International Monetary Fund

Georgia and the IMF

Press Release:
Press Release: IMF Executive Board Completes First and Second Reviews under Stand-By Arrangement and Stand-By Credit Facility Arrangement for Georgia
March 13, 2013

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

March 1, 2013

The following item is a Letter of Intent of the government of Georgia, which describes the policies that Georgia intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Georgia, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

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GEORGIA: LETTER OF INTENT

Tbilisi, March 1, 2013

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, D.C.

Dear Ms. Lagarde:

1. The convincing victory of our Georgian Dream coalition in the October 2012 parliamentary election has given our new government impetus to further advance Georgia's political and economic transformation based on transparency, accountability, and the rule of law. Free and fair conduct of the election and the peaceful handover of power demonstrate Georgia's progress toward a vibrant democracy. The newly elected parliament has approved a new government, a new prime minister, and 19 other cabinet members. Throughout this momentous transition macroeconomic stability has been maintained.

2. Although Georgia's economic performance has been solid in the recent past, our country continues to face sizeable economic and social challenges. The economy recovered quickly after the armed conflict with Russia in August 2008 and the global financial crisis of 2008–09. However, although we have achieved strong growth, serious social challenges remain, including high unemployment and widespread poverty, especially in rural areas. Our foreign trade and current account deficits remain large but are financed mainly by long-term capital inflows, which has allowed us to increase international reserves. High external indebtedness is a burden for future generations, and we are keen to address this issue and to ensure that external debt is on a sustainable downward path.

3. Our new government's economic program seeks sustained and inclusive growth while ensuring macroeconomic stability. Our priorities are to:

- Maintain a sound macroeconomic environment, backed by prudent fiscal, monetary and financial policies, to deliver sustained economic growth and higher employment.

- Preserve the strength and respect the independence of the National Bank of Georgia (NBG), as we believe there is a strong correlation between central bank independence, price stability, and economic performance. The National Bank of Georgia remains committed to price stability and to meeting its inflation target (6 percent in 2013 and 2014; 5 percent in 2015). We believe that maintaining macroeconomic stability is the surest way to sustained growth.

- Facilitate external adjustment by taking measures now to reduce the current account deficit over the medium term through reasonable fiscal consolidation, greater exchange rate flexibility, and structural reforms that will improve Georgia's competitiveness and export capacity. We will implement measures to limit noncore funding to reduce external vulnerability and protect the financial system.

- Support growth that is private sector-led, geographically diverse and which is inclusive and job-creating. We will ensure an enabling business environment by providing a level playing field for all businesses. We will remove barriers to free and fair competition, and strengthen the role of the Competition Authority. We will protect workers' rights and improve working conditions.

- Reprioritize government expenditure toward social spending; improve the quality of capital spending, while maintaining key infrastructure projects; and increase budget transparency and accountability.

4. We also intend to implement structural reforms to improve governance, encourage employment, and reduce poverty:

- In terms of governance, we will increase the transparency and accountability of the budget process. We will also strengthen the institutional framework of the Partnership Fund (PF), and publish accounts of the LEPLs every six months.

- To boost growth and employment, we will accelerate reforms aimed at improving the business environment, including strengthening competition policy and protection of property rights. We have established a Rural and Agricultural Development Fund and are facilitating creation of new investment funds to support key sectors of the economy.

- We will enhance dialogue with business and will make the tax code and tax administration more fair and comfortable for business operation, but without lowering tax rates.

- We will strengthen the social safety net to help the poorest and most vulnerable. The 2013 budget provides for an increase in basic pensions and social allowances, for the introduction of universal emergency health insurance starting from February and universal health insurance starting from July 2013, and for reducing the income tax burden on low-income workers.

5. To support this strategy, we will continue to cooperate strongly with the IMF under the 24-month Stand-By Arrangement (SBA) and Standby Credit Facility (SCF) adopted last April. We fully share the goals set under these arrangements, namely to keep the budget deficit on a reasonable downward path so as to create room for countercyclical fiscal policy, promote external adjustment, strengthen market confidence, catalyze continued official financial support, and encourage employment and reduce poverty, while maintaining the output gap close to zero. As was the case in April 2012, we project our program to be fully financed and intend to keep treating the SBA and SCF as precautionary.

6. We are current on our program obligations and have met all but one of our end-December 2012 program targets (Tables 1, 2 and 3). We met all the end-June 2012 quantitative performance criteria (PCs) and indicative targets. The fiscal deficit target was met comfortably, owing to lower-than-expected public investment. The NIR and NDA targets were also met comfortably as the NBG stepped up, and sterilized, its foreign currency purchases. We also met the structural benchmarks related to the reporting of SOEs' and LEPLs' financial flows and to the audited financial accounts of the Partnership Fund. Reflecting our commitment to stable macroeconomic policies, we met all but one of the end-December 2012 quantitative PCs and indicative targets.

7. We request a waiver for the end-December 2012 performance criterion on the deficit ceiling for the Partnership Fund, in light of the corrective measures we have implemented to ensure that this does not happen again. The PC was not met because the PF took full responsibility for the financing of the Gardabani thermal power plant (TPP) investment project (US$200 million total), after the power supplier, who negotiated a draft MoU to finance the project, decided not to participate. The PF had already advanced US$50 million to the contractor so it would have been too costly to abandon the project. This action was contrary to the PF's goal of taking minority stakes and bringing in outside private investment. We are firmly committed to taking all necessary measures to avoid this kind of issue recurring in the future. As a first step, in line with IMF technical assistance recommendations, we have amended the PF charter to limit PF participation in projects to a minority equity stake. Specifically, PF financing (debt plus equity plus guarantees) will not be allowed to exceed 100 percent of the equity of the private partner in the project. We will submit to parliament an amendment to the PF Law removing all noncommercial objectives from the PF by end-April 2013 (structural benchmark). We have also changed the management of the PF and have initiated work on a new organizational structure that will ensure more prudent decision making (see below).

