

**Georgia: Request for Three-Year Arrangement Under the Poverty Reduction and Growth Facility—Staff Report; Staff Supplement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Georgia**

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

- the staff report for the request for a three-year arrangement under the Poverty Reduction and Growth Facility, prepared by a staff team of the IMF, following discussions that ended on **February 16, 2004**, 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 May 14, 2004.** 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 supplement of **May 26, 2004** updating information on recent developments.
- a Press Release summarizing the **views of the Executive Board as expressed during its June 4, 2004 discussion** of the staff report that completed the request.
- 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\*

\*May also be 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

**Request for a Three-Year Arrangement Under  
the Poverty Reduction and Growth Facility**

Prepared by the Middle East and Central Asia Department

Approved by Julian Berengaut and Carlos Muñiz

May 14, 2004

- Program discussions were held in Tbilisi during February 4-16, 2004.
- The mission team consisted of Messrs. Neuhaus (head), van Selm, Billmeier (all MCD), Abrego (PDR), Hajdenberg (FAD), Heenan (MFD), and Ding (FIN). The mission was joined briefly by Mr. Berengaut (MCD) and was assisted by the Resident Representative, Mr. Dunn. The team cooperated with an overlapping mission from the World Bank.
- Staff met with President Saakashvili, Prime Minister Zhvania, Mr. Nogaideli (Minister of Finance), Mr. Managadze (President of the National Bank of Georgia), other senior officials, and representatives of the donor community and civil society.
- The attached letter from President Saakashvili and Prime Minister Zhvania and the Memorandum of Economic and Financial Policies (Attachments I and II) set out the authorities' economic program for 2004-06, for which they are seeking financial support under a Poverty Reduction and Growth Facility (PRGF) arrangement. Upon Board approval of this request, SDR 98 million (65 percent of quota) would be available under the arrangement, disbursed in semi-annual installments over three years.
- The Poverty Reduction Strategy Paper (IMF Country Report No. 03/265), prepared by the previous administration, and the Joint Staff Assessment (IMF Country Report No. 03/348) were considered by the Executive Board (10/17/203) together with the 2003 Article IV Consultation (IMF Country Report No. 03/346). The new government has endorsed the strategy and will update it in the course of 2004 in consultation with stakeholders.

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## EXECUTIVE SUMMARY

- **Georgia experienced rapid growth and low single-digit underlying inflation in 2003, despite a weakening in fiscal performance and a political crisis that culminated in a regime change in November.** Economic activity was buoyed by a rebound in the industrial and communications sectors, oil pipeline construction, and several one-off factors. Headline inflation rose in the latter part of the year, driven by a spike in wheat import prices, but eased somewhat in the first quarter of 2004.
- **The fiscal situation deteriorated sharply in 2003, especially because of a weakening in expenditure management and in tax enforcement.** As a consequence, the fiscal targets were missed by wide margins—including a sizable buildup in domestic expenditure arrears on pensions and wages instead of the programmed reduction.
- **Policy discussions focused on strategies to address the challenges inherited from the previous administration and to reinvigorate the reform drive.** The authorities underscored their strong electoral mandate for tackling corruption and governance problems head-on. They reiterated their endorsement of the thrust of the ex post assessment of Georgia's performance under Fund-supported programs discussed by the Board last January.
- **The authorities have requested financial support from the Fund under an arrangement supported under the PRGF, with access at SDR 98 million or 65 percent of quota.**
- **To help cover financing gaps (after Fund support) totaling some US\$245 million during the program period, Georgia is well advanced in obtaining financing assurances from the Paris Club in the form of a rescheduling of 2003 arrears and principal maturities due during the program period.** Additional financing will come, inter alia, from EU and other bilateral grants and a US\$20 million Reform Support Credit from the World Bank to be disbursed by mid-2004.
- **The centerpiece of the proposed program is a decisive attack on corruption that should underpin sizable gains in tax collections.** This should allow the government to eliminate domestic arrears during the program period, while increasing spending on core social and infrastructure projects. The program also includes reforms in the energy sector, the civil service, and state enterprise management, as well as a commitment to dismantle protectionist measures adopted in late 2002.
- **The government's resolve to tackle corruption and governance problems, if sustained, will bode well for program implementation,** but Georgia's vulnerability to exogenous shocks and lingering tensions between central and regional authorities will continue to pose downward risks.

## I. RECENT ECONOMIC DEVELOPMENTS<sup>1</sup>

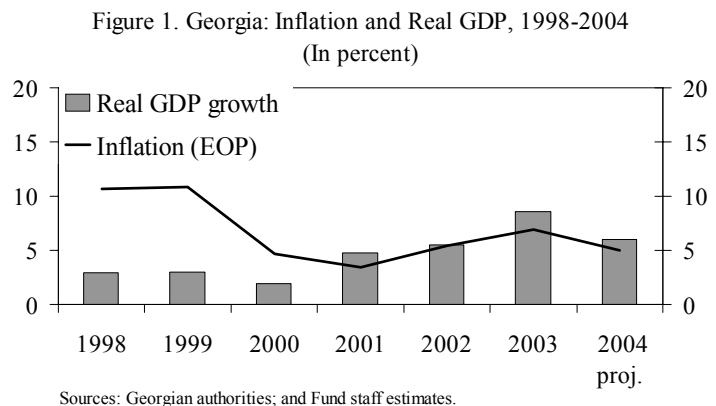
### 1. **The economy proved resilient in 2003, despite a weakening in fiscal performance and a political crisis that culminated in a regime change in November.**

Real GDP grew by 8.6 percent, led by buoyant activity in the industrial and communications sectors and construction of the Baku-Tbilisi-Ceyhan oil pipeline (which together contributed 3.5 percentage points to total output growth), as well as several one-off factors (including a recovery in farming from a bad harvest in 2002) (Table 1 and Figure 1). Nevertheless,

poverty may have well increased owing to the government's failure to fully meet wage and pension obligations. Though income distribution measured by Gini consumption coefficients improved slightly from 2000 to 2003, the incidence of poverty remains high: the latest available data (2002) show that 15 percent of the population lived in extreme poverty (less than the equivalent of US\$1 a day)

(Table 2) and 52 percent lived below

minimum subsistence standards (US\$2 a day). Underlying inflation (3 percent) stayed low in 2003, but headline end-period inflation rose to 7 percent, driven by a spike in wheat import prices stemming from crop failures in CIS grain exporters; twelve-month inflation fell back to 5.2 percent in April 2004.



2. **The fiscal situation deteriorated sharply in 2003.** Passage of an unrealistic budget by parliament, combined with a weakening in expenditure management, a slackening in tax enforcement, and shortfalls in policy-based foreign aid created large deviations from the indicative targets set under the PRGF-supported program (Table 3). The commitments deficit of the general government (2.5 percent of GDP) was two-thirds larger than programmed, leading to a regressive buildup in domestic arrears—mostly on wages and pensions—to nearly 5 percent of GDP by year's end, instead of the programmed reduction (Table 4).

3. **Energy sector quasi-fiscal losses (5.1 percent of GDP) were also higher than envisaged in 2003.** The main reasons were sagging electricity bill collections from budgetary organizations in the latter part of the year, political interference with disconnection of non-paying provincial customers, a March court-ordered reduction in power tariffs subsequently

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<sup>1</sup> For a review of performance under the previous PRGF arrangement, see the 2003 Article IV Consultation Report (IMF Country Report No. 03/346) and Georgia—Ex Post Assessment of Performance Under Fund Supported Programs (IMF Country Report No. 04/26).

lifted for provincial customers, but not in Tbilisi, and lax financial management in the gas sector.

4. **Remonetization of the economy continued in 2003**, with end-period broad money rising to 12.5 percent of GDP, from 11.6 percent in 2002. The fallout on the financial system of the economic and political dislocations was limited, owing to a liquidity tightening late in the year and accommodation of fiscal imbalances by a buildup in domestic arrears, rather than outright monetization. As market sentiment improved under the new regime, maturing t-bills have been rolled over smoothly and yields have fallen from a peak of 77 percent in October 2003 to 23.2 percent in early May 2004 (Figure 2). The lari depreciated by 5½ percent in real terms from end-2002 to March 2004, owing to a fall in the U.S. dollar vis-à-vis other major currencies (Figure 3).

5. **The banking system remains well-capitalized and liquid** (Table 5). Capital adequacy and liquidity ratios declined only slightly in 2003, despite a cumulative expansion in commercial bank credit to the private sector of 49 percent in 2002-03. Bank profitability remained robust, bolstered by continuing high lending spreads and treasury bill yields. Nonperforming loans as a proportion of total loans fell from just under 8 percent of total bank assets at end-2002 to 7.4 percent at end-February 2004. This reflects in part the continued strong growth in foreign currency lending to the trade and industrial sectors, as well as the

Figure 2. Georgia: Government Securities, 2002-2004 1/ 2/

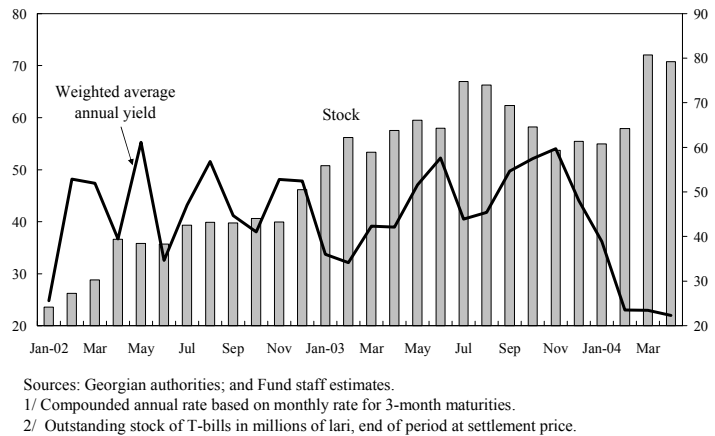
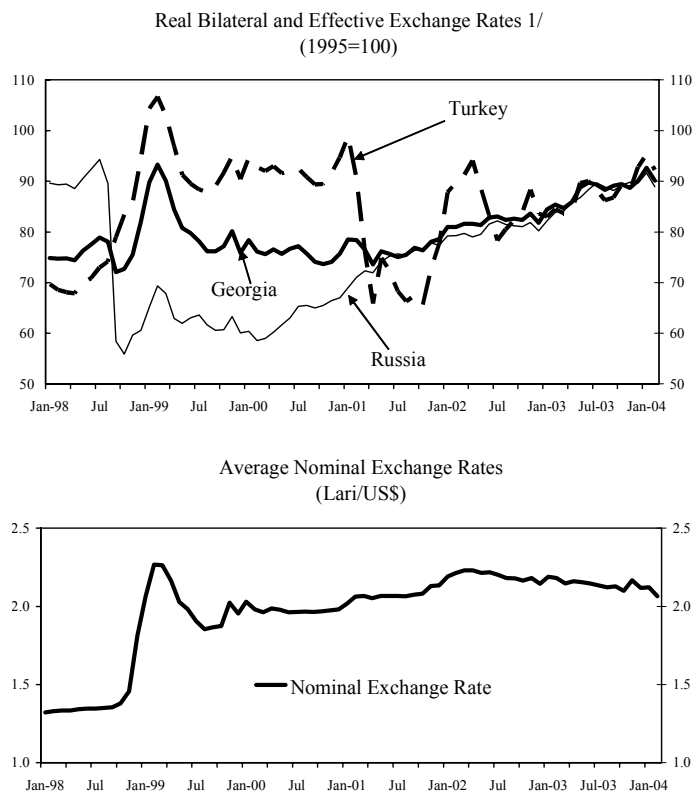


Figure 3. Georgia: Exchange Rate Developments, 1998-2004



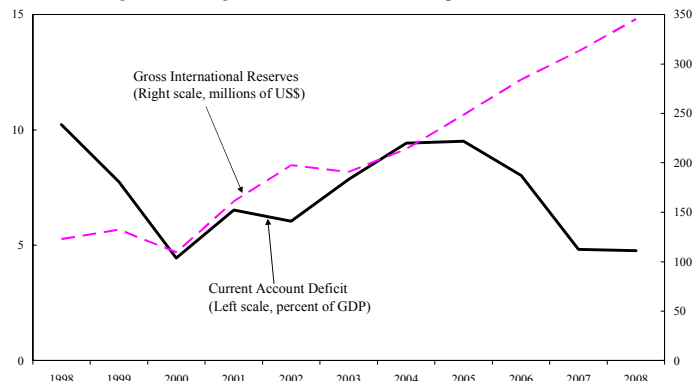
Sources: Georgian authorities; and Fund staff estimates.  
 1/ Based on INS exchange rates and CPI. An increase in the rate indicates a depreciation of lari.



expansion of on-lending operations by international development banks (subject to independent credit assessments) and financing of the pipeline and related projects.

6. **The external current account deficit widened in 2003, and much of it was covered by rising pipeline-related FDI** (Figure 4). The trade balance excluding pipeline-related imports narrowed somewhat, reflecting robust trading partner growth, higher export prices and the gains in external competitiveness mentioned above (past trade data should be interpreted cautiously because of smuggling and a break in the series in 2000). Despite significant NBG foreign exchange purchases, gross official reserves fell to 1.5 months of non-pipeline imports at end-2003 owing to policy-related shortfalls in foreign aid and IMF drawings (at end-April 2004, gross reserves stood at US\$216 million). The policy slippages, which did not permit completion of the third review under the PRGF arrangement that expired last January, also prevented consolidation of US\$51 million in 2003 principal maturities under the 2001 Paris Club rescheduling.

Figure 4. Georgia: External Sector Developments, 1998-2008



Sources: Georgian authorities; and Fund staff estimates.

7. **In the structural area, a number of steps were taken in recent months.** Regarding **public sector operations**, the interim administration introduced revenue-neutral amendments to the tax code last December (transferring land, personal income and profit taxes to local governments; replacing the tobacco tax by a combination of specific excises and VAT on tobacco products; and reintroducing some nuisance taxes abolished in August 2003). The government has also initiated a civil service reform, including a new cabinet system headed by a prime minister, consolidation of government agencies, and staff retrenchment (see below). In the **financial sector**, parliament has amended the Anti-Money Laundering law (AML) and the government has signed the Strasbourg Convention on seizure and confiscation of the proceeds from crime; a Financial Monitoring Service was created to enforce these AML provisions and additional supporting modifications to the legal framework will be introduced in the coming months to bring it into full compliance with international AML standards. The NBG has also introduced a phased increase in minimum bank capital requirements, bolstered provisioning standards, and created a special unit to handle problem banks.

8. **The new government has taken decisive steps to strengthen tax administration**, as a result of which Q1 2004 tax revenue increased by 21 percent year-on-year, exceeding the program projection for Q1 by 6 percent (non-tax revenue was also much higher than anticipated, largely due to fines for misappropriated funds paid by officials of the previous government). The favorable outcome to date provides the 2004 budget with a cushion for possible revenue shortfalls or unexpected expenditure needs later in the year. The authorities

have reassured staff that the 2004 budget to be approved by parliament will adhere strictly to the spending parameters agreed with the mission.

9. **Mikheil Saakashvili won the January 2004 presidential election by a 96 percent landslide.** Results of the March 28 parliamentary elections show that the ruling coalition obtained a strong majority in parliament. The leader of the Adjara region, Mr. Abashidze, resigned in early May following a tense standoff with the central authorities, thereby effectively resolving the long-standing dispute with the center.

## II. POLICY DISCUSSIONS AND THE PRGF-SUPPORTED PROGRAM

### A. Medium-Term Strategy

10. **The authorities stressed their resolve to address the challenges inherited from the previous administration and reinvigorate the reform drive.** They underscored their strong electoral mandate for tackling corruption and governance problems and peacefully restoring sovereignty over Georgia's whole territory. The officials reiterated their endorsement of the thrust of the ex post assessment (EPA) of Georgia's performance under Fund-supported programs discussed by the Board last January, and incorporated the main findings of the EPA in the design of the new program, especially by focusing on measures to improve governance.<sup>2</sup> The overarching objective of the government's Memorandum on Economic and Financial Policies (MEFP, Attachments I and II) is to foster rapid, sustained outward-looking growth in a low-inflation environment, in order to improve living standards and basic service delivery. As such, the program is broadly aligned with the PRSP designed in consultation with stakeholders (see IMF Country Report Nos. 03/265 and 03/348), which the new administration plans to update. Fiscal consolidation and a streamlining of government operations will be the principal levers to stabilize the economy and redirect spending to core areas. Energy sector reforms should ensure stable power supplies and lower quasi-fiscal losses, while governance improvements (Box 1) and tax reform should foster confidence and SME development (paragraph 23 of the MEFP).

11. **Program targets for 2004** comprise 6 percent real GDP growth, 5 percent end-period inflation and a modest gain in gross reserves—keeping them at 1.5 months of non-pipeline imports, as in 2003. The medium-term outlook through 2008 envisages output growth averaging 5 percent, buoyed by oil and gas pipeline construction, improvements in the business climate that should foster sustained growth in transport and services, and export diversification to lessen the vulnerability to external shocks (including by improving the VAT refund mechanism for exporters and dismantling the 2002 protectionist measures that increased the anti-export bias of the trade regime). Pursuit of prudent monetary policies

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<sup>2</sup> For a summary of official and NGO reactions to the EPA, see the statement by the Executive Director for Georgia (IMF Country Report No. 04/26) and Appendix I of this report.

would keep inflation around 5 percent (Table 6). According to the PRSP, this would allow a reduction in the share of the population living below subsistence standards from slightly over one-half in 2002 to about one-third by 2008 and one-fifth by 2015.

### **Box 1. Georgia: Improving Governance**

**Corruption is widespread in Georgia.** The country ranked 124 out of 133 countries listed in Transparency International's 2003 *Corruption Perception Index*. Several factors have historically contributed to poor governance in Georgia, including a tradition of clan and family-based loyalties, a deep-seated culture inherited from the Soviet period of avoiding tax and bill payments (exacerbated by the sharp rise in domestic energy prices after the collapse of the Soviet Union), the absence of a strong legal tradition, and a poorly-paid and equipped civil service.

**President Saakashvili campaigned on a strong anticorruption platform.** A number of high-profile former government officials suspected of corruption have been sacked and are being prosecuted. Important elements of the government's drive to reduce corruption include:

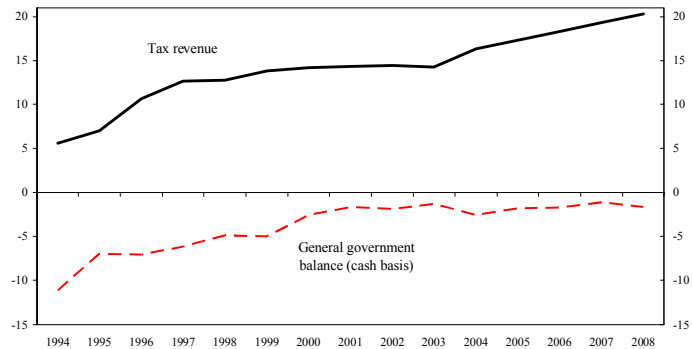
- **Liberalization of the business environment:** the new authorities aim to secure parliamentary approval of a tax reform in 2004 that will simplify the tax regime and eliminate nuisance taxes.
- **Reforms in tax and customs administration:** officials implicated in corruption or tax fraud have been sacked and prosecuted. A financial police has been created to curb tax fraud. The authorities are preparing a customs reform strategy to help reduce smuggling. Tax abuses by small-scale ("teakettle") refineries are being addressed forcefully.
- **Transparency and public oversight:** routine auditing of major SOEs will be widened in 2004 to all SOEs with a turnover above GEL 10 million (US\$5 million). Management of these enterprises will be strengthened by appointing supervisory boards guided by performance-based contracts. All public tenders will now be announced on the website of the State Procurement Agency.
- **Civil service reform:** the ongoing reform seeks to reduce public employment, improve the remuneration of remaining staff, and enforce strict codes of conduct, thereby ensuring high professional standards and reducing incentives for bribe-taking.
- **Anti-Money Laundering (AML) legislation** is being strengthened and aligned with international best practices.

## **B. Fiscal Policy and Public Sector Reforms**

12. **The authorities' strategy is to create a smaller yet stronger and financially sound public sector.** They plan to bolster tax receipts and reduce the drag from a bloated payroll and energy sector deficits to permit higher core spending, repayment of domestic arrears and

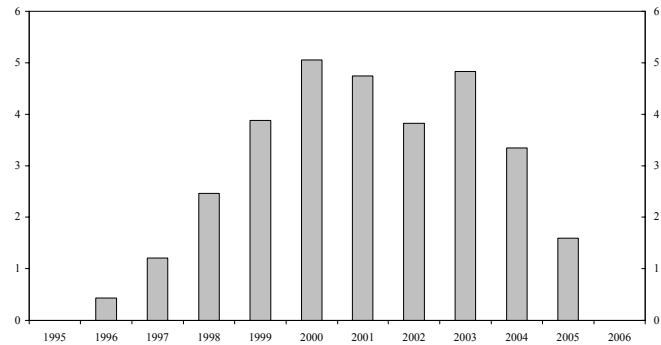
better civil service remuneration. To buttress their effort, they count on concessional foreign aid and an easing of the external debt burden. With little room for cutting non-essential spending, the fiscal path is shaped by an ambitious but realistic tax revenue target (a gain of 5-6 percentage points of GDP over the next five years, of which 1.6 percent in 2004) and limited availability of non-inflationary domestic financing (Figure 5). The commitments deficit of the general government would narrow from 2.5 percent of GDP in 2003 to 1.6 percent in 2004 and 0.5 percent in 2005-06 and the primary balance would shift from a deficit of 0.4 percent in 2003 to surpluses of 0.5 percent in 2004 and 1.1 percent in 2006. Domestic arrears will be fully cleared by the end of the program period (Appendix II and Figure 6). In line with the PRSP, social spending (other than clearance of arrears) would rise from 7.7 percent of GDP in 2003 to 8.7 percent in 2006 and just under 10 percent in 2008.

Figure 5. Georgia: Tax Revenues and Fiscal Balance, 1994-2008  
(In percent of GDP)



Sources: Georgian authorities; and Fund staff estimates.

Figure 6. Georgia: Stock of Domestic Expenditure Arrears, 1995-2006  
(In percent of GDP)



Sources: Georgian authorities; and Fund staff estimates.

13. **On the revenue side, the government's top priority is to curtail tax evasion and fraud.** Decisive actions on several fronts are well under way (Box 2 and paragraph 14 of the MEFP), including reorganization of the inland tax department; establishment of an inspectorate to improve surveillance over large excise taxpayers, as well as a financial police in the Ministry of Finance; and design of a customs reform based on donor recommendations (a prior action). While mindful of the potential downsides flagged by staff, the authorities plan to shortly announce a one-off tax amnesty. In the transition to strict tax enforcement, they see it as well-justified to spur declaration of hidden tax arrears and regularization of the informal sector. They stressed that the amnesty would henceforth encourage taxpayers to stay current, and noted that pursuing longstanding small claims would have imposed an undue administrative burden with a negligible yield.

## **Box 2. Georgia: Tax Administration Reforms**

**Reforms in tax administration underpin the government's ambitious revenue targets for the program period.** The main aspects of the reform are:

- **Reorganization of the State Tax Department (STD) and greater focus on compliance by the 5,000 largest taxpayers**, which in 2003 accounted for more than 80 percent of tax receipts, accompanied by removal of corrupt officials. Better staff training will be provided for, and new evaluation procedures put in place. STD staff will be clearly divided into those who deal with audit, enforcement, declarations, and taxpayer relations. Audit procedures will be strengthened. STD has launched a campaign to re-register current (and register new) taxpayers.
- **Establishment of an Excise Tax Inspectorate (ETI) at the Ministry of Finance** to bolster excise receipts by eliminating fragmentation in the control of excisable goods that occurred when the SCD and several units of the STD shared responsibilities in this area.
- **Creation of a Financial Police under the Minister of Finance**, replacing economic crime units in the power ministries. Investigative functions previously held by the STD and State Customs Department (SCD) have been incorporated in the new unit to enhance coordination of efforts to combat corruption. The financial police has the right to use force.
- **The government plans to grant an amnesty on previously undeclared tax arrears.** Contingent on approval of taxpayers' declarations of liabilities by a government committee, debts below GEL 1 million (US\$0.5 million) would be written off. Taxpayers declaring arrears above GEL 1 million would be expected to pay 10 percent of the amount declared before end-2004, while a payment plan would be arranged for the balance. The amnesty would not apply to arrears already registered. Taxpayers currently under criminal investigation and SOEs are excluded from the amnesty. Adherence to the amnesty law would release delinquent taxpayers from possible criminal charges and bar the authorities from auditing past tax declarations. These benefits would be annulled if taxpayers fail to meet current tax obligations or meet payments of restructured arrears.

14. **The government will also seek passage of a comprehensive tax reform by end-2004**, which was a chief plank of the president's electoral campaign (paragraph 15 of the MEFP). The aim is to simplify the tax system, broaden the base and possibly lower certain tax rates to facilitate compliance, distribute the tax burden more equitably and minimize rent-seeking. Streamlining import tariffs to reduce their level and dispersion is another major topic of the reform (see below). Staff underlined the importance of ensuring that the tax code can withstand the test of time (without piecemeal amendments driven by interest groups) and aligning tax reform with the medium-term goal of bolstering tax receipts; this suggests that any rate reductions must be tailored to progress in curbing evasion and reducing exemptions.

15. **The 2003 budget systems law is the guiding framework to strengthen budgetary design and implementation (paragraphs 17-18 of the MEFP).** The law will be modified by end-2004 (a structural PC) to align it with recent constitutional amendments and take into account FAD advice. All revenue transit accounts will be closed pending establishment of a single treasury account by June 2004, and commitment controls will be fully implemented for all treasury payments. In consultation with Fund staff, the authorities plan to devolve non-core activities of certain budgetary organizations to non-profit *legal entities of public law* (LEPLs). This should curb micromanagement of these activities by the Ministry of Finance, enhance their operational flexibility and broaden financing sources. Staff and donor advisors cautioned that this could affect budgetary transparency and accountability and limit access to public services of some population groups. The authorities indicated that these concerns would be addressed by detailed and timely LEPL reporting requirements and establishment of supervisory boards for them, chaired by the line ministries.

