INTERNATIONAL MONETARY FUND

Staff Country Reports

Georgia: Fifth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver of a Performance Criterion—Staff Paper; Staff Statement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Georgia

In the context of the fifth review under the three-year arrangement under the Poverty Reduction and Growth Facility and request for a waiver of a performance criterion, the following documents have been released and are included in this package:

- the staff report for the Fifth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver of a Performance Criterion, prepared by a staff team of the IMF, following discussions that ended on December 11, 2006, with the officials of Georgia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on February 12, 2007. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF;
- a staff statement of February 28, 2007 updating information on recent developments;
- a Press Release summarizing the views of the Executive Board as expressed during its February 28, 2007 discussion of the staff report that completed the request and review; and
- a statement by the Executive Director for Georgia.

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

Letter of Intent sent to the IMF by the authorities of Georgia*
Memorandum of Economic and Financial Policies by the authorities of Georgia
Technical Memorandum of Understanding*
*Also included in Staff Report

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

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INTERNATIONAL MONETARY FUND

GEORGIA

Fifth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver of a Performance Criterion

Prepared by Middle East and Central Asia Department

Approved by David Owen and Adnan Mazarei

February 12, 2007

Executive Summary

Despite economic sanctions imposed by Russia in 2006, Georgia's economic growth continues to be strong and inflation has declined. Growth is expected to reach 9 percent in 2006 and to slow only moderately to 7–8 percent in 2007. Inflation—a major concern at the time of the last review—was back into single digits by end-2006.

This resilience clearly demonstrates the success of economic reforms since the Rose Revolution in 2003. Improvements in the business climate combined with generally stable macroeconomic conditions have made Georgia increasingly attractive to investors. Thanks to the increase in foreign direct investment, the widening current account deficit in 2007 will be fully financed.

Discussions focused on macroeconomic policies for 2007 which will allow the authorities to meet their growth and inflation objectives, despite the remaining uncertainties about the impact of the Russian sanctions and the size of foreign inflows in 2007. In particular, tensions between the authorities' exchange rate policy and inflation objective need to be resolved. The program envisages more exchange rate flexibility and, therefore, reduced NBG foreign exchange interventions. Combined with more active use of the NBG's open market instruments, this should ensure that money supply stays under control.

The 2007 budget is an appropriate compromise between the country's pressing spending needs and the goal of macroeconomic stability, but the ministry of finance will likely face continuing pressures for higher spending. While it has an impressive track record in revenue collection, fiscal spending exceeded program ceilings in 2006. For 2007, strict fiscal discipline will be essential to ensure that inflation stays under control.

In the financial sector, prompt enactment of fit and proper legislation in line with the recommendations of the recently completed FSAP update is a priority. In an environment characterized by low monetization, partly caused by limited confidence in banks, strong legislation on fit and proper criteria is a core condition for the development of the sector.

The authorities' strong record bodes well for continued successful program implementation. Therefore, staff supports the completion of the review and the authorities' requests for a waiver and for an extension of the arrangement.

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I. RECENT ECONOMIC AND POLITICAL DEVELOPMENTS

1. **Economic growth in Georgia continued at an impressive pace in 2006, despite rapidly rising energy prices and deteriorating relations with its main trading partner.** This strong performance was largely due to a combination of macroeconomic stability, and the dramatically improved business environment as reflected in the World Bank's 2006 Doing Business survey which named Georgia the number one reformer in the world.
2. **Deteriorating relations with Russia dominated the political scene in the second half of 2006.** The Georgian government arrested several Russian military officers on charges of espionage in late-September. Although the accused were returned to Russia quickly, the Russian government indefinitely suspended all transport links and postal communication with Georgia. In addition, some Georgian immigrants working in Russia were deported and no new visas or work permits are being issued. As of January 2007, Gazprom more than doubled the price for gas deliveries to Georgia, to the level charged to Western European countries (MEFP, ¶20). Relations have started to improve moderately with the recent return of the Russian ambassador to Tbilisi.
3. **The sanctions imposed by Russia have had little impact on the Georgian economy.** Export growth continues to be strong, as Russian markets have been replaced by other countries as the main destination for most exports (except wine). While data are incomplete, there are no indications that remittance flows are shrinking significantly. Limited import price increases suggest that there was relatively easy substitution for imports from Russia. As a result, despite Russia's actions the appreciation pressure continued during most of 2006.

4. **Thanks to the resilience in the face of the sanctions imposed by Russia, the overall macroeconomic environment remained positive:**

- **Real GDP** growth through the third quarter of 2006 was 8.6 percent (year-on-year), in spite of a decline in agricultural output. Real GDP growth is estimated to be 9 percent for the year, fueled by manufacturing, services, and construction.

- **Inflation** subsided by end-2006 to 8.8 percent, well below the peak of 14.5 percent in July 2006 (Table 1). Single digit inflation was achieved due to a decline in oil prices in the second half of the year, and a slowdown in lari broad money growth, partly related to a tightening of monetary policies (MEFP, ¶3).

- The **current account** has been broadly stable compared to program projections (Table 2). Strong tourism receipts, reflecting a sharp increase in tourists from Armenia, offset higher-than-expected import volume growth, mainly in durable goods. On the capital account, FDI inflows—excluding privatization—significantly exceeded program projections.

5. **Fiscal performance in 2006 was more expansionary than planned (Table 3).** The end-September fiscal performance criteria were met. However, in contrast to the commitment to limit the annual deficit below program levels in order to further reduce inflationary pressures, spending overruns of almost one percent of GDP—mainly capital and military expenditures—were only partly offset by higher than programmed revenues. The deficit of 2.9 percent of GDP exceeded the indicative program target by 0.4 percent of GDP (MEFP, ¶4). Privatization proceeds fell short of the programmed level, due to delays in several major privatization projects. Therefore, the government accumulated fewer deposits in the banking system than programmed and the end-December indicative targets were breached. While some of the delayed privatization proceeds materialized during the first weeks of 2007, projected proceeds from the sale of an energy company were revised downwards significantly.

6. **Despite the fiscal overspending, monetary policy was on track at end-December (Tables 4 and 5).** While the end-September monetary performance criteria were met, the National Bank of Georgia (NBG)

was confronted during the last weeks of the year with the challenge of dealing with large foreign inflows, partly related to the IPO of Bank of Georgia at the London Stock Exchange. The NBG intervened heavily in the foreign exchange market to prevent what was perceived to be a temporary surge in foreign exchange inflows from influencing the exchange rate.

To limit the resulting reserve money growth, which was aggravated by the fiscal overspending, the NBG sold its modest stock of treasury bills and placed a large amount of

short-term central bank certificates during the last days of 2006. Due to these efforts, the deviation from the end-December indicative reserve money target was small. Credit growth, partly funded by rising foreign liabilities of commercial banks, slowed down during the fourth quarter (MEFP, ¶8).

7. **Overall macroeconomic performance under the program remains generally on track.** While several end-December indicative targets were missed, these deviations were partly caused by events outside the authorities' control. Overall, policies remain in line with program commitments and the trend of rising inflation, a major concern at the time of the fourth review, was reversed.

8. **Progress in structural reforms has continued, albeit more slowly than anticipated in some areas.** The poverty alleviation program—an end-June PC which applies for this review—was introduced in September (MEFP, ¶17). Progress in implementing the end-December structural performance criteria—which will be relevant for the sixth review—has been mixed. The performance criterion on the Legal Entities of Public Law (LEPL) reporting guidelines was met (MEFP, ¶7). The other end-December structural PC, calling for the enactment of fit and proper legislation in line with international best practices, was missed (MEFP, ¶14), but parliamentary approval is expected in April 2007. Going forward, progress toward the end-March benchmarks is encouraging: modernization of tax administration is well underway, and a comprehensive tax administration strategy is being prepared with support of FAD (MEFP, ¶5 and ¶28). The NBG issued regulations requiring external auditors to include issues of relevance to the NBG in their audit reports (MEFP, ¶12) and the government is preparing a financial sector reform package.

II. DISCUSSIONS OF THE 2007 MACROECONOMIC FRAMEWORK

9. **Georgia's resilience in the face of the Russian sanctions demonstrates the success of economic reforms since the Rose Revolution in 2003.** Improvements in the business

climate combined with generally stable macroeconomic conditions have made Georgia increasingly attractive to investors (MEFP, ¶18 and ¶19). The growth momentum created by these reforms has helped the economy compensate for the loss of its major export market.

10. **Against this generally positive background, discussions focused on policies to address challenges to macroeconomic stability.** In the face of the uncertainty about the impact of the Russian sanctions and the size of foreign inflows in 2007, policy flexibility will be needed to meet the authorities' objectives of continued strong GDP growth at 7–8 percent and a further reduction of inflation to 6 percent. In particular, tensions between the authorities' exchange rate policy and inflation objective need to be resolved.

A. External Sector

11. **Compared to program projections, the first round effect of Russia's actions on Georgia's current account in 2007 is estimated to raise the deficit by around 4 percent of GDP, but this estimate is plagued by uncertainties.** The impact of the sharp price increase for gas imports from Russia is projected to be modest, as demand will likely decline in response to rising prices. In addition, a general agreement was reached with the Azeri government on the delivery of gas at lower prices than the ones charged by Gazprom. There is great uncertainty about the medium-term impact of restrictions for Georgian workers and businessmen in Russia. Compared to 2006, staff currently estimates that remittances will be unchanged, instead of increasing as previously projected.

Georgia: Impact of Russia's Sanction on the 2007 Current Account
(Compared to program projections)

	in US\$ millions	in percent of GDP
Remittances from Russia are 25 percent lower	80	0.9
Exports to Russia are 75 percent lower	200	2.1
Gas imports are more expensive	100	1.1

Source: Fund staff compilations.

12. **The deterioration of the current account in 2007 is expected to be financed by increased FDI.** There are no indications that the sanctions imposed by Russia have deterred foreign investors, and staff confirmed the authorities' ambitious FDI projections. The authorities are committed to further strengthening the business environment to make Georgia even more attractive for foreign investors (MEFP, ¶40). Over the medium term, the high level of FDI should help to narrow the current account deficit by boosting export growth.

B. Monetary Sector

13. **The authorities acknowledged the tension between their wish to avoid rapid lari appreciation and the objective of reducing inflation.** They recognized that in an environment of large and volatile capital inflows, greater exchange rate flexibility would be needed to ensure adequate control of money supply. However, in view of the highly uncertain political and economic environment during much of 2006, they wanted to avoid large exchange rate swings. By allowing for a modest appreciation, the NBG was able to tighten monetary policy sufficiently to reduce inflation. The authorities emphasized that, for 2007, priority will be given to further reducing inflation. The NBG's new medium-term monetary policy strategy paper, which will be presented by mid-2007, will clearly outline policy priorities (MEFP, ¶38). The NBG emphasized that conducting monetary policies in line with the inflation target might cause operational losses, and the Ministry of Finance acknowledged that the cost of NBG interventions would ultimately be borne by the budget.

14. **To continue reducing inflation, the authorities' 2007 program envisages a further tightening of monetary policy.** Reserve money growth is programmed to slow from 19 percent in 2006 to 15 percent in 2007 (MEFP, ¶31–33). This will require the NBG to reduce its interventions sharply, although the program has room for reserve accumulation sufficient to preserve the foreign exchange reserve coverage at the end-2006 level—still low by international standards—despite the anticipated increase in imports. In order to strengthen control of reserve money during times of large swings in foreign currency inflows, measures are underway to enhance the efficiency of the NBG's open market operations (MEFP, ¶9 and ¶37). The NBG also expressed its commitment to increase interest rates, if necessary, to keep reserve money growth under control.

Gross International Reserves in Months of Imports of Goods and Services 1/	
Georgia	2.0
Moldova	2.2
Estonia	2.5
Kazakhstan	3.3
Latvia	3.3
Armenia	3.7
Ukraine	3.9
Bulgaria	4.3
Turkey	4.5
Serbia	5.2
Romania	5.6

Source: Country authorities.

1/ 2005 actual data except for Georgia where the end-2006 estimate is shown.

15. **During the first quarter, this monetary strategy will face the challenge of large foreign inflows into the banking sector.** In addition to foreign equity inflows, the placement of a Euro Bond by Bank of Georgia will create room for strong credit growth. The NBG has communicated to the relevant banks that it will not convert these inflows at a stable exchange rate, and has asked banks to plan for a gradual conversion. In addition, the minimum reserve requirement on lari denominated liabilities was increased from 0 percent to 4 percent, the same level as on foreign currency denominated liabilities, to slow down credit growth (MEFP, ¶10).

C. Fiscal Sector

16. **In view of the uncertainties of the macroeconomic situation, the government's new medium-term spending priorities will be accommodated within a broadly stable fiscal stance.** In addition to a further increase in spending for infrastructure projects, the government identified the health sector as the next core priority. On the revenue side, the government is preparing a comprehensive tax administration and tax policy strategy to provide policy directions after several years of sharp increases in the tax to GDP ratio. Privatization proceeds are expected to decline rapidly after 2007 as the privatization program comes to an end.

17. **For the 2007 budget, the authorities expressed their commitment to use a large share of additional revenues and all privatization proceeds to reduce domestic financing of the budget in order to support the fight against inflation (MEFP, ¶24).** The

overall deficit is expected to be 2.5 percent of GDP, financed by privatization proceeds. Wages and local expenditures are to be contained at 2006 levels, and taxes as a share of GDP are broadly in line with the 2006 outcome after accounting for the full year impact of lower customs duties. Budgetary allocations for social safety nets will be raised by over 50 percent, including the poverty benefit program that now covers over 200,000 people (MEFP, ¶23–25). The budget also includes a modest allocation for arrears clearance (MEFP, ¶6 and ¶15).

18. **To prevent higher gas prices for consumers during the winter heating season, the 2007 budget includes a credit line for gas distribution companies.** The loan will prevent the pass-through of the sharp price increase for gas imports from Russia. Once the delivery of cheaper gas from Azerbaijan has started in spring, prices to consumers will be increased to a level which will allow the distribution companies to repay the loans by the end of the year (MEFP, ¶20).

III. OTHER ISSUES

19. **The FSAP update conducted in February 2006 classified the financial system as generally sound, but highlighted some remaining weaknesses.** The FSSA includes the following recommendations:

- Strengthen fit and proper regulations;
- Clarify the NBG's role as a lender of last resort;
- Develop a national strategy to address the lack of financial services in rural areas;
- Enhance financial statements and accounting standards;
- Improve the Anti-Money Laundering legislation;
- Strengthen the judiciary.

20. **In reaction to technical assistance provided by STA, net international reserve (NIR) data were revised backward to January 2005 (see Statistical Annex).** The data revisions were small and all the NIR performance criteria for the relevant test dates continue to be met comfortably under the revised data.

