful implementation of the programs.