16. **Civil service reform and improvements in SOE management are important pillars of the drive to modernize the public sector (paragraphs 19 and 21-22 of the MEFP).** The initial phase of the civil service reform is under way, after the February 2004 constitutional reform creating the post of Prime Minister; formalizing the collective responsibility of ministers; and folding all state departments (land management, statistics, tourism, etc.) into line ministries. Self-financing retrenchments in government agencies are in motion within the global wage bill ceilings for 2004, and a more comprehensive and costed civil reform strategy will be developed with donor assistance in the second half of 2004. Sizable medium-term retrenchment of defense and law enforcement agencies is also planned to help modernize their activities and upgrade technology and matériel, in advance of an eventual bid to join NATO.<sup>3</sup> Regarding SOE management, the program focuses on following up on ongoing audits of three major problem companies, broadening the routine coverage of international audits to first-tier companies, and improving transparency and accountability more generally.

### C. Energy Sector Reform

17. **Energy sector reform is vital to strengthen the public finances, enhance growth prospects and improve the quality of life of the population.** Measures planned in 2004 build on a donor action plan prepared under World Bank leadership that focuses on further improving bill collections, aided by forceful disconnection of nonpaying customers and further extension of customer metering. A parallel detailed roadmap is being developed, featuring the costing of emergency repairs and investments to rehabilitate infrastructure and expand capacity (paragraph 20 of the MEFP). On this basis, the energy sector quasi-fiscal

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<sup>3</sup> Georgia's incipient plans to join NATO appear to call for raising defense spending from 0.8 percent of GDP in 2003 to 2 percent by 2008; neither the higher outlays nor the corresponding resources are included in the current fiscal projections.

deficit is projected to narrow to 4.6 percent of GDP in 2004,<sup>4</sup> from 5.1 percent in 2003 (Box 3 and Table 7). The authorities undertook to reassert the autonomy of the energy regulatory committee (GNERC), and on April 2 they appointed a new chairman tasked, inter alia, with reviewing the power tariff methodology with World Bank assistance. The program includes selection of a consultant to conduct this review as a June 2004 structural PC, and indicative targets for bill collections of electricity from main groups of customers and—for the first time—for collections from customers of the Tbilisi gas utility.

### **Box 3. Energy Sector Reforms in Georgia**

**Restoring the technical and financial viability of the energy sector and expanding capacity are key elements of the reform agenda.** The authorities have developed an emergency 16-month business plan through the winter of 2004/05 and follow-up investments to rehabilitate infrastructure and expand capacity. This should also help reduce the sector's sizable quasi-fiscal deficit.

The thrust of the authorities' energy sector strategy, which builds on the donor action plan prepared under World Bank leadership in November 2003, is to:

- **Improve bill collection rates.** While privatization of electricity distribution in Tbilisi has bolstered collection rates, nonpayment by provincial customers of the UDC utility is high and power supply is often rationed, especially outside the capital. Low collections also plague distribution by the Tbilisi gas utility (Tbilgazi). Priorities include broadening the coverage of metering, strengthening government support for disconnections, and shifting from doorstep collections to payments at service centers and banks. This should help raise cash collection rates, treated as indicative targets under the program (paragraph 20 and Table 1 of the MEFP).
- **Review the electricity tariff methodology (with donor assistance) and subsequently set and maintain tariffs at cost-recovery levels.**
- **Reassert the autonomy of the independent energy regulator (GNERC).**
- **Improve debt management in the sector and address the sector's legacy debt (with donor assistance).**
- **Rehabilitate infrastructure and expand capacity.** The government's business plan prioritizes immediate small-scale investments to reduce the need for energy imports in the coming winter. It will also seek resources for longer-term rehabilitation and capacity expansion, currently projected at US\$375 million over the next several years.

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<sup>4</sup> The 2004 budget includes funds to cover electricity consumption of budgetary organizations and disadvantaged segments of the population.

#### **D. Monetary Policy and Financial Sector Reform**

18. **The NBG will continue to pursue prudent monetary policies and the managed float of the lari to underpin price stability and competitiveness. It also will continue to reform the treasury bill market and strengthen bank supervision with MFD assistance** (paragraphs 24-25 of the MEFP). The monetary program for 2004, which assumes a further decline in velocity in line with past trends, targets end-period inflation at 5 percent—despite likely price pressures from stricter tax and customs enforcement—and a US\$29 million gain in net international reserves (Tables 8 and 9). Given the overhang of NBG lending to the government (9.7 percent of GDP at end-2003), net banking system credit granted to the Treasury is modest in 2004. In the coming years, the domestic borrowing needs of the government are expected to be met increasingly through issuance of domestic securities, as financial markets continue to deepen and risk premiums decline. NBG officials felt the banking system remained well-capitalized and liquid (except for a few banks that are not systemically important), especially since capital adequacy, provision and loan classification standards had been tightened in the past two years. They noted that the NBG has enhanced monetary policy tools and taken measures which, together with the envisaged improvements in money markets, should help slow dollarization. They recognized, however, that longer-term dollarization trends hinged mainly on improvements in the country's economic fundamentals and the business climate.

#### **E. External Sector Policies**

19. **Medium-term balance of payments prospects will be bolstered by energy-related FDI and pipeline transit fees (which are projected to rise to 1 percent of GDP a year by 2009).** Nevertheless, sustained long-term export growth hinges on fostering private activities (especially farming and tourism) with good untapped potential. The external current account deficit is projected to widen in 2004-05 with a surge in energy and other capital goods imports financed by FDI and concessional aid, but narrow steadily thereafter (Tables 10 and 11). Gross official reserves would gradually rise to just under two months of non-pipeline imports by 2008. The government will pursue prudent external debt management and will not contract or guarantee non-concessional loans during the program period (paragraph 26 of the MEFP). Cumulative financing gaps (after Fund support) totaling some US\$244 million are foreseen in 2004-06. The program's base case assumes rescheduling on Houston terms of 2003 arrears and 2004-06 pre-cutoff principal maturities (excluding obligations rescheduled under the 2001 Paris Club agreement), with non-Paris Club bilateral creditors providing comparable treatment. This operation would still leave residual gaps for 2005-06 of US\$47 million, the coverage of which will need to be identified. Georgia will also continue to seek formal agreement with Turkmenistan—its largest bilateral creditor—on rescheduling of pre-2001 arrears and 2001-02 principal maturities.<sup>5</sup> Subject to positive performance under

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<sup>5</sup> Georgia has been amortizing pre-2001 arrears and paying moratorium interest on 2001-02 maturities to Turkmenistan as if an agreement were in place, according to an informal

(continued...)



the PRGF program, EU grants (about US\$30 million in 2004) would contribute to program financing, while the World Bank would disburse a US\$20 million Reform Support Credit by mid-2004, possibly followed by program lending operations in the next few years (Appendix IV). Grants and concessional foreign loans are also anticipated to finance a sizable increase in capital spending in 2004. In particular, the EBRD's new lending to Georgia focuses on rehabilitation of the Enguri power plant and construction of energy pipelines (Appendix V). A consultative group meeting scheduled for June could mobilize additional donor funding.

20. **The updated debt sustainability analysis indicates that, absent a concessional rescheduling, Georgia would continue to face a fiscally heavy debt burden over the coming years despite the significant programmed gains in tax receipts** (see Appendix III). A rescheduling on Houston terms would provide substantial cash relief during the program period but virtually no debt reduction in NPV terms, leaving high ratios of debt and debt service relative to government revenue at least through 2010. Furthermore, sensitivity analyses show that debt indicators could deteriorate sharply in the event of a shortfall in export growth and a substantial currency depreciation. By contrast, a stock-of-debt operation on Naples terms would make the debt significantly more manageable from a fiscal standpoint, although this could quickly become fiscally burdensome in the presence of adverse shocks, highlighting Georgia's fragility and the pressure that the external debt exerts on its public finances.

21. **Georgia's trade regime ranks 1 (liberal) in the Fund's trade-restrictiveness index.** With numerous exemptions and historically high smuggling, duties collected in 2003 only amounted to 3 percent of total import value, which is very low by international and regional standards. Going forward and given the authorities' resolve to stamp out smuggling, staff urged them to streamline the tariff system and consider adopting a low uniform tariff together with a duty-drawback system and improvements in VAT refunds for exporters, as discussed with the previous government. These issues will be taken up in the design of the broader tax reform that is to be passed by end-2004; meanwhile, the program includes as an end-2004 structural benchmark the reversal of the protectionist measures taken in 2002, which increased the number of tariff bands and the maximum tariff rate (paragraph 27 of the MEFP).

## F. Program Monitoring and Risks

22. **Several prior actions before Board consideration of the arrangement underscore the authorities' commitment to the adjustment and reform effort.** Access under the

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arrangement involving in-kind payments and some debt forgiveness on arrears. The program assumes that amortization of pre-2001 arrears to Turkmenistan would continue according to the current de facto schedule, which implies a 10-year repayment period.

arrangement (SDR 98 million or 65 percent of quota) is predicated on the strength of the adjustment effort and the need to shore up gross reserves, and it implies net repayments to the Fund over the program period; Georgia's debt to the Fund would continue to represent a modest portion of its overall external indebtedness and, as such, should not pose problems for its capacity to repay the Fund (Table 12). Debt service to the Fund will peak in 2004 at 4.5 percent of exports and decline rapidly thereafter. Access to other sources of financing remains limited and largely conditional on performance under the Fund-supported program. The 2004 program will be monitored through quantitative and structural performance criteria, as well as indicative quantitative guideposts and structural benchmarks (Box 4, paragraph 28 and Tables 1 and 2 of the MEFP). Completion of the first review under the arrangement by October 2004, focusing on progress in improving governance, securing fiscal consolidation, and reforming the energy sector and the civil service, will also require observance of the June PCs. Completion of the second review by April 2005 would depend on compliance with the December 2004 targets and further progress in the areas mentioned above (Table 13).

23. **The government's resolve to tackle Georgia's difficult challenges—with strong support from the electorate and donors—bodes well for program implementation.** The main downside risks come from exogenous shocks (such as financial crises in its main trading partners or a surge in oil import prices) and potential difficulties in reasserting Georgia's full sovereignty over its territory. Fiscal risks have been mitigated by the favorable Q1 2004 outturn, as indicated above. Improved governance and SOE management also should help reduce risks on the expenditure side.

### G. Staff Appraisal

24. Under the previous two Fund-supported programs, Georgia made some progress toward macroeconomic stabilization and significant strides in financial reform. The overall results, though, fell short of expectations, while the policy drift in the past two years and the pervasiveness of corruption undermined the fiscal position and confidence. Against this backdrop, the new administration's resolve to address these challenges is encouraging.

25. The authorities' economic program for 2004-06, for which they are requesting Fund support under a PRGF arrangement, seeks to revamp governance, bolster the macroeconomic fundamentals and accelerate reforms. This should create the basis for a rapid and more equitable increase in living standards in a low-inflation environment and, together with the envisaged donor support, for medium-term fiscal and external viability.

26. The fiscal consolidation path—the centerpiece of the adjustment effort—is appropriately ambitious yet within reach, as evidenced by the budding fiscal turnaround to date. In this context, the programmed elimination of domestic expenditure arrears during the program period, with a significant down-payment in 2004, is a commendable undertaking with positive distributional and confidence-building effects. The authorities' commitments to adhere strictly to the spending parameters agreed with the mission provides an important safeguard to the fiscal program. Envisaged amendments to the budget systems law and

#### **Box 4. Georgia: Structural Conditionality in the Proposed Program**

##### **1. Coverage in the Proposed Program**

- **Governance issues**, through three structural benchmarks (SBs) aimed at improving the management and accountability of SOEs and an SB related to anti-money laundering legislation. In addition, measures to strengthen tax and customs administration listed below should also make an important contribution to improved governance.
- **Fiscal issues**, through four prior actions (PAs), three performance criteria (PCs), and four SBs. These are needed to underpin the program's key objective of increasing revenue to make room for higher spending on social programs and infrastructure, and to initiate a phased reduction of domestic arrears.
- **The banking sector**, through an SB aimed at safeguarding the integrity of the banking system.
- **The energy sector**, through two PCs and an SB that seek to address low bill collection rates and a large stock of domestic legacy debt, thereby reducing quasi-fiscal losses in the sector.

##### **2. Status of Structural Conditionality from Earlier Programs**

Performance under the Fund-supported program that expired last January was mixed, mostly because of large fiscal deviations which prevented completion of the third review. However, structural PCs and benchmarks for end-2002 established at the time of the second review have all been met, except the establishment of a fully effective Treasury Single Account and full commitment control for all treasury payments for ministries and line agencies, which is an SB for end-June 2004 under the proposed program.

##### **3. Structural Areas Covered by Bank Lending and Conditionality**

The Bank expects to disburse a US\$20 million Reform Support Credit by mid-2004, which would support immediate reforms in the areas of: (i) public sector operations, including the civil service and procurement; (ii) energy; and (iii) private sector development. The Bank is also discussing with the government a more comprehensive medium-term reform strategy that could be supported by subsequent program loans (Appendix IV).

##### **4. Other Structural Areas**

The Bank, in consultation with other donors, is taking the lead in the areas of civil service reform and privatization. While no structural PCs or benchmarks on these areas are included in the 2004 Fund-supported program, progress in implementing civil service reform is a principal topic for the first review under the arrangement (paragraph 28 of the MEFP).

measures to strengthen budgetary execution and controls are also essential to enhance spending discipline. Further, the envisaged devolution of government activities to legal entities of public law, which may result in some efficiency gains, will need to be managed carefully and in consultation with staff to preclude adverse effects on the effectiveness of budgetary controls and transparency. Going forward, the authorities need to continue with their efforts to align annual and medium-term budgets with the PRSP process.

27. Starting from a very low tax effort by international standards marred by widespread evasion, the initial focus is on securing a major improvement in tax and customs administration, especially by rooting out tax fraud and smuggling. Given the mixed international experience with tax amnesties, the effectiveness of the upcoming amnesty contemplated by the authorities would depend on the success of simultaneous efforts to bolster tax enforcement and credible assurances to the public that the amnesty would be a one-off operation. The tax code will also need to be reformed with FAD advice to simplify the tax structure, broaden the base and possibly lower some rates, while taking care to ensure that the net effect is revenue-enhancing. Based on past experience, the authorities need to insulate the modernized tax code from future ad hoc modifications prompted by vested interests.

28. The new authorities are well-embarked on far-reaching reforms of the civil service, SOE management, and the energy sector—with a view to improving the efficiency of public sector operations, reducing quasi-fiscal losses, and laying the foundations for vibrant, private sector-led growth. More detailed blueprints for actions across these areas are expected to be fleshed out as soon as practicable in consultation with stakeholders, so as to warrant strong financial and logistical support from donors and investors in the coming years. In the course of 2004, the authorities need to carefully cost the civil service reform; follow up on the ongoing audits of three problem SOEs; and broaden the routine coverage of international audits. In the energy sector, they need to review promptly the power tariff methodology to ensure that the regulatory agency can subsequently set and maintain cost-recovery tariffs; further bolster bill collections; secure concessional resources for repairs and capacity expansion; and seek a consensus with donors on a framework to treat domestic legacy debt.

29. Continued pursuit of prudent monetary policies, underpinned by fiscal consolidation and a managed exchange rate float, should be instrumental in keeping inflation low and safeguarding competitiveness. Commendable efforts to foster financial deepening and enhance monetary policy tools, prudential regulations and banking supervision in cooperation with MFD deserve to be continued. Moreover, development of a broader market for government securities should allow the NBG to wind down lending to the public sector and gradually reduce its large outstanding claims on the government.

30. The envisaged improvements in the business climate, sizable FDI-driven pipeline construction, and SME development should favorably impact the medium-term outlook. These home-grown efforts, in turn, warrant international support through grants, highly concessional loans, and an easing of the external debt burden, which will continue to be

particularly heavy from the fiscal standpoint (despite the sizable programmed gains in revenue) and could deteriorate further in the event of adverse shocks. Georgia will also require substantial technical assistance from the Fund and other sources to build capacity, adopt international best practices, and upgrade the statistical database. Meanwhile, it will be important to reduce the vulnerability to exogenous shocks by diversifying exports and building a solid reserve cushion. Access under the proposed PRGF arrangement (65 percent of quota) would buttress this latter objective, while gradually reducing exposure to Georgia in line with the current guidelines on prolonged use of Fund resources.

31. The envisaged dismantling by year's end of the protectionist measures adopted in 2002 is a reassuring indication of the authorities' commitment to a liberal trade regime. In that vein, the upcoming tax reform would provide a good opportunity to further reduce the average and dispersion of customs duties and possibly move to a low uniform tariff, thereby improving resource allocation and reducing rent-seeking and smuggling.

32. In sum, the proposed program represents a strong and credible commitment by the government to bolster the economic fundamentals and improve the population's quality of life. The risks in the outlook discussed above need, though, to be carefully managed by the authorities and further eased by reducing the vulnerability to shocks. The new authorities have shown thus far a commendable sense of ownership and have received tangible expressions of international support that augur well for program implementation. On this basis, staff recommends approval of the new arrangement by the Executive Board.

Table 1. Georgia: Selected Economic and Financial Indicators, 1999-2004

	1999	2000	2001	2002	2003 Est.	2004 Proj.
(Percentage change relative to previous year, unless otherwise indicated)						
National income and prices						
Nominal GDP	12.4	6.1	10.4	12.2	13.7	11.3
GDP at constant prices	3.0	1.9	4.7	5.5	8.6	6.0
Nominal GDP (millions of lari)	5,665	6,013	6,638	7,448	8,466	9,422
Consumer price index, period average	19.1	4.0	4.7	5.6	4.8	5.8
Consumer price index, end-of-period	10.9	4.6	3.4	5.4	7.0	5.0
Gini coefficient 1/	0.39	0.40	0.38	0.39	0.38	...
Money and credit (end-of-period)						
Reserve money	18.8	26.8	9.9	18.4	13.9	14.0
Broad money (including foreign exch. deposits)	20.7	39.0	18.5	17.9	22.8	19.5
Gross international reserves						
In months of imports of goods and services (excl. pipeline imports)	1.3	1.0	1.4	1.8	1.5	1.5
In millions of U.S. dollars	132	109	161	198	191	208
(In percent of GDP, unless otherwise indicated)						
Savings and investment						
Investment	19.2	18.2	18.5	18.4	22.3	26.6
Non-government sector	17.1	17.1	16.7	16.4	20.6	23.4
Gross Domestic Saving	11.5	13.7	11.9	12.4	14.5	17.0
Non-government sector	16.1	16.7	12.1	12.3	15.1	15.4
Current account deficit	7.8	4.4	6.5	6.0	7.9	9.6
General government 2/						
Total revenue and grants	15.4	15.2	16.3	15.8	15.7	19.0
<i>Of which:</i> Tax revenue	13.8	14.2	14.3	14.4	14.3	16.3
Total expenditure and net lending	22.1	19.2	18.3	17.8	18.2	20.5
<i>Of which:</i> Current expenditure	20.0	18.2	16.5	15.7	16.4	17.3
Primary balance	-3.9	-1.0	-0.2	0.0	-0.4	0.5
Fiscal balance, commitment basis	-6.7	-4.0	-2.0	-2.0	-2.5	-1.6
Net change in expenditure arrears	...	1.4	0.2	-0.4	1.5	-1.0
Statistical discrepancy	...	0.1	0.1	0.5	-0.3	...
Fiscal balance, cash basis	-5.0	-2.6	-1.6	-1.9	-1.3	-2.6
Financing	5.0	2.6	1.6	1.9	1.3	2.6
Privatization	0.9	0.3	0.1	0.2	0.3	0.3
External 3/	1.7	0.0	1.9	1.8	1.0	2.0
Domestic	2.3	2.2	-0.4	-0.1	0.6	0.3
Adjustment for net withheld Adjara transfers 4/	0.0	0.0	0.0	0.0	-0.7	0.0
External sector						
Trade balance	-19.1	-13.0	-15.2	-12.9	-15.6	-17.6
Trade balance excluding pipeline-related imports	-19.1	-13.0	-15.2	-12.6	-11.0	-12.5
Current account balance						
Excluding transfers	-14.3	-11.2	-13.6	-11.4	-14.1	-16.4
Including transfers	-7.8	-4.4	-6.5	-6.0	-7.9	-9.6
Net change in external arrears	2.0	2.2	0.2	0.0	1.3	-1.2
External debt	61.4	52.0	53.5	54.8	49.6	46.5

Sources: Georgian authorities; and Fund staff estimates.

1/ Gini coefficient by consumption, as reported by the State Department for Statistics.

2/ For 2003, the classification of the old Budget Systems Law is used.

3/ External financing for 2004 includes possible debt relief from the Paris Club.

4/ For 2003, deposits by the government of Adjara at commercial banks that reflect withheld tax revenues are excluded from net financing to the government.

Table 2. Georgia: Millennium Development Goals (In percent, unless otherwise specified)

	1990	1995	2001	2002
1 Eradicate extreme poverty and hunger	2015 target = halve 1990 \$1 a day poverty and malnutrition rates			
Population below US\$1 a day	...	...	...	15
Poverty gap at US\$1 a day	...	...	...	9
Share of income or consumption held by poorest 20 percent	...	...	6	...
Prevalence of child malnutrition (percent of children under 5)	...	...	3.1	...
Share of population below minimum level of dietary energy consumption	...	...	...	...
2 Achieve universal primary education	2015 target = net enrollment to 100			
Net primary enrollment ratio (percent of relevant age group)	...	...	95.2	...
Percentage of cohort reaching grade 5	...	...	...	...
Youth literacy rate (ages 15-24)	...	...	...	...
3 Promote gender equality	2005 target = education ratio to 100			
Ratio of girls to boys in primary and secondary education	94.3	95.4	102.3	...
Ratio of young literate females to males (ages 15-24)	...	...	...	...
Share of women employed in the nonagricultural sector	...	...	...	...
Proportion of seats held by women in national parliament	...	7	7	7
4 Reduce child mortality	2015 target = reduce 1990 under 5 mortality by two-thirds			
Under 5 mortality rate (per 1,000)	29	29	29	...
Infant mortality rate (per 1,000 live births)	21	28	23	24
Immunization, measles (percent of children under 12 months)	99	61	73	...
5 Improve maternal health	2015 target = reduce 1990 maternal mortality by three-fourths			
Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	22	...	...
Births attended by skilled health staff (percent of total)	...	...	96.4	...
6 Combat HIV/AIDS, malaria and other diseases	2015 target = halt, and begin to reverse, AIDS, etc.			
Prevalence of HIV, female (ages 15-24)	...	...	0	...
Contraceptive prevalence rate (of women ages 15-49)	...	...	40.5	...
Number of children orphaned by HIV/AIDS	...	...	..	...
Incidence of tuberculosis (per 100,000 people)	...	...	74.9	...
Tuberculosis cases detected under DOTS 1/	...	15	34	...
7 Ensure environmental sustainability	2015 target = various (see notes)			
Forest area (% of total land area)	43	...	43	...
Nationally protected areas (percent of total land area)	...	2.7	2.8	2.8
GDP per unit of energy use (PPP \$ per kg oil equivalent)	1.6	5.2	3.6	...
CO2 emissions (metric tons per capita)	2.8	0.4	1	...
Access to an improved water source (percent of population)	...	...	79	...
Access to improved sanitation (percent of population)	...	...	100	...
Access to secure tenure (percent of population)	...	...	..	...
8 Develop a Global Partnership for Development	2015 target = various (see notes)			
Youth unemployment rate (percent of total labor force ages 15-24)	...	...	...	...
Fixed line and mobile telephones (per 1,000 people)	...	102.2	212.5	...
Personal computers (per 1,000 people)	...	...	...	...
General indicators				
Population (in millions)	5.4	5.1	4.6	4.6
Gross domestic product (US\$ billion)	5.1	2.1	3.2	3.4
GDP per capita (US\$)	940	410	696	778
Adult literacy rate (percent of people ages 15 and over)	...	...	...	...
Total fertility rate (births per woman)	2.2	1.4	1.1	1.1
Life expectancy at birth (years)	72.3	72.5	73.2	73.3
Public and publicly guaranteed external debt (percent of GDP)	...	64.1	51.7	52.4
Investment (percent of GDP)	29.1	23.9	18.5	18.4
Trade (percent of GDP) 2/	85.6	67.9	72.9	70.3

Sources: World Development Indicators database, April 2002; Georgian State Department of Statistics; and Fund staff estimates.

Note: In some cases the data are for earlier or later years than those stated. The goal targets are the following: Goal 1: Halve, between 1990 and 2015, the proportion of people whose income is less than US\$1 a day. Halve, between 1990 and 2015, the proportion of people who suffer from hunger; Goal 2: Ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling; Goal 3: Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education no later than 2015; Goal 4: Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate; Goal 5 target: Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio; Goal 6: Have halted by 2015, and begun to reverse, the spread of HIV/AIDS. Have halted by 2015, and begun to reverse, the incidence of malaria and other major diseases; Goal 7: Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources. Halve, by 2015, the proportion of people without sustainable access to safe drinking water; Goal 8: Develop further an open, rule-based, predictable, non-discriminatory trading and financial system. Deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term. In cooperation with developing countries, develop and implement strategies for decent and productive work for youth. In cooperation with pharmaceutical companies, provide access to affordable, essential drugs in developing countries. In cooperation with the private sector, make available the benefits of new technologies, especially information and communications.

1/ Directly observed treatment, short-course case detection and treatment strategy (World Health Organization).

2/ Trade is calculated as the sum of imports and exports of goods and non-factor services relative to GDP.