21. **In order to allow sufficient time to complete the sixth review under this program, the authorities requested an extension of the PRGF arrangement until September 30, 2007.**

22. **The authorities indicated that they may request a successor arrangement after the sixth and final review of the current arrangement, which is scheduled for July 2007.** In view of the macroeconomic uncertainties Georgia is facing, the authorities expressed

interest in maintaining a close policy dialogue with the Fund, combined with an option for quick access to financing, if necessary.

IV. STAFF APPRAISAL

23. **Georgia's ability to shoulder the loss of its main export market while continuing to grow at an impressive rate underlines the success of the government's reform path.**

Staff welcomes the fact that policies remain broadly in line with program commitments, despite severe external shocks that were not anticipated in the program.

24. **The government's success in creating a better business environment has been instrumental in attracting both foreign and domestic investors.** Annual FDI flows projected at around \$1 billion over the next 2 years should help to underpin sustained strong growth over the medium term. The government's ambitious plans to move ahead with further improvements in the business environment will increase the economy's resilience to potential swings in investor sentiments and should be complemented by initiatives in the areas of property rights and the judiciary.

25. **Continued tight monetary policy and a more flexible exchange rate are needed to reduce inflation further.** The authorities' policy tightening last year was effective in putting inflation on a downward path. For the future, it will be important that the NBG reduces its foreign exchange market interventions in response to continued external inflows. Instead, reserve accumulation should be based on the need to cushion the economy against external shocks. The NBG's efforts to enhance its open market operations should allow it to maintain adequate reserve coverage while keeping money supply under control. The NBG should use its new instruments actively—with increased flexibility in interest rates—and not limit their use due to concerns over the NBG's profits.

26. **The fiscal stance is an appropriate compromise between the country's pressing need for infrastructure and social spending and the goal of macroeconomic stability.** While the Ministry of Finance has an impressive track record in revenue collection, which created space for a radical reduction in custom duties in September 2006, the fiscal spending overrun raises concerns. For 2007, it will be essential for the ministry of finance to control spending and save most additional revenues and privatization proceeds. Any such savings by the government would enable the NBG to further increase its foreign exchange reserves, without inflationary pressures. Strict fiscal discipline will be particularly important during the first quarter to ensure that inflation stays under control after the drastic swings in reserve money growth during the last weeks of 2006.

27. **In the financial sector, prompt enactment of improved fit and proper as well as anti-money laundering legislation is a priority.** In an environment characterized by low monetization, partly caused by limited confidence in banks, strong legislation in these areas is a core condition for the development of the sector.

28. As Georgia's performance under the PRGF arrangement has been strong, staff supports the authorities' request for a waiver of one performance criterion, for the completion of the fifth review, and for an extension of the arrangement until September 30, 2007.

Table 1. Georgia: Selected Macroeconomic Indicators, 2004–07

	2004	2005	2006		2007	
			Prog.	Prel.	Prog.	Proj.
(Annual percentage change, unless otherwise indicated)						
National accounts						
Nominal GDP	9,825	11,621	13,708	13,860	15,475	16,099
Real GDP	5.9	9.6	7.5	9.0	6.5	7.5
Population 1/	4.3	4.3	4.3	4.3	4.3	4.3
Consumer price index, period average	5.7	8.3	9.6	9.2	6.0	6.3
Consumer price index, end-of-period	7.5	6.2	10.0	8.8	6.0	6.0
GDP per capita (US\$)	1,188	1,486	1,736	1,809	1,938	2,156
Poverty rate (in percent) 2/	35.7	39.4	...	...	...	...
Unemployment rate	12.6	13.8	...	...	...	...
(In percent of GDP, unless otherwise indicated)						
Investment and saving						
Investment	27.5	26.3	27.4	25.0	28.1	31.7
Public	2.4	4.2	4.2	5.4	4.1	5.5
Private	25.1	22.1	23.2	19.6	23.9	26.1
Gross national saving	19.1	20.9	17.5	15.5	16.6	16.4
Public	4.7	2.7	2.1	2.6	2.1	3.1
Private	14.4	18.2	15.4	13.0	14.6	13.3
Saving-Investment balance	-8.4	-5.4	-9.9	-9.5	-11.5	-15.3
Budgetary operations						
Total revenue and grants	22.0	23.4	25.8	26.2	24.5	24.4
Of which : Tax revenue	18.4	19.8	21.6	21.7	21.5	20.9
Total expenditure and net lending	18.9	25.0	27.9	29.1	26.6	26.8
Of which : Current expenditure	16.5	20.7	23.7	23.6	22.5	21.2
Fiscal balance, commitment basis	3.2	-1.5	-2.1	-2.9	-2.1	-2.4
Net change in expenditure arrears	-2.6	-0.9	-0.4	0.3	0.0	-0.1
Statistical discrepancy	-0.8	0.0	0.0	0.3	0.0	0.0
Fiscal balance, cash basis	-0.2	-2.4	-2.5	-2.3	-2.1	-2.5
Financing	0.2	2.4	2.5	2.9	2.1	2.5
Privatization	0.9	3.6	9.0	4.7	2.0	2.9
External	0.2	-0.3	-0.2	-0.4	0.1	0.1
Domestic	-0.9	-0.9	-6.4	-1.5	0.0	-0.5
Financing gap	0.0	0.0	0.0	-0.6	0.0	0.0
(Annual percentage change, unless otherwise indicated)						
Monetary sector						
Reserve money	44.3	19.7	15.0	19.2	14.1	15.0
Broad money (including foreign exch. deposits)	42.6	26.4	27.8	39.3	21.0	27.0
Velocity of broad money, level (M3 annual average)	7.6	6.8	6.3	6.1	5.8	5.3
(In millions of U.S. dollars, unless otherwise indicated)						
External Sector						
Exports of goods and services (percent of GDP)	55.0	40.9	40.7	42.8	41.4	39.1
Annual percentage change	48.7	33.3	16.5	27.6	13.5	8.8
Imports of goods and services (percent of GDP)	52.1	53.4	58.8	60.3	60.2	60.6
Annual percentage change	46.9	28.4	28.5	37.5	14.4	19.7
Net imports of oil	264	376	492	474	561	502
Current account balance	-429	-347	-739	-742	-958	-1420
In percent of GDP	-8.4	-5.4	-9.9	-9.5	-11.5	-15.3
Gross international reserves	383	474	1,030	881	1,089	1,109
In months of imports of goods and services (excl. pipeline imports)	2.0	1.8	2.9	2.3	2.6	2.4
Foreign direct investment	420	529	1,018	861	596	1,149

Sources: Georgian authorities; and Fund staff estimates.

1/ Excludes Abkhazia residents.

2/ Agreed with the Worldbank, there were methodological changes in the calculation of poverty starting in 2004.

Table 2. Georgia: Summary Medium-Term Balance of Payments, 2005–10
(In millions of U.S. dollars)

	2005	2006		2007		2008	2009	2010
	Prel.	Prog.	Proj.	Prog.	Proj.	Proj.	Proj.	Proj.
Current account balance	-347	-739	-742	-958	-1,420	-1,330	-992	-661
Trade balance	-932	-1,412	-1,671	-1,676	-2,273	-2,282	-2,061	-1,849
Exports	1,589	1,912	1,909	2,175	2,082	2,304	2,572	2,871
Imports	-2,521	-3,324	-3,580	-3,851	-4,356	-4,585	-4,633	-4,720
Services and income (net)	76	15	269	61	213	236	321	406
Services (net)	127	61	303	104	269	290	370	454
Factor income (net)	-51	-46	-34	-43	-56	-54	-49	-48
Of which: Interest (gross)	-39	-47	-38	-46	-59	-48	-42	-43
Transfers (net)	510	658	660	656	640	715	749	782
Official transfers	147	187	190	169	170	187	175	182
Of which: General government	26	63	65	23	24	37	26	22
Other transfers	363	471	470	487	470	528	573	601
Of which: Remittances	337	433	410	446	410	465	507	531
Capital and financial account balance	570	1,289	1,130	994	1,625	1,480	1,082	756
Public sector	-49	-38	-41	96	108	133	167	156
Disbursements	62	81	76	81	76	92	96	88
Of which: World Bank	41	53	56	40	55	45	45	45
Amortization	-142	-160	-170	-94	-88	-70	-45	-48
Capital grants, incl. from MCC (beginning in 2006)	32	41	53	109	120	110	117	115
Private sector	619	1,327	1,171	899	1,517	1,347	914	601
Foreign direct investment, including privatization receipts	529	1,018	861	596	1,149	915	560	315
Other private capital, net	90	309	309	302	368	432	354	286
Errors and Omissions	-194	-56	-43	0	0	0	0	0
Overall Balance	29	494	344	36	205	150	90	96
Financing	-29	-494	-345	-36	-205	-149	-90	-96
Use of Fund resources, net	-9	-8	-8	3	3	-33	-27	-21
Purchases/disbursements	41	41	41	42	42	0	0	0
Repurchases/repayments	-51	-49	-49	-39	-39	-33	-27	-21
Program loans	13	20	20	20	20	10	5	5
Increase in reserves (-)	-91	-556	-407	-59	-228	-126	-68	-80
Change in arrears (+, increase)	0	0	0	0	0	0	0	0
Debt relief 1/	58	50	50	0	0	0	0	0
Paris Club rescheduling	58	50	50	0	0	0	0	0
Rescheduling of arrears	0	0	0	0	0	0	0	0
Financing gap	0	0	0	0	0	0	0	0
Memorandum items								
Nominal GDP	6,411	7,493	7,807	8,365	9,306	10,505	11,637	12,830
Current account deficit (percent of GDP)	5.4	9.9	9.5	11.5	15.3	12.7	8.5	5.1
Trade deficit (percent of GDP)	14.5	18.8	21.4	20.0	24.4	21.7	17.7	14.4
Merchandise export growth (percent)	24.9	20.3	20.2	13.8	9.1	10.6	11.6	11.6
Merchandise export volume growth (percent)	23.3	20.4	20.3	13.3	8.6	9.8	10.8	10.8
Merchandise import growth (percent)	26.6	31.8	42.0	15.9	21.7	5.3	1.0	1.9
Merchandise import volume growth (percent)	16.2	18.9	31.2	11.9	15.6	11.8	7.5	7.6
Gross international reserves 2/	474	1,030	881	1,089	1,109	1,235	1,303	1,383
(In months of imports of goods and services)	1.7	2.8	2.2	2.6	2.4	2.5	2.6	2.7
Public and publicly guaranteed external debt (nominal)	1,735	1,725	1,701	1,692	1,673	1,673	1,676	1,729
(In percent of GDP)	27.1	23.0	21.8	20.2	18.0	15.9	14.4	13.5
Debt service from the budget (cash)	111	143	145	125	133	102	71	72
(In percent of exports of goods and services)	4.2	4.7	4.3	3.6	3.7	2.6	1.6	1.5
Total external debt service (cash)	190	222	223	192	199	164	128	125
(In percent of exports of goods and services)	7.2	7.3	6.7	5.5	5.5	4.1	2.9	2.6

Sources: Georgian authorities; and Fund staff estimates.

1/ Includes the July 2004 Paris Club agreement on terms somewhat more generous than Houston terms.

2/ Projections at program exchange rates.

Table 3. Georgia: Operations of the General Government, 2005–07

	2005	2006						2007		
	Act.	Q3		Q4		Annual		Q1	Annual	
		Prog.	Act.	Prog.	Prel.	Prog.	Prel.	Rev. prog.	Prog.	Rev. proj.
(In millions of lari)										
Total revenue and grants	2,715	998	995	999	1,093	3,537	3,626	793	3,795	3,924
Total revenue	2,611	923	927	921	988	3,346	3,418	751	3,551	3,675
Tax revenue 1/	2,300	823	819	809	862	2,957	3,007	663	3,325	3,362
Taxes on income	291	95	93	87	130	345	386	92	416	438
Taxes on profits	210	93	105	83	72	340	341	72	412	434
Social tax	315	95	94	99	118	340	358	93	421	434
VAT	987	390	362	407	398	1,370	1,333	308	1,548	1,552
Tax department	363	140	104	144	125	460	405	101	495	485
Customs department	625	250	258	263	272	910	928	207	1,053	1,067
Customs duties	123	25	36	14	13	123	132	9	50	34
Excises	286	95	97	97	90	340	336	72	378	374
Other taxes	76	30	31	21	41	100	121	17	100	96
Nontax revenue	312	100	108	112	126	389	411	88	226	313
Of which: one-off licenses 1/	...	...	36	...	16	...	155	0	...	85
Grants	104	75	68	79	105	191	208	42	245	249
Total expenditure and net lending	2,892	1,026	1,048	1,016	1,277	3,818	4,027	851	4,119	4,310
Current expenditure	2,400	825	817	896	1,004	3,244	3,272	574	3,478	3,418
Wages and salaries	452	103	148	104	165	478	583	138	543	562
Goods and services	420	311	159	340	239	964	712	162	945	992
Transfers and subsidies	869	190	272	159	401	1,038	1,287	140	1,110	1,126
Interest payments	120	39	25	35	26	122	100	37	115	140
Domestic	82	20	15	16	15	70	64	15	53	58
External (cash)	39	19	10	19	11	52	36	22	62	82
Non-wage local government expenditures	539	182	212	257	172	642	590	97	765	597
Capital expenditure (central government)	459	200	230	111	273	551	742	145	611	890
Of which: Foreign financed	178	90	49	68	84	225	228	69	351	340
Net lending	33	1	2	9	0	24	13	132	31	3
Overall balance (commitments)	-177	-27	-53	-16	-184	-282	-401	-57	-324	-386
Adjustment to cash basis	-101	-70	-36	-73	24	-59	-3	-3	0	-10
Net change in expenditure arrears (-, reduction)	-105	-20	21	-16	2	-59	46	-3	0	-10
Statistical discrepancy	4	-50	-57	-57	22	0	-49	0	0	0
Overall balance (cash)	-278	-97	-90	-89	-159	-341	-404	-60	-324	-396
Total financing	279	97	90	89	159	341	404	60	325	396
Privatization	419	192	226	791	174	1,238	656	156	306	469
Of which: sales to nationals								7	...	28
Domestic	-104	-47	-120	-738	7	-872	-202	-89	2	-84
External	-36	-49	-16	37	-22	-25	-50	-7	16	12
Disbursements	125	46	30	74	74	187	170	27	186	166
Amortization (cash)	-162	-94	-46	-37	-96	-212	-219	-34	-170	-154
Financing gap								0	0	0
(In percent of GDP)										
Total revenue	22.5	25.3	25.6	23.6	24.4	24.4	24.7	22.5	22.9	22.8
Of which: Tax revenue	19.8	22.6	22.6	20.8	21.3	21.6	21.7	19.8	21.5	20.9
Grants	0.9	2.1	1.9	2.0	2.6	1.4	1.5	1.3	1.6	1.5
Total expenditure and net lending	24.9	28.2	28.9	26.1	31.6	27.9	29.1	25.4	26.6	26.8
Current expenditure	20.7	22.6	22.5	23.0	24.8	23.7	23.6	17.2	22.5	21.2
Of which: Defense spending 2/	3.3	...	5.4	...	...	4.4	4.9	...	...	2.4
Of which: Safety net programs 3/						...	0.9	...	...	1.2
Capital expenditure and net lending	4.2	5.5	6.4	3.1	6.7	4.2	5.4	8.3	4.1	5.5
Domestic primary balance	0.4	1.1	-0.9	0.9	-3.8	-0.5	-1.7	3.9	-0.1	-0.8
Overall balance										
Commitments	-1.5	-0.8	-1.5	-0.4	-4.5	-2.1	-2.9	-1.7	-2.1	-2.4
Cash	-2.4	-2.7	-2.5	-2.3	-3.9	-2.5	-2.9	-1.8	-2.1	-2.5
Total financing										
Privatization	3.6	5.3	6.2	20.3	4.3	9.0	4.7	4.7	2.0	2.9
Domestic	-0.9	-1.3	-3.3	-19.0	0.2	-6.4	-1.5	-2.7	0.0	-0.5
External	-0.3	-1.3	-0.4	0.9	-0.5	-0.2	-0.4	-0.2	0.1	0.1
Financing gap					0.0	0.0	0.0	0.0	0.0	0.0
(In units indicated)										
Memorandum items:										
Nominal GDP (millions of lari)	11,621	3,642	3,625	3,893	4,046	13,708	13,860	3,344	15,475	16,099

Sources: Georgian authorities; and Fund staff estimates.

