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Georgia: Fourth Review Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criterion—Staff Report; Staff Statement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Georgia

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

- the staff report for the Fourth Review Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criterion, prepared by a staff team of the IMF, following discussions that ended on August 18, 2006, with the officials of Georgia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on September 14, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF;

- a staff statement of September 27, 2006 updating information on recent developments;

- a Press Release summarizing the views of the Executive Board as expressed during its September 29, 2006 discussion of the staff report that completed the review; and

- a statement by the Executive Director for Georgia.

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

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

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

GEORGIA

Fourth Review Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criterion

Prepared by Middle East and Central Asia Department

Approved by David Owen and Adnan Mazarei

September 14, 2006

- Georgia's three-year PRGF arrangement in the amount equivalent to SDR 98 million (65 percent of quota) was approved on June 4, 2004. The third review and 2006 Article IV consultation was completed on March 31, 2006 (Country Report No. 06/171).

- Discussions for the fourth review under the PRGF arrangement were held in Tbilisi during May 11–20, and August 9–18, 2006. Staff met with the prime minister; speaker of parliament; ministers of finance, economic development, and education; president of the National Bank of Georgia; other senior government officials; civil society organizations; and members of parliament. The staff team was headed by Mr. Wakeman-Linn and the team comprised Ms. George, Mr. Billmeier (May), Ms. Dieterich (August), and Mr. Kim (all MCD), Ms. Yackovlev (FAD), and Mr. Zeuner (PDR). Mr. Christiansen, resident representative, assisted both missions.

- The attached Letter of Intent and Memorandum of Economic and Financial Policies (Attachments I and II) set out the authorities' economic program for the remainder of 2006, and the first half of 2007. The authorities have requested completion of the fourth review and a waiver for nonobservance of an end-March performance criterion.

- The authorities submitted a Poverty Reduction Strategy Paper (PRSP) progress report to the Executive Boards of the Fund and the World Bank in September 2006. The report (Country Report No. 06/360) and the related Joint Staff Advisory Note (Country Report No. 06/361) will be posted on the Fund's external website.

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EXECUTIVE SUMMARY

- **Economic growth continues to be strong, but inflation has increased substantially.** Real GDP growth in 2005 was 9.3 percent, and first quarter 2006 real GDP was 8.4 percent higher than the same period a year earlier. Inflation, however, accelerated, with the 12-month increase in the CPI rising from 4.6 percent at end-March to 14.5 percent at end July, before declining slightly to 13.4 percent at end-August. The acceleration in inflation appears to be largely due to high domestic demand, driven by more rapid-than-programmed growth in broad money.

- **All end-March quantitative performance criteria under the program were met, as were all but one of the end-June indicative targets.** The fiscal deficit at end-June was 0.6 percent of GDP higher than programmed. One structural performance criterion for the fourth review was missed, as the database of central government Legal Entities of Public Law (LEPLs) that was established by end-March was later found to have missed a number of LEPLs. The authorities have now completed the database and requested a waiver.

- **Discussions focused on macroeconomic policies for the remainder of 2006 and for 2007, with the aim of dramatically reducing inflation.** For 2006, the authorities have decided to tighten monetary policy—reducing the programmed end-year growth of reserve money from 25 to 15 percent. To bring this about, they are committed to using above-budget revenues to reduce the fiscal deficit, restrain expenditures, and approve no new expenditures for the remainder of 2006. The National Bank will also reduce its interventions in the foreign exchange market, allowing market forces to play a greater role in determining the extent of appreciation of the lari.

- **The structural agenda remains focused on further improving tax and customs administration, improving fiscal planning and public expenditure management, and strengthening financial markets.**

- **The authorities have completed all bilateral negotiations with Georgia's Paris Club and non-Paris Club creditors, except for Kazakhstan.**

- **The main risks to the economic outlook stem from domestic and external political pressures.** Restraining fiscal expenditures, despite these pressures, and allowing market forces to increasingly influence the exchange rate, will be essential to the authorities' efforts to reduce inflation.

- **Despite these risks, and the recent surge in inflation, the authorities' strong track record and their commitment to take corrective measures as needed bode well for the successful implementation of the program.**

I. Background

1. **In its third year after the Rose Revolution, the Saakashvili administration is seeking to consolidate the gains made thus far.** Economic growth has been strong with moderate inflation (until this year), the fiscal position has been significantly strengthened by much improved revenues and privatization is almost complete. Perceptions of corruption have also improved, with the World Bank rating Georgia as one of the fastest improving business climates in the world for the last two years.

Georgia: Selected Macroeconomic Indicators, 2001–05

	2001	2002	2003	2004	2005
Real GDP growth	4.7	5.5	11.1	5.9	9.3
CPI inflation, period average	4.7	5.6	4.8	5.7	8.3
Poverty rate (in percent) 1/	51.1	52.1	54.5	35.7	39.4
Tax revenue (in percent of GDP)	14.3	14.4	14.5	18.4	19.8
Fiscal balance, commitment basis (in percent of GDP)	-2.0	-2.0	-2.5	3.2	-1.5
Velocity of broad money, level (M3 annual average)	9.1	8.6	8.9	7.6	6.8
Current account balance (in percent of GDP)	-6.4	-5.8	-7.4	-8.3	-6.4
Gross international reserves (in millions of US dollars)	161	122	191	383	474

Sources: Georgian authorities; and Fund staff estimates.

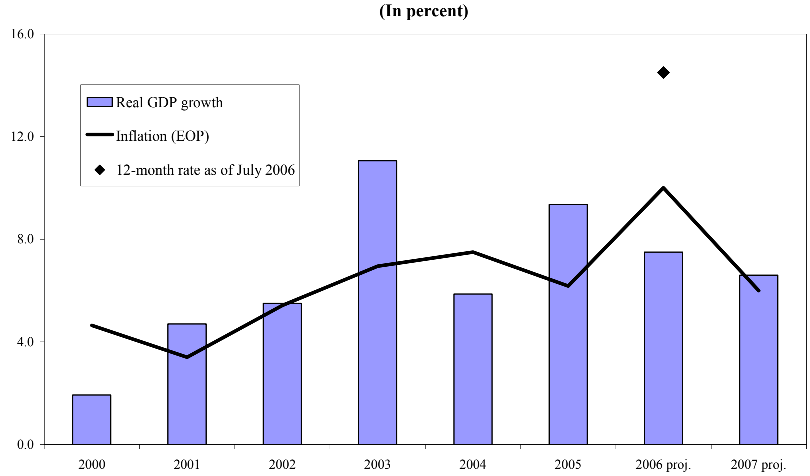
1/ There were methodological changes in the calculation of poverty starting in 2004.

2. **The challenge of strengthening Georgia's economy continues to be complicated by ongoing tensions over the breakaway regions of Abkhazia and South Ossetia, as well as deteriorating relations with Russia.** During the last year, Russia banned the import of Georgian wine, mineral water, tea and citrus fruit, and closed the one land border between Georgia and Russia, reportedly to allow Russia to undertake infrastructure improvements, effectively banning many of the remaining imports from Georgia. The Georgian parliament, increasingly unhappy with the role Russia is playing in Abkhazia and South Ossetia, voted to support a call for the removal of all Russian peacekeepers. Georgia recently notified the WTO of its intention to reopen bilateral talks on Russia's accession.

II. Recent Developments and Performance under the Program

3. **Economic growth continues to be strong, but inflation has increased substantially** (Table 1). Real GDP growth in 2005 was 9.3 percent, led by a rebound in agricultural production and continued buoyancy in manufacturing and construction. This growth continued in the first quarter of 2006, with real GDP rising by 8.4 percent. However, 12-month inflation reached 14.5 percent at end-July 2006, up from 4.6 percent at end-

Georgia: Inflation and Real GDP Growth, 2000-07
(In percent)



Sources: Georgian authorities; and Fund staff estimates.

March, before declining to 13.4 percent at end-August. While part of the rise was due to energy price increases, the broad-based nature of the price increases suggests demand pressures driven by rapid growth in broad money played a major role (Box 1). Despite the strong economic growth, the poverty rate increased from 35.7 percent in 2004 to 39.4 percent in 2005 in part due to a lack of well-targeted and stable safety nets, before improving to 33.6 percent in the first quarter of 2006.[1]

4. **Fiscal performance in Georgia continues to be dominated by over performance on tax collections.** Tax revenues in the first half of 2006 were 35 percent higher than in the first half of 2005 due to higher-than-expected VAT, customs duties, and profit tax payments, and exceeded program assumptions by 16 percent (Table 2). Based on this strong revenue performance, as well as privatization proceeds well in excess of budgeted levels, the authorities passed a supplementary budget in May that increased expenditures by 1.8 percent of GDP, and a second supplement in July that increased expenditures by a further 2.8 percent of GDP.[2] The first supplement primarily increased expenditures for local governments in advance of the upcoming local elections, while over two-thirds of the increased expenditures in the second supplement were for defense, reflecting tensions in Abkhazia and South Ossetia. Expenditures in the first half of 2006 exceeded the original budget by 28 percent.

5. **During the mission, staff noted that GEL 91.5 million recorded as nontax revenues in the first half of 2006 related to long-term (10 years or longer) leases of government property.** The authorities agreed that this amount should be reclassified as privatization proceeds, and thus financing. After this revision, the first quarter deficit was still in line with the end-March performance criterion, but the first half deficit exceeded the end-June indicative target by roughly GEL 90 million, or 0.6 percent of GDP.

6. **The trade balance deteriorated in the first half of 2006, despite export growth that appears to have been more robust than projected,** as a result of a higher price for gas ($110 per 1,000 cubic meters compared to $65 in 2005), higher oil prices, and the import bans imposed by Russia (Table 3). Inflows of privatization and privatization-related proceeds (9 percent of GDP projected for the year, of which 80 percent is expected in the second half)[3] are helping to finance the widening current account deficit.

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[1] Methodological changes in the calculation of poverty starting in 2004 mean that post-2004 poverty rates are not comparable to pre-2004 statistics.

[2] Expenditures in the second supplement were only 3.5 percent of GDP higher than programmed, as nominal GDP is forecast to be 4.8 percent higher than programmed, reflecting both stronger growth and higher prices.

[3] The quarterly profile projected reflects the timing of payments as outlined in signed privatization contracts.

Box 1. Inflation Developments in Georgia: Comparison of Core and Headline Inflation

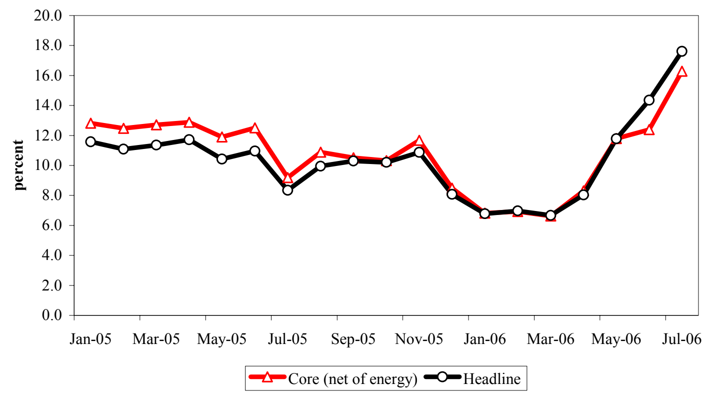
After 12 months of declining inflation, Georgia saw a sharp increase in CPI inflation beginning in the second quarter of 2006, with twelve-month inflation reaching 14.5 percent at end-July. This sudden rise in inflation roughly coincided with energy price increases, and thus the authorities initially attributed it to supply-side pressures.

A comparison of headline inflation and core inflation (excluding energy-related items), however, suggests inflationary pressures have been broad-based. From January 2005 to May 2006, the two indices of inflation have tracked quite closely. Thus it appears that high energy prices only partly explain the acceleration in inflation.

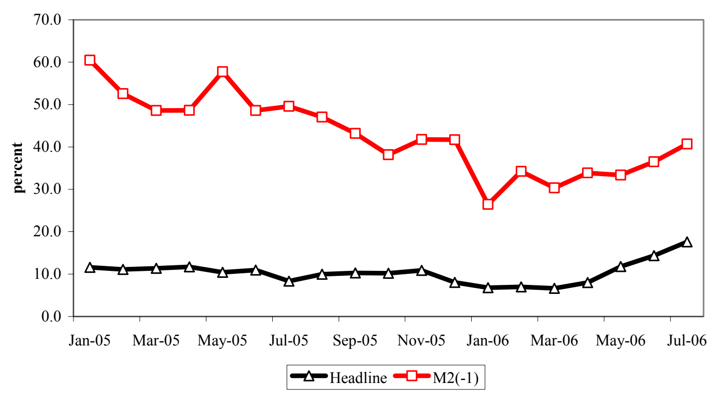
The acceleration in inflation also coincided with an acceleration in broad money growth. From 31 percent at end-2005, the 12-month growth of M2 increased to 41 percent at end-June, contributing to demand pressures.

Georgia: Inflation and Monetary Aggregate, 2005M1-2006M7

Twelve-Month Rates: Inflation 1/



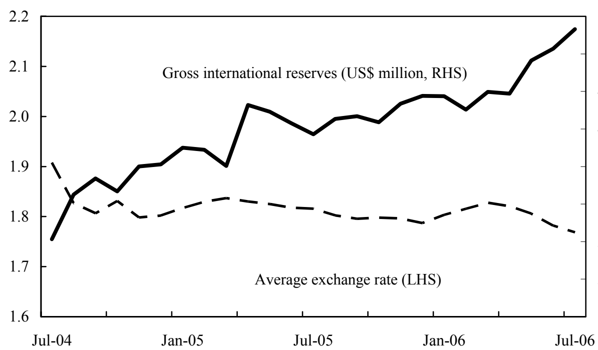
Twelve-Month Rates: Inflation and Monetary Aggregate



Source: Georgian authorities; and Fund staff estimates.
1/ Inflation is calculated as a weighted geometric average of elementary indices. For this reason, these series are not necessarily identical to the official statistics that are calculated as an arithmetic average. The CPI manual published by the ILO supports both approaches.

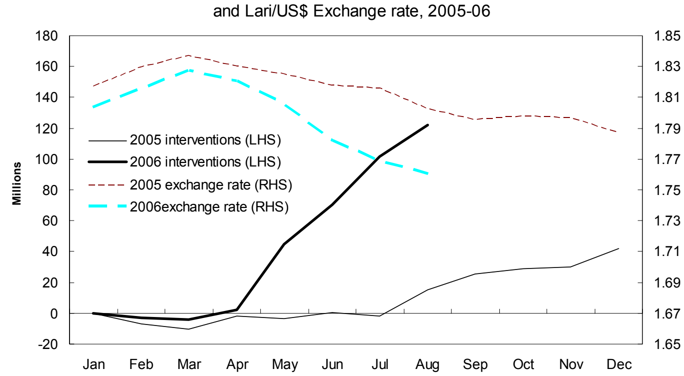
7. **Despite these large inflows, the exchange rate remained largely unchanged relative to the U.S. dollar,** as the NBG purchased around $75 million during the second quarter of 2006, compared to only $3 million during the same period last year (Tables 4 and 5). Reserve money growth was nonetheless slightly less than programmed, as above-program privatization proceeds, including lari privatization receipts, led to an over performance in net credit to government that more than offset the higher-than-programmed NIR. However, a sharp increase in the money multiplier—reflecting a continuation of the decline in the currency to deposit ratio, as well as a rapid reduction in excess reserves—resulted in 12-month broad money growth of roughly 40 percent at end-June.

