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Georgia and the IMF

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July 31, 2014

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Georgia: Letter of Intent and Technical Memorandum of Understanding

July 15, 2014

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

Appendix I. Letter of Intent

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

Tbilisi, July 15, 2014

Dear Madam Lagarde:

1. **We, the Georgian government and the National Bank of Georgia, are committed to promoting sustainable and inclusive growth, reducing macroeconomic imbalances and strengthening the resilience of our economy**. Our goal is to build a dynamic and efficient economy that supports improvements in the standard of living for the whole population. We have developed our own Socio-Economic Strategy—Georgia 2020—which has detailed policies to promote macroeconomic stability, generate a more effective public administration, strengthen private sector competitiveness, improve access to finance, and strengthen human capital. We are committed to implementing Georgia 2020 so as to achieve our goals.

2. **We are strengthening our economy and building more robust institutions for economic policy making, and are counting on IMF support to help us achieve these goals.** Our government was elected with a mandate to strengthen the protection of the poor and to expand our social safety net. In our first year of office, we kept this promise, while containing the overall level of expenditure and maintaining moderate levels of government debt. External imbalances have been reduced, albeit from a high starting point. We have remained committed to central bank independence and we have established an Economic Council, chaired by the Prime Minister, to improve the coordination of economic policy. The National Bank remains committed to low and stable inflation and to exchange rate flexibility.

3. **Despite these achievements, we are beginning to face new and difficult challenges.** In some of our main trading partners—most prominently Ukraine and Russia—uncertainty is increasing and the economic outlook is deteriorating. Although there are few signs of a domestic slowdown as of now, the outlook for exports, inward investment, and growth has become less predictable, and downside risks have increased due to the external environment. This has put us in a situation where we have to make a trade-off between stabilizing demand in the short run and reducing structural imbalances in the medium-run. While we are forced to accept that there are limits to what we can do in the very near term, we remain firmly committed to low fiscal deficits, a moderate level of public debt and a healthy external account.

4. **Our approach to these challenges will be to take a multi-year perspective, clarify our policies and make public our commitments for the coming years**. In line with this, we will:

- keep the fiscal deficit to 3.7 percent of GDP in 2014, and initiate a medium-term fiscal consolidation with substantial part of the deficit reduction in 2015, primarily based on containing current spending, supported by specific revenue measures;
- control and monitor fiscal risks, including by limiting public guarantees and other contingent liabilities, and improving the disclosure of fiscal risks in the budget;
- continue to modernize our revenue administration, including by phasing out the system of alternative audit, and introducing tax payers' accounts;
- widen the coverage of the Treasury Single Account to include all budget entities and large LEPLs;
- in response to increasing external uncertainties we will further build up fiscal and foreign reserve buffers. The IMF program will be instrumental in providing an efficient response to external shocks;
- remain committed to a floating exchange rate and pursue policies that reduce dollarization;
- strengthen our inflation targeting regime, including by improving inflation modeling and enhancing the NBG's communication strategy;
- improve national accounts statistics by introducing quarterly real national accounts from the demand side, and making business reporting to GEOSTAT compulsory; and
- introduce structural reforms to promote growth and competitiveness.

5. On the basis of these polices, and to signal our continued commitment to macroeconomic stability, we request that the IMF supports this multi-year program under a Stand-By Arrangement (SBA) for a period of 36 months in the amount of SDR 100 million (67 percent of quota). Faced with a deterioration in the external environment, we request that the IMF provides support for our balance of payments need in the amount of SDR 80 million in 2014, to allow us to maintain reserves above 3 months of imports. Of this amount, we request that SDR 40 million is made available upon the approval of the program, another SDR 40 million upon completion of the first review, and that these are provided to the budget to help avoid a draw-down of government deposits that would otherwise put additional pressures on international reserves.

6. While we do not project a significant balance of payments need as of the start of 2015, we recognize that uncertainties remain large and also see intrinsic value in remaining engaged through a Fund-supported program. We expect that the external environment will stabilize, and that we will be able to maintain adequate reserves with only minimal disbursements under the program from 2015 onwards. However, we will continue to monitor the situation carefully, and will discuss with the IMF the appropriate policy response should the external environment worsen and our balance of payments need persist. We also believe that remaining engaged with the IMF strengthens our policies and provides valuable assurances to investors and financial markets in these uncertain times, and so has value in its own right.

7. We believe that the policies set forth in this Letter will achieve the objectives of our economic program. We will monitor progress continuously in consultation with the IMF, and we stand ready to take further measures if needed to reach our objectives. We will continue to consult with the IMF on the adoption of measures, and in advance of any revisions to policies included in this Letter of Intent in accordance with the Fund's policies on such consultation. We will also provide the IMF with information it requests for monitoring program implementation. We authorize the IMF to publish this Letter of Intent and its attachments (including the Technical Memorandum of Understanding (TMU)), as well as the related Staff Report.