Table 3. Georgia: 2003 Quantitative Indicative Targets 1/

	Cumulative Change from End-December 2002												
	Stocks 2/	Mar. 2003			Jun. 2003			Sep. 2003			Dec. 2003		
	End-Dec. 2002	Indicative target	Adjusted target	Actual	Indicative target	Adjusted target	Actual	Indicative target	Adjusted target	Actual	Indicative target	Adjusted target	Actual
	(In millions of lari)												
1. Indicative targets 3/													
Floor on general govt. tax revenue (including special funds) 4/	1076.0	272.0	272.0	273.4	585.5	585.5	576.0	924.0	924.0	912.5	1284.0	1284.0	1207.7
Ceiling on cash deficit of the general govt. 5/ 8/	139.0	36.9	38.3	9.6	50.3	58.8	35.7	98.3	93.4	73.7	136.0	119.5	109.5
Ceiling on domestic expenditure arrears of the general govt.	-29.8	22.1	22.1	34.7	18.3	18.3	59.0	-6.0	-6.0	58.9	-16.0	-16.0	123.5
Floor on cigarette and petroleum revenues	124.9	31.0	31.0	23.9	66.7	66.7	53.7	100.2	100.2	89.8	146.3	146.3	133.9
Ceiling on net credit of the banking system to the general govt. (NCG) 6/ 8/	713.7	18.3	13.8	6.3	33.7	16.9	32.7	29.9	27.8	52.7	55.1	42.5	108.4
Ceiling on net domestic assets (NDA) of the NBG 6/	814.2	11.2	6.7	-5.7	33.5	16.6	-12.2	32.1	29.9	2.4	47.8	35.3	22.5
Ceiling on reserve money	509.0	-8.0	-8.0	-18.4	11.0	11.0	-3.8	64.1	64.1	41.3	57.5	57.5	70.9
	(In millions of U.S. dollars)												
Floor on total net international reserves (NIR) of the NBG 7/	-142.0	-8.9	-8.0	-5.9	-10.5	-7.7	3.9	14.9	17.1	18.1	4.5	12.5	22.5
Ceiling on contracting or guaranteeing													
A. 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	0.0	0.0	0.0
B. Nonconcessional medium- and long-term external debt	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
2. Adjusters													
A. Net foreign-currency non-project flows 7/													
Projection			-9.4			-19.6			-23.0			-33.4	
Outturn			-8.5			-16.8			-20.8			-25.4	
Adjustment to NIR target			1.0			2.8			2.2			8.0	
	(In millions of lari)												
B. Net external non-project flows to the budget 6/													
Projection			-29.2			-63.6			-76.6			-108.7	
Outturn			-24.7			-46.7			-74.5			-96.1	
Adjustment to NDA and NCG targets			-4.5			-16.8			-2.1			-12.6	
C. External project financing minus non-project grants plus external interest payments 5/													
Projection			42.7			78.0			129.0			180.1	
Outturn			44.1			86.5			124.2			163.6	
Adjustment to cash deficit target			1.4			8.5			-4.8			-16.5	
3. Deposits of the government of Adjara at commercial banks reflecting tax revenues withheld from the central government 8/				10.2			23.6			37.2			56.0

Sources: Georgian authorities and Fund staff estimates.

1/ Section 1 of this table shows quantitative indicative targets for 2003 based on cumulative changes from end-December 2002. Some ceilings and floors are subject to possible adjustment, as indicated in footnotes 5, 6, and 7, based on deviations from projections of external financing, reported in Section 3 of the table. Continuous performance criteria are defined in paragraph 53 of the MEFP (www.imf.org).

2/ Year-to-date flows for tax revenues, cash deficit, expenditure arrears, and cigarette and oil revenues.

3/ Quantitative targets for 2003 are based upon accounting exchange rates of 2.15 lari/US\$, 1.28 US\$/SDR, and 0.90 US\$/euro.

4/ Special state funds include the Pension, Employment, and Road Funds. Privatization receipts are excluded.

5/ The program target on the cash deficit is adjusted for deviations from projected disbursements of external project finance minus non-project grants plus external interest payments (Section 2C) as specified in the TMU agreed with the authorities in 2003, subject to a cap on cumulative upward adjustment of lari 80 million.

6/ Program targets on NCG and NDA are adjusted for deviations from projected net external non-project flows to the budget (Section 2B) as specified in the TMU agreed with the authorities in 2003, and subject to a cap on cumulative upward adjustment of lari 25 million.

7/ The program target on NIR is adjusted for deviations from projected net foreign-currency non-project flows (Section 2A) as specified in the TMU agreed with the authorities in 2003, subject to a cap on downward adjustment of US\$20 million.

8/ As specified in the TMU agreed with the authorities in 2003, until the Adjara revenue issue has been resolved, deposits by the government of Adjara at commercial banks that reflect tax revenues withheld from the central government will be excluded from net financing to the government. The cumulative lari amount equivalent to the non-transferred revenues will be added to the end-period outcomes for the cash deficit and net banking system credit to the government.





Table 5. Georgia: Prudential Indicators of Commercial Banks, 1997–2003  
(End-of-period)

	1997	1998	1999	2000	2001	2002	2003
Capital adequacy ratio (in percent) 1/	30.6	34.9	38.5	36.7	33.1	21.9	20.3
Leverage ratio 2/	45.0	43.5	45.6	44.2	39.9	36.1	33.5
Nonperforming loans (in percent of total loans)	5.9	5.4	6.6	7.1	11.6	7.9	7.5
Specific provisions (in percent of total loans)	5.4	3.1	2.6	4.7	7.5	4.4	4.5
Loans collateralized by real estate (in percent of total loans)	...	...	...	...	30.2	33.3	31.9
Loans in foreign exchange in percent of total loans	44.5	64.8	71.8	81.4	81.4	83.8	87.7
Net foreign assets (in millions of lari)	33.0	13.7	-6.3	-12.7	3.7	25.0	42.5
Net foreign assets (in percent of total assets)	9.7	2.9	-1.1	-1.7	0.4	2.2	3.2
Net open foreign exchange position 3/	n.a.	18.1	15.2	15.7	6.9	9.3	8.5
Liquidity ratio (in percent)	37.8	44.5	40.3	36.8	38.5	45.4	43.3

Source: National Bank of Georgia.

1/ In 2002, the risk weighting for foreign currency loans was increased to 200 percent, thereby reducing capital adequacy ratios.

2/ Defined as the ratio of total capital to total liabilities; an increase in the ratio indicates an improvement.

3/ Percent of total regulatory capital.

Table 6. Georgia: Macroeconomic Framework, 1999-2008

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
	Actuals				Est.			Proj.		
	(Percent change)									
Output, prices, money, and external trade										
Real GDP	3.0	1.9	4.7	5.5	8.6	6.0	5.0	5.0	5.0	5.0
Consumer price index (average)	19.1	4.0	4.7	5.6	4.8	5.8	5.0	5.0	5.0	5.0
Broad money (M3, lari)	20.7	39.0	18.5	17.9	22.8	19.5	18.2	17.0	15.6	13.9
Exports (US\$)	-0.3	22.5	-19.1	16.9	17.6	6.2	7.2	6.8	7.2	7.0
Imports (US\$) 1/	-13.0	-3.1	-2.3	3.5	27.6	15.5	5.0	2.7	-2.6	7.2
	(In percent of GDP)									
General government 2/										
Total revenues and grants	15.4	15.2	16.3	15.8	15.7	19.0	19.7	20.8	22.0	23.3
Tax revenues	13.8	14.2	14.3	14.4	14.3	16.3	17.3	18.3	19.3	20.3
Non-tax revenues	0.8	0.8	1.3	1.1	0.8	1.0	1.1	1.2	1.6	1.9
Grants	0.9	0.3	0.7	0.3	0.6	1.7	1.3	1.2	1.1	1.1
Expenditures and net lending	22.1	19.2	18.3	17.8	18.2	20.5	20.3	21.3	23.4	25.1
Current expenditure	20.0	18.2	16.5	15.7	16.4	17.3	17.2	18.3	20.6	22.2
non-interest	17.2	15.2	14.7	13.8	14.3	15.3	15.5	16.7	19.1	20.8
interest	2.8	3.0	1.8	2.0	2.1	2.0	1.7	1.6	1.5	1.4
Capital expenditure and net lending	2.1	1.0	1.8	2.0	1.8	3.2	3.1	3.0	2.9	2.9
Primary balance	-3.9	-1.1	-0.2	0.0	-0.4	0.5	1.1	1.1	0.1	-0.4
Overall balance (commitment basis)	-6.7	-4.0	-2.0	-2.0	-2.5	-1.6	-0.6	-0.5	-1.4	-1.8
Net change in expenditure arrears 3/	...	1.4	0.2	-0.4	1.5	-1.0	-1.4	-1.4	0.0	0.0
Overall balance (cash basis)	-5.0	-2.6	-1.6	-1.9	-1.3	-2.6	-2.0	-2.0	-1.4	-1.8
Financing	5.0	2.6	1.6	1.9	1.3	2.6	2.0	2.0	1.4	1.8
Privatization	0.9	0.3	0.1	0.2	0.3	0.3	0.3	0.3	0.3	0.3
Domestic financing	2.3	2.2	-0.4	-0.1	0.6	0.3	0.4	0.3	0.2	0.2
External financing (net)	1.7	0.0	1.9	1.8	1.0	2.0	1.3	1.4	0.9	1.3
Disbursements (incl. in-kind)	2.9	1.1	2.4	2.3	1.6	3.0	2.6	2.6	2.5	2.3
Amortization	-1.2	-1.1	-4.1	-1.6	-0.6	-3.4	-2.4	-2.1	-1.6	-1.0
Debt rescheduling	...	...	3.6	1.0	0.0	2.4	1.1	0.9	0.0	0.0
Adjustment for Net Withheld Adjara Transfers 4/	...	...	...	...	-0.7	...	...	...	...	...
Saving and investment										
Investment	19.2	18.2	18.5	18.4	22.3	26.6	27.6	26.0	22.6	23.2
Non-government sector 1/	17.1	17.1	16.7	16.4	20.6	23.4	24.4	23.0	19.7	20.3
Of which: FDI	2.2	5.0	2.5	3.8	7.8	8.0	8.0	6.3	2.5	2.7
Gross domestic saving	11.5	13.7	11.9	12.4	14.5	17.0	18.0	17.9	17.6	18.4
General government	-4.6	-3.0	-0.2	0.1	-0.7	1.6	2.5	2.5	1.5	1.1
Non-government sector	16.1	16.7	12.1	12.3	15.2	15.4	15.5	15.4	16.1	17.3
Current account deficit 1/	7.8	4.4	6.5	6.0	7.9	9.6	9.6	8.2	5.0	4.7
	(In millions of U.S. dollars; unless otherwise indicated)									
Gross official reserves of the NBG 5/	132	109	161	198	191	207	235	265	315	349
(In months of imports of non-pipeline goods and servi	1.3	1.0	1.4	1.8	1.5	1.5	1.6	1.6	1.8	1.9
(In months of imports of goods and services)	1.3	1.0	1.4	1.7	1.4	1.3	1.4	1.5	1.8	1.9
External debt, public and guaranteed										
External debt stock	1,691	1,560	1,655	1,776	1,840	1,902	1,977	2,072	2,223	2,339
External debt service, total	...	...	...	228	195	218	222	212	195	160
Memorandum items:										
Nominal GDP (in millions of lari)	5,665	6,013	6,638	7,448	8,466	9,422	10,388	11,453	12,627	13,921
Nominal GDP (in millions of US\$)	2,803	3,042	3,201	3,392	3,937	4,382	4,556	4,868	5,206	5,568
External debt stock (public and guaranteed)/ GDP	60.3	51.3	51.7	52.4	46.7	43.4	43.4	42.6	42.7	42.0
Domestic public debt/GDP	16.7	18.5	16.7	15.0	15.3	13.1	10.9	8.7	8.1	7.6
Exchange rate, average (Lari/US\$)	2.02	1.98	2.07	2.20	2.15	...	...	...	...	...
M3-velocity	n.a.	9.7	9.1	8.6	8.0	7.4	6.9	6.5	6.2	6.0
Social sector expenditures (percent of GDP)	n.a.	8.3	8.3	8.0	7.7	7.9	8.3	8.7	9.1	9.8
Social sector spending, cash basis (percent of GDP)	n.a.	6.9	8.2	8.3	7.2	8.5	9.7	10.2	9.1	9.8

Sources: Georgian authorities; and Fund staff estimates.

1/ Large oil and gas pipeline projects are projected to increase investment and the current account deficit substantially in 2003-2006.

2/ For 2003, the classification of the old Budget Systems Law is used.

3/ The projections assume net repayment of budgetary arrears of GEL 408 million during 2004-06.

4/ For 2003, deposits by the government of Adjara at commercial banks that reflect withheld tax revenues are excluded from net financing to the government.

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

Table 7. Georgia: Energy Sector Quasi-Fiscal Losses, 2001-04

	2001	2002	2003	2004 Proj.
<b>Power sector</b>				
Quantity delivered (million kWh) 1/	6085.5	6433.7	6669.8	6873.0
Cost (US cents)	4.1	4.1	4.5	4.4
Tariff (US cents)	4.1	4.1	4.2	4.2
Collection rate (percent) 2/	19.7	31.6	49.8	50.4
Generation cost (US\$ million)	247.7	263.5	298.6	305.5
Billed amount (US\$ million)	247.7	263.5	277.9	291.3
Collected amount (US\$ million)	48.8	83.3	138.3	146.9
Total losses (US\$ million)	198.9	180.2	160.3	158.5
<i>Of which:</i> price effect (US\$ million)	0.0	0.0	20.6	14.2
<i>Of which:</i> non-payment effect (US\$ million)	198.9	180.2	139.6	144.4
Total losses (percent of GDP)	6.2	5.3	4.1	3.6
<b>Gas sector</b>				
Tbilgazi: total losses (US\$ million)	...	15.6	24.9	25.4
Other consumers: total losses (US\$ million)	...	15.0	16.8	18.6
Total losses (percent of GDP)	...	0.9	1.1	1.0
<b>Energy sector (power + gas sector)</b>				
Total losses (US\$ million)	...	195.8	185.2	183.9
Total losses (percent of GDP)	...	6.2	5.1	4.6
GDP (US\$ million)	3200.9	3392.0	3928.6	4382.4

Source: Fund staff calculations, based on data provided by the authorities and energy-sector entities (GWEM, GSE, AES, Tbilgazi, and GGIC).

1/ Quantity produced domestically and net imports less 15 percent normative losses.

2/ UDC collection rate for 2002 are based on Fund staff estimates.

Table 8. Georgia: Accounts of the National Bank of Georgia, 2002-2004

	2002			2003			2004			
	Dec.	Mar.	Jun.	Dec.	Dec.		Mar.	Jun.	Sep.	Dec.
	Actual 1/	Actual 1/	Actual 1/	Actual 1/	Actual 1/	Actual 2/	Target 2/	Target 2/	Target 2/	Target 2/
	(Annual percentage change)									
Net foreign assets	16.7	15.8	22.2	25.2	15.9	17.0	17.5	13.6	12.6	18.8
Net domestic assets	2.2	-0.3	-2.1	0.0	2.8	0.4	3.2	5.3	3.7	2.2
Net claims on general government	2.3	1.8	1.4	2.2	3.5	3.5	6.7	6.0	4.7	3.4
Claims on rest of economy	0.5	-1.5	1.1	0.8	0.5	0.4	2.8	0.1	0.0	0.0
Reserve money (RM)	18.4	13.3	15.5	19.5	13.9	13.9	20.4	19.5	13.9	14.0
Currency in circulation (M0)	14.1	10.2	12.0	17.0	13.4	13.4	20.9	20.9	14.8	13.8
Required reserves	35.5	28.6	38.7	22.3	12.7	12.7	8.1	-1.2	6.3	17.4
Balances on banks' correspondent accounts	79.7	31.6	1.8	81.4	29.1	29.1	59.1	113.0	24.9	6.9
	(In percent of lagged reserve money)									
Net foreign assets	14.3	13.8	19.4	19.4	9.5	13.2	14.6	10.3	7.9	10.7
Net domestic assets	4.2	-0.5	-3.9	0.0	4.4	0.7	5.8	9.2	6.0	3.4
<i>Of which:</i> Net claims on general government	3.9	3.0	2.4	3.6	5.2	5.2	10.1	9.0	6.6	4.6
Reserve money (RM)	18.4	13.3	15.5	19.5	13.9	13.9	20.4	19.5	13.9	14.0
<i>Of which:</i> Currency in circulation (M0)	12.0	8.5	10.0	14.1	11.0	11.0	17.0	16.8	12.0	11.3
	(In millions of lari)									
Net foreign assets	-305	-318	-297	-266	-257	-329	-337	-330	-304	-267
Gold	1	1	1	2	2	2	2	2	2	2
Foreign exchange reserves (including BIS account) 3/	407	380	372	389	362	413	388	406	406	446
Use of Fund resources	-628	-614	-584	-570	-535	-622	-605	-615	-590	-593
Other foreign liabilities (net)	-86	-86	-86	-86	-86	-122	-122	-122	-122	-122
Net domestic assets	814	809	802	817	837	909	927	933	931	929
Net claims on general government	756	743	757	770	783	783	793	803	806	809
Loans	777	792	791	805	817	817	828	837	841	844
Deposits	-21	-48	-34	-36	-35	-35	-35	-35	-35	-35
Claims on rest of economy	84	81	84	84	84	118	118	118	118	118
Claims on banks	0	-5	0	2	6	6	7	7	7	7
Other items, net	-25	-11	-39	-39	-36	2	9	6	0	-5
Reserve money (RM)	509	491	505	550	580	580	591	604	627	661
Currency in circulation (M0)	417	399	408	445	473	473	482	493	511	539
Required reserves	72	74	85	83	81	81	80	84	89	96
Balances on banks' correspondent accounts	20	18	13	22	25	25	28	27	27	27
Memorandum items:										
Growth of reserve money (in percent, relative to end of previous year)	18.4	-3.6	-0.7	8.1	13.9	13.9	1.8	4.1	8.1	14.0
Foreign exchange reserves (in mlns of U.S. dollars) 3/	189	177	173	181	169	192	180	189	189	207

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 1.28 and US\$/Euro of 0.90.

2/ 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.

3/ Includes SDR holdings and foreign currency account with BIS which is used for debt service payments.

Table 9. Georgia: Monetary Survey, 2002-2004

	2002		2003				2004			
	Dec. Actual 1/	Mar. Actual 1/	Jun. Actual 1/	Sep. Actual 1/	Dec. Actual 1/ Actual 2/		Mar. Target 2/	Jun. Target 2/	Sep. Target 2/	Dec. Target 2/
	(Annual percentage change)									
Net foreign assets	22.9	23.4	27.5	43.9	23.9	23.1	25.9	23.9	5.2	24.9
Net domestic assets	4.4	3.2	4.4	9.8	11.4	9.0	8.2	9.0	9.1	10.1
Domestic credit	8.5	10.7	12.9	15.7	14.4	14.1	13.5	11.0	10.2	8.6
Net claims on general government	-1.5	-1.5	-0.1	3.9	7.3	7.3	10.5	9.8	8.8	4.1
Credit to the rest of the economy	20.8	25.1	27.8	28.5	21.4	20.4	16.2	12.0	11.3	12.4
Broad money (M3)	17.9	17.0	20.8	32.1	22.8	22.8	23.3	22.1	12.7	19.5
Broad money, excl. forex deposits (M2)	14.5	10.3	11.3	20.0	14.1	14.1	20.9	24.1	15.9	18.0
Currency held by the public	12.0	7.7	8.6	15.7	13.0	13.0	20.5	22.3	15.3	13.1
Total deposit liabilities	23.2	24.9	30.7	45.2	30.9	30.9	25.4	22.0	11.0	24.1
	(In percent of lagged broad money)									
Net foreign assets	11.4	12.1	14.1	18.2	7.7	9.9	11.4	9.5	1.3	6.7
Net domestic assets	6.6	4.9	6.7	13.9	15.1	12.9	11.9	12.5	11.4	12.9
Domestic credit	15.4	18.6	22.8	26.8	23.9	23.9	22.9	18.5	15.5	13.6
Net claims on general government	-1.5	-1.4	-0.1	3.4	6.1	6.1	8.4	7.7	6.1	3.0
Credit to the rest of the economy	16.9	20.1	22.9	23.4	17.8	17.8	14.5	10.9	9.4	10.6
Other items, net	-8.8	-13.8	-16.1	-12.9	-8.8	-11.0	-11.0	-6.0	-4.1	-0.7
Broad money (M3)	17.9	17.0	20.8	32.1	22.8	22.8	23.3	22.1	12.7	19.5
Currency held by the public	5.7	3.5	3.9	7.0	5.9	5.9	8.6	9.0	6.0	5.5
Total deposit liabilities	12.2	13.5	16.9	25.1	16.9	16.9	14.7	13.1	6.7	14.1
	(In millions of lari)									
Net foreign assets	-279	-302	-285	-186	-213	-285	-291	-281	-253	-214
Net domestic assets	1143	1188	1211	1240	1273	1345	1384	1412	1441	1482
Domestic credit	1432	1467	1529	1573	1638	1672	1703	1735	1770	1816
Net claims on general government	714	710	723	729	766	766	784	794	794	798
Public-guaranteed borrowing from DMBs	0	0	0	0	0	0	0	0	0	0
Credit to the rest of the economy	719	757	806	844	872	906	919	941	976	1018
Other items, net	-289	-279	-318	-333	-365	-327	-320	-323	-329	-334
Broad money (M3)	864	886	926	1054	1060	1060	1093	1131	1188	1268
Broad money, excl. forex deposits (M2)	462	448	450	505	527	527	542	559	585	622
Currency held by the public	391	373	375	412	442	442	449	458	475	499
Total deposit liabilities	473	513	551	642	619	619	644	672	713	768
Memorandum items:										
Growth of broad money (in percent, relative to end of previous year)	17.9	2.6	7.2	22.1	22.8	22.8	3.1	6.6	12.0	19.5
Growth of credit to the rest of the economy (in percent, relative to end of previous year)	20.8	5.3	12.2	17.4	21.4	20.4	1.4	3.8	7.8	12.4
M3 multiplier 3/	1.7	1.8	1.8	1.9	1.8	1.8	1.9	1.9	1.9	1.9
M3 velocity 4/	8.6	...	...	...	8.0	8.0	...	...	...	7.4
Foreign exchange deposits in percent of total deposits	84.9	85.3	86.3	85.5	86.1	86.1	85.6	85.1	84.5	84.0

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 1.28 and US\$/Euro of 0.90.

2/ 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.

3/ M3 divided by reserve money.

4/ Annual GDP divided by end-period M3.

Table 10. Georgia: Summary Medium-Term Balance of Payments, 1998-2008  
(In million of U.S. dollars)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
	Act. 1/ 1998	Act. 1/ 1999	Act. 1/ 2000	Act. 1/ 2001	Act. 1/ 2002	Est. 2003	Proj.				
<b>Current account balance (including transfers) 1/</b>	<b>-370</b>	<b>-217</b>	<b>-135</b>	<b>-209</b>	<b>-205</b>	<b>-310</b>	<b>-419</b>	<b>-436</b>	<b>-398</b>	<b>-258</b>	<b>-263</b>
Trade balance	-685	-536	-397	-486	-439	-615	-771	-795	-786	-687	-738
Exports (total)	478	477	584	473	553	650	691	740	791	848	907
Imports (total)	1164	1013	982	959	992	1265	1461	1535	1577	1535	1645
<i>Of which gas and oil pipeline</i>	139	0	0	0	12	180	224	206	146	0	0
Services and income (net)	86	136	55	50	53	59	53	60	79	118	147
Transfers	229	183	207	226	181	246	299	299	309	311	328
Official transfers to general government	92	69	51	81	58	56	107	99	100	93	101
Other transfers	137	114	156	146	124	190	192	200	209	218	227
<i>Of which: worker remittances</i>	71	72	77	78	72	180	187	195	204	214	222
<b>Capital account</b>	<b>246</b>	<b>141</b>	<b>70</b>	<b>112</b>	<b>114</b>	<b>300</b>	<b>396</b>	<b>410</b>	<b>361</b>	<b>203</b>	<b>258</b>
Medium- and long-term public sector loans	31	-3	-72	-46	-66	-38	23	21	30	44	78
Disbursements	113	79	35	80	95	69	140	142	143	145	147
World Bank	74	58	19	64	61	44	84	87	87	87	87
EBRD	9	4	6	2	20	6	16	19	16	17	18
IFAD	1	1	1	2	1	1	3	2	2	2	2
Bilateral	29	13	9	12	13	19	38	34	38	39	40
Amortization	82	82	107	126	160	107	117	121	114	101	69
Foreign direct investment	221	62	153	80	130	306	350	365	305	130	150
<i>Of which gas and oil pipeline</i>	174	0	0	0	15	240	280	275	195	0	0
Other private capital, net (incl. commercial banks) 2/	-6	82	-10	78	50	32	23	24	26	28	30
<b>Overall Balance</b>	<b>-124</b>	<b>-77</b>	<b>-65</b>	<b>-97</b>	<b>-91</b>	<b>-11</b>	<b>-23</b>	<b>-25</b>	<b>-37</b>	<b>-55</b>	<b>-5</b>
<b>Financing</b>	<b>124</b>	<b>76</b>	<b>65</b>	<b>97</b>	<b>91</b>	<b>10</b>	<b>-81</b>	<b>-41</b>	<b>-38</b>	<b>-69</b>	<b>-67</b>
Use of Fund resources, net	36	24	-26	24	0	-48	-13	-13	-8	-18	-33
<i>Of which: purchases/disbursements</i>	37	45	0	37	30	0	42	42	42	21	0
<i>Of which: repurchases/repayments</i>	1	21	26	13	30	48	55	55	50	39	33
Increase in reserves (-)	55	-14	23	-52	-37	7	-17	-28	-29	-51	-34
Change in arrears (+, increase)	-94	55	68	5	0	51	-51	0	0	0	0
Debt relief obtained	5	0	0	114	128	0	0	0	0	0	0
Paris Club rescheduling	...	...	...	114	128	0	0	0	0	0	0
Rescheduling of arrears	...	...	...	0	0	0	0	0	0	0	0
Macroeconomic support from the EU	122.7	12	0	5	0	0	0	0	0	0	0
<b>Financing gap</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>103</b>	<b>67</b>	<b>74</b>	<b>124</b>	<b>72</b>
Possible debt relief from Paris Club 3/	...	...	...	...	...	0	103	51	42	0	0
<b>Residual financing gap</b>	<b>...</b>	<b>...</b>	<b>...</b>	<b>...</b>	<b>...</b>	<b>0</b>	<b>0</b>	<b>15</b>	<b>32</b>	<b>124</b>	<b>72</b>
<b>Memorandum items</b>											
Current account deficit, including transfers											
(In percent of GDP)	10.2	7.7	4.4	6.5	6.0	7.9	9.6	9.6	8.2	5.0	4.7
Current account deficit, excluding pipeline-related imports	6.4	7.7	4.4	6.5	5.7	3.3	4.4	5.0	5.2	5.0	4.7
Export growth (percent)	-3.1	-0.3	22.5	-19.1	16.9	17.6	6.2	7.2	6.8	7.2	7.0
<i>Of which: volume growth</i>	1.8	2.5	25.6	-15.8	15.0	4.3	4.5	4.5	4.9	4.9	4.4
Import growth (percent)	10.6	-13.0	-3.1	-2.3	3.5	27.6	15.5	5.0	2.7	-2.6	7.2
Nonpipeline-related import growth (percent)	2.4	-13.0	-3.1	-2.3	2.2	10.8	14.0	7.4	7.7	7.3	7.2
<i>Of which: volume growth</i>	0.6	-1.3	0.3	-0.9	-2.1	6.3	7.0	7.5	6.4	6.2	5.5
Gross international reserves 4/	118.4	132.4	109.4	161.1	197.7	190.9	207.5	235.5	264.8	315.4	348.9
(In months of imports of goods and services)	1.0	1.3	1.0	1.4	1.7	1.4	1.3	1.4	1.5	1.8	1.9
(In months of imports of non-pipeline goods and services)	1.1	1.3	1.0	1.4	1.8	1.5	1.5	1.6	1.6	1.8	1.9
Debt service due	124.8	151.2	186.9	188.3	232.5	200.9	222.2	229.2	219.3	201.4	165.5
(In percent of GNFS exports)	17.3	20.5	17.1	19.4	22.7	17.0	17.7	17.0	15.1	12.8	9.8
Total external debt (nominal)	1,636	1,722	1,582	1,712	1,858	1,954	2,039	2,137	2,259	2,438	2,585
(In percent of GDP)	45.2	61.4	52.0	53.5	54.8	49.6	46.5	46.9	46.4	46.8	46.4
Public and publicly guaranteed external debt (nominal)	1,631	1,691	1,560	1,655	1,776	1,840	1,902	1,977	2,072	2,223	2,339
(In percent of GDP)	45.0	60.3	51.2	51.7	52.4	46.7	43.4	43.4	42.6	42.7	42.0

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

1/ From 2000 onwards, the current account is based on a new series estimated by the NBG, which is not consistent with data prior to 2000.

