International Monetary Fund

Georgia and the IMF

Press Release:
IMF Completes Second Review under Stand-By Arrangement for Georgia and Approves US$186.6 Million Disbursement
March 24, 2009

Country's Policy Intentions Documents

Georgia: Letter of Intent and Technical Memorandum of Understanding

March 10, 2009

GEORGIA: LETTER OF INTENT

March 10, 2009

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C.

Dear Mr. Strauss-Kahn:

1. In September 2008, the International Monetary Fund (IMF) approved a Stand-By Arrangement for Georgia to assist with the recovery from the economic dislocation caused by the conflict between Georgia and Russia. This support proved invaluable in the months immediately following the conflict and we are grateful to the IMF for the support.

2. This letter of intent describes our economic strategy and the economic policies that we plan to implement during the rest of 2009. In the face of the worsening global economic and financial situation we are committed to implementing policies that will help protect the stability of the external and financial sectors while containing the slowdown in economic growth. We remain, of course, fully dedicated to carrying out the commitments made in the letters of intent dated September 9 and November 28, 2008.

Recent Economic Developments

3. Economic performance during the first half of 2008 was robust with an increase in real GDP of 8.7 percent year-on-year. As in past years, this strong performance was due mainly to large private capital inflows. In the first six months of 2008, private capital inflows totaled nearly USD 1.7 billion and for the year as a whole these inflows were in the range of USD 2-2.2 billion. Despite strong growth, disciplined monetary and fiscal policies kept inflation in single digits at 9.8 percent for the 12 months ending in July.

4. The military conflict with Russia in August 2008 caused serious economic, social and political damage. The immediate economic consequence was the disruption of our transport infrastructure, which severely hindered economic activity, and a slowdown in private foreign inflows. The conflict, along with the serious deterioration of the global environment, has badly affected almost all sectors of the economy. As a result, growth in the third quarter was negative 3.9 percent and is expected to have contracted by another 1.8 percent in the fourth quarter. For the year as a whole, we expect growth was around 2 percent.

5. Not surprisingly, inflation has moderated significantly in recent months. Since spiking to 12.8 percent in August last year, it has subsided to 4.4 percent for the 12 months ending January 2009. This reflects credible monetary policy, declining commodity prices and shrinking domestic demand.

6. In the midst and aftermath of the conflict with Russia, we defended the exchange rate for the lari. This was deemed necessary in order to maintain macroeconomic stability and public confidence. In response to exchange rate pressures and reserve outflows in the context of the worsening global economy and a strengthening dollar, however, we devalued the lari by 16 percent in early November. While this measure eased pressure on the lari, it contributed to an immediate increase in the dollarization of bank deposits and an increase in the non-performing loans of banks.

7. Going forward, we are confident that Georgia's strong economic fundamentals, commitment to further economic reform, policy flexibility and strong support from the international donor community will allow us to overcome the current set of economic challenges. Nonetheless, we recognize there are substantial downside risks in the current environment and we are prepared to introduce the necessary policy changes should these risks materialize.

Macroeconomic Policies for 2009

8. Our major macroeconomic challenge continues to be the restoration of private capital inflows to support growth. The significant financial support made available to Georgia by the international community will be directed to capital expenditures necessitated by the conflict as well as spending to establish a foundation for sustained economic growth over the medium-term. These resources will help to support growth this year, but cannot be a full substitute for private sector investment. To enhance further our appeal to investors, we believe that maintaining macroeconomic stability and intensifying economic reforms must lie at the heart of our strategy moving forward.

9. Projecting economic growth in the present highly uncertain environment is difficult. The deleterious effects of the global economic crisis will likely result in economic growth this year that is less than originally projected. During the first half of 2009, the economy is anticipated to contract. For the year as a whole, however, we are cautiously optimistic that growth in 2009 will be positive, in the range of 2 to 3 percent, reflecting a modest recovery in the second half of the year. The recovery will be due to the lower base at end-2008, the fiscal impulse and a moderate level of private capital inflows. Whereas such inflows were slightly more than USD 2 billion in 2008, we project they will be in the range of USD 1.2 to 1.4 billion this year (excluding donor inflows), which should be sufficient to support projected growth.

