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Georgia and the IMF

Press Release:
IMF Executive Board Completes Second Review of Georgia's PRGF Arrangement and Approves US$20.2 Million Disbursement
July 20, 2005

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Georgia: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

July 2, 2005

July 2, 2005

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

Dear Mr. de Rato:

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

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

Sincerely yours,

/s/

Zurab Nogaideli
Prime Minister

/s/
Roman Gotsiridze
President of the National Bank of Georgia

/s/
Aleksi Aleksishvili
Minister of Finance

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

A. Introduction

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

B. Recent Developments and Performance

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

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

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

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

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

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

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

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

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

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

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

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

C. Economic Policies for 2005

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

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

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

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

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

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

D. Fiscal Policy

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

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

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

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

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

E. Monetary Policy

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

Accordingly, and recognizing the central role of monetary discipline in realizing our macroeconomic objectives, we propose the introduction of a performance criterion on reserve money. To enhance monetary control, the NBG will limit its foreign exchange intervention to smoothing fluctuations.

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

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

F. Structural Reform

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

Business climate

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

licenses and permits (at least by 80 percent); (ii) provide a "one-stop" and "silence is consent" system for individuals and businesses seeking licenses; (iii) create a new legal and institutional base for technical regulation; and (iv) liberalize the certification system.

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

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

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

Energy sector

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

Trade liberalization

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

G. Poverty Alleviation

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

H. Program Monitoring

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

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

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

Sources: Georgian authorities; and staff estimates.

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

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

GEORGIA: TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)

July 2, 2005

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

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

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

A. Definition of the General Government and the Public Sector

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

B. Floor on Tax Revenues

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

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

C. Ceiling on Domestic Expenditure Arrears

6. **Definition:** Domestic expenditure arrears are defined as arrears incurred by the general government on expenditure items, excluding external debt service payments. The

measurement of central government expenditure arrears will be based on the following principles: (a) goods and services have been received; (b) the bill for payment has been received; and (c) the due-for-payment date has passed and the bill has remained unpaid beyond the normal or agreed period of credit. Expenditure arrears of local governments are estimated as the difference between actual cash spending and the monthly cash limits issued prior to the beginning of the month.

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

D. Ceiling on the Cash Deficit of the General Government

8. **Definition:** The cash deficit of the general government will be measured from the financing side, and will be defined as equal to the total financing (domestic and external plus privatization proceeds) received by the general government.[1] Privatization receipts consist of all gross proceeds received by the central and local governments. Domestic financing consists of all bank and nonbank financing to the general government. External financing is defined as the total of disbursements, macroeconomic support, net change in external arrears, minus amortization. Disbursements include all project financing (capital expenditure and net lending) and balance of payments support (excluding grants) received by the budget. Amortization includes all external debt-related payments of principal; amortization to external creditors via third parties is accounted for at the time and in the amount of payment by the budget to the third party, rather than at the time of recognition of amortization by the external creditor.

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

10. **Supporting material:** Data on privatization receipts will be provided by the ministry of finance (treasury) to the IMF on a monthly basis within two weeks of the end of each

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

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

E. Ceiling on Reserve Money

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

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

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

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

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

G. Floor on Net International Reserves of the NBG

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

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

H. Ceiling on Contracting or Guaranteeing of New Nonconcessional Medium-and Long-Term External Debt by the Public Sector

(with Original Maturity of One Year or More)

17. **Definition:** Nonconcessional external loans are defined as loans from lenders other than the IMF with a grant element of less than 35 percent of the value of the loan. The grant element is to be calculated by using currency-specific discount rates reported by the OECD (CIRRs).[2] For maturities of less than 15 years, the grant element will be calculated based on six-month averages of commercial interest rates. For maturities longer than 15 years, the grant element will be calculated based on 10-year averages. This performance criterion applies not only to debt as defined in point No. 9 of the IMF's Guidelines on Performance Criteria with Respect to External Debt (Decision No. 12274-(00/85) August 24, 2000) but also to commitments contracted or guaranteed for which value has not been received.[3] Previously contracted nonconcessional external debt that has been rescheduled will be excluded from the definition of "new debt" for the purposes of this performance criterion.

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

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

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

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

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

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

J. Non-Accumulation of External Arrears

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

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

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

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

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