Georgia: International Reserves and Exchange Rate, 2004–06

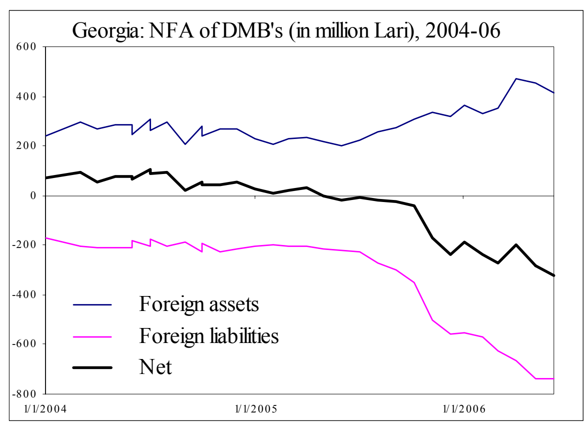


Sources: Georgian authorities; and Fund staff estimates.

Georgia: Annual Cumulative Foreign Exchange Interventions of the NBG and Lari/US$ Exchange rate, 2005-06



8. **Growth in credit to the private sector has accelerated, with 12-month growth at end-June of over 80 percent, financed by growing deposits (12-month growth of 57 percent), the reduction in excess reserves, and an increase in foreign liabilities.** As a result of this rapid credit expansion, two of Georgia's major banks fell below their capital adequacy requirements and are close to their liquidity requirements, and the net foreign position of banks has deteriorated.



9. **Performance under the program has been generally good.** All end-March 2006 quantitative performance criteria and all but one end-June indicative target were met (Table 6). On the structural side, one performance criterion was missed (Table 7). A database of central government Legal Entities of Public Law (LEPLs) was established by end-March, but it was later learned that a number of LEPLs had been inadvertently omitted. The authorities thus missed the related end-March performance criterion. These LEPLs have now been added and the database is complete. In addition, the introduction of a poverty alleviation program—an end-June performance criterion for the fifth program review—was delayed; it was implemented in Tbilisi starting in August—Tbilisi has only 8 percent of eligible

citizens—and is expected to be implemented in the rest of the country in late September prior to the test date for the fifth review.

10. **Financial sector reforms progressed,** with the government and NBG agreeing on a Memorandum of Understanding that, among other things, established a time frame for the conversion of NBG claims on the government into marketable treasury bills. The NBG also adopted a banking sector development strategy focusing on strengthening supervision, enhancing the framework for monetary policy, and encouraging the development of financial markets. At the same time, a comprehensive draft package of reforms to financial sector legislation—related to AML/CFT legislation, requirements for bank owners and managers, and securities market legislation—has been proposed by the government and remains under discussion between government, the NBG, parliament, and Fund staff.

11. **Fiscal sector reforms continued, with significant progress toward a credible Medium Term Expenditure Framework (MTEF).** In addition, the authorities have prepared draft financial monitoring and reporting guidelines for LEPLs, and have sought Fund staff comments on those guidelines. Efforts to strengthen tax and customs administration also continue. Parliament approved a revision of customs tariffs, which took effect on September 1, reducing the number of rates from 16 to 3 and the maximum rate from 30 to 12 percent. Finally, plans have been announced to merge the Tax and Customs Departments and the Financial Police, under the control of the ministry of finance.

III. Objectives of the Program and Policy Discussions

12. Discussions focused on the macroeconomic program for 2006 and 2007, with emphasis on bringing inflation under control, as well as on structural reforms in the fiscal and financial sectors.

A. Macroeconomic Framework

13. **For 2006, the program now targets real GDP growth of 7.5 percent and end-year inflation of 10 percent** although, given the high inflation and money supply growth to date (Table 8), the authorities recognize this inflation target may be hard to achieve. The authorities' views on the outlook for 2007 were very preliminary. They expect a modest slowdown in real GDP growth in 2007, with the program now projecting 6.5 percent growth, and they intend to target an inflation rate of 6 percent.

14. **The key focus of the discussions was on the question of how to reduce inflation.** The prime minister acknowledged early in the mission that there was a need to reduce the budget deficit and tighten monetary policy, and requested that the mission work with the authorities to identify concrete, realistic ways to accomplish this. It was agreed that bringing inflation down would require a smaller fiscal deficit, a more flexible exchange rate, and a slowdown in NBG's accumulation of NIR.

B. Fiscal Policy

15. **The second supplementary 2006 budget projects a cash deficit (adjusted for the reclassification of nontax revenues, as discussed above) of GEL 552 million, or 4.0 percent of the revised GDP forecast.** However, the authorities recognized that such a deficit could not be financed in a manner consistent with reducing inflation. They therefore committed to keep the 2006 deficit to not more than GEL 341 million, or 2.5 percent of GDP. To accomplish this, they expect substantial overperformance on revenues and grants relative to the supplement, on the order of 0.9 percent of GDP, a view shared by staff. In addition, the authorities anticipate some across-the-board underexecution of expenditures. Finally, the authorities committed to no further increase in expenditures in 2006, to avoid further demand pressures (MEFP, paragraphs 24–25). Staff noted that this commitment was an essential part of a credible anti-inflation policy.

Georgia: Revised 2006 Budget Plans
(In percent of GDP)

	Orig. prog.	2nd Supp.	Rev. prog.
Total revenue and grants	22.9	24.9	25.8
of which: Tax revenue	19.3	20.8	21.6
Total expenditure and net lending	25.0	28.5	27.9
Arrears clearance	-0.4	-0.4	-0.4
Overall balance (cash)	-2.6	-4.0	-2.5
Memorandum items:			
Nominal GDP (millions of lari)	13,080	13,708	13,708

16. **The authorities' privatization efforts are succeeding beyond their expectations.** While 2006 privatization proceeds are now projected to be almost four times the original budget figure, the authorities plan to save most of these additional revenues, increasing government deposits and NIR.

17. **The budget includes a provision for clearing only GEL 59 million in arrears, compared with total arrears claims outstanding at the start of 2006 of GEL 149 million.** The authorities explained that the process of verifying arrears is proving more difficult than anticipated, and it will thus not be possible for them to adhere to their program commitment to resolve all pre-2006 arrears claims before the end of the year. They nonetheless intend to clear all arrears related to wages and pensions, and most other verified arrears, before the end of 2006. The staff urged the authorities to move as quickly as possible to resolve all arrears claims, and to ensure all verified arrears are cleared in 2006, but the authorities indicated that may not be possible.

18. **The authorities' plans for the 2007 budget are at an early stage** (MEFP, paragraph 27). Key priorities for the 2007 budget will be broadly unchanged from 2006. Consistent with their goal of reducing inflation to 6 percent, and with their medium-term expenditure framework (MTEF) based on their Basic Data and Directions (BDD), they intend at this point to target a 2007 cash deficit of 2.1 percent of GDP, 0.4 percent below the revised 2006 target. This deficit will be financed by concessional external assistance and residual privatization proceeds. Consistent with their objective to reduce inflation, there would be virtually no drawdown of the deposits built up at the NBG in 2006.

19. **The authorities expressed satisfaction with the progress to date in strengthening the MTEF, while acknowledging that more remains to be done** (MEFP, paragraphs 6 and 22). The latest BDD/MTEF, based on detailed, multi-year expenditure projections, has recently been discussed by parliament, and will form the basis for the 2007 budget.

20. **On the structural fiscal front, now that the database of central government LEPLs is complete, the authorities are focused on designing and implementing an effective monitoring and reporting framework.** They intend to adopt this reporting framework by end-2006, and propose that this be a structural performance criterion. Subsequent to the mission, the staff learned that the authorities intend to divide central government LEPLs into two groups—government LEPLs and non-profit LEPLS—with the first subject to standard Treasury reporting requirements and the new reporting framework applying only to non-profit LEPLs.

21. **The authorities continue their efforts to modernize tax and customs administration.** They are in the final stages of a plan to unify the tax and customs departments, and the financial police, under the Ministry of Finance, a move designed to improve efficiency and information sharing among these agencies. In addition, the authorities are preparing a tax administration modernization strategy, focusing on enhancing self-assessment and risk management, streamlining the VAT refund mechanism, and reducing the stock of tax arrears. An FAD regional tax administration advisor will assist the authorities in these efforts. Finally, a comprehensive new customs code has recently been adopted, and will be effective from January 1, 2007. This code is designed to improve the efficiency of customs operations, and includes dispute procedures that are harmonized with the tax code and penalty provisions that should be sufficient to deter tax avoidance.

22. **The authorities reiterated their commitment to implementing the requirements of GFS 2001 at the earliest possible time** (MEFP, paragraph 30). In particular, they plan to have the functional classification of the 2007 budget in line with GFS 2001, with the economic classification in line starting with the 2008 budget.

C. Monetary and Financial Sector Policies

23. **The staff and authorities assessed recent monetary developments, including the unexpected rise in the money multiplier.** While there has been an increasing trend in the money multiplier over the last few years, partly due to the public's increasing reliance on debit and credit cards reducing currency/deposit ratios, there was a sharp jump in the multiplier during the second quarter. The explanation for this sharp increase was that banks had responded to tight liquidity conditions by reducing their holdings of excess reserves, when faced with rapidly growing demand for credit. As banks' excess reserves are now very low, the NBG believes it is unlikely that the money multiplier will increase further. Indeed, as two large banks violated the prudential standards in an effort to mobilize liquidity, and are now being required to get back in compliance, a modest reduction in the money multiplier can be anticipated over the next few months. Consistent with this, the money multiplier at end-July was somewhat lower than at end-June. For 2007, the NBG's projections assume an increase in the money multiplier in line with past trends.

24. **The authorities thus judged that, in light of this higher than anticipated money multiplier, slower reserve money growth would be needed in order to bring broad money growth back in line with their target for 2006**. The authorities have therefore decided to target 2006 reserve money growth of 15 percent, down from the 25 percent originally programmed. In addition, in order to reduce the money multiplier slightly (and in line with the FSAP recommendation to bring reserve requirements on lari and dollar deposits closer together) the NBG increased the required reserve ratio on lari deposits, and indicated that they are considering a more comprehensive reform of the complicated reserve requirements.[4] The authorities believe these measures should bring 12-month broad money growth to around 27 percent by end-2006, slightly below the programmed 29 percent and down sharply from 40 percent at end-June 2006.

25. **To achieve this reduced growth of reserve money, the authorities recognize that the NBG will need to allow the nominal exchange rate to fluctuate more** (MEFP, paragraphs 32–33). Staff expressed the opinion that the consistent excess demand for lari in the foreign exchange market indicates that the market views the exchange rate as undervalued; the authorities broadly agreed with this view. The view that the exchange rate is undervalued is consistent with staff's assessment in the most recent Article IV staff report. It was noted that the stability of the exchange rate in recent months has come at the expense of extensive NBG intervention in the foreign exchange market, and consequent growth in reserve money. Going forward, the program targets for reserve money are

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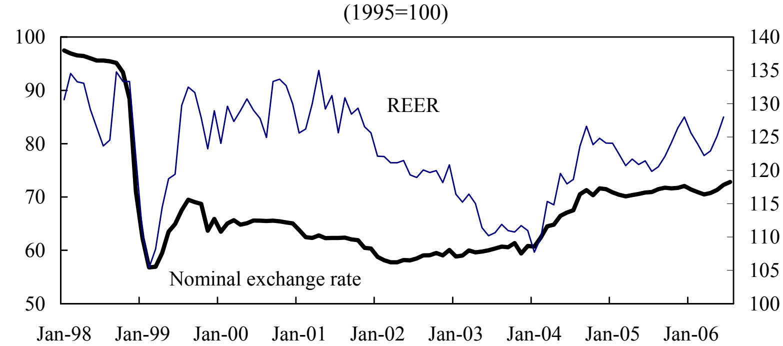
[4] In contrast to the existing minimum reserve requirement of 2 percent for Lari deposits which can be averaged over the month, the new 4 percent reserve requirement is compulsory and has no averaging mechanism. On foreign exchange reserves, a 13 percent compulsory exchange requirement applies.

consistent with only very limited NBG intervention during the last four months of 2006. The NBG also indicated its intent to more aggressively use credit and deposit auctions to reduce reserve money growth. In addition, preparations for the sale of NBG certificates of deposit, as well as treasury bills held by the NBG, will be accelerated.

Georgia: Index of Average Nominal Exchange Rate and REER (CPI based)
(1995=100)



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

26. **Credit growth has accelerated in recent months, with 12-month growth of credit to the economy exceeding 80 percent at end-June.** Staff expressed the view that this rapid credit growth is likely to slow in the coming months, as major banks are increasingly restricted in their lending activities by binding capital and liquidity requirements. While expecting some slowdown of credit growth over the next year, the authorities believe continued foreign inflows to the banking system—both loans and capital—are likely to prevent a disruptive slowing of credit growth.

27. **The authorities were in agreement with the main recommendations from the FSAP.** In the area of financial sector supervision, the FSAP mission emphasized the need to establish fit and proper criteria for bank owners, to enhance information sharing among financial sector supervisors, and to require external bank auditors to include issues of importance to the NBG in their audits and report to the NBG. The FSAP mission also provided recommendations on clarifying the NBG's role in crisis resolution and strengthening financial sector development. The NBG is moving forward with implementing these recommendations, and have already implemented a number of them (MEFP, paragraphs 36–39). In particular, the NBG will focus on recommendations to monitor the quality of the rapidly growing credit portfolio.

D. External Sector Policies

28. **With the latest trade policy reforms, Georgia now has one of the most open trade regimes in the world.** As of September 1, import tariffs have been significantly simplified and reduced to three rates (zero, five, and twelve percent). Almost 90 percent of imported goods are zero-rated and only a few agriculture products are rated at 12 percent. This reduces the average weighted tariff to 1½ percent. The productivity gains that can be expected from opening further Georgia's commodity markets to international competition should support long-run growth, improving the prospects of the tradable sectors and exports.

29. **With the recent agreements with Austria and Azerbaijan, the authorities have now finalized all debt negotiations with Paris Club and non-Paris Club creditors, except for Kazakhstan, with whom discussions are continuing.**

E. PRSP Progress Report

30. **The authorities have recently completed and submitted to the World Bank and IMF their PRSP Progress Report.** Overall, the progress report provides evidence of continued strong economic performance. However, the report would have benefited from a more comprehensive description of the government's macroeconomic framework. In particular, the report does not provide information on how the government intends to integrate its sectoral policies into the MTEF. The World Bank staff, in reviewing the PRSP Progress Report, commended the government for bold measures in fighting corruption and decisive structural reforms which have been improving the business and investment climate. While progress has been made in alleviating extreme poverty through the targeted poverty benefit program, which is being implemented in September 2006 after some delays, the World Bank staff noted that further efforts are needed to address the fragmentation of the poverty benefit system, improve targeting, and ensure its fiscal sustainability.

F. Program Risks

31. **The major risks to the program, and to Georgia's economy more generally, stem from domestic and external political pressures.** On the domestic front, the government explained that they may face significant pressures for increased expenditures in light of the upcoming elections—a risk that was reduced with the unexpected scheduling of elections to October 5, some two months earlier than expected—as well as the tensions related to Abkhazia and South Ossetia. It was agreed that, if the government is going to be successful in bringing down inflation, it will be essential that they resist such pressures. On the external side, tensions in their relations with Russia will likely continue to cause problems for Georgia's exporters. Further deterioration in these relations, if it were to occur, could significantly slow growth in Georgia.