1/ Corresponding to fixed-term (10 years or less) leases of government assets; longer leases are classified as privatization revenue.

2/ Based on Ministry of Defense budget; excludes defense spending from the President's Fund.

3/ Comprise the 'poverty benefit' income-support program, family and refugees (IDPs) allowances, and a health care program for the poor.

Table 4. Georgia: Accounts of the National Bank of Georgia, 2003–07

	2003	2004	2005	2006				2007			
	Dec. Act. 1/	Dec. Act. 2/	Dec. Act.	Mar. Act.	Jun. Act.	Sep. Act.	Dec. Prel.	Mar. Proj.	Jun. Proj.	Sep. Proj.	Dec. Proj.
(Contribution to reserve money growth in percent)											
Net foreign assets	-4.7	77.1	27.2	3.0	11.3	28.1	73.7	6.9	14.2	12.0	35.0
Net domestic assets	18.6	-32.8	-7.5	-5.3	-7.0	-18.6	-54.6	-7.9	-10.9	-4.9	-19.9
Net claims on general government	5.2	-10.5	-9.1	-9.1	-6.1	-18.3	-22.1	-7.5	-9.3	-1.7	-11.1
Claims on rest of economy	6.7	-3.5	0.0	0.0	0.1	0.1	0.2	-0.1	-0.1	0.0	-0.1
Claims on banks	1.2	-8.2	4.9	0.5	-2.6	0.6	-25.4	-2.8	-2.4	-2.0	-7.5
Other items, net	5.4	-10.6	-3.2	3.3	1.6	-1.0	-7.2	2.5	0.9	-1.2	-1.2
Reserve money	13.9	44.3	19.7	-2.3	4.3	9.5	19.2	-0.9	3.3	7.1	15.0
Currency in circulation	13.4	42.9	20.0	-4.4	-1.0	5.2	14.6	-0.5	5.3	11.6	14.8
Required reserves	12.7	13.4	40.6	7.3	22.2	55.8	73.0	-12.9	-2.3	3.5	18.8
Balances on banks' correspondent accounts 3/	29.1	169.3	-11.5	6.5	37.4	-31.9	-35.0	56.5	-13.1	-78.4	-1.4
(In millions of lari)											
Net foreign assets	-329	118	345	375	458	627	1,084	1,166	1,253	1,226	1,501
Net domestic assets	909	719	656	604	586	470	110	16	-20	52	-128
Net claims on general government	783	722	646	554	585	463	425	335	314	404	292
Claims on general government (incl. t-bills)	817	841	833	833	833	833	785	785	737	737	737
Nontradable govt. debt	...	...	...	...	785	785	785	785	689	689	689
Securitized debt (marketable)	...	...	...	...	48	48	0	0	48	0	0
Deposits	-35	-120	-187	-279	-248	-370	-360	-449	-423	-333	-445
Claims on rest of economy	118	97	97	98	98	98	99	97	97	99	97
Claims on banks	6	-41	0	5	-26	6	-255	-288	-284	-278	-345
Other items, net	2	-59	-87	-54	-71	-96	-159	-129	-148	-173	-173
Reserve money	580	837	1,001	979	1,045	1,097	1,193	1,182	1,233	1,278	1,373
Currency in circulation	473	676	811	775	803	854	930	925	979	1,037	1,067
Required reserves	81	92	130	139	159	202	225	195	219	232	267
Balances on banks' correspondent accounts 3/	25	68	60	64	83	41	39	61	34	8	39
Memorandum items:											
Growth of reserve money (in percent, relative to same period of previous year)	13.9	44.3	19.7	21.0	18.8	17.5	19.2	20.7	18.0	16.5	15.0

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

1/ Net foreign assets are valued at the program rate of 2.15 lari/US\$, US\$/SDR of 1.49 and US\$/Euro of 1.27.

2/ Net foreign assets are valued at the program rate of 1.85 lari/US\$, US\$/SDR of 1.46 and US\$/Euro of 1.21.

3/ Including overnight deposits from banks.

Table 5. Georgia: Monetary Survey, 2004–07

	2004	2005				2006 2/				2007			
	Dec. Actual 2/	Mar. Act.	June Act.	Sep. Act.	Dec. Act.	Mar. Act.	June Act.	Sep. Act.	Dec. Proj.	Mar. Proj.	Jun. Proj.	Sep. Proj.	Dec. Proj.
(Contribution to broad money growth in percent)													
Net foreign assets	43.2	-2.6	4.4	4.8	-4.4	-0.2	1.6	4.5	29.4	-4.4	-7.5	-14.9	-11.8
Net domestic assets	-0.6	1.6	3.3	14.8	30.8	5.0	18.0	22.2	9.9	2.1	15.0	28.7	38.8
Domestic credit	11.7	2.8	8.1	24.4	47.2	4.0	23.1	35.3	46.3	2.9	18.4	35.5	49.6
Net claims on general government	-2.5	-3.5	-9.8	-7.9	-7.0	-5.9	-4.6	-10.9	-10.6	-3.3	-2.4	1.0	-3.2
Public-guaranteed borrowing from DMBs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Credit to the rest of the economy	14.2	6.3	17.9	32.3	54.2	9.8	27.7	46.2	56.9	6.2	20.7	34.4	52.8
Other items, net	-12.3	-1.3	-4.7	-9.6	-16.4	1.0	-5.1	-13.0	-36.4	-0.8	-3.4	-6.8	-10.9
Broad money (M3)	42.6	-1.0	7.7	19.6	26.4	4.8	19.5	26.7	39.3	-2.3	7.4	13.8	27.0
Broad money, excl. forex deposits (M2)	60.4	-4.0	5.2	16.1	26.5	1.6	17.0	19.0	29.8	-0.7	7.2	14.3	25.1
Currency held by the public	39.5	-1.2	3.3	11.4	19.5	-3.7	-1.0	5.0	12.4	0.5	5.6	11.9	16.7
Total deposit liabilities	44.8	-0.8	10.7	25.2	31.1	10.1	32.4	40.2	56.1	-3.6	8.3	14.7	31.6
(In millions of lari)													
Net foreign assets	173	135	239	245	106	102	136	191	668	550	467	271	355
NBG	118	113	258	268	345	375	458	627	1,084	1,166	1,253	1,226	1,501
Commercial banks	55	21	-19	-23	-239	-273	-322	-435	-416	-616	-786	-956	-1,146
Net domestic assets	1,339	1,362	1,389	1,562	1,805	1,901	2,148	2,230	1,994	2,050	2,393	2,758	3,025
Domestic credit	1,796	1,839	1,918	2,164	2,510	2,586	2,951	3,184	3,395	3,471	3,884	4,339	4,716
Net claims on general government	739	687	591	620	633	521	545	424	431	342	368	458	346
Credit to the rest of the economy	1,057	1,152	1,327	1,545	1,877	2,065	2,406	2,759	2,964	3,129	3,515	3,881	4,370
Other items, net	-457	-476	-529	-602	-705	-685	-803	-954	-1,401	-1,421	-1,491	-1,581	-1,691
Broad money (M3)	1,512	1,497	1,628	1,808	1,911	2,003	2,284	2,421	2,662	2,600	2,860	3,029	3,380
Broad money, excl. forex deposits (M2)	846	812	890	982	1,070	1,088	1,252	1,273	1,389	1,380	1,490	1,588	1,738
Currency held by the public	616	609	636	686	736	709	729	773	827	831	874	925	966
Total deposit liabilities	896	888	992	1,121	1,175	1,294	1,555	1,648	1,834	1,769	1,986	2,103	2,414
Memorandum items:													
Growth of M3	42.6	34.0	37.5	36.8	26.4	33.8	40.3	33.9	39.3	29.8	25.2	25.1	27.0
Growth of M2	60.4	48.6	49.6	38.2	26.5	33.9	40.7	29.6	29.8	26.9	19.0	24.7	25.1
Growth of credit to the rest of the economy (in percent, relative to end of previous year)	16.6	9.0	25.5	46.2	77.6	10.0	28.2	47.0	57.9	5.6	18.6	30.9	47.4
Growth of credit to the rest of the economy (in percent, relative to same period of previous year)	16.6	50.3	62.0	60.6	77.6	79.3	81.4	78.6	57.9	51.6	46.1	40.7	47.4
M2 multiplier 3/	1.01	1.00	1.01	1.05	1.07	1.11	1.20	1.16	1.16	1.17	1.21	1.24	1.27
M3 multiplier 4/	1.81	1.85	1.85	1.94	1.91	2.05	2.19	2.21	2.23	2.20	2.32	2.37	2.46
M3 velocity	7.64	7.98	7.65	7.18	6.77	6.83	6.38	6.18	6.06	6.12	5.83	5.66	5.33
Foreign exchange deposits in percent of total deposits	74.3	77.1	74.5	73.6	71.6	70.8	66.4	69.6	69.4	69.0	69.0	68.5	68.0

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

1/ Net foreign assets are valued at the program rate of 2.15 lari/US\$, US\$/SDR of 1.49 and US\$/Euro of 1.27.

2/ Net foreign assets are valued at the program rate of 1.85 lari/US\$, US\$/SDR of 1.46 and US\$/Euro of 1.21.

3/ M2 divided by reserve money.

4/ M3 divided by reserve money.

Table 6. Georgia: Quantitative Performance Criteria and Indicative Targets, 2006–07 1/ 2/

	Cumulative Change from End-December 2005									
	Mar. 2006		Jun-06		Sep-06		Dec-06		Mar-07	
	Performance criteria		Indicative targets		Performance criteria		Indicative targets		Performance criteria	
	Prog.	Act.	Prog.	Act.	Prog.	Act.	Prog.	Prel.	Prog.	Rev. prog.
(In millions of lari)										
1. Quantitative targets										
Ceiling on cash deficit of the general government	34.7	3.0	65.4	155.0	252.0	245.0	342.0	404.0	393.0	464.0
Ceiling on net credit of the banking system to the general govt. (NCG)	0.0	-112.1	-17.7	-88.4	-135.6	-209.0	-872.4	-202.0	-841.4	-291.0
Ceiling on reserve money	42.9	-22.5	70.8	43.2	118.3	96.0	150.4	191.0	141.2	181.0
(In millions of U.S. dollars)										
Floor on total net international reserves (NIR) of the NBG 3/	1.8	17.5	40.2	63.6	134.5	155.6	559.8	404.5	526.2	458.5
Ceiling on contracting or guaranteeing of										
A. Nonconcessional medium- and long-term external debt	20.0	0.0	20.0	0.0	20.0	15.0	20.0	15.0	25.0	25.0
B. Short-term external debt (less than one year)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Ceiling on accumulation of external arrears	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(In millions of lari)										
2. Indicative target										
Ceiling on net domestic assets (NDA) of the NBG 3/	39.5	-55.0	-3.5	-74.4	-130.6	-192.3	-885.3	-556.6	-832.3	-640.0

Sources: Georgian authorities; and Fund staff estimates.

1/ Section 1 of this table shows quantitative targets for 2006; for stock variables, they are based on cumulative changes from end-December 2005 projections. 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/ Quantitative targets for 2006 are based on accounting exchange rates of GEL 1.85/US\$, US\$1.46/SDR, and US\$1.21/EUR.

3/ NDA and NIR data was corrected to reflect recent findings of an STA mission.

Table 7. Georgia: Macroeconomic Framework, 2005–09

	2005	2006 Prel.	2007	2008 Proj.	2009
(Percent change)					
Output, prices, money, and external trade					
Real GDP	9.6	9.0	7.5	6.5	5.5
Consumer price index (average)	8.3	9.2	6.3	5.5	5.0
Broad money (M3, lari)	26.4	39.3	27.0	25.0	25.0
Exports (US\$)	24.9	20.2	9.1	10.6	11.6
Imports (US\$) 1/	26.6	42.0	21.7	5.3	1.0
(In percent of GDP)					
General government					
Total revenues and grants	23.4	26.2	24.4	25.1	25.2
Tax revenues	19.8	21.7	20.9	21.8	22.0
Nontax revenues 2/	2.7	3.0	1.9	1.9	1.9
Grants	0.9	1.5	1.5	1.4	1.2
Expenditures and net lending	25.0	29.1	26.8	26.0	26.1
Current expenditure	20.7	23.6	21.2	21.6	22.0
Of which: external interest	0.3	0.3	0.5	0.3	0.2
Capital expenditure and net lending	4.2	5.4	5.5	4.4	4.1
Overall balance (commitment basis)	-1.5	-2.9	-2.4	-0.9	-0.9
Net change in expenditure arrears	-0.9	0.3	-0.1	0.0	0.0
Overall balance (cash basis)	-2.4	-2.3	-2.5	-0.9	-0.9
Financing	2.4	2.9	2.5	0.9	0.9
Privatization	3.6	4.7	2.9	0.3	0.1
Domestic financing	-0.9	-1.5	-0.5	-1.0	-0.4
External financing (net)	-0.3	-0.4	0.1	1.6	1.2
Saving and investment					
Investment	26.3	25.0	31.7	30.1	26.4
General government	4.2	5.4	5.5	4.4	4.1
Nongovernment sector 1/	22.1	19.6	26.1	25.7	22.3
Of which: FDI	8.3	11.0	12.3	8.7	4.8
Gross domestic saving	20.9	15.5	16.4	17.4	17.9
General government	2.7	2.6	3.1	3.5	3.2
Nongovernment sector	18.2	13.0	13.3	13.9	14.7
Current account deficit 1/	5.4	9.5	15.3	12.7	8.5
(In millions of U.S. dollars; unless otherwise indicated)					
Gross official reserves of the NBG 3/	474	881	1,109	1,235	1,303
(In months of imports of non-pipeline goods and services)	1.8	2.3	2.4	2.5	2.6
(In months of imports of goods and services)	1.7	2.2	2.4	2.5	2.6
External debt, public and guaranteed					
External debt stock	1,735	1,701	1,673	1,673	1,676
External debt service, total	190	222	192	165	128
Memorandum items:					
Nominal GDP (in millions of lari)	11,621	13,860	16,099	18,174	20,132
Nominal GDP (in millions of US\$)	6,411	7,807	9,306	10,505	11,637
External debt stock (public and guaranteed; percent of GDP)	27.1	21.8	18.0	15.9	14.4

Sources: Georgian authorities; and Fund staff estimates.