8. In light of Georgia's strong economic performance and the policies outlined in this letter, we request completion of the first and second Reviews under the SBA and SCF. Given our strong financial position, we do not intend to draw the funds available once the review is completed. As envisaged when the program was approved last April, the third review will be based on end-June 2013 performance criteria and is scheduled for completion by end-October 2013, and the fourth review will be based on end-December 2013 performance criteria and is scheduled for completion by April 10, 2014.

9. We authorize the IMF to publish this Letter of Intent and its attachments (including the Technical Memorandum of Understanding).

I. MACROECONOMIC FRAMEWORK

10. The economy continued to expand at a healthy rate in 2012 and growth is expected to remain strong in 2013. While slowing somewhat in the fourth quarter, growth is expected to have exceeded 6 percent in 2012 and to have been broad based, with strong growth in construction, manufacturing, and the financial sector. We expect growth to remain strong in 2013, reaching at least 6 percent, as the impact of renewed fiscal consolidation efforts will be offset by increases in foreign direct investment. On the plus side, growth could be significantly higher if, as we expect, Russia reopens its market to Georgian products, and the Rural and Agricultural Fund starts operations. However, on the negative side, there is the risk of continued weakness in the world economy and the Eurozone, and there are also indications of some pause in growth towards the end of 2012, which we are monitoring closely. Thus, while we are confident that growth in 2013 will reach 7 percent, we will base our policies on a more prudent assumption of 6 percent growth, and we will revisit our growth assumption during the Article IV discussions. These continued strong growth rates should be sufficient to reduce the unemployment rate further.

11. While inflation in 2012 has been much lower than expected, we expect it to gradually increase to 3 percent by end-2013 and to reach the NBG's inflation target of 6 percent sometime in 2014. Exchange rate appreciation against our main trading partners through early 2012, the decline in food prices, and slower bank credit growth have contributed to the low inflation observed in 2012, which fell below the NBG's inflation target. In 2013, we expect that domestic demand will pick up, and that bank credit will grow more rapidly again once uncertainties die out. Combined with increased social expenditures, accommodative monetary policy, and greater exchange rate flexibility, inflation should pick up during the year and approach the NBG's target. We will base our policies on the assumption of a GDP deflator of 3.5 percent in 2013 but stand ready to revisit this assumption during the Article IV discussions.

Georgia: Main Economic Indicators, 2012–13

	2012	2013 projections
	(In percent)	
Growth	6.5	6.0
Inflation, end of period	-1.4	3.2
Inflation, average	-0.9	1.0
GDP deflator, period average	1.4	3.5
Current Account deficit (in percent of GDP)	12.0	10.0

12. Starting in 2013, we will put in place measures that will support reduction of the current account deficit through the medium term. For 2012, we project that the current account deficit will remain constant at around 12 percent of GDP, rather than falling to 9.7 percent of GDP as had been projected in the program. We are committed to reducing the current account deficit to a sustainable level through a combination of policy measures. We will reduce the fiscal deficit from 3 percent of GDP in 2012 to 2.8 percent of GDP in 2013 and then gradually to 1½ percent of GDP over the medium term. We will implement this fiscal consolidation largely by streamlining import-intensive capital expenditures, which should improve the trade deficit directly and increase public savings. We will support this effort through monetary and exchange rate policies as well as macroprudential measures to limit noncore funding and to protect the financial system. Structural reforms would further enhance our competitiveness and increase exports in general, including of agriculture products, tourism, and hydropower energy. We are working closely with the EU on the Deep and Comprehensive Free Trade Agreement, which we aim to sign by fall 2013 and which we expect will take effect from 2014. We are also taking steps to reopen trade with Russia, where we anticipate significant increases in exports.

13. We plan to implement policies to improve the business and investment environment, to boost Georgia's growth, competitiveness, and employment over the medium term:

- We will enhance the capacity of the court and judicial system to more effectively handle business cases. We will improve the efficiency, effectiveness, and integrity of the tax appeal process with TA from donors and in collaboration with business representatives.
- We are committed to a stable regulatory environment, and we will reinforce the protection of property rights by lifting political pressure from the judiciary system.
- We will introduce new antitrust regulation so that a strengthened competition agency will be in place by the end of June 2013. Relevant legislative changes are already initiated.

14. We are keen to promote agricultural development and private investment. We have established a new Rural and Agricultural Fund to support agricultural development through investment in infrastructure, irrigation, and technology; access to credit; and export promotion. This fund will not be financed from the budget; it will not receive government guarantees and will not create any contingent liabilities to the government. We will also address some of the issues impeding employment creation starting with the need to upgrade skills in the labor force. We are also encouraging creation of a new private Investment Fund that will provide long-term financing for development projects. This fund will be fully private and will not receive financing or guarantees from the government. Its audited financial statements will be published regularly.