32. **Staff is also increasingly concerned about the dependence of Georgia's banking system on potentially volatile borrowing from international capital markets.** A reversal, or even a significant slowdown, in these inflows could bring credit growth in Georgia to an abrupt halt, leading to potentially severe economic disruption. While acknowledging these concerns, the authorities expressed confidence that these inflows will continue.

33. **Based on the latest joint Bank-Fund Debt Sustainability Analysis (Attachment V), staff now considers Georgia to be at low risk of debt distress.** As a result of faster-than-expected repayment of old energy debt to Turkmenistan, the end of the Paris Club flow rescheduling will not result in a significant increase in debt service payments in 2007. Strong economic performance has also contributed to lowering Georgia's debt distress risk.

Measured against the thresholds for a strong policy performer (Georgia was upgraded to a strong performer in the Bank's Country Policy and Institutional Assessment (CPIA) rating in June 2006), the baseline of the joint Bank-Fund DSA is sustainable and moderate stress to the economy would not be sufficient to return Georgia to the unsustainable debt situations of the past.

IV. Staff Appraisal

34. **Georgia should be commended for the substantial progress in reforming and strengthening its economy in recent years.** Economic growth has been strong, and there has been a dramatic improvement in governance and the business environment. Equally important has been the fiscal turnaround, with tax revenues having increased from around 14 percent of GDP in 2003 to an expected level of more than 21 percent of GDP in 2006, despite substantial cuts in tax rates and the number of taxes. This improved revenue performance has enabled the government to clear the vast majority of arrears accumulated in previous years, as well as to finance vitally needed infrastructure improvements and social programs.

35. **However, recent developments with respect to inflation are worrisome, and staff urges the authorities to act decisively to reduce inflation.** A tightening of fiscal and monetary policies is needed, before inflation expectations become entrenched and fighting inflation becomes harder.

36. **On the fiscal front, while acknowledging the significant expenditure needs in Georgia, staff is concerned that rapid increases in spending are fueling demand pressures.** In this context, staff welcomes the authorities' commitment to avoid any further increases in expenditures in 2006—a commitment staff believes is essential to a credible anti-inflation strategy—and urges the authorities to ensure that they adhere to the revised fiscal targets under the program both for 2006 and 2007.

37. **While expenditure restraint is needed, government obligations should be honored and spending on the poor protected.** Thus, the staff urges the authorities to speed up the resolution of the remaining arrears claims. Regarding the targeted poverty benefit, while welcoming its introduction in Tbilisi in August, as poverty is more severe in the rural areas, staff looks forward to the nationwide extension of this program in September.

38. **Staff welcomes the establishment of an LEPL database, the preparation of draft reporting guidelines, and the decision to impose standard Treasury reporting guidelines on government LEPLs.** Going forward, the key will be to ensure that the new reporting guidelines are sufficient to ensure the authorities have timely and accurate information on the execution of fiscal policy. In this context, staff urges the authorities to give serious consideration to staff comments on the first draft of these guidelines.

39. **With regard to monetary policy, staff strongly supports the authorities' intention to significantly reduce reserve money growth for 2006, in an effort to reduce inflationary pressures.** In this context, it will be important for the NBG to accelerate efforts to enable it to sell its stock of treasury bills, as well as central bank certificates of deposits. This will add to the monetary tools available to the NBG.

40. **In addition, it will be essential that the NBG significantly reduces its interventions in the foreign exchange market, both to enable monetary targets to be met, and to allow market forces to influence the exchange rate.** The stability of the nominal exchange rate in recent months, despite massive NBG purchases of dollars in the market, indicates that the Georgian lari is undervalued. Over time, real appreciation is therefore inevitable. By resisting nominal appreciation, the NBG is forcing the real appreciation to occur through higher inflation, with consequent damage to macroeconomic stability as well as to the poor. Continued progress in structural reforms remains key to maintaining international competitiveness.

41. **Staff urges the NBG to monitor closely the rapid growth in credit.** In addition to monitoring credit quality and ensuring banks stay in compliance with prudential requirements, the NBG should assess the risks related to the increasing dependence of commercial banks on inflows from abroad.

42. **Staff welcomes the authorities' constructive response to the recommendations of the FSAP mission, and urges them to implement these recommendations as rapidly as possible.** In particular, the adoption of Fit and Proper legislation, in line with international best practices, is urgently needed, and staff welcomes the authorities' commitment to ensuring this is done before end-2006.

43. **Staff commends the authorities for their bold steps to liberalize Georgia's trade regime.** As a small economy, these measures to open Georgia to more international competition should enhance the economy's long-term growth prospects.

44. **The main risks to macroeconomic stability, and to program implementation, stem from domestic and external political pressures.** Restraining fiscal expenditures, despite these pressures, and allowing market forces to influence exchange rates will be essential to the authorities' efforts to reduce inflation. More broadly, in light of the continuing difficult relations with Russia, the authorities will need to be prepared to respond in the event of further significant external economic shocks.

45. **Georgia's performance under the PRGF arrangement has been strong in most respects.** Based on the policy commitments in the attached MEFP, and the authorities' intention to take steps to ensure a significant reduction in inflation, staff supports the authorities' request for completion of the fourth review, and a waiver for nonobservance of a structural performance criterion.

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

	2004	2005	2006		2007
		Prel.	Prog.	Proj.	Proj.
(Annual percentage change, unless otherwise indicated)					
National accounts					
Nominal GDP (millions of lari)	9,824	11,592	13,080	13,708	15,475
Nominal GDP (US$ million)	5,126	6,395	7,070	7,493	8,365
Real GDP	5.9	9.3	6.4	7.5	6.5
Population 1/	4.3	4.3	4.3	4.3	4.3
Consumer price index, period average	5.7	8.3	5.3	9.6	6.0
Consumer price index, end-of-period	7.5	6.2	4.7	10.0	6.0
GDP per capita (US$)	1,188	1,482	...	1,736	1,938
Poverty rate (in percent) 2/	35.7	39.4	...	...	...
Unemployment rate	12.6	13.8	...	...	...
(In percent of GDP, unless otherwise indicated)					
Investment and saving					
Investment	27.5	26.3	26.6	27.4	28.1
Public	2.4	4.2	3.8	4.2	4.1
Private	25.1	22.1	22.8	23.2	23.9
Gross national saving	19.1	20.9	19.4	17.5	16.6
Public	4.7	2.7	1.6	2.1	2.1
Private	14.4	18.2	17.9	15.4	14.6
Saving-Investment balance	-8.4	-5.4	-7.1	-9.9	-11.5
Budgetary operations					
Total revenue and grants	22.0	23.4	22.9	25.8	24.5
Of which: Tax revenue	18.4	19.8	19.3	21.6	21.5
Total expenditure and net lending	18.9	25.0	25.0	27.9	26.6
Of which: Current expenditure	16.5	20.7	21.3	23.7	22.5
Fiscal balance, commitment basis	3.2	-1.5	-2.2	-2.1	-2.1
Net change in expenditure arrears	-2.6	-0.9	-0.4	-0.4	0.0
Statistical discrepancy	-0.8	0.0	0.0	0.0	0.0
Fiscal balance, cash basis	-0.2	-2.4	-2.6	-2.5	-2.1
Financing	0.2	2.4	2.6	2.5	2.1
Privatization	0.9	3.6	2.6	9.0	2.0
External	0.2	-0.3	-0.2	-0.2	0.1
Domestic	-0.9	-0.9	0.3	-6.4	0.0
(Annual percentage change, unless otherwise indicated)					
Monetary sector					
Reserve money	44.3	19.7	25.0	15.0	14.1
Broad money (including foreign exch. deposits)	42.6	26.4	29.0	27.8	21.0
Velocity of broad money, level (M3, eop)	7.6	6.8	6.0	6.3	5.8
(In millions of U.S. dollars, unless otherwise indicated)					
External Sector					
Exports of goods and services (percent of GDP)	55.0	41.0	31.2	40.7	41.4
Annual percentage change	48.7	33.3	7.5	16.5	13.5
Imports of goods and services (percent of GDP)	52.1	53.6	44.3	58.8	60.2
Annual percentage change	46.9	28.4	9.7	28.5	14.4
Net imports of oil	264	375	389	492	561
Current account balance	-429	-347	-537	-739	-958
In percent of GDP	-8.4	-5.4	-7.6	-9.9	-11.5
Gross international reserves	383	474	620	1,030	1,089
In months of imports of goods and services (excl. pipeline imports)	2.0	1.8	2.3	2.9	2.6
Foreign direct investment	420	529	390	1,018	596
Average exchange rate (lari per dollar)	1.9	1.8	...	...	...

Sources: Georgian authorities; and Fund staff estimates.

1/ Excludes Abkhazia residents.
2/ Agreed with the World Bank, there were methodological changes in the calculation of poverty starting in 2004.

Table 2. Georgia: Operations of the General Government, 2005–07
(In millions of lari)

	2005	2006									2007
	Prel.	Prog. Country Rep. No. 06/171	Q1 Prog.	Q1 Act.	Q2 Prog.	Q2 Act.	Q3 Proj.	Q4 Proj.	2 nd Supp. Budget	Annual Proj.	Annual Proj.
Total revenue and grants	2,715	2,990	637	702	707	838	998	998	3,415	3,537	3,795
Total revenue	2,611	2,819	618	685	690	818	923	920	3,237	3,346	3,551
Tax revenue 1/	2,300	2,527	513	579	624	747	823	808	2,848	2,957	3,325
Taxes on income	291	293	74	76	74	87	95	87	337	345	416
Taxes on profits	210	266	55	69	73	95	93	83	321	340	412
Social tax	315	293	48	66	56	80	95	99	320	340	421
VAT	987	1,105	230	254	280	318	390	407	1,313	1,370	1,548
Customs duties	123	143	27	32	32	51	25	14	123	123	50
Excises	286	339	63	60	89	88	95	97	338	340	378
Other taxes	76	89	15	22	20	27	30	21	97	100	100
Nontax revenue 1/	312	292	104	105	66	72	100	112	389	389	226
Of which: NBG profit transfers	40	40	40	51	0	0	0	0	51	51	40
Grants	104	171	19	17	17	20	75	79	179	191	245
Total expenditure and net lending	2,892	3,276	667	737	723	1,041	1,026	1,015	3,909	3,819	4,119
Current expenditure	2,400	2,782	589	652	637	873	825	895	3,334	3,245	3,478
Wages and salaries	452	469	117	127	117	143	103	104	478	478	543
Goods and services 2/	420	766	169	114	176	199	311	340	1,054	964	945
Of which: Defense spending 3/	389	427	...	101	...	183	...	...	641	...	...
Transfers and subsidies	869	978	206	332	226	357	190	159	1,038	1,038	1,110
Interest payments	120	123	32	27	30	22	39	35	122	122	115
Local government expenditures	539	446	65	52	87	151	182	257	642	642	765
Capital expenditure	459	461	69	83	78	157	200	111	551	551	611
Of which: Foreign financed	178	160	24	32	27	35	90	68	163	225	156
Net lending	33	34	9	3	9	11	1	9	24	24	31
Overall balance (commitments)	-177	-287	-30	-35	-16	-203	-27	-16	-493	-282	-324
Adjustment to cash basis	-102	-59	-5	32	-15	51	-70	-73	-59	-59	0
Net change in expenditure arrears (-, reduction)	-104	-59	-5	-10	-15	-13	-20	-16	-59	-59	0
Statistical discrepancy	2	0	0	42	0	64	-50	-57	0	0	0
Overall balance (cash)	-279	-346	-35	-3	-31	-152	-97	-89	-552	-341	-324
Total financing	279	346	35	3	31	152	97	90	552	341	325
Privatization	419	338	25	112	49	144	192	791	472	1,238	306
Domestic	-104	37	0	-112	-18	25	-47	-738	110	-872	2
Net NBG credit	-76	37	0	-92	-18	30	-47	-737	130	-845	2
Of which: Government deposits	-67	37	0	-92	-18	30	-47	-737	130	-845	2
Net commercial bank credit	-30	0	0	-20	0	-7	0	0	-20	-27	0
Nonbank	2	0	0	0	0	1	0	-1	0	0	0
External	-36	-29	10	3	-1	-17	-49	37	-29	-25	16
Disbursements	125	180	39	32	39	35	46	74	180	187	186
Amortization	-161	-209	-29	-28	-40	-52	-94	-37	-209	-212	-170
Memorandum items:											
Nominal GDP (millions of lari)	11,592	13,080	2,811	2,745	3,251	3,428	3,642	3,893	13,708	13,708	15,475

Sources: Georgian authorities; and Fund staff estimates.

1/ Tax revenue and nontax revenue include back tax payments from privatization of enterprises. In the first half of 2006, GEL 91.5 m were reclassified from nontax revenues to privatization.
2/ Includes other goods and services
3/ Based on Ministry of Defense budget; excludes defense spending from the President's Fund.

Table 2. Georgia: Operations of the General Government, 2005–07 (concluded)
(In percent of GDP)

	2005	2006										2007
	Prel.	Prog. Country Rep. No. 06/171	Q1 Prog.	Q1 Act.	Q2 Prog.	Q2 Act.	Q3 Proj.	Q4 Proj.	2 nd Supp. Budget	Staff Proj.		Annual Proj.
Total revenue and grants	23.4	22.9	22.6	25.6	21.8	24.4	27.4	25.6	24.9	25.8		24.5
Total revenue	22.5	21.6	22.0	24.9	21.2	23.9	25.3	23.6	23.6	24.4		22.9
Tax revenue 1/	19.8	19.3	18.3	21.1	19.2	21.8	22.6	20.8	20.8	21.6		21.5
Taxes on income	2.5	2.2	2.6	2.8	2.3	2.5	2.6	2.2	2.5	2.5		2.7
Taxes on profits	1.8	2.0	2.0	2.5	2.3	2.8	2.6	2.1	2.3	2.5		2.7
Social tax	2.7	2.2	1.7	2.4	1.7	2.3	2.6	2.5	2.3	2.5		2.7
VAT	8.5	8.4	8.2	9.3	8.6	9.3	10.7	10.5	9.6	10.0		10.0
Customs duties	1.1	1.1	1.0	1.2	1.0	1.5	0.7	0.4	0.9	0.9		0.3
Excises	2.5	2.6	2.3	2.2	2.7	2.6	2.6	2.5	2.5	2.5		2.4
Other taxes	0.7	0.7	0.5	0.8	0.6	0.8	0.8	0.5	0.7	0.7		0.6
Nontax revenue 1/	2.7	2.2	3.7	3.8	2.0	2.1	2.7	2.9	2.8	2.8		1.5
Of which: NBG profit transfers	0.3	0.3	1.4	1.9	0.0	0.0	0.0	0.0	0.4	0.4		0.3
Grants	0.9	1.3	0.7	0.6	0.5	0.6	2.1	2.0	1.3	1.4		1.6
Total expenditure and net lending	25.0	25.0	23.7	26.9	22.3	30.4	28.2	26.1	28.5	27.9		26.6
Current expenditure	20.7	21.3	21.0	23.7	19.6	25.5	22.6	23.0	24.3	23.7		22.5
Wages and salaries	3.9	3.6	4.2	4.6	3.6	4.2	2.8	2.7	3.5	3.5		3.5
Goods and services 2/	3.6	5.9	6.0	4.1	5.4	5.8	8.5	8.7	7.7	7.0		6.1
Of which: Defense spending 3/	...	...	...	3.7	...	5.3	...	...	4.7	...		...
Transfers and subsidies	7.5	7.5	7.3	12.1	6.9	10.4	5.2	4.1	7.6	7.6		7.2
Interest payments	1.0	0.9	1.1	1.0	0.9	0.6	1.1	0.9	0.9	0.9		0.7
Local government expenditures	4.6	3.4	2.3	1.9	2.7	4.4	5.0	6.6	4.7	4.7		4.9
Capital expenditure	4.0	3.5	2.5	3.0	2.4	4.6	5.5	2.8	4.0	4.0		3.9
Of which: Foreign financed	1.5	1.2	0.9	1.2	0.8	1.0	2.5	1.7	1.2	1.6		1.0
Net lending	0.3	0.3	0.3	0.1	0.3	0.3	0.0	0.2	0.2	0.2		0.2
Overall balance (commitments)	-1.5	-2.2	-1.1	-1.3	-0.5	-5.9	-0.8	-0.4	-3.6	-2.1		-2.1
Adjustment to cash basis	-0.9	-0.4	-0.2	1.2	-0.5	1.5	-1.9	-1.9	-0.4	-0.4		0.0
Net change in expenditure arrears (-, reduction)	-0.9	-0.4	-0.2	-0.4	-0.5	-0.4	-0.5	-0.4	-0.4	-0.4		0.0
Statistical discrepancy	0.0	0.0	0.0	1.5	0.0	1.9	-1.4	-1.5	0.0	0.0		0.0
Overall balance (cash)	-2.4	-2.6	-1.2	-0.1	-0.9	-4.4	-2.7	-2.3	-4.0	-2.5		-2.1
Total financing	2.4	2.6	1.2	0.1	0.9	4.4	2.7	2.3	4.0	2.5		2.1
Privatization	3.6	2.6	0.9	4.1	1.5	4.2	5.3	20.3	3.4	9.0		2.0
Domestic	-0.9	0.3	0.0	-4.1	-0.5	0.7	-1.3	-19.0	0.8	-6.4		0.0
Net NBG credit	-0.7	0.3	0.0	-3.3	-0.5	0.9	-1.3	-18.9	0.9	-6.2		0.0
Of which: Government deposits	-0.6	0.3	0.0	-3.3	-0.5	0.9	-1.3	-18.9	0.9	-6.2		0.0
External	-0.3	-0.2	0.3	0.1	0.0	-0.5	-1.3	0.9	-0.2	-0.2		0.1
Disbursements	1.1	1.4	1.4	1.2	1.2	1.0	1.3	1.9	1.3	1.4		1.2
Amortization	-1.4	-1.6	-1.0	-1.0	-1.2	-1.5	-2.6	-1.0	-1.5	-1.5		-1.1
Memorandum items:												
Nominal GDP (millions of lari)	11,592	13,080	2,811	2,745	3,251	3,428	3,642	3,893	13,708	13,708		15,475