A. Macroeconomic Framework

8. The economy has started to recover, and the benefits of this recovery are being shared more widely. Since mid-2013, there have been many encouraging signs of economic recovery: GDP has been growing consistently, inflation has moved more closely in line with the NBG's target, and private sector credit has been growing. In 2013, we increased spending on targeted social assistance from 1 to 1.8 percent of GDP, raised pensions from GEL 110 to 150 per month, and introduced universal health insurance, to make sure that the benefits of economic growth are shared more widely.

9. However, the more difficult external environment poses challenges to our economy. The combination of the slow-down in Russia and the crisis in Ukraine poses risks for the Georgian economy. While it is too early to assess to what extent the economic downturn in these countries will spill over to Georgia, we will continue to monitor developments closely. Should the external environment worsen, we stand ready to respond by revising our policies to preserve our balance of payments, including tightening monetary and fiscal policy, and allowing depreciation to maintain trade competitiveness. We estimate that the potential growth rate of our economy is above 6 percent, but given uncertainties we base policies conservatively by assuming a 5 percent growth rate for 2015.

10. We remain committed to reducing our foreign debt through lowering the current account deficit, but recent developments have made this goal more challenging. Following the sharp recession-induced contraction of the current account deficit in 2013, we projected that it would widen moderately in 2014. Faced by lower export demand and reduced remittances from Russia, we now project that the current account deficit will reach 8.5 percent of GDP in 2014. It will then fall in response to fiscal consolidation, exchange rate flexibility and reforms to improve export competitiveness, which we have committed to as part of the EU-Georgia Association Agreement (including the Deep and Comprehensive Free Trade Area (DCFTA) agreement). Our objective is to stabilize net foreign liabilities at prudent levels. In line with this, we aim for a current account deficit of 6–7 percent of GDP during the program period, and around 5 percent of GDP in the longer term, taking into account the need to maintain rapid growth.

11. The main challenge we face is to mitigate the impact of this worsening external environment while sticking to our medium-term policy objectives. Faced by the threat of lower growth in exports and remittances, and weaker FDI, in the short-term our policies will focus on maintaining trade competitiveness and avoiding a sharp drop in domestic demand. This calls for exchange rate flexibility and allowing the automatic stabilizers to work. However, we will balance these objectives with our aim of strengthening macroeconomic fundamentals by reducing fiscal and external vulnerabilities, and to reduce the underlying budget deficit so as to give more room for countercyclical fiscal policy. The remaining sections of this Letter describe the policies we will implement to overcome this challenge and to achieve our goals.

B. Fiscal Policy

12. For the medium-term, we remain committed to reducing the general government fiscal deficit to a prudent level of no more than 2.5 percent of GDP. This is consistent with our goal of keeping public debt comfortably below 40 percent of GDP, to build room for countercyclical policies, and to increase savings and so reduce our trade deficit. While we are setting ambitious goals for ourselves for improving the welfare of the Georgian people, we also understand the need to preserve fiscal sustainability.

13. In 2014, we will ensure that the general government deficit does not exceed an equivalent of 3.7 percent of GDP. Since approving the budget, uncertainties have increased. To maintain sufficient buffers, we will keep the budget deficit to no more than GEL 1,080 million, which is equivalent to 3.7 percent of GDP (performance criteria December 2014). We will do this by:

- introducing VAT payments on imports at the border, as opposed to granting a one month grace period (GEL 60 million, 0.2 percent of GDP); and
- lowering capital spending (GEL 25 million, 0.1 percent of GDP).

To avoid procyclical policies in the case the recovery should be stronger than our projection, total general government expenditure will not exceed Lari 9,012 million (performance criteria December 2014), consistent with the level set in the initial 2014 budget. While remaining committed to our annual fiscal targets, we recognize the importance of keeping a smooth deficit profile throughout the year as not to put destabilizing pressures on the economy. Our aim is to keep actual quarterly spending close to the schedule agreed with the IMF to avoid a large part of the annual deficit occurring in the final quarter.

14. We will reduce the 2015 general government deficit to no more than 3.0 percent of GDP. To do this, we will take the following measures:

- We will increase the excise on cigarettes to generate GEL 65 million (0.2 percent of GDP) in 2015. We will submit a draft law to parliament in October, and the increase will take effect from January 2015.

- While we remain committed to our agenda of supporting vulnerable groups—evidenced by the overall growth of social expenditure in 2014 of well over 20 percent—in 2015 we will keep social benefits constant in nominal or real terms, depending on the category of benefit. This measure will contain social expenditure at GEL 2,840 million, improving the balance in 2015 by 0.7 percent of GDP compared to 2014.

- We will keep spending on goods and services to no more than 1,130 million, which is consistent with keeping it constant in real terms between 2014 and 2015. This will improve the balance by 0.2 percent of GDP.