10. Our growth projection is in contrast to the estimates of the recent IMF mission. While we value the opinion of the mission, we wish to observe that IMF growth projections have consistently underestimated actual performance in Georgia. We have a more optimistic growth projection than the IMF mission, but in the spirit of cooperation and recognizing the downside risks, we have agreed to base program targets on an annual growth rate of one percent.

11. Fiscal policies will support the economic recovery with a stimulus package that includes a moderate increase in total spending, a reduction in the rate of the profit tax, and a

shift from import-intensive defense spending to labor-intensive construction projects. Particular emphasis will be given to capital projects, which improve our medium-term competitiveness as the basis for future growth. These projects will be financed mainly from the pledges of the international community. The fiscal deficit for 2009 is projected to be less than 6 percent of GDP.

12. Our expenditures will also be oriented to protecting the most vulnerable groups in society. To this end, we increased the budget appropriations for social allowances. More importantly, we enhanced the targeting of social benefits, especially in the health and education sectors. All beneficiaries of social allowances are covered by a free health insurance scheme since January 2009.

13. Further, we are revising our fiscal legal framework in order to increase the efficiency in public finance management. For this purpose, we are developing a new budget code and will have a first draft ready and submitted to the cabinet in July of 2009 (structural benchmark for end-July). The goal of creation of a new budget code is to make a budget preparation process more inclusive, enhance the budget execution monitoring process and move to performance driven policy though improving strategic planning.

14. In 2008 we delayed law changes aiming mandatory surplus and expenditures capping due to the challenging environment. If global trend continues we will delay the policy enforcement in H2 of 2009 for 2011. However we are strongly committed to disciplined fiscal policy and a budgetary surplus together with limited public outlays remain our priority for longer term.

15. The combination of a tight monetary stance in the first half of 2008 and the current economic slowdown have significantly eased inflationary pressures. For 2009, we will continue to monitor monetary conditions closely and project growth in reserve money of 8 percent, while the growth rates of broader monetary aggregates are expected to be around 4 percent for M2 and 9 percent for M3. End-period inflation is projected to be in the range of 6–7 percent for 2009.

16. The National Bank of Georgia (NBG) will publish a liquidity framework (structural benchmark for end-March 2009) that will improve liquidity forecasting and strengthen the interest rate channel. The liquidity framework will elaborate on the link between the NBG's policy rate and the operational target. It will also include an assessment of how the Monetary Operational Framework is used to steer money market rates toward the operational target. The liquidity framework will also outline the set of monetary policy instruments and procedures that comprise the Monetary Operational Framework as well as guidelines for and objectives of short-term liquidity forecasting.

17. The NBG board approved the revisions to the regulation on the lender of last resort (LOLR) function at end-December 2008 (structural benchmark for end-December 2008). The main revisions included a change that permits LOLR access only to those institutions that are judged to be solvent but experiencing short-term liquidity problems, and refined the terms and procedures for issuing LOLR loans.

18. Exchange rate policy in recent months has posed difficulties, and our policy options have been constrained by nervousness in the market. We believe that a short period of exchange rate stability was essential for restoring confidence in the aftermath of the war and global financial turmoil. It also allowed time for assessing economic developments and prospects. We remain, however, fully committed to a flexible exchange rate policy. To this end, we have limited the NBG's interventions in the foreign exchange market and allowed greater exchange rate flexibility to protect international reserves. Moreover, should it be necessary to act decisively to withdraw liquidity, the NBG is prepared to raise interest rates on central bank securities to stem demand for foreign exchange.

19. As a device for making NBG interventions more market oriented, we introduced an auction-based mechanism for central bank sales of foreign exchange. This will help to reduce market interventions and will be conducive to achieving the programs objectives.