Sources: Georgian authorities; and Fund staff estimates.

1/ Tax revenue and nontax revenue include back tax payments from privatization of enterprises. In the first half of 2006, GEL 91.5 m were reclassified from nontax revenues to privatization.
2/ Includes other goods and services
3/ Based on Ministry of Defense budget; excludes defense spending from the President's Fund.

Table 3. Georgia: Summary Medium-Term Balance of Payments, 2004–10
(In million of U.S. dollars)

	2004	2005 3/	2006		2007	2008	2009	2010
	Act.	Prel.	Prog.	Proj.	Proj.	Proj.	Proj.	Proj.
Current account balance	-429	-347	-537	-739	-958	-816	-768	-729
Trade balance	-719	-932	-1,048	-1,412	-1,676	-1,624	-1,644	-1,666
Exports	1,272	1,589	1,522	1,912	2,175	2,428	2,687	2,945
Imports	-1,991	-2,521	-2,570	-3,324	-3,851	-4,052	-4,331	-4,612
Services and income (net)	-56	76	8	15	61	75	109	136
Services (net)	17	127	67	61	104	129	152	178
Factor income (net)	-73	-51	-59	-46	-43	-54	-44	-42
Of which: Interest (gross)	-47	-39	-43	-47	-46	-49	-43	-43
Transfers (net)	345	510	503	658	656	733	767	802
Official transfers	74	147	181	187	169	187	175	182
Of which: General government	41	26	57	63	23	37	26	22
Other transfers	271	363	322	471	487	546	592	620
Of which: Remittances	205	337	271	433	446	503	547	573
Capital and financial account balance	553	570	621	1,288	994	892	914	875
Public sector	-33	-49	-43	-38	96	133	167	156
Disbursements	77	62	79	81	81	92	96	88
Of which: World Bank	39	41	52	53	40	45	45	45
Amortization	-137	-142	-160	-160	-94	-70	-45	-48
Capital grants, incl. from MCC (beginning in 2006)	28	32	38	41	109	110	117	115
Private sector	586	619	664	1,327	899	759	746	720
Foreign direct investment, including privatization rece	420	529	390	1,018	596	435	370	315
Of which: Gas and oil pipeline	280	265	125	83	0	0	0	0
Other private capital, net	166	90	274	309	302	324	376	405
Errors and Omissions	24	-194	0	-55	0	0	0	0
Overall Balance	148	29	84	494	36	76	145	147
Financing	-148	-29	-84	-494	-36	-76	-146	-147
Use of Fund resources, net	-34	-9	-8	-8	3	-33	-27	-21
Purchases/disbursements	21	41	41	41	42	0	0	0
Repurchases/repayments	-55	-51	-49	-49	-39	-33	-27	-21
Program loans	24	13	20	20	20	10	5	5
Increase in reserves (-)	-192	-91	-146	-556	-59	-53	-124	-131
Change in arrears (+, increase)	-52	0	0	0	0	0	0	0
Debt relief 2/	105	58	50	50	0	0	0	0
Paris Club rescheduling	43	58	50	50	0	0	0	0
Rescheduling of arrears	63	0	0	0	0	0	0	0
Memorandum items								
Nominal GDP	5,126	6,395	7,070	7,493	8,365	9,266	10,216	11,324
Current account deficit (percent of GDP)	8.4	5.4	7.6	9.9	11.5	8.8	7.5	6.4
Trade deficit (percent of GDP)	14.0	14.6	14.8	18.8	20.0	17.5	16.1	14.7
Merchandise export growth (percent)	74.1	24.9	8.5	20.3	13.8	11.6	10.6	9.6
Merchandise export volume growth (percent)	71.2	23.3	...	20.4	13.3	10.8	9.8	8.8
Merchandise import growth (percent)	49.9	26.6	11.3	31.8	15.9	5.2	6.9	6.5
Merchandise import volume growth (percent)	42.1	16.2	...	18.9	11.9	11.8	13.5	12.3
Gross international reserves 3/	383	474	620	1,030	1,089	1,141	1,265	1,396
(In months of imports of goods and services)	1.7	1.7	2.2	2.8	2.6	2.6	2.7	2.8
Public and publicly guaranteed external debt (nominal)	1,858	1,735	1,720	1,725	1,692	1,688	1,691	1,743
(In percent of GDP)	36.2	27.1	24.3	23.0	20.2	18.2	16.6	15.4
Debt service from the budget (cash)	106	111	143	143	125	102	71	72
(In percent of exports of goods and services)	5.4	4.2	6.1	4.7	3.6	2.7	1.7	1.6
Total external debt service (cash)	186	190	222	222	192	165	128	126
(In percent of exports of goods and services)	9.5	7.2	9.4	7.3	5.5	4.3	3.1	2.8

Sources: Georgian authorities; and Fund staff estimates.

1/ Includes the July 2004 Paris Club agreement on terms somewhat more generous than Houston terms.
2/ Projections at program exchange rates.
3/ Estimates for the current account deficit has been revised downward compared to the last staff report due to official data corrections.

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

	2003	2004	2005 2/				2006 2/				2007			
	Dec.	Dec.	Mar.	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.	Jun.	Sep.	Dec
	Actual 1/	Actual 2/	Actual	Actual	Actual	Actual	Actual	Actual	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
(Contribution to reserve money growth in percent) 4/														
Net foreign assets	-4.7	77.1	-0.5	16.8	18.0	27.2	3.0	11.3	24.9	103.4	-5.4	10.8	7.1	5.9
Net domestic assets	18.6	-32.8	-2.7	-11.7	-6.4	-7.5	-5.3	-7.0	-13.0	-88.4	4.6	-8.4	-0.3	8.2
Net claims on general government	5.2	-10.5	-6.7	-16.5	-10.4	-9.1	-9.1	-6.1	-10.8	-84.4	2.7	-12.2	-6.1	0.2
Claims on rest of economy	6.7	-3.5	0.0	0.0	-0.1	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Claims on banks	1.2	-8.2	1.3	3.8	5.0	4.9	0.5	-2.6	-3.0	-5.0	1.7	3.5	5.2	7.4
Other items, net	5.4	-10.6	2.6	1.0	-0.9	-3.2	3.3	1.6	0.7	0.9	0.2	0.3	0.5	0.7
Reserve money (RM)	13.9	44.3	-3.3	5.1	11.6	19.7	-2.3	4.3	11.8	15.0	-0.8	2.4	6.8	14.1
Currency in circulation (M0)	13.4	42.9	-2.7	2.7	10.4	20.0	-4.4	-1.0	6.7	13.9	-6.4	-1.0	5.1	13.0
Required reserves	12.7	13.4	5.8	18.2	32.2	40.6	7.3	22.2	25.1	-5.3	55.5	67.9	78.2	80.6
Balances on banks' correspondent accounts 3/	29.1	169.3	-21.8	11.1	-4.7	-11.5	6.5	37.4	52.2	73.5	-17.5	-45.3	-62.8	-54.4
(In million lari)														
Net foreign assets	-329	118	113	258	268	345	375	458	594	1,381	1,319	1,505	1,463	1,449
Net domestic assets	909	719	696	621	665	656	604	586	526	-229	-176	-326	-233	-134
Net claims on general government	783	722	666	584	635	646	554	585	537	-199	-168	-340	-269	-197
Claims on genereal government (incl. t-bills), *of which:*	817	841	842	842	836	833	833	833	833	833	833	833	833	833
Nontradable govt. debt	…	…	…	…	…	…	…	785	…	…	…	…	…	…
Securitized debt (marketable)	…	…	…	…	…	…	…	48	…	…	…	…	…	…
Deposits	-35	-120	-176	-258	-202	-187	-279	-248	-295	-1032	-1001	-1173	-1102	-1030
Claims on rest of economy	118	97	97	97	97	97	98	98	97	97	97	97	97	97
Claims on banks	6	-41	-30	-9	1	0	5	-26	-30	-50	-30	-10	10	35
Other items, net	2	-59	-37	-51	-67	-87	-54	-71	-79	-77	-75	-73	-71	-69
Reserve money (RM)	580	837	809	879	933	1,001	979	1,045	1,120	1,152	1,143	1,179	1,230	1,315
Currency in circulation (M0)	473	676	658	695	747	811	775	803	866	924	865	916	972	1,045
Required reserves	81	92	98	109	122	130	139	159	162	123	191	206	219	222
Balances on banks' correspondent accounts 3/	25	68	53	76	65	60	64	83	92	104	86	57	39	48
Memorandum items:														
Growth of reserve money (in percent, relative to same period of previous year)	13.9	44.3	36.2	34.1	24.9	19.7	21.0	18.8	20.0	15.0	16.7	12.9	9.8	14.1
Growth of currency in circulation (in percent, relative to same period of previous year)	13.4	42.9	41.2	37.8	24.4	20.0	17.8	15.6	16.0	13.9	2.3	14.0	12.2	13.0

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

1/ Net foreign assets are valued at the program rate of 2.15 lari/US$, US$/SDR of 1.49 and US$/Euro of 1.27.
2/ Net foreign assets are valued at the program rate of 1.85 lari/US$, US$/SDR of 1.46 and US$/Euro of 1.21.
3/ Including overnight deposits from banks.
4/ Contribution is defined as change of asset stock over the end-period stock of reserve money from the previous year.

Table 5. Georgia: Monetary Survey, 2003–07

	2003	2004	2005 2/				2006 2/				2007			
	Dec Actual 1/	Dec. Actual 2/	March Actual	Jun. Actual	Sep. Actual	Dec. Actual	Mar. Actual	Jun. Actual	Sep. Proj.	Dec. Proj.	Mar. Proj.	Jun. Proj.	Sep. Proj.	Dec Proj.
(Contribution to broad money growth in percent) 6/														
Net foreign assets	-0.7	43.2	-2.6	4.4	4.8	-4.4	-0.2	1.6	6.6	44.3	-3.8	-1.8	-4.4	-7.0
Net domestic assets	23.4	-0.6	1.6	3.3	14.8	30.8	5.0	18.0	18.8	-16.6	6.5	12.0	21.4	28.0
Domestic credit	27.8	11.7	2.8	8.1	24.4	47.2	4.0	23.1	26.0	-5.9	5.2	10.6	24.4	31.4
Net claims on general government	6.1	-2.5	-3.5	-9.8	-7.9	-7.0	-5.9	-4.6	-7.1	-45.6	1.3	-5.8	-2.9	0.1
Public-guaranteed borrowing from DMBs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Credit to the rest of the economy	21.7	14.2	6.3	17.9	32.3	54.2	9.8	27.7	33.0	39.8	3.9	16.4	27.3	31.3
Other items, net	-4.3	-12.3	-1.3	-4.7	-9.6	-16.4	1.0	-5.1	-7.1	-10.7	1.3	1.4	-3.0	-3.4
(Percentage change since end of previous year)														
Broad money (M3)	22.8	42.6	-1.0	7.7	19.6	26.4	4.8	19.5	25.4	27.8	2.8	10.2	16.9	21.0
Broad money, excl. forex deposits (M2)	14.1	60.4	-4.0	5.2	16.1	26.5	1.6	17.0	28.0	24.2	1.6	9.7	17.9	27.5
Currency held by the public	13.0	39.5	-1.2	3.3	11.4	19.5	-3.7	-1.0	25.8	6.0	-0.3	5.3	11.8	21.0
Total deposit liabilities	30.9	44.8	-0.8	10.7	25.2	31.1	10.1	32.4	25.1	41.4	4.2	12.5	19.4	21.0
(In million lari)														
Net foreign assets	-285	173	135	239	245	106	102	136	232	953	861	909	845	781
NBG	-329	118	113	258	268	345	375	458	594	1381	1319	1505	1463	1449
Commerical banks	44	55	21	-19	-23	-239	-273	-322	-362	-427	-457	-597	-617	-667
Net domestic assets	1345	1339	1362	1389	1562	1805	1901	2148	2165	1488	1648	1782	2010	2173
Domestic credit	1672	1796	1839	1918	2164	2510	2586	2951	3006	2398	2525	2657	2993	3164
Net claims on general government	766	739	687	591	620	633	521	545	497	-239	-208	-380	-309	-237
Credit to the rest of the economy	906	1057	1152	1327	1545	1877	2065	2406	2508	2637	2733	3037	3303	3401
Other items, net	-327	-457	-476	-529	-602	-705	-685	-803	-841	-909	-877	-875	-983	-991
Broad money (M3)	1060	1512	1497	1628	1808	1911	2003	2284	2396	2442	2509	2691	2855	2954
Broad money, excl. forex deposits (M2)	527	846	812	890	982	1070	1088	1252	1369	1329	1350	1457	1566	1694
Currency held by the public	442	616	609	636	686	736	709	729	926	781	779	822	872	944
Total deposit liabilities	619	896	888	992	1121	1175	1294	1555	1470	1661	1730	1868	1983	2010
Memorandum items:														
Growth of broad money (in percent, relative to same period of previou	...	42.6	34.0	37.5	36.8	26.4	33.8	40.3	32.6	27.8	25.3	17.8	19.2	21.0
Growth of credit to the rest of the economy (in percent, relative to end of previous year)	20.4	34.1	9.0	25.5	46.2	77.6	10.0	28.2	33.7	40.5	3.7	15.2	25.2	29.0
Growth of credit to the rest of the economy (in percent, relative to same period of previous year)	...	34.1	50.3	62.0	60.6	77.6	79.3	81.4	62.4	40.5	32.4	26.2	31.7	29.0
M2 multiplier 3/	0.91	1.01	1.00	1.01	1.05	1.07	1.11	1.20	1.22	1.15	1.18	1.24	1.27	1.29
M3 multiplier 4/	1.83	1.81	1.85	1.85	1.94	1.91	2.05	2.19	2.14	2.12	2.20	2.28	2.32	2.25
M3 velocity 5/	8.90	7.64	7.91	7.58	7.14	6.77	6.81	6.41	6.07	6.30	6.25	6.03	5.84	5.74
Foreign exchange deposits in percent of total deposits	86.13	74.32	77.05	74.47	73.58	71.61	70.76	66.39	69.87	67.00	67.00	66.00	65.00	62.69

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

1/ Net foreign assets are valued at the program rate of 2.15 lari/US$, US$/SDR of 1.49 and US$/Euro of 1.27.
2/ Net foreign assets are valued at the program rate of 1.85 lari/US$, US$/SDR of 1.46 and US$/Euro of 1.21.
3/ M2 divided by reserve money.
4/ M3 divided by reserve money.
5/ Cumulative GDP over the previous 4 quarters divided by 4-quarter-average M3.