- We will keep spending on wages and salaries constant in real terms between 2014 and 2015 at no more than 1,570 million, which will improve the balance by 0.2 percent of GDP.

- We will grant only moderate increases in subsidies and other expenditure categories, which together will improve the balance by close to 0.3 percent of GDP.

- In line with our policy to improve public infrastructure, we are also planning an increase of capital expenditure in 2015 of around GEL 400 (0.7 percent of GDP compared to 2014). There is also a need to allow for a slight increase in interest expenditure of around GEL 60 million (0.2 percent of GDP) and of net lending of around GEL 30 million (0.1 percent of GDP).

Together these measures will reduce the general government deficit to no more than 3.0 percent of GDP in 2015. We will discuss the draft 2015 budget closely with the Fund. Agreement with the Fund on a budget that includes these measures and that targets a 3.0 percent deficit for 2015 will be a structural benchmark for end-December 2014.

We will request follow-up technical assistance from the Fiscal Affairs Department (FAD) on tax policy. A recent FAD mission report has identified several potential measures (e.g. in the areas of mining, thin capitalization, taxation of immovable property and personal income tax) that could mobilize revenue while at the same time enhance equality. In consultation with the IMF, we will explore these areas for their fiscal, economic and social effects, taking into account tax administration challenges. Our objective is to raise more revenue, while improving the efficiency of the tax system and making it more equitable.

15. To keep government debt sustainable, we will seek a more balanced composition between external and domestic debt, and we do not plan to issue any public guarantees. While much of the government's external debt is long-term and concessional from IFIs, we aim to gradually lower the share of foreign currency denominated debt as the share of market-based debt increases. We recognize that public guarantees create contingent liabilities, and currently we do not have any plans to issue guarantees. However, if we were to reconsider these plans, we will consult with the IMF and WB, and we will include such guarantees in our fiscal risk statement attached to the annual budget.

16. We are considering ways to ease the access to finance problem which is an impediment to Georgia's development. Business surveys identify a lack of access to finance and equity, especially among SMEs and start-ups, among the top problems facing businesses. While we are strongly committed to removing market imperfections that impede access to finance (e.g., lack of collateral, enforcement of property rights) and to developing domestic capital markets, these reforms will take time. For that reason, we are considering establishing a financial vehicle that could facilitate private investment and improve access to finance. We are fully aware of the potential risks, and therefore we will ensure that this institution does not distort the markets, does not compete with commercial banks, does not pose undue fiscal risks, operates in line with good transparency and governance practices, and that its objectives have a sound economic foundation. We will conduct an assessment of the access to finance (structural benchmark, September 2014) and will consult with the IMF and other development partners regarding the mandate, policy instruments, structure, as well as operational and financial setting of the institution before introducing legislation for its operations.

17. The Partnership Fund will continue to operate according to its mandate of using minority co-financing to catalyze commercially viable projects with developmental objectives. As under the previous program, Partnership Fund financing (debt plus equity plus guarantees) will not be allowed to exceed 100 percent of the equity of the private partner in the project. The PF will continue to pursue only commercial objectives. In line with the earlier commitments the Partnership Fund will not run a cash deficit (performance criterion, December 2014).

C. Monetary and Financial Sector Policies

18. We remain committed to price stability and exchange rate flexibility. Maintaining monetary and financial stability requires independence of monetary policy-making. Consistent with the NBG's organic law and the Constitution of Georgia, we reaffirm the existing strong institutional and financial independence of the NBG, and also continue to recognize the importance of consistency of policies between the NBG and the government.

19. We will refine our inflation targeting framework by further customizing our modeling to Georgia's conditions and by strengthening our communication strategy. Starting in 2015, the inflation target is reduced from 6 to 5 percent. Monetary policy in 2014 will take into account the transitioning to the new inflation target. We expect inflation to reach 5 percent by the year's end, close to our target. We are keen to further enhance our monetary tools to strengthen the transmission channel. We have requested technical assistance from the IMF to improve inflation modeling and to refine our communication strategy. We are committed to regular publication each quarter of our inflation report, with associated press conferences, on a fixed pre-announced schedule. To signal our commitment to the inflation targeting regime, we are including an inflation consultation clause in the SBA, with central (bi-annual) targets consistent with inflation targets of 5 percent. There will be dual consultation bands around these targets. Should actual inflation be higher or lower than the inner consultation band of +/- 2 percent, the NBG will consult with IMF staff on the reasons for the deviation and the policies to return to target. Should actual inflation be higher or lower than the outer consultation band of +/- 3 percent, a consultation with the IMF Board will be triggered. However, in the transition period to firmly establishing the inflation consultation clause, we will continue to monitor NDA (indicative target).