2/ Includes errors and omissions.

3/ Assumes rescheduling of 2003 arrears in 2004 and of principal maturities falling due during 2004-06. Includes comparable treatment by non-Paris Club bilateral creditors.

4/ The 2003 figure differs from that in Table 8 because it reflects actual, rather than program, exchange rates.

Table 11. Georgia: External Financing Requirements and Sources, 1998-2008

(In millions of U.S. dollars)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
						Est.	Proj.				
<b>Total requirements</b>	<b>459</b>	<b>321</b>	<b>269</b>	<b>348</b>	<b>395</b>	<b>465</b>	<b>591</b>	<b>612</b>	<b>561</b>	<b>398</b>	<b>365</b>
Current account deficit	370	217	135	209	205	310	419	436	398	258	263
Capital outflows	89	104	133	139	190	155	172	176	164	140	102
Scheduled public sector amortization 1/	83	104	133	139	190	155	172	176	164	140	102
Private sector net outflows 2/	6	0	0	0	0	0	0	0	0	0	0
<b>Total sources</b>	<b>459</b>	<b>321</b>	<b>268</b>	<b>348</b>	<b>395</b>	<b>464</b>	<b>487</b>	<b>545</b>	<b>487</b>	<b>274</b>	<b>294</b>
Capital inflows	313	190	178	209	255	407	493	511	455	304	327
Foreign direct investment	221	62	153	80	130	306	350	365	305	130	150
Disbursements to public sector	92	47	35	51	75	69	120	122	123	145	147
Private sector net inflows 2/	0	82	-10	78	50	32	23	24	26	28	30
Exceptional financing	<b>91</b>	<b>144</b>	<b>68</b>	<b>191</b>	<b>177</b>	<b>51</b>	<b>11</b>	<b>62</b>	<b>62</b>	<b>21</b>	<b>0</b>
IMF	37	45	0	37	30	0	42	42	42	21	0
World Bank	21	33	0	30	20	0	20	20	20	0	0
Macroeconomic support from the EU	123	12	0	5	0	0	0	0	0	0	0
Change in arrears, net (- decrease)	-94	55	68	5	0	51	-51	0	0	0	0
Debt rescheduling obtained	5	0	0	114	128	0	0	0	0	0	0
Change in reserves (- increase)	55	-14	23	-52	-37	7	-17	-28	-29	-51	-34
<b>Financing gap</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>103</b>	<b>67</b>	<b>74</b>	<b>124</b>	<b>72</b>
Possible debt relief from Paris Club 3/						0	103	51	42	0	0
<b>Residual financing gap</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>15</b>	<b>32</b>	<b>124</b>	<b>72</b>

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

1/ Includes principal payments to the IMF.

2/ Includes errors and omissions.

3/ Assumes rescheduling of 2003 arrears in 2004 and of principal maturities falling due during 2004-06. Includes comparable treatment by non-Paris Club bilateral creditors.



Table 12. Indicators of Financial Obligations to the Fund, 2002-2010  
(In millions of SDR)

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Obligations from existing and prospective drawings									
Principal (repayments/repurchases)	23.1	33.8	37.0	36.7	33.4	25.9	22.1	22.2	21.1
Charges and interest	1.8	1.6	1.2	1.3	1.2	1.1	1.0	0.9	0.7
Total debt service to the Fund	25.0	35.3	38.2	38.0	34.6	27.0	23.1	23.1	21.8
In percent of quota	16.6	23.5	25.4	25.3	23.0	18.0	15.4	15.4	14.5
In percent of exports of goods and non-factor services	3.1	4.2	4.5	4.2	3.6	2.6	2.1	1.9	1.7
Total Fund credit	228.0	194.3	185.3	176.6	171.2	159.3	137.2	115.0	93.9
In percent of quota	151.7	129.3	123.3	117.5	113.9	106.0	91.3	76.5	62.5
In percent of GDP	8.7	6.9	6.3	5.8	5.3	4.6	3.7	2.9	2.3

Sources: Fund Finance Department and staff estimates and projections.

Table 13. Georgia: Proposed Schedule of Reviews and Disbursements  
Under a New PRGF Arrangement

	Test date	Board date	Amount
Board Approval		May 2004	SDR 14 million
First Review	June 30, 2004	October 2004	SDR 14 million
Second Review	December 31, 2004	April 2005	SDR 14 million
Third Review	June 30, 2005	September 2005	SDR 14 million
Fourth Review	December 31, 2005	March 2006	SDR 14 million
Fifth Review	June 30, 2006	September 2006	SDR 14 million
Sixth Review	December 31, 2006	March 2007	SDR 14 million

## GEORGIA'S EX POST ASSESSMENT: THE VIEWS OF THE AUTHORITIES AND CIVIL SOCIETY<sup>6</sup>

### A. Comments by Current and Former Government Officials

33. **The authorities welcomed the EPA and broadly concurred with its conclusions.** They considered the assessment to be objective and well-balanced, and to provide a succinct description of developments in Georgia under the last two PRGF-supported programs. In their view, these two programs made crucial contributions in guiding the economy through a challenging period of transition, despite recurrent problems in program implementation.

34. **Government officials regarded the resilience of corruption and poor governance as the main reasons for disappointing program performance.** Insufficient coordination within the government, lack of progress on civil service reform, inadequate oversight over SOEs, and frequent changes to the tax code to accommodate interest groups all helped perpetuate poor governance. Owing to pervasive tax fraud and corruption, revenue targets under the program could not be met, resulting in the building of domestic expenditure arrears (especially on pensions and wages) and insufficient investment in infrastructure.

35. **Government officials stressed that the absence of reliable and affordable power supplies remained a major obstacle to sustained growth.** They listed several reasons that explained the failure of reform efforts to improve the technical and financial viability of the sector, including inappropriate timing and sequencing of reforms and insufficient donor financial support. In the early stages of reform, too much donor support had been spent on recurrent expenditures (paying for fuel supplies), and too little on investment in the distribution system. In the view of these officials, substantial new donor support will be needed to improve the electricity distribution network outside Tbilisi.

36. **There was a consensus among government officials that a comprehensive tax reform is needed.** They stressed that the Tax Code introduced in 1997 initially provided a sound legal basis for taxation, but that it was subsequently diluted by amendments granting exemptions to various groups. These officials also felt that the authorities had not engaged in sufficient efforts to explain tax policy to the public. Future tax reform should reduce the tax burden on small and medium enterprises, broaden the tax base, and lead to a simplified code, thereby reducing opportunities for corruption.

### B. Comments from Civil Society Representatives

37. **NGO representatives argued that past political and economic reforms may have been inadequately synchronized, and they invited the Fund to broaden its focus to areas beyond the Fund's traditional expertise.** Focusing on economic aspects and structural

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<sup>6</sup> Comments were received from the NBS, the Ministry of Finance, two former Deputy State Ministers, a former Economic Advisor to the President, and NGO representatives.

reforms without adequate consideration of the political environment (checks and balances within the central government, the division of power and responsibilities between different branches and levels of government, etc.) may have contributed to poor program performance in the past.

38. **NGO representatives also argued that Fund-supported programs and the EPA could have put more emphasis on developing economic institutions in general, and property rights and contract enforcement in particular.** In their view, the new government's drive to combat corruption and increase tax revenue could risk weakening private property rights. They urged Fund staff to look beyond macroeconomic issues and stressed the importance of protecting private property rights in discussions with the authorities and in program design.

39. **On tax policy, civil society representatives noted that the increase in the tax to GDP ratio had slowed down after the introduction of the 1997 tax code, indicating that tax policy flaws may have contributed to disappointing revenue performance.** Moreover, in their view, more efforts were needed to improve taxpayer registry. They argued that the high rate of VAT, the poor functioning of the VAT refund mechanism, high social taxes that finance public pensions and medical insurance, and unattractive benefits from these schemes provided powerful incentives for economic activity to remain in the informal sector.

### GEORGIA: PUBLIC DEBT SUSTAINABILITY ANALYSIS

40. This appendix updates and reviews indicators of public debt sustainability in Georgia. It presents the staff's baseline scenario for general government debt through 2023 and alternative scenarios based on various shocks (these are expressed as temporary deviations from the baseline and defined relative to historical averages of key variables for 1996-2003, without dynamic feedback). The assumptions behind the baseline scenario are consistent with the macroeconomic framework presented in Table 5, additional projections through 2023, and staff views on average interest rates and access to new credit.

41. Real GDP growth rates averaging 6 percent and moderate primary deficits have helped to reduce the public sector debt relative to GDP from 60.3 percent in 2000 to 54.3 percent at end-2003. Projected output growth of 6 percent and a small primary surplus are expected to reduce this ratio to 51 percent in 2004. For the whole period under analysis, continued fiscal consolidation and sustained economic growth should lead to a steady decline in the debt to GDP ratio. Additional reductions in the stock of debt are contingent on the outcome of the upcoming Paris Club rescheduling.

42. External public debt service has imposed a heavy burden, after the rapid increase in external indebtedness in the early years of independence. Georgia has sought to ease it through several debt reschedulings, but slippages under the previous PRGF-supported program precluded consolidation of 2003 principal maturities owed to the Paris Club, and led to the accumulation of US\$51 million in arrears to bilateral creditors. After approval of the new PRGF arrangement, Georgia is expected to reach agreement on the clearance of arrears and restructuring of future obligations to make the debt service burden manageable.

43. At the end of 2003, 72 percent of general government debt was denominated in foreign currency, while government debt to the NBG accounted for 18 percent, domestic expenditure arrears for 9 percent and treasury bills for the remaining 2 percent. The large share of foreign debt implies that this component dominates the debt dynamics. Domestic expenditure arrears are to be cleared during the 2004-06 program. Improved economic conditions are also expected to favor the development of the domestic treasury bill market and reduce reliance of the government on NBG credit. The NBG is planning to convert the government debt into five-year securities and eventually offer these securities to the public.

44. The stress tests prepared by staff focus on additional risks to public debt sustainability. They show that Georgia's public debt sustainability is particularly sensitive to assumptions regarding real GDP growth and the exchange rate.

Table 1. Georgia: Public Sector Debt Sustainability Framework, Baseline Scenario, 2000-2023  
(In percent of GDP, unless otherwise indicated)

	Actual				Historical Average 5/	Standard Deviation 5/	Projections							
	2000	2001	2002	2003			2004	2005	2006	2007	2008	2004-08 Average	2013	2023
<b>Public sector debt 1/</b>	60.3	57.7	55.0	54.3			50.9	47.8	44.6	42.6	41.1		36.4	30.3
<i>Of which: foreign-currency denominated</i>	41.8	41.0	39.9	39.0			37.8	36.9	35.9	34.5	33.5		30.3	25.1
Change in public sector debt	-3.1	-2.5	-2.8	-0.6			-3.4	-3.2	-3.2	-2.0	-1.5		-0.8	-0.5
Identified debt-creating flows	1.0	-2.0	-3.6	-2.4			-2.5	-2.6	-2.6	-1.4	-0.9		-0.6	-0.5
Primary deficit	1.1	0.2	0.0	0.3	2.5	2.3	-0.5	-1.0	-1.1	-0.1	0.5	-0.4	0.6	0.4
Revenue and grants	15.2	16.3	15.8	15.7			19.0	19.7	20.8	22.0	23.3		27.9	35.4
<i>Of which: grants</i>	0.3	0.7	0.3	0.6			1.7	1.3	1.2	1.1	1.1		0.9	0.5
Primary (noninterest) expenditure	16.3	16.5	15.8	16.0			18.5	18.8	19.7	22.0	23.8		28.5	35.8
Automatic debt dynamics	-0.4	-2.2	-3.8	-3.1			-2.3	-1.9	-1.8	-1.6	-1.6		-1.3	-0.9
Contribution from interest rate/growth differential	0.2	-2.7	-2.6	-3.4			-2.1	-1.8	-1.8	-1.7	-1.7		-1.0	-0.6
<i>Of which: contribution from average real interest rate</i>	1.4	0.0	0.5	0.9			1.0	0.6	0.5	0.4	0.4		0.5	0.3
<i>Of which: contribution from real GDP growth</i>	-1.2	-2.7	-3.0	-4.4			-3.1	-2.4	-2.3	-2.1	-2.0		-1.4	-0.9
Contribution from real exchange rate depreciation	-0.5	0.5	-1.2	0.3			-0.2	-0.1	0.0	0.1	0.0		-0.3	-0.2
Other identified debt-creating flows	0.3	0.1	0.2	0.3			0.3	0.3	0.3	0.3	0.3		0.1	0.0
Privatization receipts (negative)	0.3	0.1	0.2	0.3			0.3	0.3	0.3	0.3	0.3		0.1	0.0
Residual, including asset changes	-4.1	-0.6	0.8	1.8			-1.0	-0.5	-0.6	-0.6	-0.6		-0.2	0.0
<b>NPV of public sector debt</b>	...	...	...	44.5			40.8	37.6	34.7	35.0	34.5		32.7	31.5
<i>Of which: external</i>	...	...	...	29.2			27.7	26.7	26.1	26.9	26.9		26.6	26.2
Gross financing need 2/	3.2	3.7	3.4	2.3			4.8	4.9	4.8	3.1	3.4		3.5	4.2
NPV of public sector debt-to-revenue ratio (in percent) 3/	...	...	...	284.2			215.2	190.5	166.9	158.7	148.1		117.3	89.0
<i>Of which: external</i>	...	...	...	186.2			146.0	135.3	125.2	121.9	115.5		95.4	74.1
Debt service-to-revenue ratio (in percent) 3/ 4/	23.9	22.9	19.4	15.2			18.4	18.6	17.1	9.7	7.6		4.4	2.5
Primary deficit that stabilizes the debt-to-GDP ratio	4.2	2.7	2.8	1.0			3.0	2.2	2.1	1.9	1.9		1.3	0.9
<b>Key macroeconomic and fiscal assumptions</b>														
Real GDP growth (in percent)	1.9	4.7	5.5	8.6	6.0	3.5	6.0	5.0	5.0	5.0	5.0	5.2	4.0	3.0
Average nominal interest rate on forex debt (in percent)	3.4	2.0	2.4	2.8	2.9	0.5	2.7	2.4	2.3	2.2	2.1	2.4	1.5	0.8
Average real interest rate on domestic currency debt (in percent)	5.1	0.5	0.8	3.6	0.1	9.3	2.5	2.1	3.1	4.4	4.4	3.3	5.1	5.7
Real exchange rate depreciation (in percent, + indicates depreciation)	-1.1	1.3	-3.2	0.8	0.1	15.6	-0.6	-0.2	0.1	0.1	0.1	-0.1	-0.9	-0.9
Inflation rate (GDP deflator, in percent)	4.1	5.4	6.4	4.7	10.9	12.9	5.0	5.0	5.0	5.0	5.0	5.0	4.0	3.0
Growth of real primary spending (deflated by GDP deflator, in percent)	-14.2	6.2	1.2	9.8	6.2	12.7	22.6	6.5	10.3	17.0	13.7	14.0	7.1	5.4
Grant element of new external borrowing (in percent)	...	...	...	51.3			56.3	56.1	55.5	55.5	55.6	55.8	55.6	55.5

Sources: Georgian authorities; and Fund staff estimates and projections.

1/ General government.

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues including grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

5/ Historical averages and standard deviations are derived over the past 7 years.

Table 2. Georgia: Sensitivity Analyses for Key Indicators of Public Sector Debt, 2003-2023

	Estimate		Projections					
	2003	2004	2005	2006	2007	2008	2013	2023
<b>NPV of Debt-to-GDP Ratio</b>								
<b>Baseline</b>	44.0	40.8	37.6	34.7	35.0	34.5	32.7	31.5
<b>A. Alternative scenarios</b>								
A1. Real GDP growth and primary balance are at historical averages	44.0	41.2	39.1	37.3	37.2	36.1	31.1	25.1
A2. Primary balance is unchanged from 2003	44.0	41.1	39.3	37.7	37.9	37.2	34.0	32.1
<b>B. Bound tests</b>								
B1. Real GDP growth is at baseline minus one standard deviations in 2004-2005	44.0	42.4	41.9	40.2	40.9	40.8	41.7	48.3
B2. Primary balance is at baseline minus one standard deviations in 2004-2005	44.0	41.9	40.5	38.2	38.2	37.5	34.9	32.8
B3. Combination of 2-3 using one half standard deviation shocks	44.0	42.0	40.7	38.4	38.5	37.7	35.0	33.0
B4. Long-run real GDP growth is at baseline minus one standard deviations	44.0	41.1	39.1	37.4	38.0	38.0	40.2	58.5
B5. One time 30 percent real depreciation in 2004	44.0	54.5	51.1	48.2	48.5	47.5	43.5	40.7
B6. 10 percent of GDP increase in other debt-creating flows in 2004	44.0	45.7	42.7	40.4	40.3	39.6	36.8	34.1
<b>NPV of Debt-to-Revenue Ratio 1/</b>								
<b>Baseline</b>	280.4	215.2	190.5	166.9	158.7	148.1	117.3	89.0
<b>A. Alternative scenarios</b>								
A1. Real GDP growth and primary balance are at historical averages	280.4	218.0	198.9	180.3	169.6	156.1	112.8	71.6
A2. Primary balance is unchanged from 2003	280.4	217.1	199.2	181.5	172.2	159.4	122.0	90.7
<b>B. Bound tests</b>								
B1. Real GDP growth is at baseline minus one standard deviations in 2004-2005	280.4	223.2	211.4	192.3	184.9	174.6	149.3	136.3
B2. Primary balance is at baseline minus one standard deviations in 2004-2005	280.4	221.1	205.3	183.5	173.4	160.9	125.1	92.6
B3. Combination of 2-3 using one half standard deviation shocks	280.4	221.4	206.1	184.3	174.3	161.7	125.5	93.0
B4. Long-run real GDP growth is at baseline minus one standard deviations	280.4	216.8	198.0	179.4	172.3	162.8	143.8	164.9
B5. One time 30 percent real depreciation in 2004	280.4	287.7	258.9	231.5	220.0	203.8	155.9	115.1
B6. 10 percent of GDP increase in other debt-creating flows in 2004	280.4	240.9	216.3	194.0	183.1	169.9	132.0	96.3
<b>Debt-to-GDP Ratio</b>								
<b>Baseline</b>	54.3	50.9	47.8	44.6	42.6	41.1	36.4	30.3
<b>A. Alternative scenarios</b>								
A1. Real GDP growth and primary balance are at historical averages	54.3	52.7	51.3	49.8	48.4	47.0	41.1	35.1
A2. Primary balance is unchanged from 2003	54.3	51.8	49.8	47.9	46.0	44.1	37.3	30.9
<b>B. Bound tests</b>								
B1. Real GDP growth is at baseline minus one standard deviations in 2004-2005	54.3	53.3	53.0	50.8	49.8	49.5	51.0	59.0
B2. Primary balance is at baseline minus one standard deviations in 2004-2005	54.3	53.3	52.4	48.9	46.6	44.8	39.0	31.9
B3. Combination of 2-3 using one half standard deviation shocks	54.3	53.0	51.8	48.3	45.9	44.2	38.4	31.4
B4. Long-run real GDP growth is at baseline minus one standard deviations	54.3	51.5	48.9	46.4	45.1	44.6	47.9	76.9
B5. One time 30 percent real depreciation in 2004	54.3	70.0	66.0	62.0	59.2	56.9	49.2	39.7
B6. 10 percent of GDP increase in other debt-creating flows in 2004	54.3	61.0	57.4	53.6	51.0	48.9	42.2	34.0
<b>Debt Service-to-Revenue Ratio 1/</b>								
<b>Baseline</b>	15.2	18.4	18.6	17.1	9.7	7.6	4.4	2.5
<b>A. Alternative scenarios</b>								
A1. Real GDP growth and primary balance are at historical averages	15.2	18.2	17.9	16.0	9.0	7.0	3.6	2.2
A2. Primary balance is unchanged from 2003	15.2	18.6	18.6	17.1	9.8	7.7	4.4	2.5
<b>B. Bound tests</b>								
B1. Real GDP growth is at baseline minus one standard deviations in 2004-2005	15.2	19.1	19.8	18.2	10.4	8.3	5.1	4.0
B2. Primary balance is at baseline minus one standard deviations in 2004-2005	15.2	18.6	18.8	17.3	9.7	7.6	4.5	2.6
B3. Combination of 2-3 using one half standard deviation shocks	15.2	18.9	19.2	17.6	9.9	7.8	4.6	2.6
B4. Long-run real GDP growth is at baseline minus one standard deviations	15.2	18.7	18.8	17.3	9.9	7.9	5.1	4.4
B5. One time 30 percent real depreciation in 2004	15.2	19.8	20.6	18.8	11.2	8.9	5.3	2.9
B6. 10 percent of GDP increase in other debt-creating flows in 2004	15.2	18.6	19.8	17.3	9.8	7.8	4.6	2.9
<b>Debt Service-to-GDP Ratio</b>								
<b>Baseline</b>	2.4	3.5	3.7	3.6	2.1	1.8	1.2	0.9
<b>A. Alternative scenarios</b>								
A1. Real GDP growth and primary balance are at historical averages	2.4	3.4	3.5	3.3	2.0	1.6	1.0	0.8
A2. Primary balance is unchanged from 2003	2.4	3.5	3.7	3.6	2.1	1.8	1.2	0.9
<b>B. Bound tests</b>								
B1. Real GDP growth is at baseline minus one standard deviations in 2004-2005	2.4	3.6	3.9	3.8	2.3	1.9	1.4	1.4
B2. Primary balance is at baseline minus one standard deviations in 2004-2005	2.4	3.5	3.7	3.6	2.1	1.8	1.3	0.9
B3. Combination of 2-3 using one half standard deviation shocks	2.4	3.6	3.8	3.7	2.2	1.8	1.3	0.9
B4. Long-run real GDP growth is at baseline minus one standard deviations	2.4	3.5	3.7	3.6	2.2	1.8	1.4	1.6
B5. One time 30 percent real depreciation in 2004	2.4	3.8	4.1	3.9	2.5	2.1	1.5	1.0
B6. 10 percent of GDP increase in other debt-creating flows in 2004	2.4	3.5	3.9	3.6	2.2	1.8	1.3	1.0

Sources: Georgian authorities; and Fund staff estimates and projections.

1/ Revenues are defined inclusive of grants.

### GEORGIA: EXTERNAL DEBT SUSTAINABILITY ANALYSIS (DSA)

45. This update reflects the medium-term macroeconomic framework underlying the new PRGF program and additional staff projections through 2023. It assumes continued implementation of prudent macroeconomic policies and economic reforms, improvements in the business climate, and export diversification to lessen the vulnerability to external shocks.
46. The DSA presents two scenarios:
- a. Flow rescheduling on Houston terms during the program period (2004-06), as assumed conservatively in the program;<sup>7</sup> and
  - b. Flow rescheduling on Houston terms (2004-06) followed by a Naples stock-of-debt operation at the end of the program period.
47. Key macroeconomic assumptions underlying the DSA include:
- Real GDP grows at an average rate of 5 percent during 2004-08, 4 percent during 2009-15 and 3 percent thereafter.
  - Exports and imports of goods and services (in U.S. dollar terms) grow at an annual average of about 7 percent and 6 percent, respectively over 2004-08, and at an average of about 6 percent in subsequent years.
  - Central government revenue increases by an annual average of 0.7 percent of GDP in 2004-08 and by an average 0.4 percent of GDP a year during the remainder of the projection period.
  - New borrowing is contracted mostly on concessional terms, although financing gaps are assumed (as customary) to be filled through non-concessional borrowing (see footnotes 2 and 3 in Table 1).<sup>8</sup>
  - Grants are expected to increase substantially during the program period (from 1.4 percent of GDP in 2003 to 2.2 percent during 2004-06), but to stabilize quickly before starting to decline toward the end of the projection period.