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

	Cumulative Change from End-December 2005								
	Mar. 2006		Jun. 2006		Sep. 2006		Dec. 2006		Mar. 2007
	Performance Criteria	Actual	Indicative Targets	Prelim.	Performance Criteria	Revised	Indicative Targets	Revised	Performance Criteria
	(In millions of lari)								
1. Quantitative targets									
Ceiling on cash deficit of the general government	34.7	3.0	65.4	155.0	138.2	252.0	345.6	342.0	393.0
Ceiling on net credit of the banking system to the general govt. (NCG)	0.0	-112.1	-17.7	-88.4	-50.7	-135.6	37.0	-872.4	-841.4
Ceiling on reserve money	42.9	-22.5	70.8	43.2	157.4	118.3	250.4	150.4	141.2
	(In millions of U.S. dollars)								
Floor on total net international reserves (NIR) of the NBG	1.8	16.3	40.2	61.2	118.7	134.5	151.6	559.8	526.2
Ceiling on contracting or guaranteeing of									
A. Nonconcessional medium- and long-term external debt	20.0	0.0	20.0	n.a.	20.0	20.0	20.0	20.0	25.0
B. Short-term external debt (less than one year)	0.0	0.0	0.0	n.a.	0.0	0.0	0.0	0.0	0.0
Ceiling on accumulation of external arrears	0.0	0.0	0.0	n.a.	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	39.5	-52.6	-3.5	-70.0	-62.2	-130.6	-30.1	-885.3	-832.3

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.

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.

Table 7. Georgia: Structural Performance Criteria (*) and Structural Benchmarks, 2005–06	
Measure	Timing and Status
Upgrade the *Fit and Proper* criteria for bank owners and managers to international standards, by submitting revisions to commercial banking law and related decrees.	End-December 2005; Status: met
Complete the transition to a treasury single account for central government expenditures and revenues. (*)	End-December 2005; Status: met
Complete electronic re-registration of existing taxpayers and registration of new taxpayers.	End-December 2005; Status: met
Introduce a targeted poverty benefit to replace numerous in-kind benefits.	End-December 2005 Status: not met
Publish a strategy paper on pension reform to put the social security system on a sounder fiscal footing.	End-December 2005; Status: met
Submit to parliament amendments to existing legislation that would prohibit government borrowing from the NBG under any circumstances. (*)	End-March 2006: Status: met
Submit legislation to parliament that will eliminate restrictions on the percent of total shares in a commercial bank that can be owned by an individual or legal entity.	End-March 2006; Status: met
Establish and populate a database of all central government LEPLs. (*)	End-March 2006; Status: not met
Prepare a Banking System Development Strategy for 2006-2009.	End-March 2006; Status: met
Prepare a detailed strategy for securitizing government debt to the NBG with the aim of providing additional tools of monetary policy and improving the operation of financial markets in Georgia.	End-March 2006 Status: met
Introduce a poverty alleviation program targeted on households living in extreme poverty. (*)	End-June 2006 Status: not met

Table 8. Georgia: Macroeconomic Framework, 2005–09

	2005	2006	2007	2008	2009
	Prel. Est.	Proj.			
	(Percent change)				
Output, prices, money, and external trade					
Real GDP	9.3	7.5	6.5	5.5	5.0
Consumer price index (average)	8.3	9.6	6.0	5.0	5.0
Broad money (M3, lari)	26.4	27.8	21.0	25.0	25.0
Exports (US$)	24.9	20.3	13.8	11.6	10.6
Imports (US$) 1/	26.6	31.8	15.9	5.2	6.9
	(In percent of GDP)				
General government					
Total revenues and grants	23.4	25.8	24.5	24.8	24.7
Tax revenues	19.8	21.6	21.5	21.8	22.0
Nontax revenues 2/	2.7	2.8	1.5	1.5	1.5
Grants	0.9	1.4	1.6	1.6	1.3
Expenditures and net lending	25.0	27.9	26.6	26.8	26.2
Current expenditure	20.7	23.7	22.5	22.4	22.1
Of which : external interest	0.3	0.4	0.4	0.4	0.3
Capital expenditure and net lending	4.2	4.2	4.1	4.4	4.1
Overall balance (commitment basis)	-1.5	-2.1	-2.1	-1.9	-1.5
Net change in expenditure arrears	-0.9	-0.4	0.0	0.0	0.0
Overall balance (cash basis)	-2.4	-2.5	-2.1	-1.9	-1.5
Financing	2.4	2.5	2.1	1.9	1.5
Privatization	3.6	9.0	2.0	0.3	0.1
Domestic financing	-0.9	-6.4	0.0	1.3	0.8
External financing (net)	-0.3	-0.2	0.1	0.3	0.5
Saving and investment					
Investment	26.3	27.4	28.1	28.1	27.2
General government	4.2	4.2	4.1	4.4	4.1
Nongovernment sector 1/	22.1	23.2	23.9	23.7	23.1
Of which : FDI	8.3	13.6	7.1	4.7	3.6
Gross domestic saving	20.9	17.5	16.6	19.2	19.7
General government	2.7	2.1	2.1	3.1	2.6
Nongovernment sector	18.2	15.4	14.6	16.2	17.1
Current account deficit 1/	5.4	9.9	11.5	8.8	7.5
	(In millions of U.S. dollars; unless otherwise indicated)				
Gross official reserves of the NBG 3/	474	1030	1089	1141	1265
(In months of imports of non-pipeline goods and services)	1.8	2.9	2.6	2.6	2.7
(In months of imports of goods and services)	1.7	2.8	2.6	2.6	2.7
External debt, public and guaranteed					
External debt stock	1,735	1,725	1,692	1,688	1,691
External debt service, total	190	222	192	165	128
Memorandum items:					
Nominal GDP (in millions of lari)	11,592	13,708	15,475	17,143	18,901
Nominal GDP (in millions of US$)	6,395	7,493	8,365	9,266	10,217
External debt stock (public and guaranteed; percent of GDP)	27.1	23.0	20.2	18.2	16.5
Domestic public debt (percent of GDP)	9.5	7.1	5.4	5.6	5.0
M3-velocity (M3 annual average)	7.3	6.4	6.0	5.7	5.4

Sources: Georgian authorities; and Fund staff estimates.

1/ Large oil and gas pipeline projects are projected to increase imports, investment, and the current account deficit substantially in 2003–06.
2/ Sustained increase in nontax revenues from 2006 onward reflects transit fees from the BTC oil pipeline and the South Causasus gas pipeline.
3/ International reserves are reported at current exchange rates and may differ from reserves at program rates as reported in the monetary accounts.

Table 9. Georgia: External Financing Requirements and Sources, 2004–10

(In millions of U.S. dollars)

	2004	2005	2006	2007	2008	2009	2010
Total requirements	-621	-540	-949	-1,091	-919	-840	-798
Current account deficit	-429	-347	-739	-958	-816	-768	-729
Capital outflows 1/	-192	-193	-209	-133	-103	-72	-69
Total sources	621	540	949	1,091	919	840	798
Capital inflows	714	519	1,393	1,088	961	958	923
Foreign direct investment	420	529	1,018	596	435	370	315
Disbursements to public sector	105	93	122	190	202	212	203
Private sector net inflows 2/	190	-104	254	302	324	376	405
Exceptional financing	99	113	112	62	10	5	5
IMF	21	41	41	42	0	0	0
World Bank	24	13	20	20	10	5	5
Macroeconomic support from the EU	0	0	0	0	0	0	0
Change in arrears, net (- decrease)	-52	0	0	0	0	0	0
Debt rescheduling obtained 3/	105	58	50	0	0	0	0
Change in reserves (- increase)	-192	-91	-556	-59	-53	-124	-131
Financing gap	0	0	0	0	0	0	0
Memorandum items			(In percent of GDP)				
Total requirements	-12.1	-8.4	-12.7	-13.0	-9.9	-8.2	-7.0
Total sources	12.1	8.4	12.7	13.0	9.9	8.2	7.0
Capital inflows	13.9	8.1	18.6	13.0	10.4	9.4	8.2
Exceptional financing	1.9	1.8	1.5	0.7	0.1	0.0	0.0
Change in reserves	-3.7	-1.4	-7.4	-0.7	-0.6	-1.2	-1.2

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

1/ Including scheduled public sector amortization and 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 10. Georgia: Indicators of Financial Obligations to the Fund, 2004–10
(In millions of SDR)

	2004	2005	2006	2007	2008	2009	2010
Total Fund credit outstanding	171.3	162.5	157.1	159.2	137.1	119.1	105.0
In percent of quota	114.0	106.8	104.5	105.9	91.2	79.2	69.9
In percent of GDP	4.9	3.8	3.1	2.8	2.2	1.8	1.4
In percent of exports of goods and non-factor services	8.7	6.2	5.1	4.6	3.6	2.9	2.3
Disbursements (PRGF)	14.0	28.0	28.0	28.0	0.0	0.0	0.0
Total obligations from existing and prospective drawings	38.1	37.6	34.4	26.6	22.6	18.4	14.5
Principal (repayments/repurchases)	37.0	36.7	33.4	25.9	22.1	18.0	14.1
Charges and interest	1.1	0.9	1.0	0.6	0.5	0.4	0.4
Total obligations to the Fund							
In percent of quota	25.4	25.0	22.9	17.7	15.0	12.2	9.6
In percent of GDP	0.7	0.6	0.5	0.3	0.2	0.2	0.1
In percent of exports of goods and non-factor services	2.9	2.1	1.7	1.1	0.9	0.7	0.5
Net credit from the Fund	-23.0	-8.7	-5.4	2.1	-22.1	-18.0	-14.1
Net resources from the Fund	-24.1	-9.6	-6.4	1.4	-22.6	-18.4	-14.5

Sources: IMF Finance Department; and Fund staff estimates and projections.

APPENDIX I: FUND RELATIONS

(As of July 31, 2006)

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

II. **General Resources Account:**	**SDR Million**	**Percent of Quota**
Quota	150.30	100.00
Fund holdings of currency	150.30	100.00
Reserve position in Fund	0.01	0.01

III. **SDR Department:**	**SDR Million**	**Percent of Allocation**
Holdings	7.27	N/A

IV. **Outstanding Purchases and Loans:**	**SDR Million**	**Percent of Quota**
PRGF Arrangements	158.44	105.41

V. **Latest Financial Arrangements:**

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn SDR Million)
PRGF	6/4/04	6/3/07	98.00	56.00
PRGF	1/12/01	1/11/04	108.00	49.50
PRGF	2/28/96	8/13/99	172.05	172.05

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

	Forthcoming				
	2006	**2007**	**2008**	**2009**	**2010**
Principal	15.33	25.94	22.11	17.96	14.10
Charges/interest	0.38	0.64	0.52	0.42	0.35
Total	15.71	26.57	22.63	18.38	14.45

VII. **Implementation of HIPC Initiative:**

Not applicable.

VIII. **Safeguards Assessments:**

Under the Fund's safeguards assessment policy, the National Bank of Georgia (NBG) is subject to an assessment with respect to the PRGF arrangement approved on June 4, 2004. The assessment was completed on December 10, 2004 and concluded that safeguards in place at the NBG appear generally adequate. However, certain vulnerabilities were identified in the internal audit and internal controls areas, and the safeguards assessment recommended measures to address them.

IX. **Exchange Arrangements:**

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."

X. **Article IV Consultation:**

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

XI. **FSAP Participation:**

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

XII. **Technical Assistance:**

See Table 1 of this Appendix.

XIII. **Resident Representative:**

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

XIV. **National Bank of Georgia Resident Advisors:**

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

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

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

Table 1. Georgia: Fund Technical Assistance Missions, 2001–06

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

Table 1. Georgia: Fund Technical Assistance Missions, 2001–06

Subject	Type of Mission	Timing	Counterpart
	Monetary and Financial Systems Department (MFD)		
Banking, foreign exchange reserve management, monetary programming, and research	Advisory	Feb. 26–Mar. 8, 2001	National Bank of Georgia
Payment Systems, Bank Supervision and Resolution, Internal Audit, Foreign reserve Management, and Research	Advisory	Oct. 23–Nov. 6, 2001	National Bank of Georgia
Payment Systems and Bank Resolution	Advisory	Mar. 11–19, 2002	National Bank of Georgia
Accounting and Audit, Anti-Money Laundering, Bank Supervision, and Monetary Operations	Advisory	Sep. 24–Oct 9, 2002	National Bank of Georgia
Payment Systems	Advisory	June 16–20, 2003	National Bank of Georgia
Government Securities Market, Deposit Insurance, Anti-Money Laundering	Advisory	April 20–30, 2004	National Bank of Georgia
Monetary Operations, Banking Sector Competition	Advisory	Oct. 24–Nov. 5, 2004	National Bank of Georgia
Liquidity management; trends in securities and insurance sectors	Advisory	April 18–29, 2005	National Bank of Georgia
	Statistics Department (STA)		
National Accounts	Follow-up assistance	Mar. 26–Apr. 6, 2001	State Department of Statistics
Balance of Payments Statistics	Follow-up assistance	February 13–27, 2002	State Department of Statistics
Money and Banking	Follow-up assistance	March 2–15, 2002	National Bank of Georgia
Data ROSC	Assessment of observance of standards and codes	July 15–31, 2002	State Department of Statistics, National Bank of Georgia, Ministry of Finance

Table 1. Georgia: Fund Technical Assistance Missions, 2001–06

Subject	Type of Mission	Timing	Counterpart
Balance of Payments Statistics	Follow-up assistance	May 20–June 3, 2003	State Department of Statistics
Government Finance Statistics	Follow-up assistance	Nov. 5-18, 2003	State Department of Statistics, Ministry of Finance
National Accounts	Follow-up assistance	April 26–May 7, 2004	State Department of Statistics
National Accounts	Follow-up assistance	April 18–29, 2005	State Department of Statistics
Price Statistics	Follow-up assistance	May 23–June 3, 2005	State Department of Statistics
Balance of Payments Statistics/International Investment Position	Follow-up assistance	June 15–28, 2005	State Department of Statistics and National Bank of Georgia
	Legal Department (LEG)		
Tax Code	Follow-up assistance	Jan. 28–Feb. 9, 2001	Ministry of Finance, Tax Inspectorate of Georgia
Tax Code	Follow-up assistance	Jul. 13–24, 2001	Ministry of Finance, Tax Inspectorate of Georgia

APPENDIX II: IMF-WORLD BANK RELATIONS

Partnership in Georgia's Development Strategy

1. The Government has prepared a second PRSP Progress Report– or the Economic Development and Poverty Reduction Program (EDPRP) Progress Report as it is known in Georgia. A Joint Staff Advisory Note has been prepared which together with the Progress Report on the EDPRP are being presented to the Boards of IDA and IMF in September 2006. The IMF is presenting the Staff Report of the Fourth Review under the PRGF arrangement to the IMF Board in September and the proposed Second Poverty Reduction Support Operation (PRSO II) is planned for consideration by the IDA Board of Executive Directors in October 2006. PRSO I, the first in a series of three PRSO was discussed and approved by the Board on September 15, 2005, along with a new Country Partnership Strategy (CPS) for FY06-09.