20. The financial sector has performed well despite numerous shocks. The quick and effective support from international financial institutions, has allowed the banking system to refinance its maturing foreign liabilities. The increase in non-performing loans—from 1.8 percent of the system assets in October 2007 to 12.8 percent at end 2008—reflects the deterioration in economic conditions. While it creates challenges, it does not pose a risk to the stability of the financial system. Average capital adequacy in banks remains satisfactory—about 14 percent—despite the recent need for additional provisioning. Taking into consideration our conservative capital requirements (including high risk weights on mortgages and foreign currency loans), and planned private sector injections of bank capital in the coming months, we remain confident that the banking system will continue to be sound and resilient.

21. In the current environment, it is essential for FSA to continue monitoring individual banks. To facilitate monitoring and analysis, the FSA is continuing to strengthen its institutional capacity. As part of this effort, the FSA has recently requested technical assistance from the IMF in area of stress testing. As part of this exercise and on an ongoing basis, the FSA will provide all necessary bank-by-bank data, including capital adequacy ratios, non-performing loans and current liquidity positions on a monthly basis, subject to the provisions of Georgian law. It should be stressed that these data are especially sensitive and must be subjected to the strictest confidentiality requirements by Fund staff.

22. While we are confident that our macroeconomic strategy going forward is the appropriate one, we see the potential downside risks. Consequently, we are in the process of developing a financial stability plan. The plan will contain policy actions to respond to potential situations of stress by defining the roles and responsibilities of the different players—the NBG, the FSA and the government—under each circumstance, and will be jointly prepared by the NBG, the FSA, and the Ministry of Finance. We will send this document to Fund staff, again on the condition of strict confidentiality (structural performance criterion for end-June 2009).

Program Monitoring

23. All performance criteria for the Second Review under the Stand-By Arrangement were met. We, therefore, request the completion of the second review. We will maintain the usual close policy dialogue with the Fund and stand ready to take additional measures as appropriate to ensure the achievement of the program objectives. In particular if the pressures on Georgia stemming from the global economic crisis were to be stronger than anticipated, the government would adjust its fiscal and exchange rate policy stance to maintain external stability.

24. The third and fourth reviews are expected to be completed by end-June 2009 and end-September 2009. We request the modification of the performance criteria for end-March and end-June, 2009 (attached Tables 1 and 2). We also request that the program's ceiling on contracting or guaranteeing new nonconcessional debt by the public sector accommodate borrowing from official creditors in view of the currently low interest rates, sustainable level of the public debt, and large conflict-related infrastructure needs that could not be met fully by concessional financing. This limit will be revised during subsequent reviews in case of further borrowing needs in line with the priorities outlined in the Joint Needs Assessment report. The next quarterly review will be based on end-March targets. To better capture the impact of unexpected shortfalls or surpluses in external financing, the revised Technical Memorandum of Understanding introduces adjustors to the program's quantitative targets.

25. We authorize the IMF to publish the Letter of Intent and its attachments as well as the accompanying staff report.

Sincerely yours,

/s/
Nika Gilauri
Prime Minister of Georgia

/s/
Kakha Baindurashvili
Minister of Finance

/s/
Giorgi Kadagidze
President of the NBG

Table 1. Georgia: Quantitative Performance Criteria, 2008–09

	Cumulative Change from End-June 2008					Cumulative Change from End-December 2008				
	Sep-08		Dec-08			Mar-09		Jun-09		Sep-09
	PC	Act.	PC	Adjusted PC	Act.	First review	PC 1/	First review	PC 1/	PC 1/
	(In millions of lari)									
Ceiling on cash deficit of the consolidated government	537	425	627	760	619	229	480	517	924	973
	(In millions of U.S. dollars)									
Ceiling on contracting or guaranteeing of new nonconcessional external debt by the public sector	0	0	250	...	...	250	850	250	850	850
	Stocks at the end of the period									
	(In millions of lari)									
Ceiling on net domestic assets (NDA) of the NBG 1/	765	452	214	...	116	295	310	329	446	240
	(In millions of U.S. dollars)									
Floor on net international reserves (NIR) of the NBG	602	848	851	...	909	836	633	861	585	769
Ceiling on accumulation of external arrears 2/	0	0	0	...	0	0	0	0	0	0

Sources: Georgian authorities; and Fund staff estimates.