1/ Large oil and gas pipeline projects are projected to increase imports, investment, and the current account deficit substantially in 2003–06.

2/ Sustained increase in nontax revenues from 2006 onward reflects transit fees from the BTC oil pipeline and the South Caucasus gas pipeline.

3/ International reserves are reported at current exchange rates and may differ from reserves at program rates as reported in the monetary accounts.

ATTACHMENT I. GEORGIA: LETTER OF INTENT

9 February, 2007
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 policies for 2007 that we ask to be supported by the International Monetary Fund as Trustee under a three-year Poverty Reduction and Growth Facility (PRGF) arrangement. These policies are consistent with the Economic Development and Poverty Reduction Program (EDPRP) presented to the IMF and World Bank in October 2003 and with the Annual Progress Report of our EDPRP, which was submitted in August 2006.

The Government of Georgia believes that the policies set forth in the attached memorandum will achieve the objectives of the program, but it will take any additional 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 hereby request the completion of the fifth review under the PRGF arrangement and we request a waiver for nonobservance of a structural performance criterion for end-June 2006. The performance criterion required the introduction of a poverty alleviation program targeted on households living in extreme poverty. Unfortunately, there were technical difficulties associated with the targeting mechanism that necessitated a delay. The program was, however, fully implemented in September 2006.

Further, we hereby grant our permission for the publication on the IMF's website of the staff report, the memorandum of financial and economic policies and this letter of intent.

Finally, we hereby request the extension of the present PRGF arrangement, which is due to expire on June 3, 2007, until September 30, 2007 in order to allow sufficient time to complete the sixth review under this program. Georgia will conduct discussions with the Fund staff for the sixth and final review of its program under the PRGF arrangement before end-May 2007.

Sincerely yours,

/s/
Zurab Nogaideli
Prime Minister of Georgia

/s/
Aleksi Aleksishvili
Minister of Finance

/s/
Roman Gotsiridze
President of the National Bank

ATTACHMENT II. GEORGIA: MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES**9 February 2007****Introduction**

1. The government's economic program, which is supported by a PRGF arrangement, is designed to reduce poverty through sustained and equitable economic growth in an environment of low inflation. This Memorandum of Economic and Financial Policies reviews progress with the implementation of our economic program and describes our economic policies and strategy for 2007.

Recent Economic Developments and Performance

2. Economic performance in 2006 remained favorable despite a difficult external environment. The ongoing and intensifying economic embargo by Russia has required the Georgian economy to make difficult adjustments that have slowed growth. During the course of 2006 all trade between the two countries was banned including wine, mineral water and numerous agricultural products by the Russian authorities. Further, the cost of gas imported from Russia (our primary source of supply that year) increased by 70 percent in 2006. In 2005, Russia was both our leading export market and source of imports, including energy, so the disruption caused by the embargo was considerable. Despite the loss of Russian markets, our real GDP increased by 9.5 percent during the first nine months of 2006 and we expect that real growth will be about 9 percent for the year as a whole. Furthermore, we met all quantitative performance criteria for end-September under our PRGF arrangement. This strong performance reflects the favorable impact of the ongoing economic reform process in Georgia.

3. Against a background of strong economic growth and an economy that still has numerous structural rigidities, it is not surprising that inflationary spikes occur. At end-March 2006, 12-month inflation was less than five percent. During the second quarter, however, price pressures intensified significantly with the result that by end-July, 12-month inflation was 14.5 percent. Several factors explain the upsurge in prices including increases in energy prices and excessive demand pressure stemming from a rapid expansion in broad money. Recognizing the deleterious effects of inflation for growth and on low-income households, we took decisive action to reduce the overall fiscal deficit and to slow the growth of reserve money. As a result of the latter and declining oil prices, inflationary pressure subsided in the third and fourth quarters of 2006, with the result that end-December inflation was 8.8 percent.

4. The government's overall fiscal performance continues to be strong despite the external shocks. Total revenues for 2006 were about 26.2 percent of GDP compared with 23.4 percent in 2005. Tax revenues were 21.7 percent of GDP in 2006 compared with

19.8 percent in 2005. The fiscal deficit for 2006 was about 2.9 percent of GDP, which is somewhat above program targets (based on our projections for 2006 GDP) and reflects the need for higher spending on road and energy investments, and defense requirements associated with our efforts to join NATO.

5. The main reason for our continuing success in revenue mobilization is the continuous improvement in tax administration. In order to improve further the quality and efficiency of tax administration, as of January 1, 2007 we began the process of merging the tax and customs departments and the financial police into a single entity within the Ministry of Finance. We believe this will contribute to the quality of revenue collection and to improved property rights.

6. We hoped to resolve all of the estimated GEL 149 million in claimed arrears by end-2006. Verifying arrears remains, however, a daunting task that involves extensive searches for documents and records. The verification process continued in 2006 and we verified and cleared GEL 46 million. The verification and clearance processes will continue and we remain committed to clearing the outstanding stock of verified arrears as quickly as possible.

7. We are continuing to develop tools for monitoring and assessing the performance of Legal Entities of Public Law (LEPLs). The LEPL database, which was created in 2006, is being updated on a regular basis to reflect the changing status of existing LEPLs and newly registered ones. In order to avoid accumulation of arrears and other financial problems, we issued guidelines for LEPL (mainly concentrating on schools) that cover issues such as budgeting, budget execution, reporting and analysis of reported information. These guidelines cover not-for-profit LEPLs and became effective on January 1, 2007 (structural performance criterion for end-December 2006). Further, we plan to issue subsequent guidelines in 2007 that will cover additional areas and issues.

8. During the second half of 2006, the focus of monetary policy was to reduce inflation and enhance the policy tools available to the National Bank of Georgia (NBG). A factor that contributed to the inflationary pressure experienced in 2006 was the rapid expansion of the money multiplier and, in turn, broad money. Despite the modest growth of reserve money in the 12 months prior to end-June 2006 (19 percent), broad money increased by 40 percent over the same period. Whereas at the time of the third review under the PRGF arrangement, we targeted reserve money growth of 25 percent in 2006, we subsequently reduced our target to just 15 percent in response to the inflationary spike of the second quarter. As of end-December, reserve money growth for 2006 was 19.2 percent. When adjusted for advance privatization payments that were placed in blocked accounts at commercial banks and hence counted as part of reserve money, but were not available for lending, reserve money growth was only 14 percent. This is well below the indicative target under the program and we regard this disciplined monetary policy as the major reason for our significantly improved inflation performance.

9. One ingredient in our ability to meet program targets was the recent (September 2006) introduction of auctions for certificates of deposit (CDs). The total stock of CDs at end-2006 was 23 percent of reserve money, and we regard the auctions as a useful tool for controlling liquidity and have been well received by commercial banks. Moreover, on December 8, 2006 the NBG launched open market operations using the medium-term government bonds that NBG obtained through the securitization of the government debt to the NBG. This was the response to our large-scale one-off purchase of US\$108 million, proceeds from the stock sales of the largest Georgian bank at the London Stock Exchange. At end-December, 2006 the stock of government bonds in circulation was GEL48 million.

10. At the same time, we sought to reduce the growth of broad money. In August 2006 we decided to increase the reserve requirement on lari denominated deposits from 0 to 4 percent. This contributed to slowing growth of broad money aggregate M2, which increased by 29.8 percent during 2006. Moreover, the 12-month growth rate for M2 money aggregate in October and November was on average only 20.8 percent. It is noteworthy as well, that cash held by the public, a major component of M2, increased only by 12.4 percent during 2006.

11. To promote greater transparency of the NBG's policies and operations, we have been regularly publishing monthly monetary and fiscal reviews. In 2006, we introduced quarterly inflation reports, which outline price developments and analyze the factors shaping inflation behavior in the country. The inflation report has been a useful tool for communicating the NBG's firm commitment to price stability and explaining the objectives and means of monetary policy. We have also recently launched publication of our annual financial stability report. The reports assess the current macroeconomic situation and risks present in the economy with a special emphasize on financial markets. The first report was published in October 2006.

12. To strengthen our ability to monitor developments in the banking sector, the NBG, in cooperation with commercial bank external auditors, prepared a decree in December 2006 obliging these auditors to include issues of relevance to the NBG in their audits and to report to the NBG. The decree has been sent for comments to the government agencies and is expected to be approved by end-March, 2007 (structural benchmark for end-March 2007).

13. Reflecting the success of our ongoing privatization program and our commitment to a modest fiscal deficit, we were able to increase our international reserves by a significant amount in 2006. As of end-December 2006, our stock of international reserves was \$881 million—about 2.3 months of import coverage—compared with \$474 million at end-2005. This is lower than our projection at the time of the fourth review because the privatization of some energy sector assets was delayed.

14. In October 2005, we submitted proposed legislation to parliament that would strengthen the fit and proper provisions of the commercial bank law as it pertains to bank owners and managers. These proposals have been subject to lengthy discussion in parliament and government in order to ensure that the proposed legislation is consistent with our plans for broader reform of the financial sector. Following consultation with the Fund staff, we have amended the proposed legislation. Parliament, however, will not consider the draft until the proposed legislation for financial sector reform is submitted for consideration. We expect the latter will be finalized by government in late February and submitted to parliament in March. While the delay in passage of legislation is unfortunate (structural performance criterion for end-December 2006), we believe it is essential that such provisions be coordinated with our plans for the financial sector as a whole.

15. On September 1, 2006, the liberalization of our tariff regime took an important step forward as we moved from 16 tariff bands to three. Under the new regime, about 87 percent of commodities will fall into the zero tariff band and only 12 percent at the highest tariff of 12 percent. We believe this liberalization will further strengthen the business environment and contribute to sustainable growth.

16. We have completed negotiations with all Paris Club creditors and all non Paris Club creditors except Kazakhstan. Despite several rounds of negotiations, including the most recent talks in Astana, Kazakhstan, in June 2006, a debt settlement agreement between Georgia and Kazakhstan that would correspond to the key principles underpinning Georgia's treatment under the 2001 and 2004 Paris Club frameworks has not been reached. Since Kazakhstan's debt settlement proposal imposes conditions on Georgia that are harsher than debt settlement deals offered to Georgia by its other creditors, a debt settlement on Kazakhstan's terms could generate the risk of other creditors seeking treatment on similar terms and thus of unraveling the whole structure of agreements reached by Georgia through Paris Club talks in 2001 and 2004. We are eager to continue negotiations and reach an agreement.

17. Finally, we are requesting a waiver for missing the end-June structural performance criterion regarding introduction of a targeted poverty benefit program. This program was delayed because of technical problems associated with targeting the beneficiaries. Full implementation of the targeted poverty benefit program began in September 2006.

Economic Policies for 2006 and 2007

18. Since the new government took office in early 2004, we have repeatedly demonstrated our commitment to transforming Georgia's economy into a more transparent and market-oriented system. In recognition of our reform accomplishments, the World Bank named Georgia the world's leading economic reformer. Our overall rank

as a place for doing business was 37 in 2006 compared with 112 in 2005 and 137 in 2004. In 2007, it is our goal to be one of the top 25 places in the world for doing business. We believe such accomplishment is essential to our strategy of fostering growth and poverty reduction through the expansion of the private sector.

19. A crucial ingredient in our economic growth strategy is our commitment to improve further macroeconomic stability. The major challenge facing government's economic reform program in 2007 will be to continue strengthening macroeconomic stability and enhancing the environment for foreign direct investment (FDI) in the face of the economic and social dislocations wrought by Russia's economic embargo of Georgia. Despite the difficult environment facing Georgia's economy, we believe that sustainable and broad-based growth will continue this year. The main contributing factor to the expected strong GDP growth is the dramatic increase of FDI—totaling \$1.2 billion—that is expected in 2007. Prior to the economic embargo by Russia, we projected real GDP growth of 10 percent in 2007. The loss of export markets combined with the substantial increase in the price of gas imported from Russia has, however, hurt growth prospects and we now project growth in 2007 to be at least 7.5 percent. While optimistic about the prospects for this year, we are ready to undertake any necessary actions that may be needed if the effects of the Russian embargo are worse than we envisage.

20. While the Russian sanctions have several dimensions, we are most concerned about the potential impact of substantially higher energy prices on our balance of payments. In 2005, we imported gas from Russia at a price of \$65 per thousand cubic meters (tcm), in 2006 the price was \$110 tcm and this year the price was raised to \$235 tcm. Although circumstances required that we sign an agreement with Russian suppliers for imports of up to one billion cubic meters of gas, we do not expect to purchase the full amount. As was noted in our MEFP for the fourth review under the PRGF arrangement, we hope to enhance our energy security by diversifying our sources of gas supply. Under the terms of a recent agreement with Azerbaijan, we will purchase additional gas at an average price of between \$120-150 tcm. We expect this source of supply to account for about 70 percent of projected domestic consumption this year and will result in a modest increase in the average cost of gas. In order to encourage the most efficient use of gas and to foster conservation efforts we will increase gas tariffs to prevent any general subsidy to consumers. Nonetheless, in recognition of the hardship caused by higher gas prices, we will delay raising tariffs until April and support the gas distribution companies with a loan from the budget, which will be repaid this year. In order to mitigate the impact of higher energy prices for low-income households, we plan to introduce cross-subsidized lifeline tariffs.

21. We are committed to keeping inflation in single digits as evidenced by the rapid reduction in inflation that was achieved in the second half of 2006. We believe that the economic program described herein will reduce inflation to 6 percent or less by end-

2007. As was true in 2005 and 2006, our program for reducing inflation further and enhancing macroeconomic stability will require disciplined fiscal and monetary policies. It will also require careful coordination of policies and the further development of monetary policy tools. We will, of course, continuously reevaluate our policies in the light of changing circumstances and, in consultation with Fund staff, make the necessary adjustments.

Fiscal Policy

22. The major fiscal challenge we face in 2007 is to maintain a disciplined and cautious fiscal stance in the face of the economic uncertainty associated with the Russian embargo. Additionally, we will continue the process of structural reform in the fiscal area by further improving tax administration as well as the quality of budgetary expenditures.