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<sup>7</sup> The rescheduling also includes principal arrears accumulated in 2003.

<sup>8</sup> Under the Houston-terms scenario, non-concessional borrowing accounts for about 20 percent of total new borrowing in 2004-08 and 30 percent during the remainder of the projection period. The corresponding shares under the Naples scenario are 9 percent and 1 percent respectively.



48. The Houston-terms scenario shows moderate debt ratios relative to exports and GDP at end-2003, but a very heavy debt burden relative to fiscal revenues (Table 1). This scenario implies little relief in NPV terms, since a rescheduling on Houston terms would be basically non-concessional, given that Georgia's bilateral debt is overwhelmingly non-ODA. The ratios of NPV of debt and debt service improve generally steadily throughout the projection period under this scenario, but remain high relative to government revenue at least through 2010, suggesting that Houston terms may not provide an exit rescheduling for Georgia.

49. By contrast, Naples stock operation would substantially improve debt indicators and make the debt burden significantly more manageable from a fiscal standpoint (Table 1). More specifically, it would reduce the ratios of NPV of debt to revenue and exports to about 240 percent and 80 percent, respectively, toward the end of the program period. Compared to Houston terms, it would reduce debt service due by about one-half, to 16 percent and 6 percent of revenue and exports, respectively.

50. Sensitivity analyses around the Houston-terms scenario show that debt indicators would deteriorate significantly under lower export growth or a substantial real depreciation of the lari (Table 2).<sup>9</sup> Under this scenario, even indicators relative to exports would turn highly unfavorable and remain so for a substantial period of time, suggesting a high probability of debt distress. Under Naples terms, the debt burden relative to exports looks still manageable following such shocks (Table 3), but it would quickly become fiscally heavy—especially in the event of a significant real devaluation—highlighting Georgia's vulnerability to adverse shocks and the strong burden that the external debt imposes on its public finances.

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<sup>9</sup> The sensitivity analysis assumes that borrowing in excess of the baseline is contracted on roughly concessional terms (20-year maturity, including a 5-year grace, and an interest rate of 1 percent).

Table 1. Georgia: Public External Debt Indicators Under Various Scenarios  
(In percent)

	Prel.		Projections										
	2003	2004	2005	2006	2007	2008	2009	2010	2012	2015	2018	2020	2023
<b>NPV of debt-to-revenue ratios 1/</b>													
Houston terms 2/	437	358	331	301	283	265	251	239	214	186	173	164	151
Houston flow and Naples stock operation 3/	437	358	331	236	221	205	194	184	161	137	124	114	99
<b>Debt service to revenue ratio 1/ 4/</b>													
Houston terms 2/	43.7	40.2	37.2	32.4	31.4	22.5	22.3	20.5	17.6	14.1	15.1	15.6	13.4
Houston flow and Naples stock operation 3/	43.7	40.2	37.2	32.4	16.0	12.9	14.0	13.3	11.2	7.6	7.8	7.8	7.4
<b>NPV of debt-to-exports ratio 5/</b>													
Houston terms 2/	122	116	110	106	105	103	100	98	93	88	85	83	79
Houston flow and Naples stock operation 3/	122	116	110	83	82	80	78	75	70	64	61	58	52
<b>Debt service to exports ratio 4/ 5/</b>													
Houston terms 2/	12.2	13.0	12.4	11.4	11.6	8.8	8.9	8.4	7.7	6.7	7.4	7.9	7.1
Houston flow and Naples stock operation 3/	12.2	13.0	12.4	11.4	5.9	5.0	5.6	5.5	4.8	3.6	3.9	3.9	3.9
<b>NPV of debt to GDP ratio</b>													
Houston terms 2/	37	33	33	32	32	31	31	31	29	28	29	28	28
Houston flow and Naples stock operation 3/	37	33	33	25	25	24	24	23	22	21	20	20	18

Source: Staff projections and simulations.

1/ Central government revenue, excluding grants.

2/ Rescheduling of 2003 arrears and 2004-06 principal maturities. Non-ODA debts are rescheduled at an 18-year maturity, including a 3-year grace, and at market interest rates (5 percent); ODA debts are rescheduled with a 10-year grace and a 20-year maturity at 1.4 percent. Borrowing to finance gaps remaining after rescheduling is assumed to be contracted at a 6 percent interest rates and 20-year repayment period, including a 5-year grace.

3/ Assumes flow rescheduling on Houston terms of 2004-06 principal maturities and 2003 arrears, and a Naples stock-of-debt operation taking place at end-2006. Terms for gap-financing new borrowing are as in footnote 1.

4/ Cash basis: 2003 reflects arrears accumulation and 2004-06 includes rescheduling of principal.

5/ Exports of goods and non-factor services.

Table 2. Georgia: Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt Under Houston Terms  
(In percent)

	Prel.		Projections									
	2003	2004	2005	2006	2007	2008	2009	2010	2012	2015	2018	2023
<b>NPV of debt-to-revenue ratio 6/</b>												
<b>Baseline 1/</b>	437	358	331	301	283	265	251	239	214	186	173	151
<b>A. Alternative Scenarios</b>												
A1. Key variables at their historical averages in 2004-23 2/	437	372	334	301	279	259	244	232	211	194	180	159
A2. New public sector loans on less favorable terms in 2004-23 3/	437	367	349	327	320	307	300	293	275	255	247	235
<b>B. Bound Tests</b>												
B1. Real GDP growth at historical average minus one standard deviation in 2004-05	437	374	358	325	307	286	272	259	231	201	183	156
B2. Export value growth at historical average minus one standard deviation in 2004-05 4/	437	383	402	365	343	320	302	284	247	206	181	147
B3. US dollar GDP deflator at historical average minus one standard deviation in 2004-05	437	460	514	467	440	411	390	372	332	288	263	225
B4. Net non-debt creating flows at historical average minus one standard deviation in 2004-05 5/	437	419	444	404	379	353	331	309	266	218	188	147
B5. Combination of B1-B4 using one-half standard deviation shocks	437	437	471	428	402	375	354	334	293	247	220	180
B6. One-time 30 percent nominal depreciation relative to the baseline in 2004	437	501	463	421	397	370	352	335	299	260	237	202
<b>Debt service to revenue ratio 6/ 7/</b>												
<b>Baseline 1/</b>	44	40	37	32	31	23	22	20	18	14	15	13
<b>A. Alternative Scenarios</b>												
A1. Key variables at their historical averages in 2004-23 2/	44	40	35	30	28	19	19	17	14	12	12	11
A2. New public sector loans on less favorable terms in 2004-23 3/	44	40	38	35	33	26	24	21	18	18	19	18
<b>B. Bound Tests</b>												
B1. Real GDP growth at historical average minus one standard deviation in 2004-05	44	42	40	35	34	24	24	22	19	15	16	14
B2. Export value growth at historical average minus one standard deviation in 2004-05 4/	44	40	38	33	32	23	24	25	21	17	17	14
B3. US dollar GDP deflator at historical average minus one standard deviation in 2004-05	44	52	58	50	49	35	35	32	27	22	23	20
B4. Net non-debt creating flows at historical average minus one standard deviation in 2004-05 5/	44	40	38	34	33	24	27	28	24	19	18	15
B5. Combination of B1-B4 using one-half standard deviation shocks	44	46	46	41	40	28	30	29	25	20	20	17
B6. One-time 30 percent nominal depreciation relative to the baseline in 2004 6/	44	56	52	45	44	32	31	29	25	20	21	18
<b>NPV of debt-to-exports ratio 8/</b>												
<b>Baseline 1/</b>	122	116	110	106	105	103	100	98	93	88	85	79
<b>A. Alternative Scenarios</b>												
A1. Key variables at their historical averages in 2004-23 2/	122	121	111	106	103	101	98	95	92	92	90	87
A2. New public sector loans on less favorable terms in 2004-23 3/	122	119	116	115	118	119	120	120	119	120	125	129
<b>B. Bound Tests</b>												
B1. Export value growth at historical average minus one standard deviation in 2004-05 4/	122	142	176	169	167	164	159	153	141	128	120	106
B2. Net non-debt creating flows at historical average minus one standard deviation in 2004-05 5/	122	136	148	142	140	137	132	127	115	103	95	81
B3. Combination of B1-B2 using one-half standard deviation shocks	122	127	137	131	129	127	123	119	111	102	96	86
<b>Debt service to exports ratio 7/ 8/</b>												
<b>Baseline 1/</b>	12	13	12	11	12	9	9	8	8	7	7	7
<b>A. Alternative Scenarios</b>												
A1. Key variables at their historical averages in 2004-23 1/	12	13	12	10	10	8	8	7	6	6	6	6
A2. New public sector loans on less favorable terms in 2004-23 2/	12	13	13	12	12	10	10	9	8	8	9	10
<b>B. Bound Tests</b>												
B1. Export value growth at historical average minus one standard deviation in 2004-05 3/	12	15	16	15	16	12	13	14	12	11	11	10
B2. Net non-debt creating flows at historical average minus one standard deviation in 2004-05 4/	12	13	13	12	12	9	11	11	10	9	9	8
B3. Combination of B1-B2 using one-half standard deviation shocks	12	13	13	13	13	10	10	10	10	8	9	8

Source: Staff projections and simulations.

1/ Assumes 2003 arrears and 2004-06 principal maturities are rescheduled on Houston terms.

2/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.

3/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline, while grace and maturity periods are the same as in the baseline.

4/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).

5/ Includes official and private transfers and FDI.

6/ Central government revenue, excluding grants.

7/ Cash basis. Reflects arrears accumulation in 2003 and rescheduling of principal maturities in 2004-06.

8/ Exports of goods and non-factor services.

Table 3. Georgia: Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt Under Naples Stock Operation  
(In percent)

	Prel.		Projections									
	2003	2004	2005	2006	2007	2008	2009	2010	2012	2015	2018	2023
<b>NPV of debt-to-revenue ratio 6/</b>												
<b>Baseline 1/</b>	437	358	331	236	221	205	194	184	161	137	124	99
<b>A. Alternative Scenarios</b>												
A1. Key variables at their historical averages in 2004-23 2/	437	372	334	243	223	207	196	187	174	165	158	145
A2. New public sector loans on less favorable terms in 2004-23 3/	437	367	349	262	254	241	234	227	210	189	179	158
<b>B. Bound Tests</b>												
B1. Real GDP growth at historical average minus one standard deviation in 2004-05	437	374	358	255	239	222	210	199	174	148	134	107
B2. Export value growth at historical average minus one standard deviation in 2004-05 4/	437	383	402	300	281	261	245	228	194	157	136	101
B3. US dollar GDP deflator at historical average minus one standard deviation in 2004-05	437	460	514	366	343	319	301	285	250	212	192	154
B4. Net non-debt creating flows at historical average minus one standard deviation in 2004-05 5/	437	419	444	339	316	294	274	253	213	169	143	102
B5. Combination of B1-B4 using one-half standard deviation shocks	437	437	471	348	325	302	284	265	228	186	163	124
B6. One-time 30 percent nominal depreciation relative to the baseline in 2004	437	501	463	330	310	288	271	257	226	191	173	139
<b>Debt service to revenue ratio 6/ 7/</b>												
<b>Baseline 1/</b>	44	40	37	32	16	13	14	13	11	8	8	7
<b>A. Alternative Scenarios</b>												
A1. Key variables at their historical averages in 2004-23 2/	44	40	35	30	14	11	12	12	10	8	9	9
A2. New public sector loans on less favorable terms in 2004-23 3/	44	40	38	35	19	16	16	14	12	10	12	11
<b>B. Bound Tests</b>												
B1. Real GDP growth at historical average minus one standard deviation in 2004-05	44	42	40	35	17	14	15	14	12	8	8	8
B2. Export value growth at historical average minus one standard deviation in 2004-05 4/	44	40	38	33	17	14	16	18	15	11	10	9
B3. US dollar GDP deflator at historical average minus one standard deviation in 2004-05	44	52	58	50	25	20	22	21	17	12	12	11
B4. Net non-debt creating flows at historical average minus one standard deviation in 2004-05 5/	44	40	38	34	17	14	19	21	17	12	12	10
B5. Combination of B1-B4 using one-half standard deviation shocks	44	46	46	41	20	17	19	20	17	12	12	11
B6. One-time 30 percent nominal depreciation relative to the baseline in 2004	44	46	46	41	20	17	19	20	17	12	12	11
<b>NPV of debt-to-exports ratio 8/</b>												
<b>Baseline 1/</b>	122	116	110	83	82	80	78	75	70	64	61	52
<b>A. Alternative Scenarios</b>												
A1. Key variables at their historical averages in 2004-23 2/	122	121	111	85	83	80	78	77	76	78	78	76
A2. New public sector loans on less favorable terms in 2004-23 3/	122	119	116	92	94	94	94	93	91	89	88	83
<b>B. Bound Tests</b>												
B1. Export value growth at historical average minus one standard deviation in 2004-05 4/	122	142	176	139	137	133	129	123	111	98	88	70
B2. Net non-debt creating flows at historical average minus one standard deviation in 2004-05 5/	122	136	148	119	117	114	110	104	93	80	70	54
B3. Combination of B1-B2 using one-half standard deviation shocks	122	127	137	106	105	102	99	95	86	77	70	57
<b>Debt service to exports ratio 7/ 8/</b>												
<b>Baseline 1/</b>	12	13	12	11	6	5	6	5	5	4	4	4
<b>A. Alternative Scenarios</b>												
A1. Key variables at their historical averages in 2004-23 1/	12	13	11	10	5	4	5	5	4	4	4	5
A2. New public sector loans on less favorable terms in 2004-23 2/	12	13	12	12	7	6	6	6	5	5	6	6
<b>B. Bound Tests</b>												
B1. Export value growth at historical average minus one standard deviation in 2004-05 3/	12	15	16	15	8	7	8	10	9	7	7	6
B2. Net non-debt creating flows at historical average minus one standard deviation in 2004-05 4/	12	13	12	12	6	5	7	8	7	6	6	5
B3. Combination of B1-B2 using one-half standard deviation shocks	12	13	13	12	7	6	7	7	6	5	5	5

Sources: Staff projections and simulations.

1/ Assumes flow rescheduling on Houston terms of 2004-06 principal maturities and 2003 arrears, and a Naples stock-of-debt operation taking place at end-2006.

2/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.

3/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.

4/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).

5/ Includes official and private transfers and FDI.

6/ Central government revenue, excluding grants.

7/ Cash basis. Reflects arrears accumulation in 2003 and rescheduling of principal maturities in 2004-06.

8/ Exports of goods and non-factor services.

## GEORGIA: IMF-WORLD BANK RELATIONS

### A. Partnership in Georgia's Development Strategy

51. The government's poverty reduction strategy, embodied in its first full PRSP, was presented to the Boards of IDA and the IMF in October and November 2003. An update on IDA's Country Assistance Strategy will be presented to the IDA Board along with the forthcoming adjustment credit scheduled for Board presentation in FY04.

52. 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) deepening and diversifying sources of growth; (iii) protecting the environment; and (iv) reducing poverty. Georgia has been the largest IDA borrower in the CIS, with borrowing of over US\$725 million for 34 operations. A range of instruments has been used to conduct the dialogue, including Structural Adjustment and SRS Credits. The most recent Adjustment Credits were SAC III and an Energy Sector Adjustment Credit (ESAC), both approved in FY99. SAC III supported the government's reform program, which included strengthened fiscal performance, better budgetary provisions for core social expenditures, improved legal and regulatory framework for the private sector, and accelerated privatization and market liberalization. Key reform objectives supported by the ESAC included enhanced financial sustainability and management of the energy sector, privatization, and increased poverty benefits for the socially most vulnerable. Other support has come in the form of project support and Analytical and Advisory Assistance across a broad spectrum: education, health, 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 Country Economic Memorandum (CEM) was completed in 2001, a Public Expenditure Review (PER) in 2002, and a Trade Study in 2003. The PER is being followed by an annual process-based PER exercise. A Country Procurement Assessment Review (CPAR) and a Country Financial Accountability Assessment (CFAA) have been prepared.

53. Since Georgia joined IFC in 1995, it has approved \$103.8 million of investments for eight projects. 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*. IFC has also provided equity and long-term credit lines to TBC Bank and helped establish Georgia Microfinance Bank. In the housing finance sector, IFC has provided credit lines to the Bank of Georgia and TBC Bank for housing finance and for on-lending to small and medium enterprises. The Foreign Investment Advisory Service (FIAS), a joint facility of IFC and the World Bank, carried out an assessment of Georgia's investment climate in November 2001. It has also assisted the government with legislation on foreign direct investment and establishment of an investment promotion agency.

54. Table 1 summarizes the division of responsibilities between the two institutions. In a number of areas—for example, the social sectors, rural development, environment, and infrastructure—the Bank takes the lead in the dialogue and there is no related conditionality in the IMF-supported program. The Bank is also leading the dialogue on private sector reform, and Bank analysis serves as inputs into the Fund program. In other areas—energy, the financial sector, public expenditure management, and civil service reform—both institutions have worked together. Finally, in areas like monetary policy, and inland revenue and customs, the IMF takes the lead.

## **B. IMF-World Bank Collaboration in Specific Areas**

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

55. In the **social sectors** IDA conducts updates of Georgia’s Poverty Assessment based on quarterly household data. IDA’s focus has been to improve the budget execution of 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. A Self-Reliance Fund Grant helps the authorities address the complex issues related to internally displaced people. IDA is also supporting a dialogue with the government on social protection reform that will lead to an IDA-supported project.

56. In **education**, the Adaptable Program Credit aims at improving the learning outcomes of primary and secondary students, through curriculum reform, development of an examination system, training of teachers, provision of learning materials, and development of capacity to make better use of Georgia’s physical, financial, and human resources. While the investment needs of school buildings are substantially higher than is currently affordable for Georgia, the Social Investment Fund projects continue to assist in financing urgent repairs to school facilities in many communities.

57. 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 services funded through public funds on the poor and on priority public health interventions. In addition, SAC III and the SRS Credit have supported hospital restructuring.

58. In **infrastructure**, support is being provided through the Municipal Development and Decentralization Credit and the Social Investment Fund Credit. 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.

59. In **rural development**, IDA credits have supported development of private sector farming and agro-processing improvements, agricultural credit, irrigation and drainage, and

agriculture research and extension. IDA credits have also been supporting the creation of local institutions, such as rural credit unions and water users associations.

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

60. The Bank has been leading the dialogue on structural reforms, especially through SAC III, approved by the Bank's Board in June 1999, and closed in October 2002, and through the preparation of the proposed Reform Support Credit. Despite considerable delays, the core conditions of SAC III were met, but their impact was reduced by poor governance. Institution building and technical assistance have been supported through the SRS Credit, also approved by the Bank Board on June 29, 1999. The Bank also leads in the areas of:

- a. **Privatization and Public Enterprise Reforms.** SAC III supported improvements in the environment for private sector development, focusing on: (i) simpler and more transparent licensing; (ii) more transparent government procurement; and (iii) reduced cost of entry for businesses. 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 2002 accounts of three major state-owned enterprises.
- b. **Energy.** The energy system is in poor condition, with unreliable supply, massive non-payment and mounting debts. IDA has been working with other donors, including the Fund, to encourage more private management and ownership, and to implement a series of short-term action plans to improve the overall functioning of the sector. The Fund has also been focusing on improved payments for electricity and pursuit of tariff policies at cost-recovery levels, including a Bank-assisted review of the tariff policy methodology. The proposed Reform Support Credit would support a Strategic Action Plan for the Energy Sector.
- c. **Public Sector Management.** The proposed RSC would support, inter alia, an anti-corruption strategy, administrative and civil service reform, improvements in public expenditure management, and reductions in barriers to private sector growth. The Fund is providing technical assistance in support of tax and customs administration reform.

**Areas of shared responsibility**

61. The Bank and the Fund have been working jointly in the following main areas (supported by the Bank's SAC III and SRS Credit, several investment operations, and the Fund's PRGF—further assistance is anticipated from IDA's Reform Support Credit):

- a. **Poverty Reduction Strategy.** Both institutions have been working closely with the government to support the development of the PRSP, through seminars and

workshops, direct staff input, and a multi-donor Trust Fund to assist the work of the PRSP secretariat.

- b. **Budget Planning and Execution.** The annual process-based Public Expenditure Reviews, and the proposed Reform Support Credit, will provide the underpinnings for systemic changes in expenditure management, and improvements in financial accountability. 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; and (iv) anti money-laundering legislation. 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 is now taking the lead in the areas of tax policy and tax and customs administration reform.

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

- a. **Monetary Framework.** The IMF closely collaborates with the NBG in the design and implementation of a monetary program that aims at remonetization of the economy, while keeping inflation low and rebuilding international reserves.
- b. **Economic Statistics.** IMF technical assistance has been conducive to improvements in national accounts, price, monetary and government financial statistics.

### **C. World Bank Group Strategy**

62. The Bank is currently discussing with the authorities a US\$20 million Reform Support Credit that is expected to be disbursed by mid-2004. The loan seeks to support immediate reforms in the areas of: (i) public sector operations (including the civil service and public procurement); (ii) the energy sector; and (iii) private sector development. The Bank is also discussing with the government a more comprehensive medium-term reform strategy that could be supported by subsequent program lending operations.



Table 1. Georgia: Bank-Fund Collaboration on Georgia

Area	Specialized Advice from Fund	Specialized Advice from Bank	Key Instruments
Economic Framework/Management	Monetary policy, exchange rate, fiscal, and trade policies, economic statistics	Economic growth, economic statistics	<i>IMF</i> : PRGF performance criteria and benchmarks on monetary and fiscal targets. <i>IDA</i> : Macromonitoring; Trade and Transport Facilitation Project;; Financial Sector Advisory Work; Policy Options Report; Reform Support Credit
Budget	Budget framework, tax policy and administration, customs, debt management, extra-budgetary funds	Budget management, Public Expenditure Review and Process-Based PER, Country Procurement Assessment, Country Financial Accountability Assessment	<i>IMF</i> : PRGF performance criteria on overall fiscal balance and revenue collection. <i>Bank</i> : Public Expenditure Review Updates; Support for PRSP Updates; Policy Options Report; Reform Support Credit
Public Sector Reform	Public asset management, audit of 3 problematic state-owned enterprises	Civil service reform, anti-corruption agenda, decentralization	<i>IMF</i> : PRGF <i>IDA</i> : Public Sector Management Report; Reform Support Credit
Social/Poverty	Prioritization of expenditure cuts to protect social spending	Poverty analysis; reforms in education, health, social protection; support to community driven development	<i>IMF</i> : PRGF <i>IDA</i> : Support through IDA Credits for Education, Health and Social Investment Funds, Social Protection study, SRS support for hospital restructuring.
Private Sector Development		<i>Costs of Doing Business</i> Surveys. Support for improved legislation and regulatory framework for private sector, and support for privatization and market liberalization	<i>IDA</i> : Business Environment Study, Labor Market Study, Private Sector Development Project, Trade and Transport Facilitation Credits; Reform Support Credit.
Infrastructure		Private sector participation in infrastructure	<i>IDA</i> : Support though ongoing and proposed IDA Credits for Municipal Development, Roads, Transport and Power.
Rural development		Reforms in agriculture, irrigation, forestry and, environment	<i>IDA</i> : Support though Rural Infrastructure and Water Resource studies; ongoing rural Credits, and proposed Credits for Rural Development, Rural Telecommunications, Community Based Tourism.

**GEORGIA: RELATIONS WITH THE EBRD**  
(As of December 31, 2003)

63. As of December 31, 2003, the European Bank for Reconstruction and Development (EBRD) had signed 33 investments in Georgia with cumulative commitments totaling US\$233.2 million.<sup>10</sup> Current Portfolio Stock equals to US\$127.8 million. The EBRD's first operation, a power rehabilitation project, was signed in December 1994. Since then, the pace and composition of portfolio growth have varied significantly from year to year. Two large public sector projects were signed at the end of 1998. The current portfolio includes 24 private sector projects (of which three are regional). The ratio of private sector projects in the portfolio now stands at 52 percent.

64. In the **power sector** a government-guaranteed loan was signed in December 1998 to rehabilitate the Enguri Hydro Power Plant. The rehabilitation aims to increase electricity generation by 15 percent.

65. In the **transport sector**, a government-guaranteed loan to the Georgian National Railways was signed in December 1998 to finance infrastructure improvements on the Georgian section of the South-Caucasian railway line. In March 2002, the Bank signed a loan of US\$11.6 million with the JSC Channel Energy Poti Port Ltd. The project consists of building and operating a new oil terminal in the Port of Poti, which will be able to serve the growing demand for export of oil products and derivatives from Central Asia and Azerbaijan to Africa, Europe, and United States.

66. The latest projects in the **financial sector** include a US\$6 million credit line to TBC Bank and a US\$4 million loan to Bank of Georgia for expanding SME lending, as well as a US\$1.5 million new credit line to increase the funding base for small and micro-lending activities of TbilUniversalBank, a medium-sized Georgian bank specialized in the small- and micro-enterprises market. The EBRD has also issued guarantees under its trade facilitation program.

67. In the **industrial sector** the EBRD signed US\$1.05 million convertible loan to Iberia Refreshments Ltd. holding the Pepsi franchise in Georgia. In addition, the Bank signed private-sector loan project with the Georgian Wines & Spirits Company, and an investment to develop the Chirag offshore oil field.

68. The EBRD has to date provided **technical assistance** through 108 operations, with a total commitment of US\$11.2 million.

69. Looking forward, the EBRD plans to sign in the first half of 2004 both a US\$315 million loan package to build the Baku-Tbilisi-Ceyhan oil pipeline and a

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<sup>10</sup> Evaluated at an exchange rate of US\$1.26 per euro.

