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

February 9, 2007

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

LETTER OF INTENT

9 February, 2007
Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
700 19th Street N.W.
Washington, D.C. 20431

Dear Mr. de Rato:

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

The Government of Georgia believes that the policies set forth in the attached memorandum will achieve the objectives of the program, but it will take any additional measures that may become appropriate for this purpose. The government will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultation.

We hereby request the completion of the fifth review under the PRGF arrangement and we request a waiver for nonobservance of a structural performance criterion for end-June 2006. The performance criterion required the introduction of a poverty alleviation program targeted on households living in extreme poverty. Unfortunately, there were technical difficulties associated with the targeting mechanism that necessitated a delay. The program was, however, fully implemented in September 2006.

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

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

Sincerely yours,

/s/

Zurab Nogaideli
Prime Minister of Georgia

/s/

Aleksi Aleksishvili
Minister of Finance

/s/

Roman Gotsiridze
President of the National Bank

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

9 February 2007

Introduction

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

Recent Economic Developments and Performance

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

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

4. The government's overall fiscal performance continues to be strong despite the external shocks. Total revenues for 2006 were about 26.2 percent of GDP compared with 23.4 percent in 2005. Tax revenues were 21.7 percent of GDP in 2006 compared with 19.8 percent in 2005. The fiscal deficit for 2006 was about 2.9 percent of GDP, which is

somewhat above program targets (based on our projections for 2006 GDP) and reflects the need for higher spending on road and energy investments, and defense requirements associated with our efforts to join NATO.

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

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

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

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

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

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

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

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

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

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

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

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

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

Economic Policies for 2006 and 2007

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

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

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

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

21. We are committed to keeping inflation in single digits as evidenced by the rapid reduction in inflation that was achieved in the second half of 2006. We believe that the economic program described herein will reduce inflation to 6 percent or less by end-2007. As was true in 2005 and 2006, our program for reducing inflation further and

enhancing macroeconomic stability will require disciplined fiscal and monetary policies. It will also require careful coordination of policies and the further development of monetary policy tools. We will, of course, continuously reevaluate our policies in the light of changing circumstances and, in consultation with Fund staff, make the necessary adjustments.

Fiscal Policy

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

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

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

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

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

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

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

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

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

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

Monetary Policy

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

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

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

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

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

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

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

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

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

Structural Reforms

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

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

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

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

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

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

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

Program Monitoring

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

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

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

Sources: Georgian authorities; and Fund staff estimates.

1/ Section 1 of this table shows quantitative targets for 2006; for stock variables, they are based on cumulative changes from end-December 2005 projections. The indicative target is shown in Section 2. The continuous performance criterion for external arrears is defined in paragraph 21 of the July 2005 TMU.

2/ Quantitative targets for 2006 are based on accounting exchange rates of GEL 1.85/US\$, US\$1.46/SDR, and US\$1.21/EUR.

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

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

TECHNICAL MEMORANDUM OF UNDERSTANDING

9 February 2007

1. This memorandum sets out the understandings between the Georgian authorities and the IMF staff regarding the definitions of quantitative and structural performance criteria and indicative targets, as well as respective reporting requirements for the arrangement supported under the Poverty Reduction and Growth Facility (PRGF). These performance criteria and targets are reported in Tables 1 and 2 of the Memorandum of Economic and Financial Policies (MEFP), attached to the Letter dated February 9, 2007.

2. The quantitative performance criteria (ceilings and floors) and indicative targets listed in Table 1, Sections 1 and 2, of the MEFP are defined as cumulative changes from end-December 2005.

Quantitative Performance Criteria, Indicative Targets, and Continuous Performance Criteria: Definitions and Reporting Standards**A. Definition of the General Government and the Public Sector**

3. The general government is defined as the central government, local government, extra-budgetary funds, and general government LEPLs and those LEPLs that operate on behalf of the general government. The public sector consists of the general government, and the National Bank of Georgia (NBG).

4. Supporting material: The treasury department of the ministry of finance will provide to the IMF detailed information on monthly revenues of the general government. The treasury department of the ministry of finance will provide to the IMF detailed information on monthly expenditures of the central government. The local budget department of the ministry of finance will provide to the IMF detailed information on monthly spending by the local government budgets.

B. Definition of Domestic Expenditure Arrears

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

date has passed, and the bill has remained unpaid beyond the normal or agreed period of credit, and (c) the receipt of goods and services related to the claim has not yet been verified.