23. We expect total revenue collection in 2007 to be about 24.4 percent of GDP compared with 26.2 percent in 2006. Tax revenues are expected be 20.9 percent of GDP, which reflects the significant reduction in tariff revenues stemming from our aggressive trade liberalization. We envision a fiscal deficit of 2.5 percent of GDP in order to continue our program of investment in infrastructure and to offset the contractionary effects of the Russian embargo. As in past years, financing of the budget deficit will continue to rely on external sources (e.g., World Bank and EBRD) and accumulated privatization proceeds. While the majority of external financing sources is on concessional terms, we have allowed for a modest amount (\$25 million) of non-concessional financing in order to ensure that we are able to use EBRD's technical knowledge and resources as we rebuild our infrastructure. Given our favorable external debt situation, we do not anticipate that this borrowing will be problematic. Although the inflow of privatization proceeds is projected to decrease in 2007, financing for the budget deficit will be possible by a drawdown of accumulated proceeds. This drawdown will be carefully coordinated with our monetary policy to prevent a resurgence of inflationary pressure.

24. To implement a sufficiently cautious fiscal stance for 2007, we will ensure that increases in expenditures are significantly less than any incremental tax collection compared with the 2007 budget law that was approved on December 29, 2006. In addition, we will ensure that any above-program privatization proceeds will be used to reduce domestic financing of the budget. This will have the effect of ensuring that the projected deficit of GEL 396 million is a maximum.

25. As noted above, we are continuing the process of clearing the stock of arrears from end-2005. As of end-2006, the stock of claimed arrears was about GEL 150 million, reflecting additional claims filed during the year. We anticipate verifying and clearing about GEL 10 million in 2007. When verifying and clearing arrears, we will give priority to payments that will be most beneficial to low-income groups.

26. The privatization process is ongoing and should be nearly completed this year. The process is inherently unpredictable as are projections of the proceeds. For 2006, proceeds from privatization and related receipts were about GEL 656 million, or about 4.7 percent of GDP. This year, we expect privatization proceeds of about GEL 469 million or about 2.9 percent of GDP.

27. In order to improve further our revenue administration process, we merged the tax and customs departments with the financial police effective January 1, 2007. We believe this will result in significant efficiency gains and will improve service to taxpayers. We also plan to streamline the tax appeal system, thus increasing public confidence in the fairness of the tax administration. Changes currently being considered include reducing the number of stages from three to two and increasing the amount of time for considering the appeal, i.e., from 15 days to 20. As a result, the total time for hearing a taxpayer's appeal will be reduced. Additionally, whereas presently a taxpayer may only appeal a "taxation order" issued by tax inspectors, we plan to allow taxpayers to appeal any document issued by tax inspectors.

28. We continue to prepare our tax modernization strategy with the objective to build confidence and trust of taxpayers with regard to improved tax services. In this regard, we will limit the investigative authority of the financial police. Under current legislation, the police have the authority to initiate an investigation into economic crimes related to tax matters and economic relations between individuals. Under the proposed amendments to the legislation, we will strictly limit the authority of the financial police to interfere in economic relations between private parties. Of course, in cases of tax crimes (smuggling, tax evasion, production of false excise stamps) the financial police will still be able to initiate and conduct investigations.

29. As noted at the time of the fourth review, we plan to introduce the Government Finance Statistical Manual 2001 (GFSM 2001) classification systems. In particular, the state budget used the GFSM 2001 functional classification from 2007 and will use the economic classification from 2008. The treatment of LEPLs (whether general government, not-for-profit or public corporations) will be fully consistent with the methodological requirements of GFSM 2001. Full compliance with the GFSM 2001 will be achieved progressively and should be completed by 2015 as defined in the Accounting Reform Strategy. In this context, we are grateful for the recent mission from the IMF's Statistics Department that helped us to prepare for the introduction of the new budget classification system.

30. In order to strengthen our Medium Term Expenditure Framework (MTEF) we will introduce performance criteria for line ministries. Current practice is for line ministries to present the strategies and activities necessary to meet their goals. Measuring success or failure is, however, difficult. To remedy this problem, each line ministry will be required to prepare performance indicators as part of their 2008 budget request.

Although it will take time to fully develop such indicators, we regard this move as an important step in achieving greater accountability in the budget.

Monetary Policy

31. The main objective of monetary policy in 2007 continues to be reducing inflation. Accordingly, we are aiming for end-period inflation of 6 percent or less for this year. This will require a disciplined monetary program, further refinement of our monetary policy tools and a flexible exchange rate regime. For 2007, we assume that the growth of the money multiplier will continue at a more modest pace than in 2006, 10.6 percent this year compared with 13.6 percent in 2006. Similarly, we assume that money demand will increase by about 12 percent this year compared with 10 percent in 2006. In light of these parameters, we plan to limit reserve money growth in 2007 to 15 percent and broad money growth to 27 percent.

32. Despite the effects of the Russian embargo on the Georgian exports we plan to further increase the level of gross international reserves to exceed \$1 billion by the end-2007. The main determinants of international reserve accumulation during 2007 will be privatization receipts and large private foreign capital inflows. The NBG interventions at the foreign exchange market will be constrained by the planned growth of monetary base, however if the pressure on the exchange rate intensifies than the adjustment will come on one hand through the exchange rate appreciation and on the other hand through the sterilized intervention.

33. We intend to maintain the current monetary policy stance and closely monitor the growth in monetary aggregates to achieve the targeted level of inflation of 6 percent in 2007. Although there will be important supply side shocks in 2007, like doubling of natural gas prices, we believe that these factors do not pose significant risks for maintaining price stability. Furthermore, we want to enhance the flexibility of the exchange rate by limiting the interventions at the foreign exchange market. In this context, a clear priority will be given to the price stability.

34. We plan to introduce several initiatives that will further strengthen the banking sector in 2007. The planned passage of amendments to the banking legislation that would allow enforcement of “fit and proper” regulations consistent with international best practices will ensure the quality of bank managers and owners. Beginning July 1, 2007 the minimum capital requirement for all commercial banks will increase from GEL 9.6 million to GEL 12 million. This is an important measure for encouraging the consolidation and increased efficiency of the banking sector. As it seems likely that some of the weaker commercial banks will be unable to meet this requirement, we plan to close or merge all banks by end-September 2007 that do not comply with the minimum capital requirement. This will facilitate the introduction of mandatory deposit insurance.

35. For the purpose of further strengthening the anti money-laundering environment we, together with the Financial Monitoring Service, plan to prepare draft legislation amending the law on anti money-laundering including expanding the coverage of monitoring entities, refining the identification procedures, strengthening of access to information and other technical issues. Moreover, we plan to establish criteria for suspicious transactions and financial operations taking into account the specificity of various monitoring entities.

36. Given the rapid credit growth over the last couple of years and especially the large expansion of the retail lending, the effective functioning of a credit information system becomes critical. To this end, we plan to introduce to the parliament the draft law on credit information bureaus in the first half of 2007. Objectives of the law will be to encourage the exchange of relevant information among the banks and non-bank financial institutions as well as to protect the consumer rights.

37. The NBG will continue developing its monetary policy tools and will strengthen emphasis on open market operations through direct sales and repurchase operations of the securitized government bonds. The NBG will continue regular auctions of its certificates of deposits (CDs). Furthermore, the NBG will spearhead the development of the secondary market for the government securities and the NBG CDs to boost their liquidity and contribute to the development of money and capital markets in Georgia.

38. In the first half of 2007 the NBG plans to complete its medium-term monetary policy strategy. This strategy will clearly define what will be the appropriate monetary policy framework for Georgia in the medium-term given the stronger commitment towards price stability and elaborate on the comprehensive set of measures that will enable the NBG to move in a coherent and gradual way towards the chosen framework. The formulation of the precise and more effective monetary policy framework, which is consistent with its operational framework will be vital in safeguarding the NBG's ability to meet its inflation objectives.

39. Following the recommendations of the IMF technical mission, responsibility for the compilation and dissemination of the BOP statistics has moved from the Department of Statistics of the Ministry of Economic Development to the NBG. To this end, the relevant memorandum of understanding has been signed between the two institutions. By end-March 2007, the new BOP division will be operational at the NBG and the fourth quarter 2006 BOP statistics will be published by the NBG (structural benchmark for end-March, 2007).

Structural Reforms

40. The government recognizes the importance of an aggressive structural reform program as a means of fostering growth and international competitiveness. Of particular

importance is the need to improve the business environment and strengthen the protection of property rights.

41. While we have already significantly liberalized the trade regime, we plan to introduce additional liberalization by moving to a zero-tariff regime in 2008. We are currently negotiating a free-trade agreement with Turkey and hope to begin negotiations on a free-trade agreement with the European Union in 2007. Such agreements will, in our view, encourage the Georgian export sector to become more diversified and support rapid economic growth.

42. An important element of our ongoing structural reform program will be the reform of the pension scheme. Although we have been able to double the minimum pension in nominal terms since 2005, we recognize that the pension program is not effective. Therefore, we plan to transform the pension program into an income support vehicle for all retirement age individuals. At the same time, the government will introduce measures for the development of a voluntary private pension insurance.

43. Our health reform program aims to improve the geographical and financial accessibility of services to the population, improving the quality of health services, and protecting the population against the risk of catastrophic health care expenditures. Respectively, government will concentrate on effective targeting of the health care needs of the poor with public funding, and achieving maximum coverage of the population with the basic healthcare services. To make it happen, the government will undertake structural reforms in terms of rethinking institutional functions and realignment of structures; ensuring better public oversight and streamlining of regulatory mechanisms; improving of management culture and practices for better performance and efficiency. At the same time the government will increase the public share in the total health expenditures; concentrate on optimization and rehabilitation of publicly owned healthcare infrastructure; and support private sector development in the health sphere.

44. On December 15, 2006 Georgia began participating in the International Monetary Fund's General Data Dissemination System (GDDS), marking a major step forward in the development of our statistical system. The IMF Statistics Department mission who visited Tbilisi in December advised us on Georgia's potential participation in the IMF Special Data Dissemination System (SDDS). The mission helped us develop an action plan to move Georgia from the GDDS to the SDDS. We are committed to participating in the SDDS and we believe we will be in a position to participate in the SDDS in 2007.

45. We will introduce necessary measures, through legislation or decrees, to enhance the quality of our economic data and public confidence in economic information (structural benchmark for end-March 2007). A key objective of this effort will be to strengthen the operations and increase the autonomy of the agency producing official statistics.

Program Monitoring

46. Completion of the sixth and final review under the PRGF arrangement, scheduled for mid-2007, will require observance of the quantitative performance criteria for end-March 2007 in Table 1 and the structural performance criteria for end-March 2007 shown in Table 2. The review will focus on progress in reducing inflation, strengthening monitoring and reporting of financial activities of LEPLs, reforms in tax and customs administration, and progress in financial sector reforms. It will also take stock of ongoing and planned steps to add momentum to structural reforms, especially in the areas of pensions, public sector operations, property rights, and additional trade liberalization.

Table 1. Georgia: Quantitative Performance Criteria and Indicative Targets, 2006–07 1/ 2/

	Cumulative Change from End-December 2005									
	Mar. 2006		Jun-06		Sep-06		Dec-06		Mar-07	
	Performance criteria		Indicative targets		Performance criteria		Indicative targets		Performance crieteria	
	Prog.	Act.	Prog.	Act.	Prog.	Act.	Prog.	Prel.	Prog.	Rev. prog.
(In millions of lari)										
1. Quantitative targets										
Ceiling on cash deficit of the general government	34.7	3.0	65.4	155.0	252.0	245.0	342.0	404.0	393.0	464.0
Ceiling on net credit of the banking system to the general govt. (NCG)	0.0	-112.1	-17.7	-88.4	-135.6	-209.0	-872.4	-202.0	-841.4	-291.0
Ceiling on reserve money	42.9	-22.5	70.8	43.2	118.3	96.0	150.4	191.0	141.2	181.0
(In millions of U.S. dollars)										
Floor on total net international reserves (NIR) of the NBG 3/	1.8	17.5	40.2	63.6	134.5	155.6	559.8	404.5	526.2	458.5
Ceiling on contracting or guaranteeing of										
A. Nonconcessional medium- and long-term external debt	20.0	0.0	20.0	0.0	20.0	15.0	20.0	15.0	25.0	25.0
B. Short-term external debt (less than one year)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Ceiling on accumulation of external arrears	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(In millions of lari)										
2. Indicative target										
Ceiling on net domestic assets (NDA) of the NBG 3/	39.5	-55.0	-3.5	-74.4	-130.6	-192.3	-885.3	-556.6	-832.3	-640.0

Sources: Georgian authorities; and Fund staff estimates.

1/ Section 1 of this table shows quantitative targets for 2006; for stock variables, they are based on cumulative changes from end-December 2005 projections. 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/ Quantitative targets for 2006 are based on accounting exchange rates of GEL 1.85/US\$, US\$1.46/SDR, and US\$1.21/EUR.

3/ NDA and NIR data was corrected to reflect recent findings of an STA mission.

Table 2. Georgia: Structural Performance Criteria (*) and Structural Benchmarks, 2006–07	
Measure	Timing
Adopt financial reporting guidelines for all not-for-profit LEPLs.*	End-December 2006
Enact legislation bringing Georgian Fit and Proper regulations in line with international best practices.*	End-December 2006
Introduce measures, through legislation or decrees, to enhance the operations and autonomy of the agency producing official statistics.	End-March 2007
Prepare a strategy for modernizing tax administration.	End-March 2007
The NBG will issue a regulation requiring bank external auditors to include issues of relevance to the NBG in their audits and report to the NBG.	End-March 2007
Have the BOP division at the NBG fully operational and publish 4 th quarter, 2006 BOP statistics.	End-March 2007

ATTACHMENT III. GEORGIA: TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)

9 February 2007

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 February 9, 2007.

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 2005.

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, extra-budgetary funds, and general government LEPLs and those LEPLs that operate on behalf of the general government. 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 will provide to the IMF detailed information on monthly revenues of the general government. The treasury department of the ministry of finance will provide to the IMF detailed information on monthly expenditures of the central government. The local budget department of the ministry of finance will provide to the IMF detailed information on monthly spending by the local government budgets.

B. Definition of Domestic Expenditure Arrears

5. **Definition:** Domestic expenditure arrears are defined as arrears incurred by the central and local governments on expenditure items, excluding external debt service payments. Measurement of the stock of verified 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 measured by the local budget department of the ministry of finance, and according to the same definition as above. The stock of unverified arrears will be based on the following principles: (a) the bill for payment has been received, (b) the due-for-payment date has passed, and the bill has remained unpaid beyond the normal or agreed period of

credit, and (c) the receipt of goods and services related to the claim has not yet been verified.

6. **Supporting material:** The ministry of finance will provide to the IMF monthly data on the stock as well as flow clearance of domestic expenditure arrears of the central government (from the treasury department) and local governments (from the budget department). The monthly data on the stock as well as the flow clearance of arrears provided will include a detailed breakdown by economic classification for central government and will be provided within 4 weeks. No economic classification for the stock or flow clearance of local government arrears will be required.