20. Provided that market conditions allow, we will continue to purchase foreign exchange to boost our net international reserves. Our objective is to maintain reserves comfortably above 3 months of imports. Under the Fund-supported program, we project reserves to remain at around US$2.7 billion at the end of 2014. We will achieve this goal, despite making US$257 million in repayments this year from earlier programs to the IMF. With these repayments rapidly diminishing, and with the current account declining and FDI increasing, we expect to increase reserves to US$3.0 billion in 2015—equivalent to 3.1 months of 2016 imports. To achieve this objective, while remaining consistent with our floating exchange rate regime, the NBG is planning to purchase foreign currency during 2014. However, purchases will only be made to the extent that they do not add to already existing depreciation pressures.

21. We will continue our efforts to reduce dollarization, and will implement policies that encourage the use of the Lari in the financial system. While both loan and deposit dollarization is gradually being reduced, at around 60 percent it is still too high, and there is still scope to increase the use of Lari in the financial system. Our existing policies include additional risk weighting for FX loans to unhedged borrowers, higher reserve requirements for FX liabilities and overall higher negative liquidity carry for FX liabilities. To promote long-term Lari lending, we are placing long-term government deposits with commercial banks.

22. We will continue our policies to strengthen the banking system. We believe that the banking system is relatively robust, with a capital adequacy ratio (NBG definition) for banks at 18 percent (26 percent under Basel I definition). The NPL ratio calculated according to NBG methodology has decreased to 7 percent (3 percent according to the standard 90-day overdue definition). Last year we introduced an additional liquidity requirement for large non-resident deposits and their share has stabilized at 15 percent of total deposits.

23. We appreciate the IMF-World Bank FSAP mission that visited Tbilisi in May 2014. We are discussing how to take into account the mission's assessment and recommendations into the SBA, and will likely include some of the recommendations in future program conditionality.

D. Structural Reforms

24. To achieve our goal of sustainable and inclusive growth, we are planning wide-ranging structural reforms over the coming seven years; we describe many of these in our Georgia 2020 socio-economic development strategy. Our reforms aim at addressing existing impediments to equitable growth in Georgia by promoting private sector competitiveness, strengthening human capital and improving access to finance. We are counting on the support of our development partners in implementing our structural reform agenda, including from the World Bank in the context of the Country Partnership Strategy 2014–17, the Asian Development Bank under the Country Operations Business Plan 2014–16, and the European Commission in the context of the EU-Georgia Association Agreement. We also want to continue working with the IMF to implement reforms in the areas of tax administration, public financial management and national accounts statistics.

25. As part of our Georgia 2020 strategy, we are taking the following steps to reduce poverty and inequality.

- We will improve access to education, update the infrastructure of schools and develop professional education (VET) with the objective of diminishing job mismatch. We will develop vocational education according to labor market needs, aiming at increasing the competitiveness of our workforce; strengthening public private partnership in order to improve the quality of VET system and deliver vocational education training tailored to needs.

- We will continue targeted assistance of municipalities according to their priorities and needs for upgrading infrastructure, including local roads, water supply, and irrigation.

- We will streamline the administration of targeted social assistance and also ensure that the basic package of the current universal health coverage is sustained.

26. As outlined in Georgia 2020, we will strengthen tax administration to improve the quality of taxpayer services and to secure full compliance by taxpayers with their obligations. We intend to enhance our co-operation with the IMF's Fiscal Affairs Department (FAD), and aim to modernize tax administration through the following main steps:

- **We will strengthen our tax audit capacity and increase attention to core filing and payment obligations.** Improving the level and quality of tax audit will lead to increased revenue from current non-compliers, increasing confidence and compliance by honest taxpayers and lowering overall risk in the tax system. Significantly increasing audit resources inside the GRS and phasing out the privatized component of audit (alternative audit)—while still allowing the GRS to procure specialized audit competence in specific cases—will lower risks to the tax system. We plan to increase the GRS audit staffing level significantly (from 230 today to 350 during 2015), paying attention to staff training, and will eliminate alternative audit by April 2015 (structural benchmark).

- **In 2015, we will introduce single tax payers' accounts to better manage the distribution of tax payments between different tax categories and improve the accuracy of tax payment data.** We are working towards reforming the basis for tax payments monitoring, shifting from payments data to the information in tax returns. This development will improve accuracy and facilitate a more rapid and accurate distribution of taxes, including between central and local government taxes. In line with this, we will introduce single tax payers' accounts in the first half of 2015 (structural benchmark June 2015).

- **Finally, we are also committed to reducing the stock of excess tax credits and avoiding the build-up of overdue refunds.** We continue to view timely tax refunds as an important aspect of a good business environment, and we aim at eliminating any overdue refunds. Auditing the firms with overpaid taxes will be performed based on streamlined risk based methodology. We will introduce pre-release, risk-based auditing of refund requests.