II. FISCAL POLICY

15. In view of the persistence of high current account deficits, and to create room for countercyclical fiscal policy, we are accelerating our fiscal consolidation efforts. While our medium-term fiscal objective remains to reduce the deficit to about 1.5 percent of GDP by 2016, we have reduced our fiscal deficit target to 2.8 percent of GDP in 2013 compared to the 3 percent of GDP envisaged last April. In view of the need to strengthen our social safety net while meeting our constitutional requirement to bring overall spending under 30 percent of GDP from 2014 onward, our efforts will focus primarily on increasing the efficiency of other current and capital expenditures. Consistent with our commitment to using fiscal policy in a countercyclical manner, the program includes an expenditure rule so that if revenue exceeds projection by around 0.5 percent of GDP, then the excess will be saved (performance criterion).

16. Consistent with our commitment in the March 2012 LOI and MEFP, we reduced our fiscal deficit to no more than 3.0 percent of GDP in 2012. Revenue turned out slightly higher than projected, reflecting primarily higher grants and an exceptional dividend by Georgian Railways. In addition to reducing the deficit, these higher revenues were used to finance emergency assistance in Kakheti, accelerate investment spending, and to finance the agricultural sector (by allocating an additional 81 million GEL (0.3 percent of GDP) to the Ministry of Agriculture in amendments to the 2012 budget last December).

17. Our 2013 budget aims at reducing the fiscal deficit to 2.8 percent of GDP while increasing social spending to protect the most vulnerable:

- We will increase pensions to GEL 150 (subsistence minimum) for all pensioners. Pensions will be increased in two stages. First, from April 1, pensions for pensioners below age 67 will be increased from GEL 110 to GEL 125; thus all pensioners (women from 60 and men from 65) will have equal pensions. Second, from September 1, pensions will be increased to GEL 150. Including the full year effect of the September 2012 pension increase, these will cost about 0.6 percent of GDP in 2013. The full year effect of the 2013 increases in pensions is GEL 237.3 million (0.8 percent of GDP).

- We will increase other types of pensions starting from September. Disability Pension (I group) will be increased from GEL 100 to GEL 150; Disability Pension (II group) will be increased from GEL 70 to GEL 100; Survivors' Benefits and Benefits for Victims of Political Repression will be increased from GEL 55 to GEL 100. These increases will cost GEL 26 million in 2013 (0.1 percent of GDP), with a full year effect of GEL 68.3 million (0.24 percent of GDP).

- We will double our spending on social allowances by increasing benefits and broadening their coverage starting from July 2013. This will cost an additional GEL 71.5 million in 2013 (full year cost GEL 143 million (0.5 percent of GDP)).

- We will provide universal healthcare insurance. Three different packages will be introduced for different categories of beneficiaries. Adding the cost of packages introduced in 2012, health insurance spending in 2013 will rise by GEL 350 million compared to 2012 to reach a total of GEL 505 million (1.75 percent of GDP). The annual impact of the insurance packages introduced in 2013 will be GEL 302 million (about 1 percent of GDP). We are consulting closely on this reform with the World Bank.

- We are reducing the tax burden for low-income earners by making the first GEL 150 each month of wages free from personal income tax. Tax rebates will be given in early 2014. Making the personal income tax more progressive in this way will cost 0.6 percent of GDP in 2014. We are also increasing spending on education (0.2 percent of GDP). Funding of the Ministry of Education will increase by GEL 44.2 million in 2013 to GEL 670 million. The increase is mainly directed to voucher financing of the public schools, rehabilitation of the public schools, and grants for Higher Education.

- We are also increasing spending on agriculture. Financing of the Ministry of Agriculture will be increased to 241 million GEL in 2013, mainly directed to the programs of purchasing agricultural machinery, melioration activities, and developing the agricultural sector.

- As a result of these measures, government spending on pensions, social allowances, healthcare, education, and agriculture will increase from 9.4 percent of GDP in 2012 to 11.1 percent of GDP in 2013.

18. We are taking the following measures to pay for these new socially oriented policies, and to offset the projected decline in nontax revenue and grants (by 1.2 percent of GDP). These will reduce the budget deficit to 2.8 percent of GDP:

- We are reorienting capital spending away from new government buildings and will instead prioritize infrastructure. This, along with a decline in net lending, will generate savings of around 2 percent of GDP. Government investment will still be around 6.5 percent of GDP, which is high compared to neighboring countries.

- We will introduce a nominal freeze on all other categories of spending. This will save 1.5 percent of GDP in 2013.

19. Consistent with our election mandate and our vision for Georgia, we will adopt a number of reforms to contain fiscal risks and increase fiscal transparency.

20. First, we will define the Partnership Fund's role more clearly and strengthen its governance:

- The PF's overarching goal is to catalyze private investment in key sectors through providing cofinancing (in the form of minority equity or debt financing) in situations where the private sector cannot mobilize sufficient funding from the market without some form of state participation.

- We are reviewing the PF's existing investment portfolio and will halt projects that are not commercially viable. We are currently involved in negotiations with several investors who would potentially acquire majority equity in the Gardabani TPP project so that it can become private. If these negotiations are not successful, we will work on alternative options to reduce the PF equity in this project to a minority.

- In the coming months we will review the PF's role, bearing in mind its relation to the new Rural and Agricultural Fund and also that the PF owns state assets of considerable value. We will consult with the Fund and the World Bank before concluding this review.