C. Ceiling on the Cash Deficit of the General Government

7. **Definition:** The cash deficit of the central and local governments will be measured from the financing side, and will be defined as equal to the total financing. Total financing will be defined as the sum of (i) domestic financing from banks and non-banks, (ii) external financing, and (iii) privatization receipts. 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 leases and the sale of licenses of duration lasting 10 years and longer. Domestic financing consists of all bank and non-bank financing to the central and local 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.

8. **Supporting material:** Data on privatization receipts will be provided by the treasury department of the ministry of finance to the IMF on a monthly basis within two weeks of the end of each month. The data will be consistent with the revenue account(s) in the NBG. Data on domestic bank and non-bank 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 debt unit at the ministry of finance (specifying projects by creditor) within two weeks of the end of each month. All external financing data in the budget will be consistent with the detailed data and projections provided by the debt unit at the ministry of finance at the time the budget is submitted to parliament. Data will be provided at the actual exchange rates.

D. Ceiling on Reserve Money

9. **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.

10. **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

11. **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.

12. **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, including the breakdown of treasury bill holdings by banks and non-banks. Data will be provided 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).

E. Floor on Net International Reserves of the NBG

13. **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.

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

F. 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)

15. **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).¹ 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.² 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.

16. **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. Data will be provided using actual exchange rates.

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

17. **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.

¹ 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.

² 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 lessor 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."

18. **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. Data will be provided using actual exchange rates.

H. Non-Accumulation of External Arrears

19. **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.

20. **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.

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

21. **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).

22. **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 two week of the end of each month. Data will be provided 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).

INTERNATIONAL MONETARY FUND

GEORGIA

**Fifth Review Under the Three-Year Arrangement Under the Poverty Reduction and
Growth Facility and Request for Waiver of a Performance Criterion**

Informational Annex

Prepared by Middle East and Central Asia Department

February 12, 2007

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ANNEX I. GEORGIA: FUND RELATIONS

(As of December 31, 2006)

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

II. General Resources Account:	SDR Million	Percent of Quota
Quota	150.30	100.00
Fund holdings of currency	150.30	100.00
Reserve position in Fund	0.01	0.01
III. SDR Department:	SDR Million	Percent of Allocation
Holdings	0.60	N/A
IV. Outstanding Purchases and Loans:	SDR Million	Percent of Quota
PRGF Arrangements	157.11	104.53

V. **Latest Financial Arrangements:**

<u>Type</u>	<u>Approval Date</u>	<u>Expiration Date</u>	<u>Amount Approved (SDR million)</u>	<u>Amount Drawn SDR Million)</u>
PRGF	6/4/04	6/3/07	98.00	70.00
PRGF	1/12/01	1/11/04	108.00	49.50
PRGF	2/28/96	8/13/99	172.05	172.05

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

	Forthcoming				
	2007	2008	2009	2010	2011
Principal	25.94	22.11	17.96	14.10	17.90
Charges/interest	<u>0.71</u>	<u>0.59</u>	<u>0.49</u>	<u>0.42</u>	<u>0.33</u>
Total	26.64	22.70	18.45	14.52	18.23

VII. **Implementation of HIPC Initiative:**

Not applicable.

VIII. **Safeguards Assessments:**

Under the Fund's safeguards assessment policy, the National Bank of Georgia (NBG) is subject to an assessment with respect to the PRGF arrangement approved on June 4, 2004.

The assessment was completed on December 10, 2004 and concluded that safeguards in place at the NBG appear generally adequate. However, certain vulnerabilities were identified in the internal audit and internal controls areas, and the safeguards assessment recommended measures to address them.

IX. Exchange Arrangements:

(a) Since April 29, 1993, the Tbilisi Interbank Currency Exchange (TICEX), established by the NBG and a group of commercial banks, has conducted periodic auctions to determine the exchange rate of the domestic currency vis-à-vis the U.S. dollar. These auctions are conducted daily. Foreign exchange bureaus are allowed to buy and sell foreign currency bank notes. Georgia's exchange rate regime is classified as "managed floating."

(b) Georgia maintains no exchange restrictions on the making of payments and transfers for current international transactions except for exchange restrictions maintained for security reasons, and notified to the Fund pursuant to Executive Board Decision No. 144-(52/51).

X. Article IV Consultation:

The 2006 Article IV consultation was concluded on March 31, 2006.

XI. FSAP Participation:

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

XII. Technical Assistance:

See Table 1 of this Appendix.

XIII. Resident Representative:

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

XIV. National Bank of Georgia Resident Advisors:

Ms. Vance, MAE peripatetic banking supervision advisor to the NBG, commenced a series of visits to Tbilisi in September 1997. Mr. Nielsen, an MAE advisor, provided technical assistance to the NBG in May 1998. Mr. Viksnins was an MAE peripatetic advisor to the NBG president starting in October 1999. Mr. Fish was resident advisor on banking supervision from August 10, 1999 to January 31, 2002. Mr. Bernard Thompson provided peripatetic technical assistance in accounting and internal audit in March and August 2000. Mr. Wellwood Mason provided technical assistance on payment system issues on a peripatetic basis in 2002 and 2003. Mr. Howard C. Edmonds serves since September 2004 as a resident advisor on banking supervision issues.

XV. Ministry of Finance Resident Advisors:

Mr. Sharma was an FAD resident advisor and assisted the authorities in the development of a Treasury beginning in May 1997. Mr. Sainsbury, an FAD advisor, assisted the Ministry of Finance from June 1998 to November 1999. Mr. Chaturvedi was FAD resident advisor in 2001 and 2002 to assist the authorities in continuing the development of the Treasury and the Treasury Single Account, in revising the legislative framework, expenditure control systems, and budgeting issues. Between 2001 and 2003, Mr. Welling was an FAD peripatetic advisor to assist the State Customs Department in preparing and introducing measures for the custom reform and modernization program. In March 2005, Mr. Zohrab started advising the authorities on treasury-related reforms, and his term ended in November 2006.

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

Subject	Type of Mission	Timing	Counterpart
Fiscal Affairs Department (FAD)			
Public Expenditure Management	Assessment of Treasury system and preparing work plan for the resident advisor	Jun. 12–19, 2001	Ministry of Finance
Public Expenditure Management	Review of the draft Budget System Law	Mar. 14–Apr. 02, 2002	Ministry of Finance
Public Expenditure Management and Fiscal ROSC	Assessment of Treasury system and of observance of standards and codes	Jan. 16–30, 2003	Ministry of Finance
Public Expenditure Management	Assessment of Treasury System and implementation of Budget Systems Law	Sep. 29–Oct. 11, 2003	Ministry of Finance
Tax and Customs Administration	Assistance in taxation of excisable goods	Oct. 27–Nov. 13, 2003	Ministry of Finance
Tax Policy	Review of Tax Policy	June 8–21, 2004	Ministry of Finance
Public Expenditure Management	Assessment of Treasury system.	Nov. 8–23, 2004	Ministry of Finance
Revenue Administration	Modernizing Tax Administration	November 2005	Ministry of Finance
Tax Administration	Installation	July 9–14, 2006	Ministry of Finance
Tax Administration	Follow-up assistance	Oct. 9–25, 2006	Ministry of Finance

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

Subject	Type of Mission	Timing	Counterpart
Tax Administration Reform	Provide strategic and technical advice on tax administration reform program	Jan. 17–30, 2007	Ministry of Finance
Monetary and Capital Markets Department (MCM)			
Banking, foreign exchange reserve management, monetary programming, and research	Advisory	Feb. 26–Mar. 8, 2001	National Bank of Georgia
Payment Systems, Bank Supervision and Resolution, Internal Audit, Foreign reserve Management, and Research	Advisory	Oct. 23–Nov. 6, 2001	National Bank of Georgia
Payment Systems and Bank Resolution	Advisory	Mar. 11–19, 2002	National Bank of Georgia
Accounting and Audit, Anti-Money Laundering, Bank Supervision, and Monetary Operations	Advisory	Sep. 24–Oct 9, 2002	National Bank of Georgia
Payment Systems	Advisory	June 16–20, 2003	National Bank of Georgia
Government Securities Market, Deposit Insurance, Anti-Money Laundering	Advisory	April 20–30, 2004	National Bank of Georgia
Monetary Operations, Banking Sector Competition	Advisory	Oct. 24–Nov. 5, 2004	National Bank of Georgia
Liquidity management; trends in securities and insurance sectors	Advisory	April 18–29, 2005	National Bank of Georgia
Statistics Department (STA)			
National Accounts	Follow-up assistance	Mar. 26–Apr. 6, 2001	State Department of Statistics
Balance of Payments Statistics	Follow-up assistance	February 13–27, 2002	State Department of Statistics
Money and Banking	Follow-up assistance	March 2–15, 2002	National Bank of Georgia

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

Subject	Type of Mission	Timing	Counterpart
Data ROSC	Assessment of observance of standards and codes	July 15–31, 2002	State Department of Statistics, National Bank of Georgia, Ministry of Finance
Balance of Payments Statistics	Follow-up assistance	May 20–June 3, 2003	State Department of Statistics
Government Finance Statistics	Follow-up assistance	Nov. 5–18, 2003	State Department of Statistics, Ministry of Finance
National Accounts	Follow-up assistance	April 26–May 7, 2004	State Department of Statistics
National Accounts	Follow-up assistance	April 18–29, 2005	State Department of Statistics
Price Statistics	Follow-up assistance	May 23–June 3, 2005	State Department of Statistics
Balance of Payments Statistics/International Investment Position	Follow-up assistance	June 15–28, 2005	State Department of Statistics and National Bank of Georgia
Price Statistics	Follow-up assistance	June 20–July 13, 2006	State Department of Statistics
Balance of Payments	Follow-up assistance	Sept. 6–19, 2006	National Bank of Georgia
GDDS/Government Finance Statistics	Follow-up assistance	Nov. 8–22, 2006	State Department of Statistics, National Bank of Georgia, Ministry of Finance
Legal Department (LEG)			
Tax Code	Follow-up assistance	Jan. 28–Feb. 9, 2001	Ministry of Finance, Tax Inspectorate of Georgia
Tax Code	Follow-up assistance	Jul. 13–24, 2001	Ministry of Finance, Tax Inspectorate of Georgia

ANNEX II. GEORGIA: IMF-WORLD BANK RELATIONS

Partnership in Georgia's Development Strategy

1. The Government has prepared a second PRSP Progress Report—or the Economic Development and Poverty Reduction Program (EDPRP) Progress Report as it is known in Georgia. A Joint Staff Advisory Note was prepared which together with the Progress Report on the EDPRP were presented to the Boards of IDA and IMF in September 2006. The IMF presented the Staff Report of the Fourth Review under the PRGF arrangement to the IMF Board in September 2006. The latest World Bank Country Partnership Strategy (CSP) of Georgia for FY06-09 was presented to the World Bank Board of Executive Directors in September 2005. The Second Poverty Reduction Support Operation (PRSO II), the second in a series of PRSOs was discussed and approved by the Board in September 2006, and a proposed third PRSO is currently under preparation.
2. The Fund has taken the lead in assisting Georgia in improving macroeconomic stability and pursuing fiscal reforms. The World Bank has taken the lead in the policy dialogue on structural issues, focusing on: (i) strengthening public expenditure management; (ii) improving performance of the public sector; (iii) reducing corruption; (iv) deepening and diversifying sources of growth; (v) protecting the environment; and (vi) reducing poverty. Georgia is one of the largest IDA borrowers in the CIS, with borrowing of US\$861.6 million for 37 operations. The PRSO program has supported further elaboration and implementation of the key elements of the Government's poverty reduction strategy as described in the PRSP Progress Report (or EDPRP Progress Report).
3. The PRSO program focuses on four central reform areas: (i) strengthening public sector accountability, efficiency, and transparency; (ii) improving electricity and gas sector services; (iii) improving the environment for private sector development; and (iv) improving social protection, education and health care services.
4. Other support has come in the form of project support and Analytic and Advisory Activities across a broad spectrum of areas including education, health care, social protection, energy, roads, water and sanitation, agriculture, agricultural research and extension, irrigation and drainage, forestry, environment, biodiversity, enterprise development, municipal development, judicial reform, and cultural heritage. A Public Expenditure Review (PER) was prepared in 2002, and a Trade Study in 2003. A Country Procurement Assessment Report (CPAR) was prepared in 2002 and a Country Financial Accountability Assessment (CFAA) in 2003. A Country Fiduciary Assessment (CFA) is scheduled for FY07. A series of annual programmatic Poverty Assessments are being implemented with a report to be issued in 2007. A Programmatic Public Finance Policy Review (PPFPR) and a Country Economic Memorandum (CEM) are planned for FY08.

5. Georgia became a shareholder and a member of IFC in 1995. As of January 1, 2007, IFC has invested around \$180 million to finance projects in the financial, infrastructure, oil and gas, and manufacturing sectors. In the financial sector, IFC has focused on supporting the development of the housing finance market, providing investment and technical assistance to two leading banks – the Bank of Georgia and TBC Bank. To reach small and medium enterprises, IFC helped to establish ProCredit Bank of Georgia, the country's first bank specializing in lending to micro and small enterprises. IFC has also provided a credit line to TBC Leasing to support the rapid growth of their portfolio of SME clients; this project grows out of two year's of technical assistance to the Government and private sector to support the growth of the leasing sector. IFC continues to look for opportunities to support these clients, as well as other emerging financial market leaders to deepen the financial sector and increase the range of financial products available.

6. In the real sector, IFC's most recent transaction is a loan to TAV to support their construction of new airport terminals in Tbilisi and Batumi. In oil transit, IFC has provided equity and credit to local and international companies, including investments by British Petroleum and other sponsors in the construction of the Baku- Supsa Early Oil Pipeline and the Baku-Tbilisi-Ceyhan Pipeline. Other investment projects have been in electricity distribution (AES-Telasi), mineral water (GGMW), and glass bottle production (Ksani Glass Factory). In the real sector, IFC continues to look for opportunities to support the growth of the private sector, particularly in export-oriented companies or those that support overall private sector development. Sectors of interest include agribusiness, infrastructure, manufacturing, and the development of natural resources.

7. IFC has also provided donor-supported technical assistance to strengthen its client banks and introduce new financial products (including leasing and housing finance). IFC is currently providing technical assistance in Georgia to improve the business climate and corporate governance practices. The World Bank-IFC Doing Business report has ranked Georgia as the top reformer in its Doing Business 2007 report, and the Government is actively engaged with IFC to make further progress on reforms for the business enabling environment.

8. The division of responsibilities between the two institutions is described in the next section. In a number of areas—for example, the social sectors, rural development, environment, and infrastructure—the World Bank takes the lead in the dialogue and there is no related conditionality in the IMF-supported program. The World Bank is also leading the dialogue on private sector development and energy, and the World Bank analysis serves as inputs into the Fund program. In other areas—the financial sector, public expenditure management, and civil service reform—both institutions are working together. Finally, in areas like monetary policy and domestic customs revenue, the IMF takes the lead.