US\$25 million loan for constructing the South Caucasus (SCP) gas pipeline. Furthermore, the EBRD will launch its Early Transition Countries (ETC) initiative, which is designed to enhance the EBRD's transition impact in the poorest CIS countries, including Georgia, and to enhance EBRD activities in all the sectors it is involved. Under the ETC, the EBRD expects: to allocate more resources to these countries, including in the field; to take more risk (e.g., allowing a higher risk-weighted average of its overall portfolio), while adhering to sound banking principles; to expand and adapt existing financing instruments; and to develop new ones, taking into consideration the specific circumstances of the ETC countries. Deeper and more efficient support of the donor community will be sought in joint TA and grant co-financing of EBRD-led projects and programs.

Table 1. Georgia: EBRD Portfolio for Georgia  
As of December 31, 2003  
(In millions of U.S. dollars)

Project Name	Date of Agreement	Outstanding Amount
<b>Public Sector Projects</b>		
Power Rehabilitation Project	19-Dec-94	9.1
Georgia Enguri Hydro Power Plant	22-Dec-98	33.6
Georgia: Trans-Caucasian Rail Link Project	22-Dec-98	15.5
Tbilisi Airport Refurbishment	13-Jul-95	2.8
<b>Private Sector Projects</b>		
Bank of Georgia Equity and Convertible Loan	16-Jul-98	3.1
Bank of Georgia—SME Loan	27-Jul-03	4.0
Commercial Bank of Greece (CBG) Georgia	11-Sep-96	0.6
TBC Bank—SME Credit Line	19-Dec-03	3.0
TBC Bank (Sub Project of Georgia SME)	12-Dec-96	1.1
Intellectbank (Sub Project of Georgia SME)	11-Nov-97	1.0
TbilComBank (Sub Project of Georgia SME)	12-Dec-96	1.3
TbilcreditBank (Sub Project of Georgia SME)	12-Dec-96	0.9
Tbiluniversalbanki (Sub loan of Georgia SME)	18-Mar-97	0.5
TbilUniversalBank Small and Micro-Lending Convertible Loan	18-Jul-03	1.5
United Georgian Bank	20-Nov-97	9.3
MBG Additional Senior Loan US\$3 million (FIISF)	04-Feb-02	0.0
ProCredit Bank, Georgia (Formerly MBG)	30-Mar-00	3.4
ProCredit Bank, Georgia—Senior Loan	11-Oct-01	6.0
TFP: Bank of Georgia	2-Mar-01	8.7
TFP: TBC Bank	17-Aug-99	0.5
TFP: United Georgian Bank	31-Mar-01	0.4
TFP: Tbiluniversal Bank (TUB)	29-Sept-00	0.0
JSC Channel Energy Poti Port	19-Mar-02	11.6
Georgian Wines	29-Sep-99	2.8
DIF Iberia Refreshments	25-Sep-03	1.0
Regional Fund Investments		6.1
<b>Total</b>		<b>127.8</b>

1/ US\$ amounts calculated at an exchange rate of 1.2599 U.S. dollars per euro, as of December 31, 2003.

**GEORGIA: FUND RELATIONS**  
(As of March 31, 2004)

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

II.	<b>General Resources Account:</b>	<b>SDR Million</b>	<b>Percent of Quota</b>
	Quota	150.30	100.00
	Fund holdings of currency	161.86	107.69
	Reserve position in Fund	0.01	0.01

III.	<b>SDR Department:</b>	<b>SDR Million</b>	<b>Percent of Allocation</b>
	Holdings	9.69	N/A

IV.	<b>Outstanding Purchases and Loans:</b>	<b>SDR Million</b>	<b>Percent of Quota</b>
	PRGF Arrangements	177.15	117.86
	Systemic transformation	11.56	7.69

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	1/12/01	1/11/04	108.00	49.50
PRGF	2/28/96	8/13/99	172.05	172.05
Stand-by	6/28/95	2/28/96	72.15	22.20

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

	Forthcoming				
	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
Principal	31.45	36.72	33.44	25.94	22.11
Charges/interest	<u>0.99</u>	<u>0.73</u>	<u>0.51</u>	<u>0.36</u>	<u>0.24</u>
Total	32.44	37.45	33.95	26.30	22.35

VII. **Safeguards Assessments:**

A safeguards assessment of the NBG under the Fund's safeguards assessment policy was completed on January 24, 2002. It found that NBG safeguards may not be generally adequate and proposed several recommendations to address the vulnerabilities, as reported in IMF Country Report No. 02/261. Implementation of the recommendations has been monitored by staff and is considered complete. A follow-up assessment of the NBG will be necessary in the context of a successor arrangement. The necessary documentation was requested from the authorities on January 23, 2004, and the assessment is now planned for the second half of 2004.

**VIII. Implementation of HIPC Initiative:**

Not applicable.

**IX. Exchange Arrangements:**

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," with asymmetric intervention limited to the buying side.

**X. Article IV Consultation:**

The 2003 Article IV consultation was concluded on October 17, 2003.

**XI. FSAP Participation:**

Two FSAP missions visited Tbilisi during May 1-15, and July 24-August 7, 2001.

**XII. Technical Assistance:**

See Table 1 of this Appendix.

**XIII. Resident Representative:**

The fourth resident representative, Mr. Dunn, took up his post on August 16, 2001, replacing Mr. Lane.

**XIV. National Bank of Georgia:**

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.

**XV. Ministry of Finance Resident Advisors:**

The late 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. Mr. Welling is FAD peripatetic advisor to assist the State Customs Department in preparing and introducing measures for the custom reform and modernization program. A series of two-month visits have been scheduled. Two visits took place in February-March and July-August 2001. A third, shorter visit took place in late 2003.

Table 1. Georgia: Fund Technical Assistance Missions, 2001-04

Subject	Type of Mission	Timing	Counterpart
<b>Fiscal Affairs Department (FAD)</b>			
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
<b>Monetary and Exchange Affairs Department (MAE)</b>			
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

Table 1. Georgia: Fund Technical Assistance Missions, 2001-04

Subject	Type of Mission	Timing	Counterpart
Payment Systems	Advisory	June 16-20, 2003	National Bank of Georgia
<b>Statistics Department (STA)</b>			
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
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
<b>Legal Department (LEG)</b>			
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

## GEORGIA: STATISTICAL ISSUES

70. The Fund has provided Georgia with substantial technical assistance in the compilation of macroeconomic statistics (Appendix VI, 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 availability of resources. Problems are particularly acute in the compilation of national accounts, balance of payments, foreign trade, and fiscal statistics. Nonetheless, the core statistical indicators compiled by the authorities are provided on a timely basis and are adequate to enable staff to monitor macroeconomic developments under the program.

### Real Sector

71. The quality of GDP estimates has improved, although the State Department of Statistics (SDS) still faces problems with compiling reliable national accounts. 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 by activity follow an established schedule. Flash annual estimates are available just a month after the reference period, preliminary estimates after four months, and a final estimate after 13 months. The recent *Report on the Observance of Standards and Codes* prepared by the IMF's Statistics Department (STA) in July 2002 found that data sources used for the compilation of national accounts statistics are inadequate. The coverage of the business register is not comprehensive because of the lack of economic census data. The coverage of units in terms of value added is relatively good for industry, satisfactory for transport and communications, and poor for agriculture, retail trade, construction, catering, and services. Administrative sources used to estimate the non-observed economy are limited, and data for imports and exports of services (taken from the balance of payments) are inadequate. The main weakness of the statistical techniques used for national accounts are the compilation of the constant price estimates as well as the assessment and validation of source data. Given the sizeable infrastructure investment underway, technical assistance will need to focus on refining statistical coverage of such projects. A technical assistance mission in national accounts is scheduled for April/May 2004.

### Money and Banking

72. A March 2002 STA mission found that the authorities had implemented many of the recommendations made by the December 2000 mission, but in a piecemeal manner that left a number of methodological problems unresolved. To address them, the mission advised the NBG (1) to break down resident data beyond the subsectors of "general government" and "the rest of the economy," in order to provide more disaggregated information about the sectoral distribution of credit; (2) to incorporate all Fund-related accounts transparently in the central bank survey; and (3) to distinguish restricted deposits of insolvent banks from the deposit liabilities that qualify for inclusion in broad money. The mission also reviewed



implementation of the NBG's new chart of accounts (introduced January 1, 2001) and associated changes in procedures for compiling monetary statistics to ensure error-free data classification. In July 2002, an STA mission visited Georgia to conduct the data ROSC. It 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.

### **Government Finance**

73. The fiscal accounts are presented on a cash basis for reporting purposes. Classification broadly follows the analytic framework of *GFSM 1986*, 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. Specifically, the treasury adopts a single-entry cash basis, whereas line departments and other budgetary organizations typically employ a Soviet-era system. The single-entry system hampers the treasury's capacity to reconcile bank statements and hinders the reporting of information on accounts payable. Another statistical 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 that is maintained on a double-entry cash basis. There are substantial differences in the classification systems of different government subsectors, including the extrabudgetary fund and the social security fund. Bridge tables linking national classification codes and *GFSM 2001* codes need to be used in reporting GFS, and a migration path leading more fully to data compilation in accordance with *GFSM 2001* needs to be established soon.

### **Balance of Payments**

74. The authorities have started to implement the recommendations of the previous technical assistance missions (February 2002 and May 2003) and of the 2002 data ROSC mission. In particular, the SDS is now using "mirror statistics" to estimate trade flows as well as data from consumer expenditure surveys to estimate some major imports of goods. At the same time, the Customs Department of the Ministry of Finance has improved data collection on trade flows by computerizing clearance procedures in 60 percent of customs offices and initiating the compilation of trade statistics by its Goods Monitoring Division. However, SDS has made little progress, if any, on improving staffing arrangements and preparing documentation on the sources and methods for balance of payments compilation since the Data ROSC mission. The May 2003 mission focused on identifying new data sources and made arrangements for the provision of additional information for compilation of the balance of payments. With the assistance of SDS staff, the mission prepared a first draft of the

metadata, including a description of the data sources and the methods for data processing and estimation. The mission also identified several problems in the direct investment data collection system, made recommendations on its improvement and elaborated a new methodology to estimate reinvested earnings. It also identified errors in the presentation of data on reserve assets and other assets and liabilities of the NBG and recommended corrective actions

**Georgia: Core Statistical Indicators**  
(As of March 23, 2004)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Gov. Balance	GDP/ GNP	External Debt/Debt Service
Date of latest observation	3/20/04	3/19/04	2/29/04	2/29/04	2/29/04	3/16/04	2/04	1/04	12/03	2/04	Q4/03	2/04
Date received	3/22/04	3/22/04	3/10/04	3/10/04	3/17/04	3/22/04	3/11/04	3/6/04	2/9/04	3/21/03	2/02/04	3/12/04
Frequency of data	D	D	M	M	M	W	M	M	Q	M	Q	M
Frequency of reporting	W	W	M	M	M	W	M	M	Q	M	Q	M
Frequency of publication	M	M	M	M	M	M	M	M	Q	M	Q	M
Source of update	A	A	A	A	A	A	A	A	A	A	A	A
Mode of reporting	C,V,O (e-mail)	C,V,O (e-mail)	C,V,O (e-mail)	C,V,O (e-mail)	V,O (e-mail)	V,O (e-mail)	V,O (e-mail)	V,O (e-mail)	V, O (e-mail)	V,O (e-mail)	C,V,O (e-mail)	C,V
Confidentiality	C	C	C	C	C	C	C	C	C	C	C	C

**Abbreviations:**

Frequency of data/reporting	D	Daily
	W	Weekly
	M	Monthly
	Q	Quarterly
	A	Annually
Source of Update	Other	(explained)
	A	Direct reporting by central bank, Ministry of Finance, or other official agency
Mode of Reporting	C	Cable or fax
	V	Staff visits
	O	Other (explained)
	A	For use by the staff only
	B	For use by the staff and Executive Board
Confidentiality	C	Unrestricted use
	D	Embargoed for a specified period and thereafter unrestricted use
	E	Subject to other use restriction

Mrs. Anne O. Krueger  
Acting Managing Director  
International Monetary Fund  
700 19<sup>th</sup> Street, N.W.  
Washington, D.C. 20431

May 12, 2004

Dear Mrs. Krueger:

The new government of Georgia has inherited daunting economic and financial challenges. The weakening in the public finances, owing to widespread corruption and tax evasion, had hampered the state's ability to remain current on wages and pensions and to deliver basic public goods and services. Macroeconomic stability has, nonetheless, been maintained, even as the country passed through its recent political crisis. With support from the IMF, the World Bank and other donors, the country is embarking on a wide-ranging economic adjustment and reform program to create the conditions for sustained and equitable economic growth and poverty reduction in an environment of low inflation.

The attached Memorandum of Economic and Financial Policies outlines our broad macroeconomic objectives and policies through 2006 and provides specific targets for 2004. At the center of the program is a sustained fiscal adjustment that will be supported by structural reforms, in particular efforts to mobilize revenue and rationalize the tax code, as well as to create an efficient and accountable civil service, improve state property management, and rehabilitate the energy sector.

In support of our economic reform program, Georgia requests a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF) in an amount equivalent to SDR 98 million (65 percent of quota), following implementation of the prior actions set out in Table 2.

The government believes that the policies set forth in the attached Memorandum of Economic and Financial Policies (MEFP) are adequate to achieve the objectives of the program, but it will take any other measures that may become appropriate for this purpose. The government of Georgia 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. Moreover, after the period of the PRGF arrangement, and while Georgia has outstanding financial obligations to the Fund from loans and earlier arrangements, the government will consult with the Fund on Georgia's economic and financial policies from time to time, at the initiative of the government or at the request of the Managing Director. Georgia will conduct with the Fund the first semi-annual review of its program before October 31, 2004, as described in the attached memorandum.

Sincerely yours,

/s/

Mikheil Saakashvili  
President of Georgia

/s/

Zurab Zhvania  
Prime Minister

## GEORGIA: MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES FOR 2004

### A. Introduction

1. This memorandum sets out the economic and financial policies of the Georgian government for 2004, which are aimed at sustained output growth and poverty reduction. These policies are the basis for a new three-year Fund-supported program under a PRGF arrangement.
2. The recent leadership change in our country provides a fresh opportunity to tackle corruption and governance issues, improve the efficiency, effectiveness and transparency of the government, and strengthen the country's macroeconomic fundamentals. This will be critical for achieving long-term economic growth and poverty reduction, as set out in the Economic Development and Poverty Reduction Program (EDPRP). In 2004, our program will focus on achieving the following objectives:
  - To maintain a stable macroeconomic environment, supported by a prudent monetary policy and further fiscal consolidation;
  - To raise tax revenue by accelerating administrative reforms in the tax and customs areas, as well as through tax policy measures;
  - To make further improvements in budgetary expenditure management and to link the budgetary process more closely with the EDPRP;
  - To conclude a new debt rescheduling agreement with the Paris Club and secure agreements with non-Paris Club bilateral creditors on comparable terms;
  - To dramatically improve governance and reduce the scope for corrupt practices by implementing a phased reform of the public sector, focusing initially on the civil service and state property management;
  - To accelerate other important structural reforms, particularly to rehabilitate the energy sector and improve the business climate; and
  - To strengthen the financial system by promoting further banking sector consolidation and financial market deepening, building on earlier reforms to strengthen supervision, and by implementing new anti-money laundering legislation.
3. We discuss these objectives in more detail below. In addition, we have reached understandings with Fund staff on a set of macroeconomic targets and structural benchmarks (Tables 1 and 2) for 2004, which are specified in the attached Technical Memorandum of Understanding.

## **B. Past Economic Performance**

4. Georgia made progress in implementing the economic program supported under the previous PRGF arrangement. Notable achievements include higher GDP growth than originally envisaged, maintaining low inflation, and introducing further reforms in the areas of tax policy and administration and the financial sector. However, progress was slow in some key areas, constrained in large part by weak governance and pervasive corruption. There was no sustained improvement in tax revenue collections, due to lax tax enforcement and tax code amendments that narrowed the tax base. Regional instability and a poor investment climate have undermined prospects for foreign investment. The situation in the energy sector remains serious and continues to pose a significant risk to macroeconomic stability and growth. Poverty remains widespread.

5. Real GDP grew by 8.6 percent in 2003, led by construction activities buoyed by the Baku-Tbilisi-Ceyhan oil pipeline, a recovery of farming from a bad harvest in 2002 and rehabilitation of certain industrial plants. End-period inflation rose from 5.4 percent during 2002 to 7 percent in 2003, driven in part by a sharp increase in wheat prices as a result of crop failures in the main CIS grain exporters. The 2003 target for tax revenue set under the previous IMF-supported program was missed by some 0.7 percent of GDP, especially because of a slackening in tax and customs administration. As a result, the stock of domestic expenditure arrears (accumulated since 1998) increased by GEL 123 million to 4.8 percent of GDP by year's end, instead of declining as programmed. The government deficit on a cash basis amounted to 1.3 percent of GDP in 2003 (compared with the indicative target of 1.6 percent), while the deficit on a commitment basis was 2.4 percent (versus the target of 1.3 percent). Monetary policy in 2003 was broadly in line with the program, assisted by continued remonetization of Georgia's economy. The NBG continued to float the lari, pursuing limited intervention to bolster reserves, and the lari remained broadly stable vis-à-vis the U.S. dollar in 2003. In real effective terms, however, the lari depreciated by 9 percent during the year, owing in part to the weakening of the dollar relative to other major currencies. In spite of active NBG intervention in the foreign exchange market, gross international official reserves fell slightly to 1.5 months of imports of non-pipeline goods and services, largely because of the inability to maintain the PRGF program on track and make the related IMF drawings.

6. Structural reforms in the fiscal area advanced in 2003, albeit with delays. The new Budget System Law passed in April 2003 provides a useful framework for improved public expenditure policy and management. The tax reform of August 2003 should simplify compliance and facilitate tax enforcement, aided by the strengthened investigative powers granted to the Ministry of Finance. Further revenue-neutral tax policy measures were introduced in December 2003 in order to ease the tax burden on small farmers, while offsetting the potential revenue loss to the central and local governments. These included (i) shifting collection of the land tax to local governments and giving them the legal option to raise the land tax rate on larger landholders; (ii) fully transferring the personal income and profit taxes to local governments (the State Tax Department will continue to collect them on

their behalf); and (iii) introducing a new taxation regime for tobacco products. Moreover, various “nuisance taxes” that had been abolished in the August tax package were reintroduced in December to sustain the local government revenue base, although the longer term goal of the government is to phase out nuisance taxes in the context of a broader tax reform discussed below. Progress was made towards the establishment of a commitments control system by the treasury for all payments by state ministries and line agencies, and towards the establishment of a single treasury account, which will become fully effective April 1, 2004. The government program for 2004, outlined below, aims to build on these reforms.

7. In the energy sector, implementation of the action plan agreed with the donors in November 2002 was mixed. In May 2003, the electricity distribution utility outside Tbilisi (UDC) was brought under private management, but transfers from UDC to the wholesale electricity market continued to fall short of expectations throughout the year. The financial viability of the sector was also undercut by a court-ordered 11 percent reduction in power tariffs in effect since March 1, 2003. Bill collections from direct customers and budgetary organizations improved during the year, but the Q4 target for budgetary organizations was missed by a wide margin. In November 2003, agreement was reached on a modified action plan for the sector, including protection of power industry assets from trespassers seeking to avoid disconnection of non-paying customers and realistic budgeting to enable full payment of electricity bills by central and regional governments. However, progress in implementing that plan was mixed, and in February 2004 the energy sector stakeholders and donors proposed to strengthen this action plan by (i) forcefully disconnecting nonpaying customers; (ii) improving debt management in the sector, including to settle the sector’s sizable legacy debt; and (iii) developing business plans to improve the performance of all major electricity distributors, including by improving their collection rates. Implementation of these measures is a key element of our economic reform strategy for 2004.

8. Financial sector reforms advanced in 2003 as the NBG secured regulatory changes to better target its banking supervisory authority. On-site inspections were made less predictable and more focused on problem banks. An anti-money laundering law was passed by parliament in early June 2003 and a Financial Monitoring Service was established under the NBG’s auspices. Progress toward developing the market for government securities remained nonetheless limited.

9. The current account deficit including transfers widened to 8 percent of GDP in 2003 (from 6 percent in 2002), much of it covered by rising pipeline-related FDI. Because of slippages under the PRGF-supported program, which precluded the consolidation of 2003 principal maturities owed to the Paris Club, Georgia accumulated US\$51 million in arrears to its bilateral creditors by end-December 2003, and a further building up of arrears of some US\$12 million is now estimated during the first quarter of 2004. The financing assurances that we expect to receive from the Paris Club in the near future will pave the way for clearing these arrears. Georgia remained current on its interest obligations to them and on all obligations to multilateral creditors.

### **C. The Government Program**

10. Our medium-term program features a rapid and decisive turnaround in governance, tax enforcement, and capacity building, and it also envisages a careful sequencing of reforms. Broadly consistent with the base case of the EDPRP, we assume 5 percent real GDP growth over 2004-06, slightly above the 1998-2003 average, though growth could well turn out to be faster if our efforts to improve the business climate and foster private investment bear fruit. Inflation is targeted to remain low as the NBG maintains prudent monetary policies. Efforts to strengthen governance and reduce corruption will be aimed at improving public sector operations, especially by creating a leaner, efficient, and accountable civil service and improving the management and accountability of SOEs. Tax enforcement will be strengthened by improving administration in the revenue-raising agencies, fighting corruption and smuggling, simplifying the tax system, and broadening the tax base. Progress on these fronts should allow us to achieve an increase in the tax revenue to GDP ratio of some 5-6 percentage points over the next five years. An increase of this magnitude, though relatively ambitious, appears to be feasible and necessary to secure fiscal sustainability and unwind domestic expenditure arrears. Progress in these areas will help us regain the confidence of donors and investors to secure higher aid flows and spur investment, both of which are critical for achieving the economic growth and poverty reduction goals laid out in the EDPRP. The new government has endorsed the EDPRP prepared by the previous administration and will update the poverty reduction program in the course of 2004 in consultation with stakeholders. A key objective of the EDPRP is to reduce the proportion of the population living below the official minimum subsistence levels, from 52 percent in 2002 to 20-25 percent by 2015. Other areas where we intend to make progress over the program period include strengthening the financial system and reducing its remaining vulnerabilities, and peacefully regaining full control over Georgian territory and normalizing relations with Russia, while continuing to integrate Georgia into the world economy.

11. The medium term macro-economic framework underpinning this three-year Fund-supported program includes projections for government revenue and expenditure that are somewhat higher than in the baseline scenario presented in the EDPRP. These projections are justified in the light of our intensified efforts to mobilize tax revenue and secure additional foreign aid, so as to make room for priority social and infrastructure spending. The improved medium-term outlook will be reflected in the EDPRP progress report to be prepared later this year.

12. Our economic program for 2004, more specifically, will focus on improving governance and the investment climate. Toward these ends, we will advance key aspects of the unfinished agenda for structural reform, underpinned by a continued prudent macroeconomic stance. As noted above, a high priority will be given to increasing government revenue to make room for higher spending on social programs and on infrastructure, as well as to initiate the phased reduction in the stock of domestic expenditure arrears. Another focus of our efforts will be to strengthen the performance of SOEs in an effort to avert fiscal pressures and improve resource allocation. We intend to take further



steps to strengthen banking supervision in order to promote a sound financial sector and enhance financial intermediation that will facilitate investment and growth. Energy sector reform will be pursued to alleviate pressure on the budget and promote more reliable power supply. By refraining from commercial external borrowing and restructuring current obligations on bilateral debt, we aim to remove a significant obstacle to growth.

### **Macroeconomic prospects**

13. We are confident that Georgia will achieve solid economic growth in 2004, supported by the construction of the Baku-Tbilisi-Ceyhan Oil Pipeline and sustained growth in our principal trading partners. The 2004 program targets a real GDP growth rate of 6 percent and inflation of around 5 percent. We anticipate a small gain in net foreign assets, which would keep gross reserve coverage at about 1½ months of non-pipeline imports.

### **Fiscal policy**

14. The 2004 budget aims to increase tax revenue by at least 1.5 percent of GDP. The overall fiscal deficit will decline to 1.6 percent of GDP on a commitment basis and 2.6 percent on a cash basis, allowing for net repayments of expenditure arrears of 1.0 percent of GDP and thereby reducing the stock of arrears to 3.3 percent of GDP by end-2004. The increase in tax revenue will hinge on improving tax and customs administration, especially regarding excise and value added taxes and customs duties. In this regard, we have taken decisive measures to ensure the integrity and professionalism of tax and customs officials and will vigorously pursue cases of tax fraud and other abuses. We have created a financial police in the Ministry of Finance, while abolishing the economic crime units in the power ministries. Moreover, we are overhauling the Tax Department, and—without duplicating the functions of the Large Taxpayer Unit—we have created a new Excise Tax Inspectorate, which is now fully operational and incorporates the responsibilities of the Excise Stamp Service and the Excise Program Monitoring Bureau, as well as the excise collection functions of the Tax Department. Additional measures that will be taken to increase excise tax revenue include (a) targeting anti-smuggling efforts at access routes to major population centers; (b) intensifying surveillance over small-scale (“tea-kettle”) oil refineries; and (c) introducing far-ranging improvements in the personnel management of the Tax and Customs Departments. In addition, the Ministry of Finance will prepare an effective customs reform and anti-smuggling strategy, in cooperation with other government agencies and donors. The new PRGF program includes a performance criterion on collections of fuel and cigarette excises, demonstrating our resolve to curb widespread evasion of these taxes.

15. To prepare for a deepening of reforms initiated in 2003, we will formulate a comprehensive review of tax policy in 2004, supported by donor technical assistance, for which we will seek parliamentary approval by end-2004. In this connection, we aim to broaden the tax base beginning with the 2005 budget, by dismantling exemptions (especially on the corporate income tax and VAT), while eliminating nuisance taxes to simplify the tax

regime. Discussions are continuing toward a normalization of revenue transfers from Adjara to the central government.

16. Non-tax revenue will rise significantly from 2005 onward, in the form of transit fees for oil transported through the Baku-Tbilisi-Ceyhan Oil Pipeline. In-kind transit fees from the South Caucasus Pipeline (SCP) are expected to start in 2006. In 2004, we will develop plans for a mechanism for transparent reporting of these revenues, and for monetizing the in-kind SCP fees.