1/ Actual figures and quantitative targets are based on program exchange rates.
2/ The continuous performance criterion for external arrears is defined in paragraph 15 of the TMU.

Table 2: Structural Benchmarks and Performance Criteria

Action	Proposed Time Frame (end of period)	Type of Conditionality	Status
FSA and NBG to sign and implement a memorandum of understanding to strengthen cooperation.	End-Oct-08	Structural Benchmark	Observed
NBG to introduce revised LOLR facility.	End-Dec-08	Structural Performance Criterion	Observed
Submission to parliament of a state budget for 2009 with an overall fiscal deficit of no more than 3¾ percent of projected GDP (subject to an adjustor of at most 3 percent of GDP as set out in the TMU).	End-Dec-08	Structural Benchmark	Observed
NBG to develop and publish a liquidity management framework, including the introduction of a refinancing mechanism as the main instrument to provide liquidity.	End-Mar-09	Structural Benchmark	
The NGB, the FSA, and the government to develop a financial stability plan that will contain policy actions to respond to potential situations of stress by defining the roles and responsibilities of the different players—the NBG, the FSA and the government—under each circumstance.	End-Jun-09	Structural Performance Criterion	
Appointment of the remaining members to the FSA board.	End-Jun-09	Structural Benchmark	
Submission of a new budget code to the cabinet to make the budget preparation process more inclusive, enhance the budget execution monitoring process, and move to performance driven policy by improving strategic planning.	End-Jul-09	Structural Benchmark	

Georgia: Revised Technical Memorandum of Understanding

March 10, 2009

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 Stand-By Arrangement (SBA). It replaces the technical memorandum of understanding dated November 28, 2008.

2. These performance criteria and indicative targets are reported in Tables 1 and 2 of the Memorandum of Economic and Financial Policies (MEFP), attached to the letter dated November 28, 2008 and Table 1 attached to the Letter of Intent dated March 10, 2009. The exchange rate for the purposes of the program of the Georgian lari to the U.S. dollar is set at GEL 1.67 = $1. The corresponding cross exchange rates are provided in Table 1.

Consolidated Government and the Public Sector

3. **Definition:** The consolidated government is defined as the central government, local governments, extrabudgetary funds, public services providing general government system LEPLs, and the Sovereign Wealth Funds (Future Generations and Stable Development Funds). In case the government establishes extrabudgetary funds, they will be consolidated within the consolidated government. The public sector consists of the consolidated government and the National Bank of Georgia (NBG).

4. **Supporting material:** The Treasury Department of the Ministry of Finance (MOF) will provide to the IMF detailed information on monthly revenues, expenditures, and arrears of the consolidated government. In addition, data will be provided on the cash balances in the accounts of the Ministry of Finance.

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

A. Ceiling on the Cash Deficit of the Consolidated Government

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

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

  (i) Loans provided by commercial banks to the consolidated government minus accounts held by the consolidated government at commercial banks. These accounts and loans will be monitored based on the NBG's monetary survey. Any other securities issued by the consolidated government (for example, promissory notes) are also included in domestic financing.

  (ii) Loans provided by the NBG to the consolidated government minus accounts of the consolidated government held at the NBG in lari and foreign currency. Accounts that are outside of the MOF's control are excluded from domestic financing. These accounts include VAT refund account; earmarked grants account; account for state agencies deposits; account for local government revenues for the day to be transferred to their account; national disaster fund account; and investment grant and credit account. As of December 31, 2008, cash balances in these accounts were lari 768 million. These accounts will be monitored based on the changes in cash balances as recorded by the Treasury Department.

  (iii) Treasury bills that have been securitized and sold by the NBG, including the bills that have been purchased by nonbanks.

- Net external financing is defined as the total of loans disbursed to the consolidated government for balance-of-payments support and project financing (capital expenditure and net lending), net change in external arrears, change in the accounts of the consolidated government abroad, including the accounts of the Sovereign Wealth Fund, minus amortization. Amortization includes all external debt-related payments of principal by the consolidated government. 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.