2. The Fund has taken the lead in assisting Georgia in improving macroeconomic stability and pursuing fiscal reforms. The World Bank has taken the lead in the policy dialogue on structural issues, focusing on: (i) strengthening public expenditure management; (ii) improving performance of the public sector; (iii) reducing corruption; (iv) deepening and diversifying sources of growth; (v) protecting the environment; and (vi) reducing poverty. Georgia is one of the largest IDA borrowers in the CIS, with borrowing of US$830.8 million for 40 operations. The PRSO program has supported further elaboration and implementation of the key elements of the Government's poverty reduction strategy as described in the PRSP Progress Report (or EDPRP Progress Report).

3. The PRSO program focuses on four central reform areas: (i) strengthening public sector accountability, efficiency, and transparency; (ii) improving electricity and gas sector services; (iii) improving the environment for private sector development; and (iv) improving social protection, education and health care services.

4. Other support has come in the form of project support and Analytic and Advisory Activities across a broad spectrum of areas including education, health care, social protection, energy, roads, water and sanitation, agriculture, agricultural research and extension, irrigation and drainage, forestry, environment, biodiversity, enterprise development, municipal development, judicial reform, and cultural heritage. A Public Expenditure Review (PER) was prepared in 2002, and a Trade Study in 2003. . A Country Procurement Assessment Report (CPAR) was prepared in 2002 and a Country Financial Accountability Assessment (CFAA) in 2003. Updates of these are scheduled for FY07. A series of annual programmatic Poverty Assessments are being implemented with the 2006 report to be issued shortly. A Country Economic Memorandum (CEM) is being prepared in FY07 and a Public Expenditure Review is planned for FY08.

5. Georgia became a shareholder and a member of IFC in 1995. As of January 1, 2006, IFC has invested around $137 million to finance projects in the financial, power, oil

and gas, and manufacturing sectors. IFC continues to explore the investment opportunities in partnership with strategic investors in both the financial and real sectors of the country. In the financial sector, IFC has focused on supporting the development of the housing finance market, providing credit lines and technical assistance to the leading banks – the Bank of Georgia and TBC Bank. To reach small and medium enterprises, IFC helped to establish ProCredit Bank of Georgia, the country's first bank specializing in lending to micro and small enterprises. Most recently, IFC has provided a credit line to TBC Leasing to support the rapid growth of their portfolio of SME clients; this project grows out of two year's of technical assistance to the Government and private sector to support the growth of the leasing sector.

6. In oil transit, IFC has provided equity and credit to local and international companies, including investments by British Petroleum and other sponsors in the construction of the Baku-Supsa Early Oil Pipeline and the Baku-Tbilisi-Ceyhan Pipeline. Other investment projects have been in electricity distribution (AES-Telasi), mineral water (GGMW), and glass bottle production (Ksani Glass Factory). IFC has also provided donor-supported technical assistance to strengthen its client banks, introduce new financial products (including leasing and housing finance), support public-private partnerships in the energy sector, and to improve the business climate and corporate governance practices.

7. The Foreign Investment Advisory Service (FIAS), a joint facility of IFC and the World Bank, carried out an Assessment of Administrative Procedures for Doing Business in 2003. FIAS finalized an advisory project in July 2004 to assist the Government in its efforts to remove administrative obstacles to investment to improve the business environment for private businesses, and the Private Enterprise Partnership (PEP) did an extensive study of the barriers to SMEs, finalized in early 2005.

8. Table 1 summarizes the division of responsibilities between the two institutions. In a number of areas—for example, the social sectors, rural development, environment, infrastructure, and judicial reform—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 development and energy, and Bank analysis serves as inputs into the Fund program. In other areas—the financial sector, public expenditure management, and civil service reform—both institutions are working together. Finally, in areas like monetary policy and domestic customs revenue, the IMF takes the lead.

IMF-World Bank Collaboration in Specific Areas

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

9. In the **social sectors**, IDA updates Georgia's Poverty Assessment based on quarterly household survey data. IDA's focus has been to improve execution of budgetary expenditures for health, education and poverty benefits and to raise the efficiency in the use

of scarce public resources. Through the Social Investment Fund credits, IDA is focusing in particular on areas with high poverty levels to provide basic infrastructure to the poorest communities. Through the PRSO program, IDA is strengthening the dialogue with the Government on social protection reform (safety nets, pensions, poverty benefits, labor market institutions and policies). Under the PRSO program, a poverty benefit targeted for the extreme poor is being implemented.

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

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

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

13. In **rural development**, IDA credits have supported development of private sector farming and agro-processing improvements, agricultural credit, irrigation and drainage, and agricultural research. IDA credits have also been supporting creation of local institutions, such as rural credit unions and water users associations. A recently approved Rural

Development Project is to develop the productivity and profitability of the private agriculture sector with the aim to increase incomes and employment and reduce poverty in rural areas

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

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

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

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

b) **Energy**. The energy system is in poor condition, with unreliable supply and unsustainable debts. However, under the PRSO program, the Georgian authorities have made progress and payment collections and service levels have improved substantially in the power sector. The Government of Georgia has been working with IDA and other donors, including the Fund, to implement a series of short-term action plans and longer-term steps to improve the overall functioning of the sector. IDA has also provided additional funding to the power sector in 2004. At the beginning of the PRGF program, the Fund has been focusing on reducing quasi-fiscal losses in the sector. The Bank through the PRSO program focused on improved bill collections, and supported the pursuit of tariff policies at cost-recovery levels was facilitated by a Bank-assisted review of the tariff policy methodology. The Georgian authorities prepared the Energy Sector Strategic Action Plan for 2005-08 which is being implemented and updated periodically under the PRSO program. In a new operation, the Bank will finance a feasibility study for a major, new hydropower plant that could add about 20 percent to the country's hydropower capacity.

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

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

Areas of shared responsibility

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

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

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

c) **Financial Sector Reforms**. The joint Financial Sector Assessment Program has supported: (i) strengthened banking and non-banking supervision; (ii) introduction of international accounting standards; (iii) consolidation of banks through higher capital requirement ratios; (iv) anti money-laundering legislation; (v) strengthening the regulatory environment and removing impediments for development of viable non-bank financial institutions; and (vi) strengthening the payment system. IFC has worked to strengthen the banking sector through investment and technical assistance, and has supported the development of the financial leasing market through technical assistance. The Fund has focused on banking supervision, anti-money laundering legislation, and improvements in monetary control instruments with extensive technical assistance from its Monetary and Financial Systems Department.

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

a) **Fiscal Framework and reforms in tax policy and tax and customs administration**. The Fund's focus on prudent fiscal policy has served as an important framework for IDA's work on public expenditure management. The Fund's Fiscal Affairs Department has the lead in the areas of tax policy and tax and customs administration reform.

b) **Economic Statistics.** IMF technical assistance has been conducive to improvements in national accounts, price, monetary and government financial statistics. The Bank's grant on Statistical Capacity Building will build on the recommendations of Fund TA to strengthen the quality of national accounts statistics.

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

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

World Bank Group strategy

On September 15, 2005, the World Bank Executive Board endorsed the new Country Partnership Strategy (CPS) for FY06-09 designed to assist Georgia with deeper institutional reform as well as more fundamental infrastructure improvements. *The CPS builds on the EDPRP, as well as emerging Government strategic thinking on the development framework. In doing so, it targets several goals: (i)* ***Generating growth and job creation*** *by removing barriers to private sector development and improving infrastructure, finance and markets; (ii)* ***Enhancing human development and social protection*** *through improved education, health, social protection, and community services; and (iii)* ***Strengthening public sector management and budgetary processes*** *to enable Georgia to better plan and meet its own development goals.*

Along with the CPS, the First PRSO, of a series of three single tranche annual Poverty Reduction Support Operations was approved of which US$13.5 million is a regular IDA credit and US$6.5 million is an IDA grant. The Second PRSO for US$ 20 million is being presented to the Bank's Board in October 2006. Other recent operations include a US$5 million Infrastructure Pre-Investment Facility Project, a US$3 million Public Sector Financial Management Reform Support Project, a US$24 million Reform Support Credit, a US$20 million Secondary and Local Roads Project, a US$3.6 million Electricity Market Support Project, a US$10 million Rural Development Project, and a US$5 million Irrigation and Drainage Community Development Project Additional Funding for flood control. The Bank continues its discussion with the Government on a more comprehensive medium-term reform strategy that would be supported by future Poverty Reduction Support Operations and technical assistance operations.

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

Table 1. Georgia: Bank-Fund Collaboration on Georgia

Area	Specialized Advice from the Fund	Specialized Advice from the Bank	Key Instruments
Economic Framework/Management	Monetary policy, exchange rate, fiscal, and trade policies, economic statistics	Economic growth, economic statistics	*IMF:* PRGF performance criteria and benchmarks on monetary and fiscal targets. *IDA:* The PRSO program; macromonitoring; Trade and Transport Facilitation Project; Financial Sector Advisory Work; Policy Options Report.
Budget	Budget framework, tax policy and administration, customs, debt management, extra-budgetary funds	Budget management, Public Expenditure Review, Country Procurement Assessment, Country Financial Accountability Assessment	*IMF:* PRGF performance criteria on overall fiscal balance and revenue collection. *Bank:* The PRSO program; Programmatic Public Expenditure Review
Public Sector Reform	Public asset management, audit of 3 problematic state-owned enterprises	Civil service reform (including pay and employment reform), anti-corruption agenda, decentralization	*IMF:* PRGF *IDA*: the PRSO program, and the Public Sector and Financial Management Reform Project
Social/Poverty	Prioritization of expenditure cuts to protect social spending	Poverty analysis; reforms in education, health, social protection; support to community driven development	*IMF:* PRGF *IDA*: Support through the PRSO program and IDA Credits for Education, Health and Social Investment Funds, Programmatic Poverty Assessment, SRS support for hospital restructuring, Pensions and Social Assistance Note, Policy work in health sector reform under the MTEF.
Private Sector Development		*Costs of Doing Business* Surveys. Support for improved legislation and regulatory framework for private sector	*IDA:* The PRSO program; Business Environment Study, Integrated Trade Development Strategy, Labor Market Study. *IFC:* investments and technical assistance.
Infrastructure		Private sector participation in infrastructure	*IDA*: Support though ongoing and proposed IDA Credits for Municipal Development and Decentralization Project II (MDDP II), Secondary and Local Roads, and Transport, Infrastructure Pre-Investment Facility. *IFC:* investments and advisory services.
Energy		Reforms and sector improvements	*IDA:* The PRSO program. Support through ongoing credits for Power, Energy Transit, technical assistance, and joint donor policy dialogue.
Rural development		Reforms in agriculture, irrigation, forestry and, environment	*IDA:* Support though Rural Infrastructure and Water Resource studies; ongoing rural Credits, and proposed Credits for Rural Development, Rural Telecommunications, Community Based Tourism.

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

APPENDIX III: RELATIONS WITH THE EBRD
(As of December 31, 2005)

1. As of December 31, 2005, the European Bank for Reconstruction and Development (EBRD) had signed 49 investments in Georgia with cumulative commitments totaling US$401.3 million.[1] Current Portfolio Stock equals to US$259.8 million. The EBRD's first operation, a power rehabilitation project, was signed in December 1994. Since then, the pace and composition of portfolio growth has varied significantly from year to year. Current portfolio includes thirty three private sector projects (of which five projects are regional). The ratio of private sector projects in the portfolio now stands at 80 percent.

2. During 2004, all operations signed in Georgia were in the private sector and amounted to US$95.2 million. The energy sector accounted for the largest share of signings – US$78.6 million. The Bank also provided an additional SME line of credit to a local bank for US$2.7 million, an equity increase in a local partner bank and expanded its Trade facilitation program by US$10.9 million. Financial support to the local production sector was also provided, including a US$1.1 million equity investment to a local private sector refreshment drinks producer and a US$1.2 million equity investment in a private local wine producer.

3. During 2005, the Bank signed 18 transactions in Georgia for US$105.9 million in total of which all but one were in the private sector and all were without sovereign guarantees. These included: three DIF equity investments (US$5.3 million) all in agribusiness; two MCFF risk sharing facilities with local banks (US$10.0 million); the first ever municipal transport project with no SG (US$3.4 million); one regional energy project (US$29.4 million); a wine bottling project (US$7.3 million); a SME credit line (US$10.0 million); two MCFF sub-loans (US$5.0 million); two bank capital increases (US$1.5 million); the first ever syndicated loan to a local bank (US$20.0 million in total, of which US$7.0 million on EBRD's account); the first loan to a local leasing company (US$3.0 million); and TFPs with three partner banks (US$24.1 million).

4. The EBRD is helping Georgia to benefit from its privileged location, transforming it into a regional transportation and natural resources hub. Georgia is part of the 'Early Transition Countries' (ETC) initiative. Launched in April 2004, the initiative aims to increase investments in the Bank's seven poorest countries. The initiative builds on international efforts to address poverty in these countries. Through this initiative, the EBRD will focus its efforts on private sector business development and selected public sector interventions. It aims to stimulate market activity by using a streamlined approach to financing, focusing on smaller projects, mobilizing more investment, and encouraging

[1] Evaluated at an exchange rate of US$1.183 per Euro.

ongoing economic reform. The Bank will accept higher risk in the projects it finances in the ETCs, while still respecting the principles of sound banking.