- In the meantime, we will continue to strengthen the PF's governance in line with IMF technical assistance recommendations. In addition to restricting the PF's participation in projects to a minority stake, we will submit to parliament an amendment to the PF law to remove noncommercial objectives from the PF (structural benchmark, end-April 2013). In the meantime, the PF will not engage in any activities with noncommercial objectives.

21. Second, we will increase budget transparency and accountability by providing the public with more information on government spending. Starting from end-July 2013, we will publish semiannual public sector accounts that cover the general government and the LEPLs (structural benchmark, end-July 2013). The government will review its policy with regard to the issuance of guarantees. In the meantime, it will not issue guarantees.

22. Third, we will be considering public sector involvement in large hydropower projects in accordance with our strategy for the further development of the energy sector, provided that all related fiscal risks are assessed. The government will abstain from outright guarantees; however, the issuance of PPA guarantees for domestic supply may be necessary for power plant investment projects. In line with World Bank recommendations, we will consider further liberalization of the energy market and modifications to the rules governing the energy market. Any subsequent public sector involvement, if warranted, will take place based on (i) the financial viability of the projects; (ii) the associated fiscal risks (including in the form of contingent liabilities); and (iii) economic benefits to Georgia. We are also working with the regulator to review applicable methodologies for energy tariffs and will consult with the World Bank on this.

23. Electricity tariffs were reduced by 3.54 tetri (about 22-28 percent of the tariff) as of January 2013 for consumers who consume less than 300 kWH per month. The reduction was achieved through a renegotiation of tariffs with the operating companies. In the Kakheti region, this reduction will be financed from the state budget, but with a small estimated cost of 875,000 GEL for the first three months of the year.

24. We are receiving TA from the IMF and intend to strengthen revenue administration:

- We will strengthen taxpayer registration, the management of tax return filing compliance, and debt management.
- We will increase the number and qualification of auditors and continue the US Treasury Office of Technical Assistance modern audit training program.
- In line with international practice, we are working on legislation that will allow auditors controlled access to bank account information for the purpose of carrying out audits.
- In concert with scaling up GRS audit capacity, we plan to review by end-2013 the private sector-led alternative audit program introduced in recent years.
- We will review the GRS' excessive reliance on fees and charges, with the goal of ensuring that all core tax administration operational activities are provided free of charge. This will encourage higher levels of voluntary compliance by taxpayers.

- We propose to further develop taxpayer service and compliance programs with an emphasis on tailoring these to the needs of different taxpayer segments. We have already introduced special services for micro and small enterprises through both service centers and electronically.

III. MONETARY AND EXCHANGE RATE POLICIES

25. We remain committed to price stability and exchange rate flexibility. Maintaining monetary and financial stability requires credible policymaking independence. As such, as stated in the NBG's organic law and in the Constitution of Georgia, we reaffirm the existing strong institutional and financial independence of the NBG and also the importance of strong cooperation between the government and the NBG. In 2012, inflation fell well below our 6 percent target because of the base effect from one-off price increases in 2011 and was driven mainly by the decline in food prices and the decline in prices of other imported goods. The NBG will gradually decrease its inflation target towards its medium-term objective of 3 percent. For 2013 and 2014, we are committed to our monetary policy objective of keeping inflation to 6 percent, declining to 5 percent in 2015. The NBG is committed to explaining in public any deviations from these targets and for regularly making public its revised inflation and macroeconomic projections. Changes in the monetary policy rate will be guided by developments in credit and monetary aggregates complemented by our inflation forecast model but with the primary goal of achieving our inflation target.

26. We will continue our policy of purchasing foreign exchange to boost our net international reserves. During 2012, we purchased a (net) total of US$155 million, so that our gross international reserves increased to US$ 2.873 billion. In 2013, gross reserves are expected to decline moderately to US$ 2.635 billion, but will stay comfortably above 3 months of 2014 imports of goods and nonfinancial services.

27. We will refine our inflation targeting framework by further customizing our modeling to Georgia's conditions and by assisting with the implementation of a credit conditions survey. The NBG will continue to invest in human capital to further strengthen modeling and forecasting skills to refine the new FPAS framework for forecasting inflation. In the first half of 2013, the International School of Economics in Tbilisi, assisted by the NBG, will launch a business confidence survey that will measure inflation expectations. Moreover, the NBG will launch a new credit conditions survey to assess present and expected credit conditions, which will further assist the forecasting analysis.

28. To strengthen external communication, a new Inflation Report will be introduced in 2013. The revised document will be more forward looking and will provide to the public the NBG's views on the outlook for inflation, economic growth, and the broad macro environment. The report will give medium-run inflation and output projections in fan charts. In case actual inflation deviates from the targeted level, the NBG will continue to explain in detail the main reasons why the target was missed, showing the revised future inflation path, and will explain how and when inflation will be back on track. The new Inflation Report will be part of the communication strategy that the

NBG plans to implement starting from February-March 2013. We believe that a broader communication strategy, comprising regular meetings with analysts, journalists and other experts, could significantly improve the public's understanding of monetary policy, improve credibility, and increase accountability of the NBG.

29. To accelerate de-dollarization and to strengthen the monetary transmission mechanism, we will implement policies to encourage the use of the lari in the financial system. The NBG has relaxed collateral standards for refinancing loans and will encourage commercial banks to issue long-term standardized lari CDs. We are also considering placing long-term government deposits with commercial banks (in exchange for sale of treasury bills to commercial banks) to promote long-term lari lending.