17. The new Budget Systems Law abolished the system of protected items starting with the 2004 budget, thereby fostering greater operating flexibility and discouraging accumulation of new expenditure arrears. In 2004, we will introduce a number of amendments to further enhance the law's effectiveness, including (a) aligning it with recent constitutional amendments; (b) upgrading its status to that of an organic law; (c) revising the budget preparation calendar to allow more time for negotiations between the Ministry of Finance and spending agencies on the agencies' budget allocations; and (d) strengthening the treasury's exclusive control over the treasury single account. Regarding the accumulated stock of domestic expenditure arrears, we have effectively stopped the build-up of these arrears and plan to reduce them by some GEL 90 million (1.0 percent of GDP) in 2004, focusing initially on settling arrears on wages and pensions. Subsequent to auditing the stock of all expenditure arrears, we will develop a plan to settle them before the expiration of the PRGF-supported program. This plan will be incorporated in the Medium-Term Expenditure Framework, which will include sufficient budgetary appropriations for this purpose. We will also audit the registers of pensioners and internally displaced persons (IDPs), to make sure that payments are made only to those who are entitled to receive a state pension and/or refugee allowance. In 2004, all revenue transit accounts at the banking system will be closed as an interim step to the establishment of a single treasury account by end-June 2004, and full commitment control for all payments by the treasury for state ministries and line agencies will be established. Cash and debt management will be improved by preparing realistic monthly projections for cash and spending and by providing financial markets with timely information on projected treasury bill auctions.

18. We will transfer a number of functions currently in the domain of budgetary organizations to legal entities of public law (LEPLs), with a view to improving the focus of budgetary organizations on their core activities. The exact list of functions to be transferred to LEPLs will be determined in the course of 2004, in close consultation with Fund staff. To safeguard the transparency and accountability in the use of budget resources, all transfers to LEPLs will go through line ministries as program financing to those entities, with each line ministry being legally responsible for ensuring that funds are used properly. In addition, all LEPLs will be held to high transparency standards and will be obliged to fully disclose all their revenues and expenditures as well as to report them in a timely manner to the Ministry of Finance.

19. Efforts to improve the governance, efficiency and transparency of key state-owned enterprises (SOEs) are an important element of our 2004 reform agenda. At present, the government does not exert sufficient control over these enterprises and their financial reports are neither reliable nor systematic. As a result, many large SOEs are not subject to hard budget constraints and systematically evade payment of taxes and dividends to the budget. In 2003, the Ministry of State Property Management was dissolved, and its tasks were transferred to the Ministry of Economy, which has assumed responsibility for privatization. A new Enterprise Management Agency (EMA) now oversees the management of SOEs by appointing supervisory boards and preparing enterprises for privatization. Although no major privatizations are now envisaged to take place in 2004, besides the sale of the Agrobusiness Bank, the EMA is reviewing procedures for subsequent privatizations (possibly including medium- and large-scale SOEs) during the program period. We view improved transparency and accountability of SOEs as an effective tool for better performance. Toward that end, the 2002 accounts of three major companies (Georgian Railways, Poti Port, and Madneuli Mining Company) are being audited by reputable international experts, selected in July 2003 through a competitive bidding process. The audit reports will be certified by end-July 2004 and published within one month of their completion. Based on the experience gained in 2003, we plan to broaden the coverage of international audits to all ten SOEs with a turnover exceeding GEL 10 million (US\$5 million), starting in 2004 with the state telecommunications company (Elektrokavshiri) and the Tbilisi Airport Authority. These companies will be expected to publish the audit results and maintain high auditing standards henceforth. Our ultimate goal is to improve the monitoring of financial accounts of the major parastatals, so as to allow for a broadening of the coverage of the fiscal accounts over the medium term.

### **Energy sector and other structural reforms**

20. The 2004 reform program will continue to focus on improving financial performance and governance of the energy system, which are fundamental from the fiscal and resource allocation standpoints. A 16-month business plan for the power sector through the winter of 2004/05 is being developed in consultation with donors and key sector participants to address the more urgent problems in the sector. The centerpiece of that plan is to secure a further sustained increase in collection rates in the sector. Moreover, a longer-term strategy will be formulated to rehabilitate and upgrade the sector's infrastructure and mobilize the corresponding investment resources, currently estimated at US\$375 million for the power and gas sectors over the next several years. Within this comprehensive framework, and while political discussions continue to regain full Georgian sovereignty over the breakaway regions, the government will also address the problems created by the electricity that is consumed but not paid for by Abkhazia. Progress in the design and implementation of energy sector reform will be a principal topic covered during the first review under the program, as discussed below. The review will assess, inter alia, progress in improving bill collection rates, implementing the strategy to address energy sector legacy debt, and securing domestic and external resources to rehabilitate power and gas infrastructure. Privatization of electricity distribution in Tbilisi has contributed to higher collection rates and more reliable power

supply in the capital; however, in the rest of the country, collection rates are low, and electricity supply has not improved. In April 2002, most municipally owned distribution companies outside Tbilisi were consolidated into a single, state owned United Distribution Company (UDC), which was put under private management contract in May 2003. Virtually all power distribution, transmission and dispatch, as well as part of the country's generation capacity has now been brought under private management contract. Combined with strong support for policies to cut off non-paying consumers of electricity and further work to extend the metering of customers, this should result in an increase in cash collections for electricity consumption for direct customers of the wholesale electricity market to 90 percent, and for budgetary organizations to 97 percent on average in 2004 (including 100 percent of billing in the third and fourth quarters of the year). In addition, the UDC's collection rate is targeted to increase to an average of 25 percent of billing in 2004. We will closely monitor the collection performance of the other distribution companies (Adjara and Kakheti) and will withdraw the licenses from small distributors that currently operate within the territory of the main electricity distribution companies. Tbilgazi's collection system has been moved to banks, to boost the collection rate to 32 percent on average in 2004. We aim to further increase UDC's and Tbilgazi's collection rates during the remainder of the program period, following the completion of ongoing metering programs. In 2004, the government will fully reassert the autonomy of the Georgian National Energy Regulatory Committee (GNERC) in conducting its regulatory activities, including formulation of energy tariff policy and licensing of energy sector utilities. Moreover, a comprehensive review of the electricity tariff methodology will be initiated by end-June 2004 with donor assistance.

21. Achieving tangible and substantial improvement in governance by reforming the public sector is an important objective of our 2004 economic reform program. Toward that end, the constitutional reform passed in February 2004 has created the position of Prime Minister, abolished all state departments and subordinated them directly to the respective line ministries, and institutionalized the notion of collective responsibility of ministers. We will thoroughly revise the mandates of the remaining 15 ministries, their structures, internal procedures and process, as well as coordination and reporting mechanisms. These reforms should help to enhance the effectiveness of government. State procurement will be strengthened by announcing all public tenders on the website of the State Procurement Agency.

22. Civil service reform will be pursued with the aim of creating a competent, motivated and well-remunerated yet affordable civil service, thereby improving the efficiency of government structures and reducing incentives to engage in corrupt practices. To achieve this, we will develop in the second half of 2004 a comprehensive and carefully costed civil service reform strategy that will (i) develop merit-based recruitment, remuneration and suspension mechanisms, (ii) revise the current grading system, (iii) provide for professional development, and (iv) introduce and enforce disciplinary and ethic codes. Donors have agreed to provide technical and financial support for this effort. A number of ministries have already started to reduce staff through self-financing retrenchments, with a corresponding envisaged increase in salaries to remaining personnel (after clearing wage arrears and

effecting severance payments). We also plan to effect payment of government salaries by direct deposit, replacing the current cash payments system, as another aspect of our efforts to improve public sector efficiency and reduce the scope for corruption.

23. By simplifying the tax regime and strengthening governance as discussed above, the business climate should improve significantly and conditions should be created for small and medium-sized enterprises (SMEs) to flourish. Supporting measures in that direction will include (i) creating an investment and trade development agency with donor support that would serve as a “one-stop shop” for investors; (ii) appointing a business ombudsman in the Ministry of Economy; and (iii) strengthening microfinance institutions.

### **Monetary and financial sector policies**

24. The monetary program for 2004 remains focused on maintaining inflation in the 5 percent range and strengthening the foreign reserve position of the NBG. It envisages reserve money growth of 14 percent and broad money growth of 19 percent, assuming that recent trends in remonetization continue. The lari’s floating exchange rate regime will be maintained. The NBG has enhanced its monetary policy tools by reviving and expanding the lari interbank market in 2003 in the form of a redesigned credit auction that better fulfills the needs of banks; credit auctions are now held several times a week. Access to a portion of required reserves as collateral for the credit auction has been made automatic. We anticipate that this expansion in the availability of secure, liquid, lari-denominated assets, along with a gradual improvement in the business climate and the introduction of differential reserve requirements in 2003, will stem and possibly reverse the trend toward dollarization over the medium term. Our goal is to further improve the functioning of interbank and treasury bill markets, in particular through the development of a primary dealer system in 2004. We recognize that these measures may mitigate dollarization marginally, and that a more substantial reversal of this phenomenon depends on gradual, continued improvement in the economic fundamentals and investor confidence.

25. Besides continuing our efforts to increase financial sector transparency, we are developing a strategy for further banking sector consolidation in 2004 and already introduced a phased increase in minimum capital requirements. With regard to banking supervision, we have begun (i) regular stress testing of the banking system in line with the IMF’s Monetary and Financial Systems Department (MFD) recommendations; (ii) implementing the principles and procedures of the NBG’s analytical framework for bank resolution; and (iii) utilizing predictable and progressively stronger supervision measures for banks in distress (i.e., those rated as CAMEL three, four or five according to internationally-accepted supervisory criteria). Additionally, the government will propose necessary changes in legislation to provide the NBG with the legal authority to disqualify auditors from performing bank audits and require them to disclose violations of law, regulations, or significant misrepresentation of financial data to the NBG. Following Georgia’s ratification of the Strasbourg Convention Number 141 on “Laundering, Search, Seizure and Confiscation of the Proceeds from Crime,” thereby binding Georgia to full compliance with the requirements

contained therein, the authorities are now proceeding to bring the Georgian legislation and enabling regulations on AML into full compliance with the international agreement, in consultation with the IMF's Legal Department.

### **External policies**

26. The end of the Paris Club consolidation period in 2002 resulted in 2003 in a sharp increase in Georgia's external debt service due and in the accumulation of external arrears noted above. To clear these arrears and achieve medium term external viability, we intend to request a rescheduling of 2003 arrears and eligible 2004-06 maturities (i.e., bilateral pre-cutoff obligations, excluding those rescheduled under the 2001 arrangement), with comparable treatment by non-Paris Club bilaterals. We will also continue negotiations with Turkmenistan to reach a formal agreement on the rescheduling of pre-2001 arrears, as well as 2001 and 2002 principal maturities. In this connection, we have reviewed the implications for Georgia of the Paris Club's new Evian approach. The latest Debt Sustainability Analysis, which has been updated in advance of a request for a new arrangement, suggests that absent a concessional restructuring, Georgia would continue to face a heavy debt burden. We will pursue prudent external debt management and will not contract or guarantee any non-concessional loans during the program period.

27. Georgia will continue to maintain a liberal foreign trade regime. In December 2002, parliament passed legislation increasing the level and the dispersion of import duties, taking advantage of the margins provided at the time of Georgia's accession to the WTO. The number of tariff bands was increased from 3 to 22 and the maximum tax rate was increased from 12 percent to 30 percent. While the increase in average protection—evidenced by a one percentage point rise in the weighted average tariff to 11.3 percent—is modest, tariff dispersion has increased substantially. In keeping with Georgia's outward-looking growth strategy, we will phase out the protective measures introduced in late 2002, with a view to reducing the level and dispersion of import tariffs, thereby reducing rent-seeking opportunities, by end-2004. More generally, and in conjunction with the comprehensive tax policy assessment to be conducted this year as noted above, we will review the scope for eventually adopting a low uniform import tariff (accompanied by introduction of a duty-drawback system and improvements in the VAT refund mechanism for exporters). Given the anti-smuggling efforts mentioned earlier, we believe it should be possible to liberalize the trade regime while simultaneously raising duty collections, improving resource allocation, and reducing the anti-export bias of the trade regime.

### **D. Program Monitoring**

28. Progress in implementing the program will be monitored through quantitative performance criteria and indicative targets set forth in the attached Table 1, as well as structural performance criteria and benchmarks as listed in Table 2. Semiannual performance criteria will be monitored under two reviews. Completion of the first review, scheduled for October 2004, will require observance of the performance criteria for end-June 2004, as

shown in Tables 1 and 2. The review would focus on progress in improving governance, securing fiscal consolidation, and launching or implementing reforms in the energy sector and the civil service. Key governance-related elements of conditionality for this review will be (i) progress on implementation of our customs reform strategy; (ii) development and implementation of a comprehensive, 16-month emergency plan to restore the viability of the electricity sector, featuring inter alia a move of collection systems for payments to electricity distributors in major towns outside Tbilisi to banks or service centers; (iii) the strengthening of the supervisory boards of Madneuli mining and Elektrokavshiri; and (iv) publication of the audits of the 2002 accounts of Poti Port, Georgian Railways, and Madneuli Mining Company. The second review, scheduled to be completed by April 2005, will assess developments in the areas mentioned above and gauge program performance on the basis of end-December 2004 quantitative performance criteria and indicative targets. Key governance-related elements of conditionality for this review will include reversal of the changes in import tariffs introduced in December 2002 and initiation of additional audits of two key SOEs.

Table 1. Georgia: 2004 Quantitative Performance Criteria and Indicative Targets 1/

	Stocks 2/ End-Dec. 2003	Cumulative Change from End-December 2003			Performance Criteria
	Actual	Mar. 2004 Preliminary estimates	Jun. 2004 Performance Criteria	Sep. 2004 Indicative target	
1. Quantitative targets 3/					
Floor on general govt. tax revenue (including special funds) 4/	1207.7	312.9	685.2	1101.0	1538.5
Ceiling on cash deficit of the general govt. 5/	109.5	81.2	151.6	179.5	240.4
Ceiling on domestic expenditure arrears of the general govt.	123.5	-6.3	-25.8	-52.2	-93.4
Floor on tobacco and petroleum revenues	133.9	39.0	92.8	174.5	259.2
Ceiling on net credit of the banking system to the general govt. (NCG)	766.1	18.2	27.7	27.4	31.4
Ceiling on net domestic assets (NDA) of the NBG	909.0	18.4	24.3	21.5	19.6
		(In millions of lari)			
Floor on total net international reserves (NIR) of the NBG	-153.1	-3.6	-0.2	11.9	28.8
Ceiling on contracting or guaranteeing of					
A. Nonconcessional medium- and long-term external debt	0.0	0.0	0.0	0.0	0.0
B. Short-term external debt (less than one year)	0.0	0.0	0.0	0.0	0.0
Ceiling on accumulation of external arrears	0.0	0.0	0.0	0.0	0.0
		(In millions of U.S. dollars)			
2. Indicative targets					
Ceiling on reserve money	579.9	10.7	23.8	47.0	81.3
		(In millions of lari)			
Average monthly cash collection rates (CCR)					
CCR from Direct Customers of the Georgian Wholesale Electricity Market (GWEM)	88.0	85.0	90.0	90.0	95.0
CCR from the General Government	51.0	6/	95.0	100.0	100.0
CCR from UDC customers	19.0	18.0	20.0	27.0	35.0
CCR from Tbilgazi customers	22.8	25.0	29.0	34.0	40.0
		(In millions of lari)			
3. Baseline assumption on external project financing 5/	127.7	77.5	159.4	228.9	289.1

Sources: Georgian authorities and Fund staff estimates.

1/ Section 1 of this table shows quantitative targets for 2004 based on cumulative changes from end-December 2003. The ceiling for the cash deficit of the government is subject to possible adjustment, as indicated in footnote 5, based on deviations from projections of external financing, reported in Section 3 of the table. Indicative targets are shown in Section 2. The continuous performance criterion for external arrears is defined in paragraph 23 of the TMU.

2/ Year-to-date flows for tax revenues, cash deficit, expenditure arrears, and tobacco and petroleum revenues. Monetary outcomes reflect revaluations due to changed program exchange rate assumptions. Collection rates are for the fourth quarter of 2003.

3/ Quantitative targets for 2004 are based upon accounting exchange rates of GEL 2.15/US\$, US\$ 1.49/SDR, and US\$ 1.27/EUR.

4/ Special state funds include the Pension, Employment, and Road Funds. Privatization receipts are excluded.

5/ The program target on the cash deficit is adjusted for deviations from projected disbursements of external project finance (Section 3) as specified in the TMU agreed with the authorities in February 2004, subject to a cap on the cumulative upward adjustment of GEL 100 million for calendar year 2004.

6/ The cash collection rate from the General Government in the third quarter of 2003 was 95.4 percent.



Table 2. Georgia: 2004 Structural Conditionality

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**Prior Actions**

- Secure approval by parliament of a sound 2004 budget in line with the parameters agreed with the mission, as specified in paragraph 14.
- Establish an Excise Tax Inspectorate, as specified in paragraph 14.
- Prepare a customs reform and anti-smuggling strategy paper formulated by the Ministry of Finance in cooperation with other government agencies.
- Register all small scale ('teakettle') refineries for excise duty purposes.

**Structural Performance Criteria**

- Refrain from issuing government guarantees on domestic loans (continuous structural performance criterion).
- Select a consultant to conduct the review of the electricity tariff methodology (by end-June 2004).
- Issue a strategy paper to deal with internal electricity sector legacy debts (by end-June 2004).
- Secure parliamentary approval of amendments to the Budget Systems Law to align it with recent constitutional amendments and to implement the recommendations of the October 2003 FAD TA mission (by end-December 2004).
- Secure parliamentary approval of a Tax Reform, as specified in paragraph 15 (by end-December 2004).

**Structural Benchmarks**

- Refrain from engaging in offset transactions to settle tax obligations or government electricity bills (continuous structural benchmark).

Table 2. Georgia: 2004 Structural Conditionality (concluded)

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- Establish full commitments control for all payments by the Treasury for state ministries and line agencies, close all revenue transit accounts (thereby making the Treasury Single Account fully effective) and move the VAT refund accounting and payment to the Treasury (the tax administration services of the Ministry of Finance will remain in full control of verifying and approving VAT refunds) (by end-June 2004).
  - Appoint new supervisory boards for the Madneuli mining and Elektrokavshiri state enterprises that will be guided by performance-based contracts, which will require them to exercise effective oversight of management to ensure improved transparency in the operations of these enterprises (by end-June 2004).
  - Move the collection systems for payments to electricity distributors in major towns outside Tbilisi to banks or service centers (by end-June 2004).
  - Submit to parliament legislation enabling the NBG to disqualify auditors from performing bank audits and require auditors to disclose violations of laws, regulations, or significant misrepresentation of financial data to the NBG (by end-June 2004).
  - Post the results of the audits of the 2002 accounts of Poti Port, Georgian Railways and Madneuli Mining Company, including the management letters in the official websites of the Ministry of Finance and the Ministry of Economy (by end-August 2004).
  - Secure parliamentary approval of enabling legislation to allow for provisional measures (i.e., freezing and seizure) and confiscation related to the anti-money laundering legislation (by end-September 2004).
  - Initiate international audits of the Tbilisi Airport Authority and the state telecommunications company (Elektrokavshiri) by issuing tenders and selecting auditors (by end-September 2004).
  - Audit the stock of domestic expenditure arrears by verifying all claims on the state budget (by end-December 2004).
  - Reverse the changes in foreign trade tariffs that were introduced in December 2002 (by end-December 2004).
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**GEORGIA: TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)**

May 12, 2004

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 April 22, 2004.

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 2003. The program allows for an automatic adjustment to the cash deficit target in case of deviations of external project financing from expectations, subject to a cap on the upward adjustment.

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

**A. Definition of the General Government and the Public Sector**

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

**B. Floor on Tax Revenues**

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

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

**C. Floor on Revenues from Tobacco and Petroleum Products**

6. **Definition:** This target is defined as the total of (1) customs duties, excise duties, and VAT collected by the State Tax Department and the State Customs Department on the domestic production, sales and imports of petroleum products; (2) the fixed tax collected on production, sales, and imports of tobacco products until July 1, 2004; and (3) the fixed tax and VAT collected on production, sales and imports of tobacco products afterwards.

7. **Supporting material:** The Ministry of Finance will provide data with a breakdown into the main categories of products on a monthly basis within two weeks of the end of each month.

#### **D. Ceiling on Domestic Expenditure Arrears**

8. **Definition:** Domestic expenditure arrears are defined as arrears incurred by the general government on expenditure items, excluding external debt service payments. The measurement of central government expenditure arrears will be based on the following principles: (a) goods and services have been received; (b) they have been certified to conform to the order of the contract; (c) the bill for payment has been received; and (d) the due-for-payment date has passed and the bill has remained unpaid beyond the normal or agreed period of credit. Extrabudgetary funds will start using the same method from June 2004 onwards. Until then, the net change in arrears will be estimated as the difference between actual cash spending and the monthly cash limits issued prior to the beginning of the month. Expenditure arrears of local governments are also estimated as the difference between actual cash spending and the monthly cash limits issued prior to the beginning of the month.

9. **Supporting material:** The Ministry of Finance (Treasury) will provide monthly data, with a detailed breakdown by economic and organizational category, on cash spending and commitments made by the central government, and/or cash limits issued to the spending units. Information on cash limits and spending commitments will be provided within two weeks from the beginning of each month. Information on cash spending will be provided within four weeks of the end of each month. The local budget department in the Ministry of Finance will provide information on monthly spending by the local budgets, and the extrabudgetary funds will provide information, through the Ministry of Finance, on their monthly expenditures.

#### **E. Ceiling on the Cash Deficit of the General Government**

10. **Definition:** The cash deficit of the general government will be measured from the financing side, and will be defined as equal to the total financing (domestic and external, plus privatization proceeds) received by the general government.<sup>11</sup> Privatization receipts consist of all gross proceeds received by the central and local governments. Domestic financing consists of all bank and non-bank financing to the general government. External financing is defined as the total of disbursements, macroeconomic support, net change in external arrears, minus amortization. Disbursements include all project financing (capital expenditure and net lending) and balance of payments support (excluding grants) received by the budget.

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<sup>11</sup> Modest differences between the recorded financing and the cash deficit, calculated from “above the line” as expenditures plus net lending minus revenues and grants, can be attributed to check-float and smaller errors and omissions.

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.

11. **Adjustment clauses:** The ceiling will be adjusted to reflect cumulative deviations from program assumptions on **external project financing** for capital expenditure or net lending. The ceiling at the end of a quarter will be adjusted upward (downward) by the full amount of the cumulative excess (shortfall) of external project financing. There will be a cap on cumulative upward adjustment of GEL 100 million for calendar year 2004.

12. **Supporting material:** Data on privatization receipts will be provided by the Ministry of Finance (Treasury) 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 by the NBG. A table on external project financing will be provided monthly by the Ministry of Finance (specifying project by creditor) within two weeks of the end of each month.

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

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

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

#### **G. Ceiling on Net Domestic Assets of the NBG**

15. **Definition:** Net domestic assets of the NBG are defined as the difference between 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).

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

## H. Floor on Net International Reserves of the NBG

17. **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 2.15 lari per U.S. dollar, US\$1.49 per SDR, US\$1.27 per euro, and a gold price of US\$425.00 per ounce). Gross 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 reserve assets. Reserve liabilities include the use of Fund resources and any other liabilities of the NBG.

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

## I. Ceiling on Contracting or Guaranteeing of New Non-Concessional Medium- and Long-Term External Debt by the Public Sector (with Original Maturity of One Year or More)

19. **Definition:** Non-concessional 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).<sup>12</sup> 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 Foreign Debt (Decision No. 12274-(00/85) August 24, 2000) but also to commitments contracted or guaranteed for which value has not been received.<sup>13</sup>

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<sup>12</sup> An electronic spreadsheet file that shows the relevant discount rates reported by the OECD (CIRRs) will be provided on a periodic basis by Fund staff.

<sup>13</sup> 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  
(continued...)

Previously contracted non-concessional external debt that has been rescheduled will be excluded from the definition of "new debt" for the purposes of this performance criterion.

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

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

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

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

**K. Non-Accumulation of External Arrears**

23. **Definition:** During the period of the arrangement, the general government and the NBG will not accumulate any new external payment arrears. Official arrears on external debt service obligations include any non-payment of interest and/or principal *in full and on time* falling due to all creditors, including the Fund, the World Bank, and other official creditors.

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

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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."

**L. Indicative Target for Reserve Money**

25. **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.

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

**M. Target for Electricity Cash Collection Rate from Direct Customers of the Georgian Wholesale Electricity Market (GWEM)**

27. **Definition:** The cash collection rate is defined as the ratio of all cash payments received in each month to the lari amount billed in the previous month. "Cash offset" payments—direct cash payments from Direct Customers of the GWEM to power generators, bypassing the GWEM—will be included in the cash collection rate if the payment took place with prior GWEM approval and was motivated by the impossibility of paying the GWEM at that time, due to the fact that the GWEM's bank accounts were frozen. Direct customers of the GWEM are defined as all customers receiving electricity through the GWEM excluding the electricity distribution companies. For comparability purposes, the data will separately include the delivered, billed and collected amounts from all transactions originated from direct contracts concluded after February 1, 2002 by any current or former member of the Wholesale Electricity Market. Quarterly collection rates in each quarter are calculated by taking quarterly collections in the current quarter divided by billings in the last month of the previous quarter and the first two months of the current quarter.

28. **Supporting material:** The Ministry of Energy will provide both aggregated data on electricity delivery, billing and collection amounts as well as a breakdown into payments by all individual customers of the GWEM and individual transactions based on direct contracts described in the definition above. The total payments received from each customer of the GWEM as well as payments originating from the direct contracts will be broken down into cash, cash offset and offset payments. Subsidies paid in cash by donors to the GWEM should be included in the cash component of payments. Monthly data will be reported within three weeks of the end of each month.

**N. Target for Electricity Cash Collection Rate from the General Government**

29. **Definition:** The cash collection rate is defined as the ratio of all cash payments received by electricity distribution companies in each month to the lari amount billed in the previous month. Quarterly collection rates in each quarter are calculated by taking quarterly collections in the current quarter divided by billings in the last month of the previous quarter and the first two months of the current quarter.