27. We believe that comprehensive, accurate and transparent management of public finances is crucial for fiscal stability, and we will continue public financial management reforms. We are committed to developing our framework for assessing and disclosing fiscal risks under various macroeconomic scenarios by including in the 2015 budget a fiscal risk statement, supported by FAD (structural benchmark (December 2014)). We will also continue to broaden the coverage of our fiscal accounts, consolidating LEPLs in the 2014 government financial statements (structural benchmark, June 2015). The fiscal rules limiting the deficit to 3 percent of GDP, gross public debt to 60 percent of GDP and expenditure to 30 percent of GDP is a cornerstone of our fiscal policy framework. We intend to make it more transparent and to increase accountability. We will consult with the IMF on the best practices of fiscal rules.

28. We will improve fiscal transparency and cash management by including more government entities in the treasury system. Starting in 2015, all central and local budget units will be executed by the Treasury, and all their cash inflows and outflows will be integrated into the Treasury Single Account.

29. We are committed to strengthening our statistics, in part because these are a precondition for strong economic policy-making, and we will increase resources to GEOSTAT to do this. To improve the quality and coverage of statistics, we will revise the Law on Statistics by December 2014 to make it mandatory for businesses to report to GEOSTAT, and ensure appropriate application of sanctions for nonreporting, in line with IMF and United Nations recommendations. So as to improve our understanding of the labor market and the condition of workers, and to make this more timely, we will provide new resources so that GEOSTAT will be able to publish quarterly labor force statistics (including rural-urban and regional unemployment rates). This will bring us into line with international standards. Building on technical assistance from the IMF's Statistics Department (STA), we aim to publish GDP by expenditure in constant prices (structural benchmark, December 2015).

30. Parliament recently passed a law placing Georgia's Financial Monitoring Service (FMS) under the Prime Minister. We remain committed to preserving the strong operational independence of the FMS and protecting the confidentiality and integrity of banking data to which the FMS has privileged access, including not sharing records with other government entities. The Government will request a consultation with MONEYVAL and the Egmont Group. If need be, we will submit an amended law to Parliament to reflect the recommendations of MONEYVAL and the Egmont Groups together with the IMF's comments. The FMS will continue to honor its bilateral obligations with financial monitoring units in other countries. The Government will continue to strictly enforce AML/CFT regulations and will widen AML/CFT oversight of new activities, such as gambling and leasing.

31. To support sustainable growth and to improve the trade balance, we are launching a wide range of structural reforms:

- Our government will take a unified approach to the support it provides underdeveloped sectors of the economy. To this end, we will work with the World Bank to review the performance of the largest funds and to prepare an action plan for their future operation, including possible consolidation, by September 2014.

- We are taking steps to further streamline the business environment, with a focus on small and medium-sized enterprises (SMEs). With this objective, we have recently established the Entrepreneurship Development Agency (EDA), which will start full-scale operations in the second half of 2014. EDA will, among other things, provide training to entrepreneurs and start-ups, and support export promotion and SMEs' adaptation to DCFTA requirements. By the end of 2015, we will elaborate an SME development strategy.

- In line with our commitments under the EU-Georgia DCFTA, we are strengthening the legislative and institutional framework in the food safety area. We amended the Code on Food/Feed Safety, Veterinary and Plant Protection, and we are continuing to strengthen the National Food Agency. Also, by the end of 2015, we will elaborate a list of EU sanitary and phytosanitary, animal welfare and other legislative measures to be approximated by Georgia under the EU-Georgia DCFTA.

- According to the EU-Georgia DCFTA, we will continue the development of a national system of quality infrastructure. In order to bring the Georgian national market surveillance system in line with best practice in the EU, we will elaborate a market surveillance action plan in accordance to relevant gap analysis and needs assessment by the end of 2015. The gap analysis and needs assessment will be carried out during 2015.

- In order to improve labor market matching we will streamline communication systems between employers and jobseekers through online web-portals, where the registration of jobseekers is free. By the end of 2014, the module of the employer's registration will be added to the web-portal. In addition, in 2014 a System of Labour Mediation will be formed, which will support the effective resolution of labor disputes.

E. Program Monitoring and Safeguards

32. We recognize the importance of completing an updated safeguards assessment of the NBG by the first review under the SBA arrangement. We are approving a memorandum of understanding between the Ministry of Finance and the NBG to clarify responsibilities related to the financial obligations associated with IMF resources for budget support.

33. Our program will be monitored through quantitative performance criteria (PC), indicative targets (IT), structural benchmarks (SB), and an inflation consultation clause set out in Tables 1 and 2 and described in the attached Technical Memorandum of

Understanding (TMU). We ask that reviews are conducted based on end-September and end-December 2014 test dates and semi-annually thereafter based on end-June and end-December test dates. The first and second reviews will be expected to take place after November 15, 2014 and February 15, 2015, respectively.