IV. FINANCIAL SECTOR

30. We are taking steps to further strengthen the financial sector and to enhancing the regulatory environment:

- Competition in the banking industry has intensified. However, our financial sector maintains comfortable buffers of capital and liquidity. The capital adequacy ratio as defined by the BIS is around 24.6 percent (NBG definition: 16.5 percent); the BIS Tier I ratio is 18.8 percent (NBG definition: 13.2 percent). Liquid assets (excluding short-term loans) cover 53 percent of client deposits and 33.7 percent of total liabilities, while the liquidity ratio (NBG definition) stands at 40 percent. These high capital and liquidity ratios mean that our banks have very low levels of leverage, with a net loans-to-capital ratio of only 3.5.

- Given that there is very little difference at present between the cost of funds and the cost of equity, we believe that our conservative capital requirements do not impede efficiency; on the contrary, they contribute to a lower cost of funds due to lower bank credit risk. We are committed to ensuring that banks will continue to improve their efficiency without compromising their financial soundness.

- We will encourage banks to develop enhanced pricing models for their products. We have developed common guidelines for the development of those models and have intensified profitability analysis of the banks to identify profit and loss generating sources.

31. We will continue the transition towards Basel III compliance and risk-based supervision. In 2013, banks should start to comply with the standardized approach of Pillar 1 of Basel III. In line with the transition to Pillar 2, banks are expected to submit their first Internal Capital Adequacy Assessment Process (ICAAP) forms in 2013. Banks will also perform firm-level stress tests under macro scenarios. These results will be used for Pillar 2 capital requirements. We have initiated programs to help financial sector firms make this transition, especially regarding ICAAP, while some banks are receiving assistance from external consultants to smooth the process.

32. **In line with Basel III, we are monitoring the need for additional countercyclical measures, vis-à-vis our old, more rigid methodology of changing the risk weighting for FX assets in the capital adequacy ratio; which, given the high dollarization of the banking system, has been quite an effective regulatory tool.** We have developed the framework for monitoring domestic systemically important banks (D-SIBs), in line with recent Basel recommendations. This framework, together with the development of micro-level stress tests, will gradually replace the current, less fine-tuned approach.

33. **Starting from 2012, the NBG has made efforts to make the liquidity coverage ratio (LCR) the core liquidity ratio for banking supervision.** We are currently calibrating our use of the LCR. Currently we use the LCR as a monitoring tool; after some further fine-tuning, we aim to adopt it by end-2013, well ahead of Basel III's 2015 deadline. Within our LCR, we already include higher liquidity requirements for nonresident deposits compared with resident deposits. Going beyond Basel recommendations, our LCR also accounts for such characteristics as: withdrawable vs. non-withdrawable deposits, parent financing vs. private financing, concentration, and loan quality.

34. **While in the past we have relied mainly on moral suasion, we are now taking a more formal approach to discouraging nonresident deposits**. By June 2013, we will introduce a transitory liquidity ratio for nonresident deposits, which will take effect until the full LCR comes into force. Provided nonresident deposits are no more than 10 percent of total deposits (in which case we believe they can be a useful source of diversified funding), they will face the standard 30 percent liquidity requirement. For each percentage point above the 10 percent threshold, the liquidity requirement for nonresident deposits will increase by the same amount. Thus if nonresident deposits make up 15 percent of total deposits, then total nonresident deposits will face a liquidity requirement of 35 percent. At the same time, the NBG will continue to work on distinguishing nonresident depositors with no interest in the country from non-residents who have close economic links to Georgia (employees of international organizations and embassies, diaspora, foreign companies with business relations in Georgia, etc.). While hard to calculate precisely, our current estimates suggest the share of NRDs of people with no other interests in the country is less than half of total reported NRDs. This will help us refine our supervisory measures.

35. **After upgrading the NBG's supervisory structure and approach, we completed a self-assessment of our regulatory framework against Basel Core Principles**. To complement our self-assessment we have developed General Risk Assessment Program (GRAPE), a document which describes our approach to supervision. We aim to send GRAPE and our self-assessment documents to the IMF for review by March 2013. These would be important inputs for an FSAP, which we request from the Fund and which we hope will be launched by the end of 2013.

36. **We are continuing our attempts to further de-dollarize the banking system.** Our existing policies, including additional risk weighting for FX loans, higher reserve requirements for FX liabilities, and overall higher negative liquidity carry for FX liabilities already discourage FX funding and FX lending. Our micro-level stress testing framework (to be performed by banks in 2013) will also take into account currency-induced credit risk. Furthermore, to address the macro-level

implications of dollarization, in our new framework we will impose a capital add-on for FX lending on top of the amounts indicated by the micro stress tests. We will do this gradually in 2013–14. The use of higher-than-required run-off rates for FX deposits, once our LCR framework takes effect, should also help discourage the use of foreign currency.

V. EMPLOYMENT AND POVERTY REDUCTION

37. We are implementing a set of policies to encourage employment and reduce poverty:

- We have established a Rural and Agricultural Fund to provide necessary support for infrastructure development and modernization in the agricultural sector. This will alleviate rural poverty and unemployment and increase agricultural exports.
- To address the shortage of skilled workers, we will create vocational and technical training programs. We intend to improve the effectiveness and efficiency of the professional education system in Georgia through enhancing social partnership, reviewing occupational standards and educational programs, linking educational programs to labor market demands, and upgrading the qualifications of those engaged in professional education. We will work to develop the professional education infrastructure and to provide quality assurances. Intense cooperation between the line ministries, donor community, and industry representatives has been launched to facilitate the creation of professional and technical training programs for ensuring the provision of a skilled workforce.
- We will strengthen workers' rights through amendments to the Labor Code. One amendment regarding social partnership—improving the dialogue and working relations between the employer (union of employers), the employee (union of employees) and state agency representatives—was approved by parliament on December 27, 2012. This will bring Georgia in line with ILO standards while keeping Georgia attractive as a place for doing business.
- To promote additional assistance for the most vulnerable, we will improve the targeting of existing social programs.