IMF-World Bank Collaboration in Specific Areas

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

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

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

11. In **health**, IDA credits support the government in improving health care financing, exploring risk-pooling options, introducing a new system of primary health care, and improving the focus of publicly-funded services to the poor and on priority public health interventions. IDA is engaged in policy work in health sector reform in the context of the PRSO program through a health care reform sub-component as well as through the public expenditure policy reform sub-component.

12. In **infrastructure**, support is being provided through the Secondary and Local Roads Project, the Municipal Development and Decentralization Project II and the Social Investment Fund Project. These projects provide financing at the community level for critical infrastructure needs, primarily for school and health facility heating and repair, small hydropower schemes to provide electricity, drinking water and sanitation rehabilitation, as well as transportation infrastructure rehabilitation. IFC supported the privatization of Tbilisi electricity distribution through an investment in AES-Telasi, and IFC Advisory Services advised the Government on the management contract for UEDC. The recently approved Infrastructure Pre-Investment Facility project is to facilitate infrastructure investments of

strategic importance and/or special complexity by providing technical assistance to assess the feasibility and effectiveness of investments, focusing on energy and transport sectors.

13. In **rural development**, IDA credits have supported development of private sector farming and agro-processing improvements, agricultural credit, irrigation and drainage, and agricultural research. IDA credits have also been supporting creation of local institutions, such as rural credit unions and water users associations. A recently approved Rural Development Project is to develop the productivity and profitability of the private agriculture sector with the aim to increase incomes and employment and reduce poverty in rural areas.

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

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

15. The World Bank leads the dialogue on structural reforms through the PRSO program. Institution building and technical assistance have been supported through the Structural Reform Support Project. The World Bank also leads in the areas of:

a) **Private Sector Development.** The PRSO program focuses on improving investment climate and reducing constraints to private sector development in Georgia. IDA has also been supporting private sector participation in other areas, such as energy, urban services and agriculture. The IMF has worked with the authorities to initiate audits of the accounts of three major state-owned enterprises.

b) **Energy.** The energy system was in poor condition, with unreliable supply and unsustainable debts. However, under the PRSO program, the Georgian authorities have made progress and payment collections and service levels have improved substantially in the power sector. The Government of Georgia has been working with IDA and other donors, including the Fund, to implement a series of short-term action plans and longer term steps to improve the overall functioning of the sector. IDA has also provided additional funding to the power sector in 2004. At the beginning of the PRGF program, the Fund has been focusing on reducing quasi-fiscal losses in the sector. The World Bank through the PRSO program focused on improved bill collections, and supported the pursuit of tariff policies at cost-recovery levels was facilitated by a World Bank-assisted review of the tariff policy methodology. The Georgian authorities prepared the Energy Sector Strategic Action Plan for 2005–08 which is being implemented and updated periodically under the PRSO program. In

a new operation, the World Bank will finance a feasibility study for a major, new hydropower plant that could add about 20 percent to the country's hydropower capacity.

c) **Public Sector Management.** The PRSO program supports through its first pillar, inter alia, improving public expenditure policies and management; implementing procurement reform; strengthening public financial management accountability; implementing intergovernmental fiscal reform; developing a strategy for administrative and civil service reform; and implementing the National Anti-corruption Strategy. The Public Sector Financial Management Reform Support Project (IDA grant pooled together with resources from other donors) is to provide technical assistance and capacity building in support of the first pillar of the PRSO program. The Fund is providing technical assistance in support of tax and customs administration reform.

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

Areas of shared responsibility

16. The World Bank and the Fund have been working jointly in the following main areas:

a) **Poverty Reduction Strategy.** Both institutions have been working closely with the Government to support the implementation of the PRSP (or EDPRP as it is known in Georgia), through seminars and workshops, direct staff input, and donor coordination. A JSAN on the progress with implementation of the Government's EDPRP was issued in September 2006.

b) **Budget Planning and Execution.** The PRSO program is supporting reforms to improve public expenditure policies and management including development of an MTEF, and strengthening public financial accountability. The Public Sector Financial Management Reform Support Project is financing technical assistance and necessary investment to support budget planning and management processes within the MoF and line ministries. The Fund is focusing on treasury reform within the Ministry of Finance.

c) **Financial Sector Reforms.** The joint Financial Sector Assessment Program has supported: (i) strengthened banking and non-banking supervision; (ii) introduction of international accounting standards; (iii) consolidation of banks through higher capital requirement ratios; (iv) anti money-laundering legislation; (v) strengthening the regulatory environment and removing impediments for development of viable non- bank financial institutions; and (vi) strengthening the payment system. IFC has worked to strengthen the banking sector through investment and technical assistance, and has supported the

development of the financial leasing market through technical assistance. The Fund has focused on banking supervision, anti-money laundering legislation, and improvements in monetary control instruments with extensive technical assistance from its Monetary and Financial Systems Department.

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

- a) **Fiscal Framework and reforms in tax policy and tax and customs administration.** The Fund's focus on prudent fiscal policy has served as an important framework for IDA's work on public expenditure management. The Fund's Fiscal Affairs Department has the lead in the areas of tax policy and tax and customs administration reform.
- b) **Economic Statistics.** IMF technical assistance has been conducive to improvements in national accounts, price, monetary and government financial statistics. The World Bank's grant on Statistical Capacity Building will build on the recommendations of Fund TA to strengthen the quality of national accounts statistics.

12

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

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

World Bank Group Strategy

On September 15, 2005, the World Bank Executive Board endorsed the new Country Partnership Strategy (CPS) for FY06-09 designed to assist Georgia with deeper institutional reform as well as more fundamental infrastructure improvements. *The CPS builds on the EDPRP, as well as emerging Government strategic thinking on the development framework. In doing so, it targets several goals: (i) Generating growth and job creation by removing barriers to private sector development and improving infrastructure, finance and markets; (ii) Enhancing human development and social protection through improved education, health, social protection, and community services; and (iii) Strengthening public sector management and budgetary processes to enable Georgia to better plan and meet its own development goals.* Along with the CPS, the First PRSO, of a series of single tranche annual Poverty Reduction Support Operations was approved of which US\$13.5 million is a regular IDA credit and US\$6.5 million is an IDA grant. The Second PRSO for US\$ 20 million of IDA credit was approved by the World Bank's Board in October 2006. Other recent operations include a US\$5 million Infrastructure Pre-Investment Facility Project, a US\$3 million grant Public Sector Financial Management Reform Support Project, a US\$24 million Reform Support Credit, a US\$20 million Secondary and Local Roads Project,

a US\$3.6 million Electricity Market Support Project, a US\$10 million Rural Development Project, and a US\$5 million Irrigation and Drainage Community Development Project Additional Funding for flood control. The World Bank continues its discussion with the Government on a more comprehensive medium-term reform strategy that would be supported by future Poverty Reduction Support Operations and technical assistance operations.

Questions may be referred to Ms. R. Quintanilla (202-473-7673), Ms. Afsaneh Sedghi (202-473-7518), or Mr. A. Cholst (202-458-0324).

ANNEX III. GEORGIA: RELATIONS WITH THE EBRD

(As of December 31, 2006)

1. As of December 31, 2006, the European Bank for Reconstruction and Development (EBRD) had signed 72 investments in Georgia with cumulative commitments totaling US\$525.14 million.¹ Current Portfolio Stock equals to US\$349.1 million. The EBRD's first operation, a power rehabilitation project, was signed in December 1994. Since then, the pace and composition of portfolio growth has varied significantly from year to year.
2. During 2006, the Bank signed 26 transactions in Georgia for US\$150.25 million. The project examples include: additional US\$10 million loan to Georgia State Electro System for Enguri HPP Phase II rehabilitation program; US\$ 21.2 million loan to TAV Georgia, the concession of the Tbilisi International Airport for construction of new passenger terminals in Tbilisi and Batumi; mortgage loan of US\$8 million to Bank Republic and US\$3 million credit line for on-lending purposes to SMEs; Loan to the cities of Kutaisi and Poti of €3 million and €2.5 million respectively to improve the water supply in the cities.
3. The ratio of private sector projects in the portfolio now stands at 84.4 percent. The Bank plans to focus primarily on private sector financing, but may also consider selected public sector projects. The Bank will give preference to non-sovereign operations although, where sovereign guarantees will be required, donor co-funding on a grant basis will be sought.
4. The EBRD is helping Georgia to benefit from its privileged location, transforming it into a regional transportation and natural resources hub. Georgia is part of the 'Early Transition Countries' (ETC) initiative. Launched in April 2004, the initiative aims to increase investments in the Bank's seven poorest countries. The initiative builds on international efforts to address poverty in these countries. Through this initiative, the EBRD focuses its efforts on private sector business development and selected public sector interventions. It aims to stimulate market activity by using a streamlined approach to financing, focusing on smaller projects, mobilizing more investment, and encouraging ongoing economic reform. The Bank will accept higher risk in the projects it finances in the ETCs, while still respecting the principles of sound banking. Since launch of the ETC initiative the Bank's annual business volume in Georgia has been increased five times.

¹Evaluated at an exchange rate of US\$1.3168 per euro.

Table 1. Georgia: EBRD Portfolio for Georgia
As of December 31, 2006 (US\$, million)

Project Name	Date of Agreement	Outstanding Amount
Bank Republic - MSE Loan	27/04/06	3.0
Bank Republic Equity	15/09/06	8.2
Bank Republic Mortgage Loan	20/12/06	4.0
Bank of Georgia - SME Loan	23/07/03	0.8
DIF - Delidor	17/06/05	1.6
DIF - Georgian Hazelnut Production Ltd.	26/10/06	0.8
DIF - Iberia Refreshments	25/09/03	2.7
DIF - Imedi L	30/12/06	1.5
DIF - Lomisi	20/12/05	3.3
DIF - Mantashev Trade Rows JSC	22/12/06	0.8
DIF - Teliani Valley	20/05/04	1.3
DLF - BTM TEKSTIL	21/12/06	2.3
DLF - Georgian Hazelnut Production Ltd	26/10/06	3.3
DLF - Lomisi	08/12/06	2.0
ETC Non-Bank MFI Framework II - Constanta	28/11/06	3.0
Georgia: Trans-Caucasian Rail Link Project	22/12/98	8.9
Georgian State Electrosystem	22/12/98	33.6
Georgian Wines & Spirits Ltd.	10/03/05	7.3
Intellectbank (Sub Project of Georgia SME)	11/11/97	0.3
JSC Channel Energy Poti Port	19/03/02	9.2
Kutaisi Water Project	15/09/06	4.0
MCFF - Bank of Georgia Full Recourse Portion	14/06/05	5.0
MCFF - BoG Iberia Refreshments Sub-Loan (NRP)	27/09/06	3.2
MCFF - TBC Bank - Nola Ltd Sub-Loan (NRP)	22/12/05	0.7
MCFF - TBC Bank JSC Full Recourse Portion	13/06/05	5.0
MCFF - TBC Bank Lomisi Ltd Sub-Loan (NRP)	03/08/05	3.1
MCFF BOG - Renewable Energy Programme - Okami	21/12/06	0.1
SHPP NRP		
MCFF BOG - Renewable Energy Programme Lopota	21/12/06	0.2
SHPP NRP		
Poti Water Supply Project	15/09/06	3.3
Power Rehabilitation Project	20/12/94	4.6
ProCredit Bank Georgia	11/10/01	3.0
Regional TFP: Bank Republic (Guarantee & Pre-export)	15/02/06	2.3
Regional TFP: Bank of Georgia (Guarantee & Pre-export)	29/07/99	10.7
Regional TFP: Cartu Bank	28/04/06	0.1
Regional TFP: TBC Bank (guarantee & pre-export)	17/08/99	9.1
Regional TFP: United Georgian Bank (UGB)	24/12/00	9.5
TBC Bank - SME Credit Line	19/12/03	4.5
TBC Bank - Syndicated Loan	20/12/05	7.0
TBC Bank Mortgage Loan	29/06/06	15.0
TBC Bank SME Credit Line III	26/09/05	5.0
TBC Leasing - Equity Investment	01/03/06	0.1
TBC Leasing, Senior Debt	21/12/05	3.0
TbilComBank (Sub Project of Georgia SME)	12/12/96	0.3

Tbilisi International Airport	17/05/06	27.0
Tbilisi Public Transport Project	29/07/05	3.7
United Georgian Bank (debt, equity)	20/11/97	2.4
United Georgian Bank Capital Increase	09/10/06	2.3
United Georgian Bank Credit Line 2004	09/10/06	10.0
Direct Investments / Sub Total		242.0
Regional Projects		
BIH	18/12/06	6.0
BSR Europe Co-Investment Facility	14/08/06	9.2
Baku-Tbilisi-Ceyhan (BTC) Pipeline	03/02/04	62.2
Baring Vostok Private Equity Fund	13/12/00	0.2
First NIS Regional Fund	21/11/94	0.0
Lukoil Overseas : South Caucasus Gas Pipeline	28/07/05	29.4
		107.1
TOTAL		349.1

ANNEX IV. GEORGIA: STATISTICAL ISSUES

1. The Fund has provided substantial technical assistance in the compilation of macroeconomic statistics (Appendix I, Table 1). Despite improvements in the areas of national accounts, price, monetary, and government finance statistics, the quality of macroeconomic statistics remains poor, reflecting deficiencies in statistical methodologies, coverage, and insufficient resources. Problems are particularly acute in the compilation of national accounts, balance of payments, foreign trade, and fiscal statistics. The transfer of responsibility for the balance of payments from the State Department of Statistics (SDS) to the National Bank of Georgia (NBG) in January 2007 is expected to lead to improvements in external sector statistics.
2. Nonetheless, the core statistical indicators compiled by the authorities are provided on a timely basis and are generally adequate for surveillance and program monitoring. The data module of the Report on the Observance of Standards and Codes (ROSC), prepared in July 2002 was published on the Fund's external website on May 27, 2003. In August 2005, the authorities notified the Fund of their commitment to participate in the IMF's General Data Dissemination System (GDDS), and appointed a national GDDS coordinator. A GDDS/SDDS mission from the Statistics Department visited Tbilisi during November 8–22, 2006 and finalized the metadata for participation in the GDDS. The mission also made recommendations about the steps to be taken by the authorities to subscribe to the Special Data Dissemination Standard (SDDS). The implementation of these recommendations was included in the plans for improvement under the GDDS for 2007. On December 15, 2006 Georgia began participation in the GDDS.

Real sector

3. National accounts statistics follow the concepts and definitions of the *System of National Accounts 1993*, with GDP estimates by production and expenditure compiled annually and quarterly. Revisions of the national accounts follow an established schedule. Preliminary national accounts estimates are available after 85 days, and final estimates after 13 months. The 2002 data ROSC mission found several weakness regarding data sources; inadequate coverage of the business register; poor coverage of units in terms of value added for agriculture, retail trade, construction, catering, and services; limited administrative sources to estimate the non-observed economy; and inadequate data for imports and exports of services (taken from the balance of payments). Follow-up missions in early 2004 and April 2005 found that although the authorities have made good progress in addressing some of these issues, there was scope for improving the constant price estimates and advancing in the development of the system of supply and use tables. Regarding price statistics, a May/June 2006 mission reported important progress regarding the development of agricultural indices and plans to upgrade both CPI and PPI methodology, PPI specification, and dissemination practices.