Very truly yours,

/s/
Irakli Garibashvili
Prime Minister of Georgia

/s/
Giorgi Kvirikashvili
Deputy Prime Minister of Georgia

/s/
Nodar Khaduri
Minister of Finance of Georgia

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

Table 1. Georgia: Inflation Consultation Targets and Bands for 2014

	End September	End December
Inflation Consultation Bands for CPI (in percent)		
Central point	5	5
Inner band, upper limit/lower limit	7/3	7/3
Outer band, upper limit/lower limit	8/2	8/2

Table 2. Georgia: Quantitative Performance Criteria and Indicative Targets for 2014

	End September	End December
Performance Criteria		
Ceiling on the General Government cash deficit (in mn lari)	810	1,080
In Percent of GDP	*2.8*	*3.7*
Ceiling on Expenditures of the General Government	-	9,012
Floor on NIR of NBG (End-period stock, in mn USD)	1,510	1,520
Ceiling on the accumulation of external arrears of the General Government (continuous criterion) (in mn USD)	0	0
Ceiling on the cash deficit of the Partnership Fund (in mn lari)	0	0
Indicative Targets		
Ceiling on NDA of NBG (End-period stock, in mnl lari)	450	600

Table 3. Georgia: Proposed Structural Benchmarks

Measure	Date
Financial Sector	
With the support of the World Bank, conduct a thorough assessment of the presence, nature and remedies for credit market imperfections	End-Sep 2014
Fiscal	
Include in the 2015 state budget a statement of fiscal risks	End-Dec 2014
Approve the budget for 2015 with 3 percent of GDP deficit	End-Dec 2014
Abolish the alternative tax audit program	End-April 2015
Introduce a single taxpayer account system in the General Revenue Service	End-June 2015
Consolidate LEPLs[1] in the 2014 government financial statements	End-June 2015
Statistics	
Publish GDP by expenditure in constant prices	End-Dec 2015

[1]LEPL: Legal Entities of Public Law. They are semi-autonomous government agencies receiving partial financing from the budget.

Attachment I. Technical Memorandum of Understanding (TMU)

1. This memorandum sets out the understandings between the Georgian authorities and the IMF staff regarding the definitions of quantitative performance criteria and indicative targets, as well as respective reporting requirements used to monitor developments under the Stand-By Arrangement. To this effect, the authorities will provide the necessary data to the IMF as soon as it becomes available.

2. Inflation consultation targets and bands, performance criteria and indicative targets are listed in Tables 1 and 2 attached to the Letter of Intent dated July 15, 2014. The Georgian Lari to U.S. Dollar exchange rate is assumed to be GEL 1.75 = $1 for the purpose of the program. Table 1 below includes the corresponding cross exchange rates.

Table 1. Program Exchange Rates

	Currency Name	**Currency/US$**
SDR	Special Drawing Rights	0.65
GEL	Georgian Lari	1.75
EUR	Euro	0.73

A. General government and the public sector

3. **Definition:** The general government is defined as the central government and local governments, excluding Legal Entities of Public Law. The definition of the general government includes any new funds, or other special budgetary or extra-budgetary entities that may be created during the program period to carry out operations of a fiscal nature as defined in the IMF's Manual on Government Finance Statistics 2001. The authorities will inform IMF staff on the creation of any such entities without delay. The general government does not include State-Owned Enterprises and the Partnership Fund. The public sector consists of the general government, Legal Entities of Public Law and public financial and non-financial corporations, including the National Bank of Georgia.

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 within two weeks of the end of each month and monthly expenditures and arrears of the central government within four weeks of the end of each month. The Ministry of Finance will provide the stock of general government debt, broken down by currency and original maturity within one month from the end of each quarter. The Treasury will provide, on a daily basis, the cash balances in all the accounts of the general government as of the end of the previous business day.

B. Quantitative performance criteria, indicative targets and continuous performance criteria: definitions and reporting standards

Quantitative Performance Criteria and Indicative Targets

5. The quantitative performance criteria and indicative targets specified in Tables 2 attached to the Letter of Intent are:

- a performance criterion (ceiling) on the cash deficit of the general government;
- a performance criterion (ceiling) on the expenditures of the general government;
- a performance criterion (floor) on the net international reserves (NIR) of the NBG;
- a continuous performance criterion (zero ceiling) on the accumulation of external arrears;
- a performance criterion (ceiling) on the cash deficit of the Partnership Fund; and
- an indicative target (ceiling) on the net domestic assets (NDA) of the NBG; and

6. Performance criteria and indicative targets have been set for end-September and end-December 2014 (the next two test dates). They are monitored on a cumulative basis from the beginning of the calendar year (with the exception of the NIR and NDA targets, which are monitored in terms of stock levels), while the continuous performance criterion is monitored on a continuous basis.