38. We are launching extensive reforms to raise living standards in agriculture, which employs almost half of our population. These reforms include improvement of irrigation and drainage systems (already started and to be implemented throughout 2013), which will result in expansion of irrigated areas and improvement of land productivity; establishment of district level information and extension centers for providing advice, and extension services to farmers hence improving their efficiency (recruitment has already started and these centers will function from March 2013); enhancement of cooperation and provision of support to smallholder farmers to improve food security and decrease rural poverty (new legislation on agricultural cooperatives should be in place by late Spring 2013); and improvement of food safety regulations and administration to approximate Georgian standards and legislation with those of the European Union. Moreover, the introduction of modern technologies and development of credit schemes together with commercial banks and microfinance organizations will provide affordable agricultural loans to farmers through the private sector.

VI. OTHER ISSUES

39. We have made good progress improving our Balance of Payment Statistics. In June 2012, we started to report our external sector statistics in BPM6 format. To further improve compliance with BPM6, we will launch two new survey forms for collecting data on manufacturing and insurance services early in 2013. With Fund technical assistance, we are updating the methods applied for adjusting trade statistics. We strengthened the data sharing agreement between the NBG and the National Statistics Office of Georgia (GeoStat), which will help improve data quality. To make further progress, we will initiate an amendment to the Law on Official Statistics to strengthen GeoStat's legal right to collect necessary statistical data by obliging private entities to provide the information to GeoStat upon request (with penalties for noncompliance). The Law requires that such information is treated in strict confidence and disseminated only in aggregated form. We will ensure that GeoStat has adequate resources (including additional staff and funding) to perform current and upcoming tasks, including the population census in 2014, and to produce higher frequency indicators of the real economy.

Sincerely yours,

/s/
Bidzina Ivanishvili
Prime Minister of Georgia

/s/
Nodar Khaduri
Minister of Finance of Georgia

/s/
Giorgi Kadagidze
Governor of the National Bank of Georgia

Table 1. Georgia: Quantitative Performance Criteria and Indicative Targets, 2012

	June-12	June-12	June-12	Dec-12	Dec-12	Dec-12
	PC	Adjusted PC	Actual	PC	Adjusted PC	Actual
	(Cumulative change since the beginning of the year, in mill lari)					
Ceiling on the cash deficit of the general government	190	195	29	943	952	779
Ceiling on the cash deficit of the PF	0	…	-33	0	…	10
	(End-period stock, in mill lari)					
Ceiling on NDA of NBG 1/	99	127	-28	238	254	95
	(End-period stock, in mill USD)					
Floor on NIR of NBG 1/	1,116	1,099	1,177	1,196	1,186	1,326
	(Cumulative change since the beginning of the year, in mill USD)					
Ceiling on the accumulation of external arrears	0	…	0	0	…	0
	Indicative Target		Actual	Indicative Target		Actual
Ceiling on contracting or guaranteeing of external debt by the public sector	800	…	554	1,100	…	724

Sources: Georgian authorities and Fund staff estimates.

1/ Actual figures and quantitative targets are based on program exchange rates.

Table 2. Georgia: Quantitative Performance Criteria, 2013

	June-13	Dec-13
	PC	PC
	(Cumulative change since the beginning of the year, in mill lari)	
Ceiling on the cash deficit of the general government	150	819
Ceiling on the cash deficit of the PF	0	0
Ceiling on the expenditures of the general government	3,900	8,890
	(End-period stock, in mill lari)	
Ceiling on NDA of NBG 1/	94	84
	(End-period stock, in mill USD)	
Floor on NIR of NBG 1/	1,296	1,416
	(Cumulative change since the beginning of the year, in mill USD)	
Ceiling on the accumulation of external arrears	0	0
	Indicative Target	Indicative Target
Ceiling on contracting or guaranteeing of external debt by the public sector	500	1200

Sources: Georgian authorities and Fund staff estimates.

1/ Actual figures and quantitative targets are based on program exchange rates.

Table 3. Georgia: Structural Benchmarks

Structural Benchmarks and proposed Structural Benchmarks	Date	Status
The Ministry of Finance will provide to the IMF an annual report of the financial flows for each of the 5 largest SOEs as well as an annual report consolidating the financial flows of the 5 largest LEPLs	End-June 2012	Met
The PF will publish and transmit to its Supervisory Board its audited IFRS compliant financial statements for 2011	End-Sept 2012	Met
Submit to parliament an amendment to the PF law to remove non-commercial objectives from the PF	End-April 2013	
Implement prudential measures in line with paragraph 34 of the letter of intent	End-June 2013	
Develop and publish public sector accounts that cover the general government and the LEPLs	End-July 2013	

Sources: Georgian authorities and Fund staff estimates.

ATTACHMENT I. TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)

March 1, 2013

1. This memorandum sets out the understandings between the Georgian authorities and the IMF staff regarding the definitions of quantitative performance criteria and indicative targets, as well as respective reporting requirements for the Stand-By Arrangement and Standby Credit Facility.