Table 1. Georgia: EBRD Portfolio for Georgia
As of December 31, 2005 (US$, million)

Project Name	Date of Agreement	Outstanding Amount
Public Sector Projects		
Power Rehabilitation Project	19-Dec-94	6.1
Georgia State Electro system	22-Dec-98	27.0
Georgia: Trans-Caucasian Rail Link Project	22-Dec-98	11.1
SOCAR - South Caucasus Gas Pipeline (regional)	4-Nov-04	9.0
Private Sector Projects		
Bank of Georgia Equity and Convertible Loan	16-Jul-98	2.4
Bank of Georgia – SME Loan	27-Jul-03	3.5
Bank of Georgia Capital Increase	16-Nov-05	1.0
MCFF Bank of Georgia Full Recourse Portion	14-Jun-05	5.0
MCFF TBC Bank Full Recourse Portion	13-Jun-05	5.0
MCFF TBC Bank Lomisi Ltd Sub Loan	03-Aug-05	3.5
MCFF - TBC Bank Nola Ltd Sub-Loan (NRP)	2-Dec-05	1.5
TBC Bank - SME Credit Line	19-Dec-03	6.0
TBC Bank SME Credit Line III	26-Sept-05	10.0
TBC Bank Syndicated Loan	20-Dec-05	7.0
TBC Leasing, Senior Debt	20-Dec-05	3.0
Intellectbank (Sub Project of Georgia SME)	11-Nov-97	0.5
TbilComBank (Sub Project of Georgia SME)	12-Dec-96	0.6
TbilcreditBank (Sub Project of Georgia SME)	12-Dec-96	0.0
United Georgian Bank	20-Nov-97	3.2
ProCredit Bank, Georgia (Formerly MBG)	30-Mar-00	2.6

ProCredit Bank, Georgia - Senior Loan	11-Oct-01	6.0
TFP: Bank of Georgia (Guarantee & Pre-export)	2-Mar-01	17.2
TFP: TBC Bank (Guarantee & Pre-export)	17-Aug-99	4.5
TFP: United Georgian Bank	31-Mar-01	1.9
JSC Channel Energy Poti Port	19-Mar-02	10.2
Tbilisi Public Transport	29-Jul-05	3.7
Georgian Wines	29-Sep-99	0.6
Georgian Wines & Spirits Ltd	10-March-05	7.3
DIF Iberia Refreshments	25-Sep-03	2.2
DIF Teliani Valley	20-May-2004	1.1
DIF Delidor	17-June-05	1.5
DIF-Lomisi Ltd	20-Dec-05	3.0
Baku-Tbilisi-Ceyhan (BTC) Pipeline (regional)	03-Feb-04	62.5
Lukoil Overseas : South Caucasus Gas Pipeline (regional)	28-Jul-05	29.4
Regional Fund Investments		0.7
Total		**259.8**

1/ US$ amounts calculated at an exchange rate of US$1.183 U.S. dollars per Euro, as of December 31, 2005.

APPENDIX IV: STATISTICAL ISSUES

1. The Fund has provided Georgia with substantial technical assistance in the compilation of macroeconomic statistics (Appendix I, Table 1). Despite improvements in the areas of national accounts, price, monetary, and government finance statistics, the quality of macroeconomic statistics remains poor, reflecting deficiencies in statistical methodologies, coverage, and insufficient resources. Problems are particularly acute in the compilation of national accounts, balance of payments, foreign trade, and fiscal statistics. Nonetheless, the core statistical indicators compiled by the authorities are provided on a timely basis and are generally adequate for surveillance and program monitoring. The data module of the Report on the Observance of Standards and Codes (ROSC), prepared in July 2002 was published on the Fund's external website on May 27, 2003. In August 2005, the authorities notified the Fund of their commitment to participate in the IMF's General Data Dissemination System (GDDS), and appointed a national GDDS coordinator. As a next step to formal GDDS participation, the authorities will need to prepare GDDS metadata and plans for statistical improvement. A STA mission to assist the authorities in their preparation for participation in the GDDS is planned for November 2006.

Real sector

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

Money and banking

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

recommended increased transparency regarding access by governmental agencies to monetary statistics prior to their release to the public.

4. In response to a request from STA, the NBG has compiled a pilot set of monetary data using the framework of the new Standardized Report Forms (SRF). Subsequent STA review of the data validated the resulting monetary aggregates and the NBG has been providing regular updates of these data to STA. These data will be published in the forthcoming *IFS Supplement.* Also, beginning from December 2001, data published in *IFS* have been revised in accordance with the SRF.

Government finance

5. Government finance statistics (GFS) on a cash basis are reported to STA for publication in the *GFS Yearbook.* Classification broadly follows the analytic framework of the 1986 *Government Finance Statistics Manual*, but the concepts and definitions of revenue, expenditure, and financing differ from the international standard in significant respects. In addition, the central treasury and line departments employ differing accounting systems, with the treasury having a single-entry cash basis. The single-entry system hampers the treasury's capacity to reconcile bank statements and hinders the reporting of information on accounts payable. Another issue concerns the limited budget classifications available for expenditure. Discrepancies can arise when matching budget appropriations with the classified expenditure because the locally developed structure of expenditure codes changes frequently. Consequently, statistical performance and reliable budget reporting could improve once the treasury adopts internationally accepted accounting standards, including a unified treasury general ledger maintained on a double-entry cash basis. There are substantial differences in the classification systems of different government subsectors. Bridge tables linking national classification codes and the *Government Finance Statistics Manual 2001 (GFSM 2001)* codes were established by a GFS mission in 2003 and used in 2004 to report 2004 GFS in the *GFS Yearbook*. The authorities plan to compile and disseminate government finance statistics on a *GFSM 2001* basis starting in 2007.

Balance of payments

6. A June 2005 balance of payments (BOP) statistics mission found that the authorities have partially implemented the recommendations of the 2002 data ROSC and 2002 and 2003 BOP missions. The State Department of Statistics (SDS): (1) expanded the data sources for several of the balance of payments items, such as transportation, travel, insurance, communications, government services, and current and capital transfers; (2) implemented new software for the database of customs declarations; and (3) produced the balance of payments in the standard format recommended by the Fund, with the separate identification of exceptional financing transactions. The mission also found that the Customs Department (CD) improved the trade data collection system by (1) installing in all of the customs offices the ASYCUDA client-server system, which is designed to maintain the customs declarations

database in real time; (2) elaborating and implementing the instructions for completing customs declarations; and (3) improving verification of customs declarations. However, SDS failed to improve staffing arrangements; on the contrary, during the latest SDS reorganization, the number of permanent staff was reduced, while communication equipment was upgraded. The June 2005 BOP statistics mission focused on (1) analyzing the situation in which the NBG plans to assume the responsibility for the compilation of the balance of payments; (2) reviewing estimation methods for compiling data on various components of the balance of payments, with particular attention for the estimation of workers' remittances and compensation of employees; and (3) identifying data sources, collecting preliminary data, and producing a partial international investment position statement. As reflected in the MEFP, agreement has been reached between the SDS and the NBG to move the main responsibility for compiling BOP data to the NBG. A follow up technical assistance mission in balance of payments statistics is planned for September 6−19, 2006.

GEORGIA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(as of August 29, 2006)

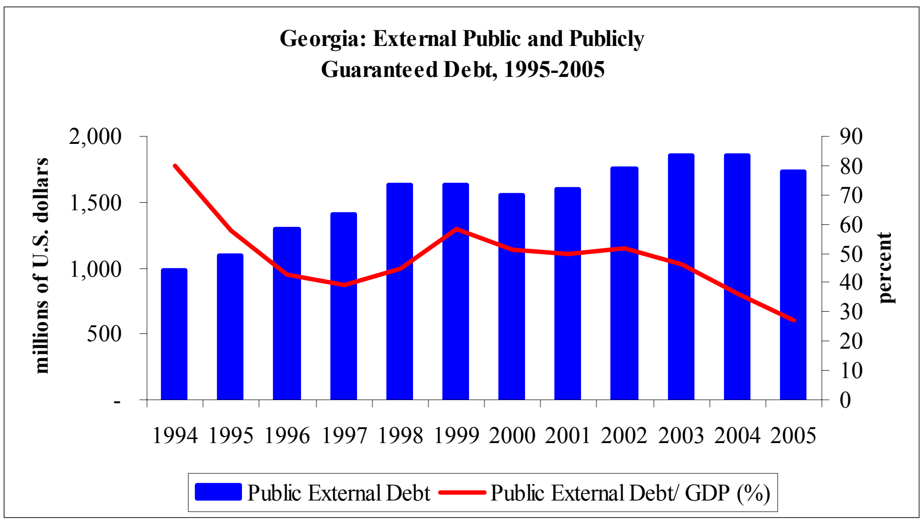
	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]	Memo Items:	
						Data Quality – Methodological soundness[7]	Data Quality – Accuracy and reliability[8]
Exchange Rates	8/21/06	8/22/06	D	W	M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	8/21/06	8/22/06	D	W	M		
Reserve/Base Money	7/06	8/10/06	M	M	M	O, LO, LO, O	O,O,O,O,LO
Broad Money	7/06	8/17/06	M	M	M		
Central Bank Balance Sheet	7/06	8/10/06	M	M	M		
Consolidated Balance Sheet of the Banking System	7/06	8/17/06	M	M	M		
Interest Rates[2]	7/31/06	8/10/06	W	W	M		
Consumer Price Index	7/06	8/7/06	M	M	M	O,LO,O,O	LO,LO,O,O,O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	7/06	8/23/06	M	M	M	LNO,LO,LNO, O	LO,O,LO,O,O
Stocks of Central Government and Central Government-Guaranteed Debt[5]	8/05	9/14/05	M	M	M Domestic not disseminated		
External Current Account Balance	Q1/06	6/30/05	Q	Q	Q	O,LO,LO,LO	LNO,LNO, LNO,LNO, LNO
Exports and Imports of Goods and Services	6/06	08/15/06	M	M	M		
GDP/GNP	Q1/06	6/27/06	Q	Q	Q	O,LO,O,LO	LNO,LNO,LNO, LO,LO
Gross External Debt	08/05	09/06/05	M	M	M		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).
[7] Reflects the assessment provided in the data ROSC (published on May 27. 2003, and based on the findings of the mission that took place during July 15 – 31, 2002) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[8] Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

APPENDIX V: DEBT SUSTAINABILITY ANALYSIS (DSA)[1]

Background

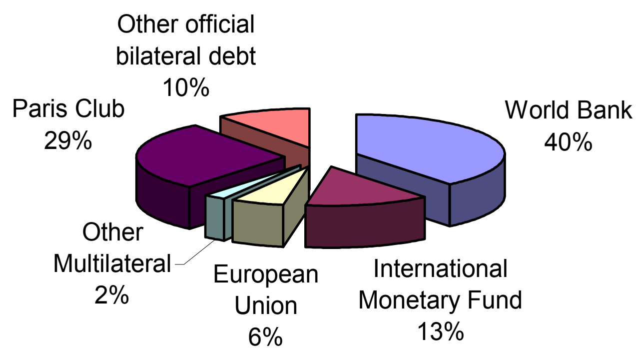
1. **Over the last decade, Georgia's external public and publicly guaranteed (PPG) debt burden has fallen from more than 80 percent of GDP to less than 30 percent.** Heavy borrowing for energy imports in the initial years after independence account for the rapid build-up of external PPG debt. The stock exceeded $1 billion by the end of 1995. Owing to robust growth, the debt-to-GDP ratio declined to below 50 percent in 1996–98, before the sharp depreciation of the lari against the U.S. dollar during the Russia crisis wiped out some of this gain. The debt-to-GDP ratio has again been declining since then. The pace increased after the Rose revolution as a result of strong growth, restrained borrowing and fast repayment of energy debt to Turkmenistan.



2. **Over the same period, the composition of Georgia's external PPG debt by creditor changed markedly.** Whereas bilateral debt comprised over 80 percent of total external debt ten years ago, this share dropped to less than 40 percent by end-2005. By contrast, the share of multilateral creditors increased from under 5 percent in 1994 to more than 60 percent. This change in creditor composition has resulted in a significant increase in the degree of concessionality. The grant element in 2005 was higher than 30 percent.

[1] Prepared jointly by IMF and World Bank staffs.

Georgia: Creditor Composition of PPG External Debt, 2005



3. **The recent positive developments need to be sustained to avoid the debt legacy of the past.** External debt service payments reached about 70 percent of exports of goods and services in 1995. The very low levels of fiscal revenues excluding grants at less than 13 percent of GDP for much of the 1990s made servicing external debt particularly problematic. As a result, a series of rescheduling agreements since 1995 were concluded[2], but arrears continued to accumulate through 2004, including on the rescheduled debt. In contrast to the past, today external debt service payments amount to 13 percent of exports (on an accrual basis). Fiscal non-grant revenues on the order of 24 percent of GDP have eased the fiscal financing constraint on debt servicing as well.

4. **From a peak of 17 percent of GDP in 2000, the stock of domestic PPG debt steadily declined to about 10 percent at end-2005.** This amounts to about 26 percent of total general government debt at the time. Debt to the National Bank of Georgia (NBG) accounted for about 75 percent of this amount. The remaining amount of domestic general government liabilities were mostly expenditure arrears. In terms of domestic debt and bond issues, the medium term strategy of Georgia is to gradually replace the NBG debt with government securities.

5. **Public debt for the purpose of this DSA is defined narrowly on a gross basis and excludes debt owed by (formerly) state-owned enterprises, especially in the energy sector.** Serious data issues hamper the analysis of SOE debt. Moreover, large debt write-offs and other forms of debt settlement are expected in the near future in the context of the privatization of state-owned enterprises and rehabilitation of the energy sector. This DSA

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[2] They include eleven bilateral rescheduling agreements in 1995-98, followed by the first Paris Club flow rescheduling on Houston terms in 2001. A debt treatment under the Evian approach was granted in 2004, which includes a goodwill clause to reconsider Georgia's debt situation at the end of the current agreement. Bilateral agreements on terms comparable to the 2004 Paris Club flow rescheduling are in place with all non-Paris Club creditors except Kazakhstan.

also excludes contingent liabilities from the Soviet era, including deposits at the former state savings bank. Amounts outstanding and the terms of their treatment (if any) are very uncertain. External debt excludes private sector debt for lack of data. The outstanding stock is thought to be small. However, commercial bank data suggest that these liabilities could be growing fast. The authorities are therefore encouraged to continue their efforts to collect more systematically data on private bank and non-bank indebtedness abroad.

Debt sustainability analysis

6. **Georgia's debt distress risk is low.**[3] The baseline scenario indicates that the risk of debt distress is low, and remains so throughout the projection period. All external debt indicators are well below the relevant debt-burden thresholds. However, some debt indicators remain vulnerable to stress testing of key variables.

Indicative External Debt Burden Indicators 1/
(in percent)

	Georgia (strong policy performer)		Thresholds by policy performance		
	2005	2006-016 2/	Weak	Medium	Strong
NPV of debt in percent of:					
Exports	92	56	100	150	200
GDP	23	14	30	40	50
Revenues 3/	102	64	200	250	300
Debt service in percent of:					
Exports	14	4	15	20	25
Revenues 3/	12	5	25	30	35

1/ A country with a CPIA rating equal or below 3.25 is considered a weak policy performer, while a CPIA rating above 3.75 indicates strong performance. The stronger the performance, the higher the debt ratios consistent with sustainability. Refer to Figure 1b.
2/ Simple average.
3/ Excluding grants.

7. **Under the baseline scenario (Box 1), debt ratios remain on a downward trend (Table 1a and Figure 1a).** Public debt falls from about 36 percent of GDP at end-2005 to 20 percent at end-2010 and continues to decline thereafter. In net present value (NPV) terms, public debt at about 137 percent of revenues is expected to fall by 60 percent before the end of the decade. The debt service-to-revenue ratio is estimated to improve from 17 percent of fiscal non-grant revenues in the base year to 5 percent in 2010.

8. **Official external debt indicators also fall steadily under the baseline scenario with debt ratios continuing to shrink gradually (Table 1b and Figure 1b).** Georgia's external public debt stood at about 27 percent of GDP at end-2005, equivalent to 92 percent of exports in NPV terms. Debt service ratios are also comfortably below the relevant thresholds for a strong policy performer.

[3] The CPIA for Georgia has been upgraded from medium to strong performer in June, 2006 due to the recent improvement in the policy and institutional performance.