30. **Supporting material:** The Ministry of Energy will provide data on electricity delivery, billing and total collection amounts (separate data for local and central budgetary



organizations). This data will be reported for each electricity distribution company and as an aggregate. Monthly data will be reported, within three weeks of the end of each month.

**O. Target for Cash Collection Rate of the United Distribution Company (UDC)**

31. **Definition:** the cash collection rate is defined as the ratio of all cash payments by customers to UDC each month to the lari amount billed in the previous month. Transfers by international donors to help needy individuals pay their bills (such as transfers under the Georgian Winter Heat Assistance Program) are not included in cash payments. Quarterly collection rates in each quarter are calculated by taking quarterly collections in the current quarter divided by billings in the last month of the previous quarter and the first two months of the current quarter.

32. **Supporting material:** The Ministry of Energy will provide data on UDC's billing and received payments on a monthly basis, within three weeks of the end of each month.

**P. Target for Gas Cash Collection Rate of Tbilgazi**

33. **Definition:** the cash collection rate will be defined as the ratio of all cash payments by customers to Tbilgazi each month to the lari amount billed in the previous month. Quarterly collection rates in each quarter are calculated by taking quarterly collections in the current quarter divided by billings in the last month of the previous quarter and the first two months of the current quarter.

34. **Supporting material:** The Ministry of Energy will provide data on Tbilgazi's billing and received payments on a monthly basis, within three weeks of the end of each month.

INTERNATIONAL MONETARY FUND

GEORGIA

**Request for a Three-Year Arrangement Under the Poverty Reduction and Growth Facility—Supplementary Information**

Prepared by the Middle East and Central Asia Department

Approved by Julian Berengaut and Carlos Muñiz

May 26, 2004

1. This supplement provides an update on economic and policy developments since the issuance of the staff report. These developments do not change the thrust of the staff appraisal.
2. Paris Club creditors agreed on May 26 to consider Georgia's request for debt rescheduling in mid-2004, thereby providing the requisite financing assurances for the proposed PRGF-supported program.
3. All prior actions specified under the program have been met (Table 1). In particular, on May 11, parliament adopted a budget for 2004 that is in line with the parameters agreed with staff. The budget law features receipts that are slightly higher (0.1 percent of GDP) than originally projected, stemming in part from a slight upward revision in foreign grants. With spending kept essentially at the originally agreed level (despite minor changes in composition), the general government deficit on a commitment basis was lowered by a similar amount. In early April, the authorities closed all revenue transit accounts in the banking system and established a single treasury account (part of the end-June structural benchmarks).
4. The State Department of Statistics (SDS) has just released an upward revision in the real GDP growth rate for 2003, to 11.1 percent (compared with the original estimate of 8.6 percent), based on a particularly strong showing of the construction and agriculture sectors, as well as preliminary results for Q1 2004 pointing to year-on-year growth of 9.5 percent. A recent STA mission concluded that the SDS data are generally sound, but proposed a number of improvements in the estimation of national accounts from the expenditure side.
5. Macroeconomic performance in the year-to date has been strong (Table 2). Q1 general government tax revenues exceeded the program estimate by a wide margin (although the results for tobacco and fuel excises were slightly lower than expected, prompting the authorities to intensify their efforts to stem evasion in this area). Year-on-year, general

government tax revenues in the first four months of 2004 increased by 28 percent, and state budget revenues (central government and extrabudgetary funds) over January to mid-May 2004 increased by 42 percent. The buoyancy of receipts has allowed the authorities to reduce domestic expenditure arrears by some GEL 30 million during the first quarter of the year, well in excess of the original estimate. Credit expansion in Q1 2004 was also lower than the program estimate, owing in part to the larger-than-expected buildup in government deposits at the NBG as a result of the strong revenue performance just mentioned. Broad money grew by 21 percent in the 12 months to April 2004.

6. Tensions between the central government and Adjara, which had flared up in recent months, have been resolved after the provincial leader, Mr. Abashidze, stepped down and fled into exile in early May. A transitory administration under direct control of the President of Georgia has been installed, and elections for the regional legislature will be held in June. Adjara's trade with the rest of the Georgia and exports through the port of Batumi have since been normalized, although some damage to infrastructure will need to be repaired.

7. In the energy sector, the authorities recently concluded discussions with the World Bank on credits that will finance sector restructuring, extension of the management contract for the state-owned power transmission company, and labor retrenchment costs associated with downsizing this company. Discussions are well advanced on the establishment of an agency to deal with legacy debt and KfW expects to tender soon for experts to help the government run this agency. Q1 2004 program estimates for utility bill collection rates were missed for all groups of customers, except for the major provincial power utility (UDC); political pressures against disconnection of nonpaying customers in the run-up to the March 2004 parliamentary elections apparently played a part, but the government has indicated that it is now fully committed to supporting sector reform efforts, and it has secured funding for metering and rehabilitation programs that should allow for a catch up in collection rates during the remainder of 2004.

8. The authorities have prepared a civil service reform concept paper that is being reviewed by the World Bank and other donors. The current draft envisages creation of common civil service rules across the three branches of government, competitive recruitment procedures, clear guidelines for dismissals for misconduct, and establishment of training programs for professional development.

9. Audits of three key SOEs (Georgian Railways, Madneuli Mining, and Poti Port) are now well advanced. The authorities expect the audits of the latter two to be completed by end-May, and the Railways audit to be finalized by end-June. Audit reports for all three enterprises will be published after completion.

10. An FAD advisory mission on tax reform is scheduled for early June. The team will build on a concept paper prepared by the government that calls for major simplification of the tax system. The government plans to send a tax reform bill to parliament by mid-July and to seek its approval by September, in time for preparation of the 2005 budget.

11. Following ratification by parliament last February of the Strasbourg Convention on *Laundering, Search, Seizure and Confiscation of the Proceeds from Crime* to align Georgia's Anti-Money Laundering (AML) drive with international best practice, the government formally sent the ratification instruments to the Council of Europe in early May. In a related development, a recent MFD mission advised the National Bank of Georgia on capacity building in the AML and combating the financing of terrorism (CFT) areas; the mission also advised on steps to facilitate secondary trading in government securities, including introduction of a primary dealer system, and the eventual design of a deposit insurance system.

12. Georgia has been selected as one of 16 eligible countries to benefit from the Millennium Challenge Account (MCA), a new U.S. government initiative to foster growth and alleviate poverty in low-income countries that display strong program ownership and are decisively tackling corruption. Staff from the newly-established Millennium Challenge Corporation are expected to visit Georgia shortly to discuss the authorities' plans in that regard. Georgia has also expressed interest in participating in the G-8 Transparency Initiative, which seeks to help developing countries to strengthen institutions and enhance transparency in public financial management and accountability.

Table 2. Georgia: Performance at End-March 2004

	Cumulative Changes Since End-December 2003	
	Original Estimates	Prel.
	(In millions of lari)	
General government tax revenue (incl. special funds)	312.9	331.7
Cash deficit of the general government (GG)	54.1 1/	-4.8
Domestic expenditure arrears of the GG	-6.3	-29.5
Tobacco and petroleum revenues	39.0	37.8
Net credit of the banking system to the GG (NCG)	18.2	7.1
Net domestic assets (NDA) of the NBG	18.4	-51.2
	(In millions of U.S. dollars)	
Net international reserves of the NBG	-3.6	30.4
Contracting or guaranteeing of		
A. Nonconcessional medium- and long-term external debt	0.0	0.0
B. Short-term external debt (less than one year)	0.0	0.0
Accumulation of external arrears	0.0	... 2/
	(In millions of lari)	
Reserve money	10.7	14.1
	(In percent)	
Average monthly cash collection rates (CCR)		
CCR from Direct Customers of the wholesale market (GWEM)	85.0	70.7
CCR from the General Government	95.0	67.7
CCR from UDC customers	18.0	18.6
CCR from Tbilgazi customers	25.0	21.8

1/ Cash deficit adjusted for unanticipated external project finance.

2/ In the period January-April 2004, Georgia accumulated US\$11.7 million in principal arrears but remained current on interest payments. By providing financing assurances, the Paris Club indicated its intention to clear arrears to Paris Club members in the context of a debt rescheduling operation.

Table 1. Georgia: Status of Prior Actions

	Measure	Status
1.	Secure approval by parliament of a sound 2004 budget in line with the parameters agreed with the mission.	Done. On May 11, parliament adopted a budget for 2004 in line with the parameters agreed with the February 2004 mission.
2.	Establish an Excise Tax Inspectorate.	Done. The Inspectorate was established by ministerial order on March 25, 2004.
3.	Prepare a customs reform and anti-smuggling strategy paper formulated by the Ministry of Finance in cooperation with other government agencies.	Done. The paper was submitted to IMF staff on May 11.
4.	Register all small-scale ('teakettle') refineries for excise duty purposes.	Done. All 23 small-scale refineries have now been registered with the Excise Tax Inspectorate.



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FOR IMMEDIATE RELEASE  
June 4, 2004

International Monetary Fund  
Washington, D.C. 20431 USA

### **IMF Approves US\$144 Million PRGF Arrangement for Georgia**

The Executive Board of the International Monetary Fund (IMF) today approved a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF) in an amount equivalent to SDR 98 million (about US\$144 million) to support the government's economic program into June, 2007. The first disbursement of SDR 14 million (about US\$21 million) under the arrangement will become available immediately.

The PRGF is the IMF's concessional facility for low-income countries. It is intended that PRGF-supported programs are based on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners and articulated in a Poverty Reduction Strategy Paper (PRSP). This is intended to ensure that PRGF-supported programs are consistent with a comprehensive framework for macroeconomic, structural, and social policies to foster growth and reduce poverty. PRGF loans carry an annual interest rate of 0.5 percent and are repayable over 10 years with a 5 ½-year grace period on principal payments.

Following the IMF Executive Board discussion, Takatoshi Kato, Deputy Managing Director and Acting Chairman, stated:

“The new Georgian authorities have launched an ambitious reform effort aimed at addressing governance issues, improving the efficiency and effectiveness of the public sector, and strengthening the macroeconomic fundamentals, with a view to achieving long-term economic growth, poverty reduction, and private sector development.

“The centerpiece of the reform program is a decisive attack on corruption to bolster tax collections, thereby allowing the government to eliminate domestic expenditure arrears, while increasing core spending on social projects and infrastructure. Reforms in tax and customs administration underpin the government’s revenue efforts. Later this year, the government will seek parliamentary approval of a tax reform, aimed at simplifying the tax structure, broadening the tax base, and eliminating exemptions and nuisance taxes. The strong fiscal performance in the year to date indicates that Georgia is well on track to meet the program’s ambitious fiscal targets.

“Restoring the physical and financial viability of the energy sector is a key element of the reform agenda. Improved bill collection should help reduce the sizeable quasi-fiscal deficits in the sector. In addition, the authorities are expected to shortly review the power tariff methodology as a

stepping-stone toward the setting of cost-recovery tariffs by the energy regulatory agency. In cooperation with donors, the government is also about to establish a framework for the treatment of domestic legacy debt in the sector.

“Far-reaching reforms of the civil service, state-owned enterprise management, and the foreign trade regime are other important components of the structural reform agenda. The authorities are developing a comprehensive civil service reform strategy, and they have also undertaken to broaden the coverage of international audits to include all major state-owned enterprises and to reverse the protectionist measures introduced in December 2002.

“The monetary authorities will continue to pursue a prudent monetary policy, underpinned by fiscal consolidation and a managed exchange rate float, to keep inflation low and safeguard competitiveness. They will continue their efforts to foster financial deepening and enhance monetary policy tools, in particular by introducing a primary dealer system for government securities in the course of 2004.

“In the near future, Georgia will seek a debt rescheduling with Paris Club creditors and agreements with non-Paris Club bilateral creditors on comparable terms. The authorities intend to pursue prudent external debt management, refraining from contracting or guaranteeing any non-concessional loans during the program period,” Mr. Kato said.

## ANNEX

### **Recent economic developments**

Georgia’s economy proved resilient in 2003, despite a weakening in fiscal performance and a political crisis that culminated in a regime change in November. Real GDP growth, originally reported at 8.6 percent in the program documents, was subsequently revised by the State Department of Statistics to 11.1 percent, led by buoyant activity in the construction and agricultural sectors, as well as several one-off factors. Underlying inflation (3 percent) stayed low in 2003, but headline inflation rose to 7 percent, driven by a spike in wheat import prices stemming from crop failures in CIS exporters. Performance in early 2004 was also strong, with real GDP growing in the first quarter at 9.5 percent and 12-month CPI inflation at 5.2 percent through April 2004.

The fiscal situation deteriorated sharply in 2003. The commitments deficit of the general government (2.5 percent of GDP) was much larger than programmed, leading to a progressive buildup in domestic arrears—mostly on wages and pensions—to nearly 5 percent of GDP by year’s end, instead of the programmed reduction. By contrast, fiscal performance in early 2004 was strong, with tax revenue in the year to date exceeding expectations by wide margins. On May 11, Parliament adopted a sound budget for 2004, in line with the broad parameters discussed with Fund staff.

### **Program summary**

Georgia’s economic reform program, which is supported by the new arrangement under the Poverty Reduction and Growth Facility, aims to foster rapid, sustained outward-looking growth in



a low-inflation environment, in order to improve living standards and basic service delivery. The centerpiece of the program is a decisive attack on corruption that should underpin gains in tax collections. This should allow the government to eliminate domestic expenditure arrears during the program period, while increasing spending on core social and infrastructure projects. Energy sector reforms should ensure stable power supplies and lower quasi-fiscal losses, while governance improvements and tax reform should foster confidence and SME development.

Program targets for 2004 comprise 6 percent real GDP growth, 5 percent end-period inflation and a modest gain in international reserves, keeping them at 1.5 months of non-pipeline imports, as in 2003. The medium-term outlook through 2008 envisages output growth averaging 5 percent, buoyed by oil and gas pipeline construction, improvements in the business climate that should foster sustained growth in transport and services, and export diversification. Pursuit of prudent monetary policies would keep inflation around 5 percent. According to the PRSP, this would allow a reduction in the share of the population living below subsistence standards from slightly over one-half in 2002 to about one-third in 2008 and one-fifth by 2015.

Georgia became a member of the IMF on May 5, 1992; its quota is SDR 150.3 million (about US\$221 million), and its outstanding use of IMF credit currently totals SDR 180 million (about US\$265 million).

Georgia: Selected Economic and Financial Indicators, 1999-2004

	1999	2000	2001	2002	2003 Est.	2004 Proj.
(Percentage change relative to previous year, unless otherwise indicated)						
National income and prices						
Nominal GDP	12.4	6.1	10.4	12.2	13.7	11.3
GDP at constant prices	3.0	1.9	4.7	5.5	8.6	6.0
Nominal GDP (millions of lari)	5,665	6,013	6,638	7,448	8,466	9,422
Consumer price index, period average	19.1	4.0	4.7	5.6	4.8	5.8
Consumer price index, end-of-period	10.9	4.6	3.4	5.4	7.0	5.0
Gini coefficient 1/	0.39	0.40	0.38	0.39	0.38	...
Money and credit (end-of-period)						
Reserve money	18.8	26.8	9.9	18.4	13.9	14.0
Broad money (including foreign exch. deposits)	20.7	39.0	18.5	17.9	22.8	19.5
Gross international reserves						
In months of imports of goods and services (excl. pipeline imports)	1.3	1.0	1.4	1.8	1.5	1.5
In millions of U.S. dollars	132	109	161	198	191	208
(In percent of GDP, unless otherwise indicated)						
Savings and investment						
Investment	19.2	18.2	18.5	18.4	22.3	26.6
Non-government sector	17.1	17.1	16.7	16.4	20.6	23.4
Gross domestic saving	11.5	13.7	11.9	12.4	14.5	17.0
Non-government sector	16.1	16.7	12.1	12.3	15.1	15.4
Current account deficit	7.8	4.4	6.5	6.0	7.9	9.6
General government 2/						
Total revenue and grants	15.4	15.2	16.3	15.8	15.7	19.0
<i>Of which:</i> Tax revenue	13.8	14.2	14.3	14.4	14.3	16.3
Total expenditure and net lending	22.1	19.2	18.3	17.8	18.2	20.5
<i>Of which:</i> Current expenditure	20.0	18.2	16.5	15.7	16.4	17.3
Primary balance	-3.9	-1.0	-0.2	0.0	-0.4	0.5
Fiscal balance, commitment basis	-6.7	-4.0	-2.0	-2.0	-2.5	-1.6
Net change in expenditure arrears	...	1.4	0.2	-0.4	1.5	-1.0
Statistical discrepancy	...	0.1	0.1	0.5	-0.3	...
Fiscal balance, cash basis	-5.0	-2.6	-1.6	-1.9	-1.3	-2.6
Financing	5.0	2.6	1.6	1.9	1.3	2.6
Privatization	0.9	0.3	0.1	0.2	0.3	0.3
External 3/	1.7	0.0	1.9	1.8	1.0	2.0
Domestic	2.3	2.2	-0.4	-0.1	0.6	0.3
Adjustment for net withheld Adjara transfers 4/	0.0	0.0	0.0	0.0	-0.7	0.0

Georgia: Selected Economic and Financial Indicators, 1999-2004/Cont

	1999	2000	2001	2002	2003 Est.	2004 Proj.
External sector						
Trade balance	-19.1	-13.0	-15.2	-12.9	-15.6	-17.6
Trade balance excluding pipeline-related imports	-19.1	-13.0	-15.2	-12.6	-11.0	-12.5
Current account balance						
Excluding transfers	-14.3	-11.2	-13.6	-11.4	-14.1	-16.4
Including transfers	-7.8	-4.4	-6.5	-6.0	-7.9	-9.6
Net change in external arrears	2.0	2.2	0.2	0.0	1.3	-1.2
External debt	61.4	52.0	53.5	54.8	49.6	46.5

Sources: Georgian authorities; and IMF Staff estimates.

1/ Gini coefficient by consumption, as reported by the State Department for Statistics.

2/ For 2003, the classification of the old Budget Systems Law is used.

3/ External financing for 2004 includes possible debt relief from the Paris Club.

4/ For 2003, deposits by the government of Adjara at commercial banks that reflect withheld tax revenues are excluded from net financing to the government.

**Statement by Jeroen Kremers, Executive Director for Georgia  
and Nikoloz Gigineishvili, Advisor to Executive Director  
June 4, 2004**

In the Buff statement on Georgia's Ex Post Assessment last January we conveyed to the Board that the new authorities were fully committed to sound macroeconomic policies, ready to revitalize long standing structural and institutional reforms, and prepared to launch fight against corruption and crime. Given earlier poor record of ownership and political support for Fund programs, at that time some Directors expressed concerns about the resolve of the new administration to deliver on their promises. However, since then the government has made important strides in key areas, managed to over-perform fiscal revenue targets and achieved notable progress in reforming governance and combating corruption, smuggling and tax evasion.

Georgia has successfully implemented all prior actions for the new program and is requesting a three-year PRGF arrangement in an amount of SDR 98 million (65 percent of quota). The authorities attach great importance to this program because it is vital for building domestic and international credibility, enhancing investor confidence and mobilizing further donor and public support for an ambitious reform agenda. In line with the welfare objectives of the Economic Development and Poverty Reduction Program (EDPRP), the key priority in the short and medium term is to promote growth and create new employment opportunities by improving the business environment and attracting investments, and at the same time to provide at least minimum social protection. While the authorities are well aware of the major challenges ahead, they stand committed to prudent macro management and sound structural reforms, and are keen and confident that the new program will be far more effective and successful than the previous ones.

Following the "rose revolution" in November 2003, Georgia has achieved peaceful resolution of tensions with Adjara province. As Adjara had long been a major source of smuggling and tax evasion, this development will generate beneficial fiscal effects and substantially contribute to business climate improvement and anti-corruption efforts.

**Fiscal Area**

The 2004 budget agreed with Fund staff, which has been recently passed by Parliament, projects revenue growth of 1.6 percent of GDP. This is a rather ambitious target, especially for the first year in a new political environment, when a number of radical structural, institutional and administrative changes are expected. The authorities recognize the risks and acknowledge the immediate need for a turnaround in the fiscal area to meet outstanding domestic and external obligations. As an indication of the credibility of their commitment, the 1<sup>st</sup> quarter tax revenue and total revenue targets have been exceeded by 6 and 15 percent respectively, allowing the government not only to honor its current liabilities, but to start repaying accumulated arrears, especially those on pensions, salaries and refugee benefits. The entire stock of arrears will be cleared by the end of the program period.

To closely align fiscal policy with the EDPRP objectives, spending priorities of the 2004 budget have also changed significantly from previous years. Higher outlays are envisaged on healthcare and education. At the same time to contribute to a better business environment, funding has been increased for infrastructure development – road repair and construction – as well as for the energy sector, which is in urgent need of rehabilitation.

Improving fiscal effectiveness is a top priority for the Georgian authorities and, with technical and financial assistance of the IMF, World Bank and donors, they are determined to resolve the outstanding issues. From April 5, 2004 all transit accounts have been consolidated into a single treasury account to ensure better transparency and accountability of the management of public funds. A tax reform aimed at streamlining and optimizing the tax structure and broadening the tax base is underway in close cooperation with the Fund's Fiscal Affairs Department. A technical assistance mission on tax issues is scheduled for June. It is expected that the new tax code will be in place and operational no later than January 1, 2005.

In order to improve collection of excise taxes, especially on gasoline and tobacco, which are the most troubled areas, an Excise Tax Inspectorate was created in the Tax Department of the Ministry of Finance to take full control over taxation of excise goods (a prior action). These efforts have paid off as collections from tobacco and alcoholic beverages have more than doubled in the first four months of 2004 relative to the same period of last year. Financial police was also set up within the Ministry of Finance, taking over responsibilities for fighting economic and financial crimes from various units in the ministries of interior and security. To increase transparency and efficiency of the Customs Department, combat smuggling and reduce opportunities for corruption, a strategy for customs reform has been developed envisaging functional enhancement and considerable reorganization of the structure and staff.

The external position of Georgia remains difficult. Paris Club creditors have provided financing assurances and agreed to discuss debt rescheduling soon after the IMF Board considers a new PRGF program. On their part, the Georgian authorities stand fully committed to sound macro policies and strong reform efforts that, they acknowledge, are essential for containing the vulnerabilities.

### **Monetary Policy and Financial System**

No significant changes in policy directions and operational practices have occurred after the change of power since also during the previous period, with its high degree of political independence, well trained professional staff and sound monetary management practices in place, the National Bank of Georgia (NBG) was a major anchor to macroeconomic stability in the country.

With price stability as an overriding objective, the NBG will continue to pursue balanced policies to control inflation and facilitate external competitiveness, the accumulation of international reserves and the ongoing process of gradual remonetization. The floating exchange regime with the NBG intervening only to prevent excessive appreciation has proved to have served the objectives of the National Bank well, and will be

maintained throughout the program period. In order to gradually operationalize liquidity management tools and improve the effectiveness of monetary policy, increasing emphasis will be placed on more active utilization of market instruments such as repo and reverse repo transactions, and standing deposit and credit facilities.

Developments in the treasury bill market have been remarkable as interest rates declined from more than 70 percent on 6-month bills just before the November events, to about 20-25 percent on almost 1 year bills since February 2004. The change in market perceptions reflects growing confidence.

Conditions of the banking sector continued to improve. Total assets of banks and the credit volume increased by 20 and 24 percent respectively in 2003, and the share of non-performing loans in the total credit portfolio fell slightly. Deposits have grown as well, the share of household deposits increased from 46 percent in 2002 to 54 percent in 2003 indicating improving trust of individuals in the banking sector.

In the area of banking regulation and supervision the process of harmonization of policies with the European standards and the Basel Core principles is underway. Particular attention has been paid to corporate governance, risk management and transparency and accountability issues. New capital adequacy requirements, which now take into account market risks, have been implemented, and regulations limiting loan concentration and large risk exposures in line with the European Directives have been enacted.

In February the parliament has passed the remaining pieces of Anti-Money Laundering legislation bringing it to full conformity with EC guidelines.

### **Anti-Corruption Efforts and Civil Service Reform**

The new authorities have taken an uncompromising stand against power abuse and criminal activities. Radical and fast improvements in this direction are considered to become the foundation for a better investment environment and business development, which are the guiding principles of the government's economic strategy as stipulated in the EDPRP.

A strong anti-corruption drive has been supplemented by amendments to laws and provisions that promote law enforcement and restrict the discretionary power of controlling agencies against businesses. Given the experience that MPs have effectively used their position and immunity to protect particular business interests, amendments to the constitution have been adopted that limit the immunity of legislators.

The most important development in this respect is the change that is occurring in the general attitude towards corruption. The public at large no longer considers state capture and bribery as socially acceptable. Society is becoming more intolerant to corruption and favors reacting resolutely to any form of power abuse. This process is nurtured by the authorities as this change of mentality is seen as the main building block of a less corruption-prone society.

The authorities have initiated a profound public sector reform. The ultimate goal is to get rid of the bulky, rigid and ineffective government structure, and instead develop a small, but efficient, flexible and transparent system with clearly defined functions and responsibilities. The first step of the reform was a constitutional amendment that established a Cabinet of Ministers to ensure better coordination and team responsibility of all members of the government. At the same time the number of ministries has been reduced from 16 to 15, while independent state departments and agencies have been either abolished or merged with the line ministries of respective profile. A detailed scheme and a timetable for the considerable downsizing and internal reorganization of ministries are now being developed, as a result of which public sector employment is expected to decrease by about 25-30 percent. A key component of the civil service reform is restructuring of the compensation and motivation system, which is envisaged to attract and retain more professional staff. Salaries to key categories of state officials have already been increased. The intended downsizing of the government will free up additional resources, which will also be used for raising public sector compensation.

Lastly, let us convey the Georgian authorities' highest appreciation for the Fund's continued support and tireless efforts rendered to Georgia for many years. The authorities are extremely grateful to the staff and management for valuable advice and financial and technical assistance. As before, they readily consent to the publication of the staff report and the supplement paper.