Money and banking

4. A March 2002 STA mission found that the authorities had implemented many of the recommendations made by the December 2000 mission. The July 2002 data ROSC found that most elements in the data quality assessment framework for monetary statistics were fully or largely observed, and recommended improvements in the statistical coverage of non-bank depository corporations and the provision of documentation on metadata. It also recommended increased transparency regarding access by governmental agencies to monetary statistics prior to their release to the public.

5. In response to a request from STA, the NBG has begun compiling monetary data using the framework of the new Standardized Report Forms (SRF) and has been providing regular updates of these data to STA. These data were published in the December 2006 issue of the *IFS Supplement*. Also, beginning from December 2001, data published in *IFS* have been revised in accordance with the SRF.

Government finance

6. Government finance statistics (GFS) on a cash basis are reported to STA for publication in the *GFS Yearbook*. Classification broadly follows the analytic framework of the 1986 *Government Finance Statistics Manual*, but the concepts and definitions of revenue, expenditure, and financing differ from the international standard in significant respects. In addition, the central treasury and line departments employ differing accounting systems, with the treasury having a single-entry cash basis, which hampers the treasury's capacity to reconcile bank statements and hinders the reporting of information on accounts payable. Another issue concerns the limited budget classifications available for expenditure. Discrepancies can arise when matching budget appropriations with the classified expenditure, because the locally developed structure of expenditure codes changes frequently. Consequently, statistical performance and reliable budget reporting could improve once the treasury adopts internationally accepted accounting standards, including a unified treasury general ledger maintained on a double-entry cash basis. There are substantial differences in the classification systems of different government subsectors. Bridge tables linking national classification codes and the *Government Finance Statistics Manual 2001 (GFSM 2001)* codes were established by a GFS mission in 2003 and used for reporting. The authorities plan to compile and disseminate government finance statistics on a *GFSM 2001* basis starting in 2007.

Balance of payments

7. A technical assistance mission in September 2006 assisted the authorities to prepare an action plan for the transfer of responsibility for the compilation of the balance of payments from the SDS to NBG; advised on the structure of new balance of payments division; and developed a framework for the collection of source data. Also, the mission further developed the framework for compilation of an international investment position statement; and assisted in the preparation of metadata in connection with Georgia's participation in the GDDS.

8. Following the transfer of the balance of payments compilation function to the NBG in mid-January 2007, a new law on official statistics is expected to be presented to Parliament for approval in mid 2007. It identifies the NBG as one of the producers of official statistics and defines its responsibility as compiler of the balance of payments statistics. The NBG will also be empowered to collect source data from economic agents in all sectors. The SDS will remain the main provider of data for goods, services, and direct investment. A Statistics Advisor stationed in Baku will, through a series of peripatetic visits, assist the Georgian authorities to develop the balance of payments information base, including the development of an international transactions reporting system.

**GEORGIA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
(AS OF JANUARY 26, 2007)**

	Date of latest observation	Date received	Frequency of Data ⁶	Frequency of Reporting ⁶	Frequency of publication ⁶	Memo Items:	
						Data Quality – Methodological soundness ⁷	Data Quality – Accuracy and reliability ⁸
Exchange Rates	8/21/06	8/22/06	D	W	M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	8/21/06	8/22/06	D	W	M		
Reserve/Base Money	12/06	1/8/07	M	M	M	O, LO, LO, O	O,O,O,O,LO
Broad Money	12/06	1/17/07	M	M	M		
Central Bank Balance Sheet	12/06	1/8/07	M	M	M		
Consolidated Balance Sheet of the Banking System	12/06	1/17/07	M	M	M		
Interest Rates ²	12/06	1/8/07	W	W	M		
Consumer Price Index	7/06	8/7/06	M	M	M	O,LO,O,O	LO,LO,O,O,O
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴	7/06	8/23/06	M	M	M	LNO,LO,LNO, O	LO,O,LO,O,O
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	8/05	9/14/05	M	M	M Domestic not disseminated		
External Current Account Balance	Q1/06	6/30/06	Q	Q	Q	O,LO,LO,LO	LNO,LNO, LNO,LNO, LNO
Exports and Imports of Goods and Services	6/06	08/15/06	M	M	M		
GDP/GNP	Q1/06	6/27/06	Q	Q	Q	O,LO,O,LO	LNO,LNO,LNO, LO,LO
Gross External Debt	08/05	09/06/05	M	M	M		

¹Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

²Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

³Foreign, domestic bank, and domestic nonbank financing.

⁴The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

⁵Including currency and maturity composition.

⁶Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).

⁷Reflects the assessment provided in the data ROSC (published on May 27, 2003, and based on the findings of the mission that took place during July 15 – 31, 2002) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).

⁸Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

Press Release No. 07/36
FOR IMMEDIATE RELEASE
March 1, 2007

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Fifth Review of Georgia's PRGF Arrangement and Approves US\$21.1 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) completed today the fifth review of Georgia's performance under the three-year program supported by the Poverty Reduction and Growth Facility (PRGF) arrangement. In completing the review, the Board approved the authorities' requests for a waiver for the nonobservance of the end-June 2006 structural performance criterion on the introduction of a poverty alleviation program targeted on households living in extreme poverty and for an extension of the arrangement until September 30, 2007.

The Executive Board approved the PRGF arrangement on June 4, 2004 (see [Press Release No. 04/107](#)) for an amount equivalent to SDR 98 million (about US\$147.5 million). Completion of this review will enable Georgia to draw the equivalent of SDR 14 million (about US\$21.1 million), bringing total disbursements under the arrangement to the equivalent of SDR 84 million (about US\$126.4 million).

Following the Executive Board discussion of Georgia's economic performance, Mr. Takatoshi Kato, Deputy Managing Director and acting Chair, made the following statement:

“Georgia’s economy has continued its remarkable performance, in spite of the loss of major export markets and higher energy prices. This resilience is a testament to the success of the administration’s emphasis on improving the business climate while maintaining macroeconomic stability. In addition, implementation of the government’s well-targeted extreme poverty benefit program should help to reduce poverty in Georgia.

“The authorities are advancing their structural reform agenda to consolidate and upgrade revenue administration, create greater accountability and transparency in the public sector, and establish the conditions for the development of a nascent financial sector. Moving ahead in these areas is important for sustainable growth in the medium term. In this regard, prompt enactment of fit and proper and anti-money laundering legislation will be crucial.

“In addition to maintaining high growth, the authorities’ economic program for 2007 aims to keep inflation in single digits by restraining government demand pressures, and limiting

foreign exchange market interventions in the face of inflows, thereby allowing more exchange rate flexibility. Going forward, the government should be ready to tighten fiscal and monetary policies beyond levels now envisaged, if inflationary pressures pick up.

Strong and sustained implementation of the authorities' reform policies this year should further protect Georgia's economy from external shocks and maintain its attractiveness to investors," Mr. Kato said.

Statement by IMF Staff Representative
February 28, 2007

1. The following information has become available since the issuance of the staff report. These developments do not change the thrust of the staff appraisal.
2. After falling into single digits at end-2006, 12-month CPI inflation increased to 10.4 percent in January 2007 (reflects 2.7 percent monthly inflation), due to increases in administered prices of water and health services, and continued price pressures in the food market.
3. Reserve money growth accelerated to 25 percent as of end-January, reflecting a slowdown in the placement of NBG certificates. As credit growth also slowed, excess liquidity increased sharply. Despite large official foreign exchange purchases during February, reserve money has been declining in recent weeks due to higher NBG certificate placements and a relatively tight fiscal stance.
4. The authorities regard the rise in the CPI in January as disappointing, but are not surprised given the higher tariffs for water and health services. Preliminary indications are that price pressures have subsided in February. The authorities remain confident that they will meet the end-March monetary targets. They are mindful of the build-up in excess liquidity that has the potential for a sudden credit expansion, but are prepared to counter that development, if necessary. Continued revenue over-performance (revenues in January reached 46 percent of the Q1 target) in February and March should also reduce inflationary pressures.

**Statement by Yuriy Yakusha, Alternate Executive Director for Georgia
and Thomas Rookmaaker, Advisor to Executive Director
February 28, 2007**

Background

During the latter half of 2006, Georgia successfully passed a test on its economic strength. Despite the difficult external environment in the context of the Russian sanctions imposed on Georgia last spring, the performance of the Georgian economy has been strong in many ways. The broad-based GDP growth is estimated at 9 percent for 2006, while at the time of the Third PRGF Review last March, growth was still projected at 6.4 percent. Georgia has successfully diversified its exports within a short period of time. Looking forward, GDP growth is expected to remain relatively high in light of a strong improvement in the business climate over the past couple of years. FDI is expected to increase sharply in 2007. The authorities are strongly committed to further improve the business climate. Structural reforms include pension sector reform, strengthening of statistics, healthcare reform and further liberalization of the trade regime. While Georgia already has one of the most open trade regimes in the world, the authorities have the intention to move to a zero trade tariff in the foreseen future. After the Doing Business Report proclaimed last year that Georgia was the number one reformer and took the 37th position in its business environment ranking, recently the Heritage Foundation stated that in its survey of 157 countries, Georgia takes the 35th place when it comes to economic freedom.

Monetary policy and the external sector

Inflation pressures remain an important economic challenge, requiring a continuation of prudent fiscal and monetary policies. The spike in inflation last July – which was a result of higher gas prices, exogenous shocks and excess liquidity given a higher than expected money multiplier growth – was brought back to 8.8 percent at end-2006. The overall fiscal deficit was brought down and reserve money growth was slowed. In August, the NBG increased the reserve requirements for lari denominated liabilities from 0 to 4 percent, and started aggressively auctioning certificates of deposits (CDs), a new instrument used by the NBG, and withdrew liquidity throughout the month of December (not only during the last few days of December, as stated in the staff paper). Moreover, the NBG successfully launched its open market operations with securitized government bonds in November and sold in full its relatively modest stock of government paper. As a result, at end-December the NBG had withdrawn liquidity equivalent to 27 percent of reserve money. As inflation slightly rose again in January – mainly attributable to higher prices for vegetables and doubling of potable water tariffs – the authorities believe in the one-off nature of this spike and reiterate their commitment to keeping inflation low by further tightening monetary policy throughout the entire year. For 2007, the target will be to reduce inflation to 6 percent or less.

The authorities are committed to a flexible exchange rate, while, at the same time, avoiding excessive exchange rate volatility. Interventions by the NBG in the foreign

exchange market in December were needed to avoid unstable exchange rate developments as a result of short-term inflows related to an IPO on the London Stock Exchange of the Bank of Georgia, the largest commercial bank in the country, and large-scale privatization inflows.

Fiscal policy

The preliminary fiscal deficit of 2.9 percent of GDP for 2006 was somewhat above program targets. This figure may change depending on the final data for GDP. Also in light of potential inflationary pressures, the authorities recognize the need for prudent fiscal policy. Hence, a decline in the fiscal deficit to 2.4 percent of GDP is planned for 2007. In the past the authorities have proved to be able to generate higher than expected tax revenues. They plan to use income from privatization above programmed levels to reduce domestic budget financing.

Tax administration reform is currently well underway. The tax and customs departments have been merged with the financial police in an effort to improve both efficiency and the service to tax payers, while at the same time, contribute to the fight against corruption and smuggling. Furthermore, the Medium-Term Expenditure Framework will be strengthened further. As indicated in the MEFP, line ministries will need to make use of performance indicators.

The authorities are fully committed to clear the stock of verified arrears as soon as possible. It proved impossible to clear all arrears so far, since verifying the claims turned out more difficult than expected. In verifying and clearing arrears, priority will be given to those payments that will be most beneficial to low-income groups.

The financial sector

One of the authorities' priorities is the development of a sound, modern financial system. The NBG has developed a comprehensive financial sector strategy with the aim to enhance financial intermediation, strengthen confidence in the banking sector and improve banking supervision. As part of this strategy, the IFRS standard has been introduced for banks and improvements have taken place with respect to the methodology of bank's internal control, capital investments and risk assessments. Moreover, the NBG's crisis management strategy is gradually being improved. To stimulate consolidation in the financial sector, absolute minimum capital requirements for banks have been raised and by July 1, 2007 all banks will have to hold a minimum capital of GEL 12 million. Those banks that turn out not to be able to comply will be closed or merged. Clearly, the NBG does not have the intention to use its resources to subsidize the resolution of insolvent banks. Furthermore, the NBG launched the publication of annual financial stability reports last October.

The government is currently preparing a financial sector reform package, which has the intention to make Georgia more attractive for foreign banks. Some recent developments indicate significant steps forward in the process of opening up Georgia's financial sector. In

September, Société Générale acquired a 60 percent share in Bank Republic, while the EBRD acquired a 10 percent share. In addition to the above mentioned IPO on the London Stock Exchange, Bank of Georgia earlier this month offered its first eurobonds.

The authorities attach great value to the FSAP Update exercise, of which the mission visited Tbilisi one year ago, and they are currently in the process of following up on the recommendations. The FSSA states that the financial system is generally sound, although a few institutions remain relatively weak. In fact, stress tests pointed to weaknesses in only one institution, which is under closely scrutiny by the NBG. The FSSA shows that the performance of banks and the resilience of the system as a whole have improved in recent years, as illustrated by a decline in nonperforming loans. Both on-site and off-site supervision has been strengthened by training of staff and new regulations, while the authorities recognize that consolidated supervision needs to be improved further. Strengthening consolidated supervision is part of NBG's financial sector development strategy.

The authorities recognize the importance of appropriate fit and proper regulations and AML/CFT legislation. The fit and proper draft legislation has been amended following comments made by staff and will now be considered by Parliament together with the above mentioned proposed financial sector reform legislation that is expected to be sent to Parliament next month. To further strengthen AML/CFT legislation, amendments will include enlargements of the monitoring scope and enhancements in identification procedures.

Poverty reduction

Poverty reduction remains a key priority. Since last September, some 112,000 families receive well-targeted financial assistance from the state. Basic health insurance is now provided to some 870,000 families with free consultation and essential medical treatment. Last month, about 60,000 citizens of Tbilisi have received special debit cards, which can be used for, e.g., 50 percent discounts on public transportation and utilities.

Statistics

Notwithstanding resource constraints, the authorities are determined to improve statistics. To this end, Georgia started participating in the GDDS last December and has set the goal to participate in the SDDS as soon as this year. The recent TA missions on statistics related to the balance of payments and government finance proved very useful. The NBG's new balance of payments division has been fully operational since January 1. Moreover, the operations and autonomy of the agency producing official statistics will be enhanced (benchmark for end-March 2007).

Finally, we wish to convey the authorities' deepest appreciation for the mission team's policy advice and dedication. The authorities have greatly benefited from staff's advice and continue to enjoy a very fruitful relationship with the Fund.