Inflation Consultation Mechanism

7. Inflation consultation bands around a central target are set for each test date under the program, and for quarterly dates in between to help assess program performance, see table 1 attached to the Letter of Intent. Inflation is identified as the 12-month percentage change of the consumer price index (CPI) as measured and published by the National Statistics Office of Georgia (Geostat). Should the observed year-on-year rate of CPI inflation fall outside the outer bands specified in Table 2 below on any one of the program's test dates, the authorities will consult with the IMF's Executive Board on the reasons for the deviation and the proposed policy response before further purchases can be requested under the SBA. The NBG will discuss with IMF staff should the observed year-on-year rate of CPI inflation fall outside of the inner bands specified for each test date in Table 2.

Table 2. Inflation Consultation Target and Bands		
	September 30, 2014	December 31, 2014
Inflation target	5.0	5.0
Inner band	±2.0	±2.0
Outer band	±3.0	±3.0

Ceiling on the Cash Deficit of the General Government

8. **Definition:** The cash deficit of the general government will be measured from the financing side at current exchange rates. Accordingly, the cash deficit is defined as the sum of: i) net domestic financing from banks and nonbanks; ii) net external financing; and iii) privatization receipts.

9. Net domestic bank and nonbank financing is defined as:

a. Net lending (borrowing net of repayments) provided by commercial banks to the general government, including securities (for example T-Bills), plus the use of deposits held by the general government in commercial banks. Monitoring of net lending and the use of government deposits will be based on the NBG's monetary survey and Treasury data. The change in local governments' cash balances in commercial banks for budget financing purposes will be monitored based on the 'budget of territorial unit' account data provided by the Treasury Department.

b. Net lending (borrowing net of repayments) provided by the NBG to the general government, including securities (for example T-Bills), plus the use of deposits of the general government held at the NBG. Monitoring of net lending and use of government deposits will be based on the central bank survey and treasury data. The change in cash balances of the general government at the NBG for budget financing purposes will be monitored based on the 'State Budget's Treasury Single Account (TSA)', 'Revenue Reserve Account' data provided by the Treasury Department and 'Accounts of Territorial Units' provided by the Treasury Department. From 2015, the balance of local government accounts will be monitored using the NBG's monetary survey.

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

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

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

12. Supporting Material:

a. Data on domestic bank and nonbank financing will be provided to the IMF by the NBG and the Treasury Department of the Ministry of Finance within four weeks after the end of each month.

b. Data on external project financing as well as other external borrowing will be provided to the IMF monthly by the Ministry of Finance (specifying projects by creditor) within two weeks of the end of each month.

c. Data will be provided at actual exchange rates.

d. Data on privatization receipts of the general government 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.

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

Ceiling on the Expenditures of the General Government

13. Definition: Expenditures of the general government comprise all current and capital expenditures as well as net lending according to GFSM 1986: i) current expenditures comprise compensation of employees, purchase of goods and services, subsidies, grants, social expenditures, other expenditures, other accounts payables, and domestic and external interest payments; ii) capital expenditure includes projects financed by foreign loans and grants as well as domestically financed capital expenditure; and iii) net lending is defined as lending minus repayments to the general government.

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

Ceiling on the Cash Deficit of the Partnership Fund

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

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

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

18. Supporting Material: The Ministry of Finance will provide to the IMF detailed information on the Partnership Fund's quarterly revenue, expenditure and financial operations within four weeks of the end of each quarter.

Floor on the Net International Reserves of the NBG

19. Definition: Net international reserves (NIR) of the NBG in U.S. dollars are defined as foreign assets of the NBG minus the sum of foreign liabilities of the NBG, including all of Georgia's liabilities to the IMF. Foreign assets of the NBG include gold, gross foreign exchange reserves, Georgia's SDR holdings, and the reserve position in the IMF. Gross foreign exchange reserves of the NBG are defined as liquid, convertible currency claims of the NBG on nonresidents, including cash holdings of foreign exchange that are readily available. Pledged or otherwise encumbered assets, including (but not limited to) assets used as collateral (or guarantee for third party external liabilities) are excluded from foreign assets. Foreign liabilities of the NBG shall be defined as the sum of Georgia's outstanding liabilities to the IMF (at face value), Georgia's SDR allocation, and any other liabilities of the NBG (including foreign currency deposits of financial institutions at the NBG and currency swaps and foreign exchange forward contracts with financial institutions), excluding the foreign exchange balances in the government's account with the NBG. For program monitoring purposes, the stock of foreign assets and foreign liabilities of the NBG shall be valued at program exchange rates as described in paragraph 2 above. The stock of NIR amounted to US$1,452 million as of March 31, 2014 (at program exchange rates).

20. Adjustors: The floor of the NIR of the NBG will be adjusted:

- Upward/downward by 50 percent for any excess/shortfall in the balance of payments support loans and balance of payment support grants relative to the projected amounts presented in Table 3.