- 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, including privatization proceeds which were transferred to the Sovereign Wealth Funds. This includes receipts from the sales of shares, the sale of assets as well as leases and the sale of licenses with duration of 10 years and longer.

6. **Supporting material:**

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

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

- Data will be provided at the actual exchange rates.

- Data on the accounts of the Sovereign Wealth Funds will be provided by the NBG.

- Data on privatization receipts will be provided by the Treasury Department of the MOF to the IMF on a monthly basis within two weeks of the end of each month. The data will be consistent with the revenue account(s) in the NBG.

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

B. Floor on the Net International Reserves of the NBG

7. **Definition:** Net international reserves (NIR) of the NBG in U.S. dollars are defined as foreign assets minus foreign liabilities of the NBG. Foreign assets of the NBG include gold, gross foreign exchange reserves, 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 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 shall be defined as outstanding liabilities to the IMF and any other liabilities of the NBG. This defined, the definition of NIR excludes foreign assets stemming from foreign currency deposits of financial institutions at 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 on paragraph 2 above. The stock of NIR amounted to $891.9 million as of December 31, 2008 (at the program exchange rate).

8. **Adjustors:**

The floor on the NIR of the NBG will be adjusted:

- (a) upward/downward by 50 percent for any excess/shortfall in the balance-of-payments support loans and balance-of-payments support grants relative to the projected amounts presented in Table 2.
- (b) upward 100 percent for any shortfall in the amount of conversion for government imports relative to the projected amounts presented in Table 2.

9. **Supporting material:** Data on net international reserves (both at actual and program exchange rates); net foreign financing (balance of payments support loans, cash grants to the consolidated government, amortization (excluding repayments to the IMF), interest payments on external debt by the MOF and the NBG); conversions for government imports and transfers of receipts from the Sovereign Wealth Funds 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 weekly basis within three working days following the end of the week.

C. Ceiling on Net Domestic Assets of the NBG

10. **Definition:** Net domestic assets of the NBG are defined as the difference between its net foreign assets and reserve money. Thus defined, the net domestic assets are 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). Performance against the NDA target will be measured at program exchange rates.

11. **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 weeks of the end of each month. Data will be provided using both actual and program exchange rates.

12. **Adjustors:**

The ceiling on the NDA of the NBG will be adjusted:

- (a) downward/upward by 50 percent for any excess/shortfall in the balance-of-payments support loans and balance-of-payments support grants relative to the projected amounts presented in Table 2.
- (b) downward 100 percent for any shortfall in the amount of conversion for government imports relative to the projected amounts presented in Table 2.

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

13. **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.

14. **Supporting material:** Details of all new commitments and government guarantees for external borrowing, with detailed explanations, will be provided by the MOF to the IMF on a monthly basis within two weeks of the end of each month. Data will be provided using actual exchange rates.

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[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. A web-based grant element calculator is available at http://www.imf.org/concessionality.

[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 leaser retains the title to the property. For the purpose of the Guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair, or maintenance of the property. (b) Under the definition of debt set out in point 9(a) above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt."

E. Continuous Performance Criteria on Nonaccumulation of External Arrears

15. **Definition:** During the period of the arrangement, the consolidated government and the NBG will not accumulate any new external payment arrears on debt service obligations to official creditors. Official external payment arrears are defined as unpaid debt service by the consolidated government and the NBG beyond 30 days after the due date. The performance criterion on nonaccumulation of external debt is continuous.

16. **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.

Table 1. Program Exchange Rates

	Currency Name	Currency/US$
SDR	Special Drawing Rights	0.65
GEL	Georgian lari	1.67
EUR	Euro	0.72

Table 2. Projected Balance-of-Payments Support Financing 1/
(In million U.S. dollars)

	Balance-of-payments support grants	Balance-of-payments support loans	Conversion for government imports
March 31,2009	6.5	0	105.2
June 30, 2009	32.5	0	196.2
September 30, 2009	207.8	0	255.6
December 31, 2009	269.6	80.0	395.8

1/ Cumulative from the beginning of the calendar year.