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

C. Ceiling on the Cash Deficit of the General Government

7. **Definition:** The cash deficit of the central and local governments will be measured from the financing side, and will be defined as equal to the total financing. Total financing will be defined as the sum of (i) domestic financing from banks and non-banks, (ii) external financing, and (iii) privatization receipts. Privatization receipts consist of all transfers of monies received by the central and local governments in connection with the sale of central or local government assets. This includes receipts from leases and the sale of licenses of duration lasting 10 years and longer. Domestic financing consists of all bank and non-bank financing to the central and local government. External financing is defined as the total of disbursements, macroeconomic support, net change in external arrears, minus amortization. Disbursements include all project financing (capital expenditure and net lending) and balance of payments support (excluding grants) received by the budget. Amortization includes all external debt-related payments of principal; amortization to external creditors via third parties is accounted for at the time and in the amount of payment by the budget to the third party, rather than at the time of recognition of amortization by the external creditor.

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

D. Ceiling on Reserve Money

9. **Definition:** Reserve money is defined as currency in circulation and required reserves of deposit money banks and balances on banks' correspondent accounts at the NBG.

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

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

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

12. **Supporting material:** The NBG will provide the monetary survey to the IMF on a monthly basis within three weeks of the end of each month. The NBG will also provide to the IMF information on the activities of the treasury bill market, including the breakdown of treasury bill holdings by banks and non-banks. Data will be provided using program assumptions on bilateral exchange rates (GEL 1.85 per U.S. dollar, US\$1.46 per SDR, and US\$1.21 per euro).

E. Floor on Net International Reserves of the NBG

13. **Definition:** Net international reserves (NIR) of the NBG in U.S. dollars are defined as foreign assets minus foreign liabilities of the NBG, using program assumptions on bilateral exchange rates (GEL 1.85 per U.S. dollar, US\$1.46 per SDR, and US\$1.21 per euro). Foreign assets of the NBG include gold, gross foreign exchange reserves, SDR holdings, and the reserve position in the Fund. Gross foreign exchange reserves of the NBG are defined as liquid, convertible currency claims of the NBG on nonresidents that are readily available. Pledged or otherwise encumbered assets, including, but not limited to, assets used as collateral (or guarantee for third party external liabilities) are excluded from foreign assets. Foreign liabilities include the use of IMF resources and any other liabilities of the NBG.

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

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

15. **Definition:** Nonconcessional external loans are defined as loans from lenders other than the IMF with a grant element of less than 35 percent of the value of the loan. The grant element is to be calculated by using currency-specific discount rates reported by the OECD (CIRRs).¹ For maturities of less than 15 years, the grant element will be calculated based on six-month averages of commercial interest rates. For maturities longer than 15 years, the grant element will be calculated based on 10-year averages. This performance criterion applies not only to debt as defined in point No. 9 of the IMF's Guidelines on Performance Criteria with Respect to External Debt (Decision No. 12274-(00/85) August 24, 2000) but also to commitments contracted or guaranteed for which value has not been received.² Previously contracted nonconcessional external debt that has been rescheduled will be excluded from the definition of "new debt" for the purposes of this performance criterion.

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

¹ An electronic spreadsheet file that shows the relevant discount rates reported by the OECD (CIRRs) will be provided on a periodic basis by IMF staff.

² Point No. 9 of the IMF's guidelines reads as follows: "(a) For the purpose of this guideline, the term "debt" will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows: (i) loans, i.e., advances of money to obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans and buyers' credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements); (ii) suppliers' credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and (iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the leaser retains the title to the property. For the purpose of the Guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair, or maintenance of the property. (b) Under the definition of debt set out in point 9(a) above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt."

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

17. **Definition:** This performance criterion applies to debt as defined in point No. 9 of the IMF's Guidelines on Performance Criteria with Respect to External Debt (Decision No. 12274-(00/85) August 24, 2000), see footnote 5, as well as to commitments contracted or guaranteed for which value has not been received.

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

H. Non-Accumulation of External Arrears

19. **Definition:** During the period of the arrangement, the general government and the NBG will not accumulate any new external payment arrears on debt service obligations to official creditors, including the IMF and the World Bank. Official external payment arrears are defined as unpaid debt service by the general government and the NBG beyond the due date. This definition excludes debt subject to rescheduling under the July 2004 Paris Club agreement or as agreed under a bilateral agreement with a creditor. The performance criterion on non-accumulation of external debt is continuous.

20. **Supporting material:** Details of official arrears accumulated on interest and principal payments to creditors will be reported to the IMF within one week from the date of the missed payment. Data will be provided using actual exchange rates.

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

21. **Definition:** Net domestic assets of the NBG are defined as the difference between its net foreign assets and reserve money. Net domestic assets are defined as the sum of net claims on the government (the sum of loans and treasury bills purchased by the NBG, less deposits of the government with the NBG), claims on banks, claims on the rest of the economy, and other items net (comprising the NBG capital accounts, net unclassified assets, counterpart funds and exchange rate revaluation).

Supporting material: The NBG will provide to the IMF its balance sheet, which includes data on its net domestic assets, on a monthly basis within two week of the end of each month. Data will be provided using program assumptions on bilateral exchange rates (GEL 1.85 per U.S. dollar, US\$1.46 per SDR, and US\$1.21 per euro).