2. These performance criteria and indicative targets are reported in Tables 1 and 2 attached to the letter of intent dated March 1, 2013. The exchange rate for the purposes of the program of the Georgian lari to the U.S. dollar is set at GEL1.67 = $1. The corresponding cross exchange rates are provided in Table 1.

I. GENERAL GOVERNMENT AND THE PUBLIC SECTOR

3. **Definition:** The general government is defined as the central government and local governments. It does not include Legal Entities of Public Law, State-Owned Enterprises, or the Partnership Fund (PF). The public sector consists of the general government and the National Bank of Georgia (NBG).

4. **Supporting material:** The Treasury Department of the Ministry of Finance (MOF) will provide to the IMF detailed information on monthly revenues of the general government within two weeks of the end of each month and monthly expenditures and arrears of the central government within four weeks of the end of each month. In addition, the treasury will provide, on a daily basis, the cash balances in all the accounts of the general government as of the previous business day.

II. QUANTITATIVE PERFORMANCE CRITERIA, INDICATIVE TARGETS, AND CONTINUOUS PERFORMANCE CRITERIA: DEFINITIONS AND REPORTING STANDARDS

A. Quantitative Performance Criteria and Indicative Targets

5. The quantitative performance criteria and indicative targets specified in Tables 1 and 2 attached to the letter of intent are:

- a performance criterion (ceiling) on the cash deficit of the general government;
- a performance criterion (ceiling) on the expenditures of the general government;
- a performance criterion (ceiling) on the cash deficit of the Partnership Fund;
- a performance criterion (ceiling) on the net domestic assets (NDA) of the NBG;

- a performance criterion (floor) on the net international reserves (NIR) of the NBG;
- a continuous performance criterion (zero ceiling) on the accumulation of external arrears; and
- an indicative target (ceiling) on the contracting and guaranteeing of new total external debt by the public sector.

6. The performance criteria and indicative targets have been set for end-June and end-December 2013, and are monitored on a cumulative basis from the beginning of the calendar year (with the exception of the NIR and NDA targets, which are monitored in terms of stock levels), while the continuous performance criterion is monitored on a continuous basis.

B. Ceiling on the Cash Deficit of the General Government

7. **Definition:** The cash deficit of the general government will be measured from the financing side at current exchange rates and will be defined as equal to total financing. Total financing will be defined as the sum of (i) net domestic financing from banks and nonbanks, (ii) net external financing, and (iii) privatization receipts.

- Net domestic financing consists of bank and nonbank net financing to the general government, which will be defined as follows:

  (i) Net lending (borrowing net of repayments) provided by commercial banks to the general government plus the use of deposits held by the general government at commercial banks. Monitoring of net lending and government accounts will be based on the NBG's monetary survey and treasury data. The change in cash balances of the local government at commercial banks for budget financing purposes will be monitored based on the "budget of territorial unit" account data provided by the treasury department. Any securities issued by the general government and purchased by commercial banks (for example, T-Bills) are also included in domestic financing.

  (ii) Net lending (borrowing net of repayments) provided by the NBG to the general government plus the use of deposits of the general government held at the NBG. Monitoring of net lending and government accounts will be based on the central bank survey and treasury data. The change in cash balances of the central government at the NBG for budget financing purposes will be monitored based on the "State budget's Treasury single account (TSA)" and "Revenue reserve account" data provided by the treasury department. Any securities issued by the general government and purchased by the NBG (for example, T-Bills) are also included in domestic financing.

  (iii) Any securities issued by the general government and purchased by nonbanks (for example, T-Bills or securitized claims on the government sold by the NBG) are also included in domestic financing.

- Net external financing is defined as the total of loans disbursed to the general government for budget support (including the financing from the IMF whose domestic counterpart is used to finance the budget), and project financing (capital expenditure and net lending), net change in external arrears, change in the accounts of the general government abroad, minus amortization and net deposit accumulation in the state budget's foreign currency account. Amortization includes all external debt-related payments of principal by the general government.

- Privatization receipts consist of all transfers of monies received by the central and local governments in connection with the sale of central or local government assets. This includes receipts from the sale of shares, the sale of nonfinancial assets as well as leases and the sale of licenses with duration of 10 years and longer.

8. Supporting Material:

- Data on domestic bank and nonbank financing will be provided to the IMF by the NBG and the treasury department of the MOF within four weeks after the end of the month.

- Data on external project financing as well as other external borrowing will be provided to the IMF monthly by the debt unit at the MOF (specifying projects by creditor) within two weeks of the end of each month.

- Data will be provided at the actual exchange rates.

- Data on privatization receipts of the general government will be provided by the treasury department of the MOF to the IMF on a monthly basis within two weeks of the end of each month.

- Data on securitized debt sold by the NBG, including the securities that have been purchased by nonbanks, will be reported by the NBG on a monthly basis within two weeks of the end of each month.

C. Ceiling on the Expenditures of the General Government

9. Definition: Expenditures of the general government comprise all current and capital expenditures as well as net lending: (i) current expenditures comprise compensation of employees, use of goods and services, subsidies, grants, social expenses, other expenses, other account payables, and domestic and external interest payments; (ii) capital expenditures include projects financed by foreign loans and grants; and (iii) net lending is defined as lending by, minus repayments to, the general government.