- Upward/downward by 50 percent for any excess/shortfall in the disbursements of the project loans and project grants to the treasury single account at the NBG relative to the projected amounts presented in Table 3.

Table 3. Projected Balance of Payment Support Financing[1]

(in millions of U.S. dollars)

	Balance of payments support loans and grants	Project loans and grants
September 30, 2014	106.6	119.5
December 31, 2014	164.3	180.5

[1] Cumulative from the beginning of the calendar year.

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

Ceiling on Net Domestic Assets of the NBG

22. Definition: Net domestic assets (NDA) of the NBG are defined as the difference between reserve money and NIR as defined above in paragraph 19. Therefore, the ceiling on NDA is defined as projected reserve money minus the target NIR. Thus defined, the stock of NDA amounted to GEL -21 million on March 31, 2014.

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

- Upward/downward by 50 percent for any shortfall/excess in the balance of payments support loans and balance of payments support grants relative to the projected amounts presented in Table 3.

- Upward/downward by 50 percent for any shortfall/excess in the disbursement of the project loans and project grants to the treasury single account at the NBG relative to the projected amounts presented in Table 3.

24. Supporting material: The NBG will provide to the IMF its balance sheet, which includes data on reserve money and net domestic assets on a daily basis. Data will be provided using both actual and program exchange rates.

Continuous Performance Criterion on Accumulation of General Government External Arrears

25. Definition: External debt is defined as set forth in point No. 9 of the Executive Board Decision No. 6230-(97/140), as revised on August 31, 2009 (Decision No. 14416-(09/91).[1] External debt is defined as debt contracted by the general government with nonresidents other than the IMF.

26. Definition: External arrears are defined as unpaid external debt service by the general government to official and private creditors beyond 30 days after the due date.

27. Supporting Material. Details of external arrears accumulated on interest and principal payments to creditors will be reported to the IMF within one week from the date of the missed payment. Data will be provided using actual exchange rates.

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

Appendix to the TMU: The Partnership Fund

Organization and operational structure

A. Legal Structure

The Partnership Fund (PF) is incorporated as a Joint Stock Company (JSC). Under civil law, JSCs are profit maximizing entities, organized with value creation as their main objective.

B. Corporate Governance

The PF is organized as a commercial financial institution. Its governance structure includes:

- An investment board, currently composed of internal members (CEO, CIO, portfolio officers) and can add external members (like experts and private sector representatives), which approves business cases and initiates projects;
- A risk management committee, composed of internal members (CFO, Chief Legal Officer, and Chief Accountant), which advises on project risks to be reflected in project implementation agreements;
- A supervisory board (i.e. board of directors), which approves projects (based on the feasibility studies, risk assessments, and business cases presented by the investment board and risk committee) and approves budget for project development needs. The supervisory board includes members of the government and is chaired by the Prime Minister; and
- In cases of equity participation in projects, the PF needs government approval.

Corporate mandate and portfolio management

C. Corporate Mandate

The corporate mandate of the PF is approved by the supervisory board and the government. The PF will provide project financing through equity participations, senior loan, quasi-equity through subordinated convertible debt, and performance bonds/guarantees. Investments will focus on the following sectors: energy, agriculture, manufacturing, and real estate. Under its corporate mandate, the PF is not allowed to provide financing to the service industry. The PF will charge market rates for services provided.

D. Portfolio Management Strategy

The PF's portfolio management strategy has been developed. It sets portfolio limits, performance management objectives, and project evaluation guidelines, and will be based on the following principles:

- The PF will participate only in commercially viable projects; and
- The PF's performance will be monitored on the basis of the following evaluation criteria: IRR, APV, sharp ratio, and risk adjusted return.

E. Project Development Methodology

The PF will only participate in projects in which a corporate investor, with sufficient experience in industry, expresses its willingness to take an equity participation that represents at least 51 percent of the project's total equity. PF financing (debt plus equity plus guarantees) will not be allowed to exceed 100 percent of the equity of the private partner in the project. The PF will pursue only commercial objectives.

Reporting and Auditing

The PF will engage an internationally recognized auditing company to conduct semi-annual IFRS audits of its financial statements.

The PF will hire on a permanent basis the services of rating agencies, which will prepare regular ratings reports—there will no minimum rating requirement for the PF.

The PF's audited financial statements, as well as the ratings reports will be available on permanent basis to a broad audience.

Fiscal risks associated with the PF will be limited since:

- The PF projects don't create any kind of contingent liability for the sovereign balance sheet, as the government as no legal obligation to bail out the PF, should it become illiquid or insolvent;
- All liabilities of the PF are limited to its own balance sheet;
- The PF has its own revenue sources, namely: the dividends from its investments, the interest earnings from the loans its provides, the fees it charges on the guarantees it provides, and the proceeds of asset sales; and
- The PF may decide to borrow from credible financial institution with recourse to its balance sheet facility and without state guarantee.