10. Supporting material: Data for monitoring expenditures will be derived from the accounts of the general government covered under the ceiling (based on state, local authority, and autonomous republics budgets). The Ministry of Finance is responsible for such reporting according to the above definition. Data on expenditures of the general government should be reported within four weeks after the end of the quarter.

D. Ceiling on the Cash Deficit of the Partnership Fund

11. Definition: The cash deficit of the Partnership Fund will be measured as its expenditures minus its revenues.

12. The PF's revenues comprise the dividends from its assets and investments, the interest earnings from the loans it provides, the fees it charges for the services and guarantees it provides, and any other income earned from its assets.

13. The PF's expenditures comprise all current and capital expenditures. Current expenditures comprise compensation of employees, use of goods and services, transfers to other entities, other account payables, and domestic and external interest payments. Capital expenditures will comprise the net acquisition of nonfinancial assets as defined under GFSM 2001. The PF's purchases of financial assets (e.g. lending and equity participations) will not be considered part of its expenditures.

14. Supporting Material: The MoF will provide to the IMF detailed information on the PF's quarterly revenue, expenditures, and financial operations within four weeks of the end of each quarter.

E. Floor on the Net International Reserves of the NBG

15. Definition: Net international reserves (NIR) of the NBG in U.S. dollars are defined as foreign assets of the NBG minus the sum of foreign liabilities of the NBG. Foreign assets of the NBG include gold, gross foreign exchange reserves, Georgia's SDR holdings, and the reserve position in the IMF. Gross foreign exchange reserves of the NBG are defined as liquid, convertible currency claims of the NBG on nonresidents, including cash holdings of foreign exchange 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 of the NBG shall be defined as the sum of Georgia's outstanding liabilities to the IMF (at face value), Georgia's SDR allocation, and any other liabilities of the NBG (including foreign currency deposits of financial institutions at the NBG and currency swaps and foreign exchange forward contracts with financial institutions), excluding the foreign exchange balances in the government's account with the NBG. For program monitoring purposes, the stock of foreign assets and foreign liabilities of the NBG shall be valued at program exchange rates as described in paragraph 2 above. The stock of NIR amounted to $1,152 million as of December 31, 2011 (at the program exchange rate).

16. **Adjustors:** The floor on the NIR of the NBG will be adjusted:

- Upward/downward by 50 percent for any excess/shortfall in the balance of payments support loans and balance of payments support grants relative to the projected amounts presented in Table 2.

- Upward/downward by 50 percent for any excess/shortfall in the disbursements of the project loans and project grants to the treasury single account at the NBG relative to the projected amounts presented in Table 2.

17. **Supporting Material:** Data on net international reserves (both at actual and program exchange rates); net foreign financing (balance of payments support loans, cash grants to the general government, amortization (excluding repayments to the IMF), interest payments on external debt by the MOF and the NBG); and conversions for government imports will be provided to the IMF in a foreign exchange cash flow table (which include details of inflows, outflows, and net international reserves) on a weekly basis within three working days following the end of the week.

F. Ceiling on Net Domestic Assets of the NBG

18. **Definition:** Net domestic assets of the NBG are defined as the difference between reserve money and NIR as defined above in paragraph 15. Therefore, the ceiling on NDA is defined as projected reserve money (as defined in Table 3) minus the target NIR.

19. **Adjustors:** The ceiling on the NDA of the NBG will be adjusted:

- Upward/downward by 50 percent for any shortfall/excess in the balance of payments support loans and balance of payments support grants relative to the projected amounts presented in Table 2.

- Upward/downward by 50 percent for any shortfall/excess in the disbursements of the project loans and project grants to the treasury single account at the NBG relative to the projected amounts presented in Table 2.

20. **Supporting Material**: The NBG will provide to the IMF its balance sheet, which includes data on reserve money and net domestic assets on a weekly basis within three working days following the end of the week. Data will be provided using both actual and program exchange rates.

G. Ceiling on Contracting or Guaranteeing of New External Debt by the Public Sector

21. Definition: External debt is defined as set forth in point No. 9 of the Executive Board Decision No. 6230-(79/140), as revised on August 31, 2009 (Decision No. 14416-(09/91)).[1] External debt is defined as debt contracted by the public sector with nonresidents other than the IMF. Previously disbursed external debt that has been rescheduled will be excluded from the definition of "new debt" for the purposes of this performance criterion.

22. Supporting Material: Details of all new contracted debt and government guarantees for external borrowing, with detailed explanations, will be provided by the MOF to the IMF on a quarterly basis within thirty days of the end of each quarter. Data will be provided using actual exchange rates.

H. Continuous Performance Criterion on Accumulation of External Arrears

23. Definition: External arrears are defined as unpaid debt service by the public sector to official and private creditors beyond 30 days after the due date.

24. 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. Data will be provided using actual exchange rates.

[1] 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 sometime 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."

Table 1. Program Exchange Rates		
	Currency Name	**Currency/US$**
SDR	Special Drawing Rights	0.65
GEL	Georgian lari	1.67
EUR	Euro	0.77

Table 2. Projected Balance of Payments Support Financing 1/ (In millions of U.S. dollars)		
	Balance of payments support loans and balance of payments support grants	Project loans and project grants
June 30, 2013	22.5	83.8
December 31, 2013	86.5	215.5

1/ Cumulative from the beginning of the calendar year.

Table 3. Projected Reserve Money (End-of-period stock, in millions of lari)	
June 30, 2013	2,258
December 31, 2013	2,449