9. **Alternative scenarios and bound tests are constructed to examine the sensitivity of the baseline projection of PPG debt to a range of potential shocks (Tables 2a and 2b).** Most of these factors would not jeopardize Georgia's debt sustainability. The main exception is a temporary decline of export value growth for two years to one standard deviation below historical averages. In this case, the NPV of debt-to-exports ratio would rapidly increase in the medium term, even if the gap were financed at better than commercial terms (30 percent grant element). This outcome does not bode well in light of recent trade developments. Export volumes of scrap metal, Georgia's main export commodity, are dwindling while Russia imposed import bans on Georgian wine, mineral water, tea, and citrus fruits. With official reserves relatively low (at about 3 months of imports), this could erode hard gained exchange rate stability.

Box 1. Georgia: Macroeconomic Assumptions Underlying the DSA

A baseline macroeconomic framework similar to the ones used in previous exercises also underpins this DSA:

Real GDP growth is estimated to be 7.5 percent in 2006 before gradually falling to a projected 5 percent in 2009 and 4 percent in 2016 as Georgia progresses toward a higher income level. Long-run equilibrium growth is assumed to be sustained at 3.5 percent after 2019.

Inflation is assumed to fall from a projected 10 percent in 2006 to 5 percent by 2008. A further decline to 4 percent during 2011–15 and 3 percent thereafter is assumed, keeping pace with overall macroeconomic improvement. The **real exchange rate** relative to the dollar is assumed to appreciate at almost 3 percent per year in 2006–15, when substantial foreign capital is expected to flow into Georgia in a fast growing period. After 2015, the real exchange rate is assumed to appreciate at a much slower pace—less than one percent per year.

Export growth is projected to average more than 13 percent over 2006–10, before declining to about 6 percent for the remainder of the projection period. **Import growth** is expected to average close to 13 percent over 2006–10, before converging to 6 percent for the remainder of the projection period.

Somewhat different than earlier exercises, the average **external current account deficit** is forecast to remain above 7 percent of GDP for most of 2006–10 and would converge to 5 percent of GDP on average during the remainder of the projection period to support a faster modernization of the Georgian economy than previously assumed.

Regarding **fiscal policy**, the authorities are expected to build on the recent success of their tax and governance reforms. Tax revenues are projected to amount to about 22 percent of GDP in 2006, gradually improving to a long-run level of about 23 percent. Government spending is expected to remain stable at around 25 percent of GDP. As a result, the overall deficit would fall from less 1.8 percent of GDP in 2006–09 to less than 1.1 percent in 2010–16, followed by a balanced budget.

Small financing gaps are filled with **new public borrowing** largely on concessional terms. The bulk of the financing of the external current account deficit will be private both on the creditor and debtor side, as expected for a country in Georgia's per capita income group.

10. **A temporary widening of the annual current account deficit (by 5 percentage points of GDP each year in 2007–09) would not lead to key debt indicators breaching indicative thresholds.** Such a scenario would only have temporary effects on the debt stock ratios through the medium term. However, debt service relative to exports would be permanently higher compared to the baseline. The assumed current account deterioration

could be the result of a further deterioration of economic relations with Russia resulting in a sharp increase in the price of gas from Russia before Georgia can access alternative sources and/or a temporary disruption of remittance inflows before alternative money transfer channels are found. Restricted access to concessional credit will have permanent effects on NPV ratios (Table 2b, scenario A2). If the decline in concessionality of the new borrowing assumed in the baseline is limited to a 2-percentage point higher interest rate, however, key ratios do not breach indicative thresholds over the projection period.

11. **The main risk to fiscal debt sustainability would be a decline in GDP growth.** The NPV of debt-to-GDP ratio would rise to 30 percent in the long run in the case of permanent slow down of GDP growth. This permanent shock to real GDP growth would also push the NPV of debt-to-revenues ratio to 128 percent by 2026. Against this background, the authorities should continue to strengthen competitiveness of their tradable sector and improve the business climate to support baseline growth.

Table 1a.Georgia: Public Sector Debt Sustainability Framework, Baseline Scenario, 2003-2026
(In percent of GDP, unless otherwise indicated)

	Actual					Estimate	Projections								
	2003	2004	2005	Historical Average 5/	Standard Deviation 5/	2006	2007	2008	2009	2010	2011	2006-11 Average	2016	2026	2012-26 Average
Public sector debt 1/	58.9	48.9	36.4			30.4	25.6	23.8	21.5	20.2	18.2		12.2	4.7	
o/w foreign-currency denominated	45.6	34.5	26.8			23.3	20.2	18.2	16.5	15.3	14.0		9.9	4.1	
Change in public sector debt	-3.7	-10.1	-12.5			-5.9	-4.8	-1.8	-2.3	-1.3	-2.0		-0.7	-0.4	
Identified debt-creating flows	-5.6	-18.1	-10.6			-11.2	-2.0	-1.3	-1.3	-1.0	-0.5		-0.1	-0.2	
Primary deficit	0.4	-4.4	0.5	1.6	3.0	1.2	1.4	0.6	0.2	0.5	0.8	0.8	0.4	0.0	0.1
Revenue and grants	16.2	22.0	23.4			25.8	24.5	24.5	25.0	24.8	24.5		24.8	25.1	
of which : grants	0.6	1.3	0.9			1.4	1.6	1.6	1.4	1.2	0.7		0.3	0.2	
Primary (noninterest) expenditure	16.6	17.6	23.9			27.0	25.9	25.1	25.2	25.3	25.3		25.2	25.2	
Automatic debt dynamics	-5.6	-11.8	-7.0			-4.0	-2.7	-1.6	-1.4	-1.4	-1.3		-0.5	-0.2	
Contribution from interest rate/growth differential	-5.4	-4.1	-4.9			-3.0	-1.9	-1.1	-0.9	-0.8	-0.8		-0.4	-0.2	
of which : contribution from average real interest rate	0.8	-0.8	-0.8			-0.5	-0.1	0.2	0.2	0.2	0.2		0.1	0.0	
of which : contribution from real GDP growth	-6.2	-3.3	-4.2			-2.5	-1.9	-1.3	-1.1	-1.0	-1.0		-0.5	-0.2	
Contribution from real exchange rate depreciation	-0.2	-7.7	-2.0			-1.0	-0.8	-0.5	-0.5	-0.6	-0.6		...	...	
Other identified debt-creating flows	-0.3	-2.0	-4.1			-8.4	-0.6	-0.3	-0.1	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	-0.3	-0.9	-3.6			-8.0	-0.6	-0.3	-0.1	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	-1.1	-0.5			-0.4	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	2.0	8.1	-2.0			5.3	-2.8	-0.5	-1.0	-0.4	-1.4		-0.7	-0.2	
NPV of public sector debt	53.0	42.6	32.2			27.1	23.5	22.1	20.5	19.3	17.5		11.7	5.1	
o/w foreign-currency denominated	39.6	28.3	22.7			20.0	18.1	16.5	15.5	14.4	13.3		9.4	4.4	
o/w external	39.6	28.3	22.7			20.0	18.1	16.5	15.5	14.4	13.3		9.4	4.4	
NPV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	9.0	9.1	10.1			9.9	8.5	7.0	5.7	5.4	5.4		3.0	1.5	
NPV of public sector debt-to-revenue ratio (in percent) 3/	…	193.4	137.4			105.2	95.9	90.3	82.1	77.9	71.6		47.0	20.1	
o/w external	…	128.3	96.8			77.5	73.9	67.4	62.2	58.3	54.3		37.8	17.5	
Debt service-to-revenue ratio (in percent) 3/ 4/	36.6	22.5	17.3			14.3	9.5	8.0	6.0	5.4	5.3		2.3	0.9	
Primary deficit that stabilizes the debt-to-GDP ratio	4.0	5.7	13.0			7.1	6.2	2.4	2.5	1.8	2.8		1.2	0.4	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	11.1	5.9	9.3	6.5	3.5	7.5	6.5	5.5	5.0	5.0	5.0	5.8	4.0	3.5	4.1
Average nominal interest rate on forex debt (in percent)	2.1	1.2	1.1	2.9	1.9	1.7	1.9	2.1	1.7	1.6	1.4	1.7	1.1	1.2	1.1
Average real interest rate on domestic currency debt (in percent)	6.2	-2.0	-2.0	0.0	4.1	-3.4	-0.5	4.5	5.1	6.0	5.8	2.9	6.3	6.1	7.2
Real exchange rate depreciation (in percent, + indicates depreciation)	-0.5	-18.1	-6.5	-2.3	16.0	-3.9	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	3.5	8.4	7.9	10.5	15.3	10.0	6.0	5.0	5.0	5.0	5.0	6.0	3.0	3.0	3.3
Growth of real primary spending (deflated by GDP deflator, in percent)	16.7	12.3	48.2	11.6	16.6	21.2	2.2	2.5	5.2	5.3	5.2	6.9	3.8	3.8	4.0
Grant element of new external borrowing (in percent)	25.7	36.0	33.3	25.6	9.2	42.1	48.1	59.2	58.6	59.4	45.7	52.2	35.0	...	...

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

1/ [Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.]

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 generally derived over the past 10 years, subject to data availability.

Table 1b. Georgia: External Debt Sustainability Framework, Baseline Scenario, 2003-2026 1/
(In percent of GDP, unless otherwise indicated)

	Actual			Historical Average	Standard Deviation	Estimate	Projections								
	2003	2004	2005	1999-2005		2006	2007	2008	2009	2010	2011	2006-11 Average	2016	2026	2012-26 Average
External debt (nominal) 1/	**46.3**	**36.2**	**27.1**	**...**	**...**	**23.0**	**20.2**	**18.2**	**16.5**	**15.4**	**14.1**	**...**	**9.9**	**4.1**	...
Of which : public and publicly guaranteed (PPG)	46.3	36.2	27.1	...	...	23.0	20.2	18.2	16.5	15.4	14.1	...	9.9	4.1	...
Change in external debt	-5.3	-10.1	-9.1	...	...	-4.1	-2.8	-2.0	-1.7	-1.2	-1.3	...	-0.5	-0.3	...
Identified net debt-creating flows	-8.8	-10.1	-10.0	...	...	-5.5	3.1	3.1	3.1	2.9	3.1	...	4.0	4.2	...
Non-interest current account deficit	**6.3**	**7.7**	**4.8**	**5.7**	**1.3**	**9.4**	**11.0**	**8.5**	**7.3**	**6.2**	**5.6**	**8.0**	**5.2**	**5.3**	**5.2**
Deficit in balance of goods and services	15.0	14.0	14.6	...	...	18.8	20.0	17.5	16.1	14.7	13.7	...	11.6	10.3	...
Exports	18.3	24.8	24.8	...	...	25.5	26.0	26.2	26.3	26.0	25.3	...	21.6	20.0	...
Imports	33.3	38.8	39.4	...	...	44.4	46.0	43.7	42.4	40.7	39.1	...	33.2	30.3	...
Net current transfers (negative = inflow)	-6.6	-6.7	-8.0	-6.8	0.9	-8.8	-7.8	-7.9	-7.5	-7.1	-6.7	...	-5.1	-3.8	**-4.7**
Other current account flows (negative = net inflow)	-2.1	0.4	-1.8	...	...	-0.7	-1.2	-1.1	-1.3	-1.4	-1.4	...	-1.4	-1.3	...
Net FDI (negative = inflow)	**-8.4**	**-8.2**	**-8.3**	**-6.2**	**2.8**	**-13.6**	**-7.1**	**-4.7**	**-3.6**	**-2.8**	**-2.0**	**-5.6**	**-1.0**	**-0.9**	**-1.0**
Endogenous debt dynamics 2/	**-6.7**	**-9.5**	**-6.6**			**-1.3**	**-0.8**	**-0.7**	**-0.6**	**-0.5**	**-0.5**	**...**	**-0.3**	**-0.1**	**...**
Contribution from nominal interest rate	1.0	0.7	0.6	...	...	0.5	0.4	0.3	0.3	0.2	0.2	...	0.1	0.0	...
Contribution from real GDP growth	-4.9	-2.1	-2.7	...	...	-1.7	-1.2	-1.0	-0.8	-0.7	-0.7	...	-0.4	-0.1	...
Contribution from price and exchange rate changes	-2.9	-8.1	-4.5	...	...	…	…	…	…	…	…	...	…	…	...
Residual (3-4) 3/	**3.5**	**0.0**	**0.9**	**...**	**...**	**1.3**	**-5.9**	**-5.1**	**-4.7**	**-4.1**	**-4.4**	**...**	**-4.4**	**-4.6**	**...**
Of which : exceptional financing	-1.4	2.2	0.3	...	...	7.6	0.6	0.4	0.8	0.7	1.1	...	0.8	0.3	...
NPV of external debt 4/	...	...	22.9	...	...	19.8	18.1	16.5	15.6	14.5	13.4	...	9.4	4.4	...
In percent of exports	...	...	92.3	...	...	77.5	69.7	63.1	59.2	55.9	52.8	...	43.4	22.0	...
NPV of PPG external debt	**...**	**...**	**22.9**	**...**	**...**	**19.8**	**18.1**	**16.5**	**15.5**	**14.5**	**13.4**	**...**	**9.4**	**4.4**	**...**
In percent of exports	...	...	92.2	...	...	77.5	69.7	63.1	59.1	55.9	52.8	...	43.4	22.0	...
Debt service-to-exports ratio (in percent)	26.6	18.0	14.2	...	...	12.9	7.7	5.7	3.8	3.3	3.3	...	1.7	1.2	...
PPG debt service-to-exports ratio (in percent)	26.6	17.8	14.1	...	...	12.9	7.7	5.7	3.7	3.3	3.2	...	1.7	1.2	...
Total gross financing need (billions of U.S. dollars)	0.1	0.2	0.1	...	...	-0.1	0.5	0.5	0.5	0.5	0.6	...	1.0	1.7	...
Non-interest current account deficit that stabilizes debt ratio	11.7	17.7	13.9	...	...	13.5	13.8	10.5	8.9	7.4	6.9	...	5.6	5.6	...
Key macroeconomic assumptions															
Real GDP growth (in percent)	11.1	5.9	9.3	6.1	3.4	7.5	6.0	5.5	5.0	5.0	5.0	5.7	4.0	3.5	4.2
GDP deflator in U.S. dollar terms (change in percent)	5.9	21.3	14.1	3.2	12.7	9.0	5.3	5.0	5.0	5.6	6.2	6.0	3.3	3.0	3.6
Effective interest rate (percent) 5/	2.3	2.0	2.0	3.3	2.2	2.0	2.1	1.7	1.7	1.5	1.4	1.7	1.3	0.0	1.0
Growth of exports of G&S (U.S. dollar terms, in percent)	32.1	74.1	24.9	37.0	25.5	20.3	13.8	11.6	10.6	9.6	8.6	12.4	6.0	6.0	6.1
Growth of imports of G&S (U.S. dollar terms, in percent)	33.9	49.9	26.6	28.5	19.3	31.8	15.9	5.2	6.9	6.5	7.0	12.2	5.5	6.0	5.9
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	35.3	32.8	32.9	31.0	31.8	33.4	32.9	32.4	29.7	34.3
Memorandum item:															
Nominal GDP (billions of U.S dollars)	4.0	5.1	6.4	...	...	7.5	8.4	9.3	10.2	11.3	12.6	...	20.0	38.6	...

Source: Staff simulations.

1/ Includes public sector external debt.
2/ Derived as $[r - g - \rho(1+g)]/(1+g+\rho+g\rho)$ times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.
3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.
4/ Assumes that NPV of private sector debt is equivalent to its face value.
5/ Current-year interest payments devided by previous period debt stock.

Table 2a.Georgia: Sensitivity Analysis for Key Indicators of Public Debt 2006-2026

	Estimate	Projections						
	2006	2007	2008	2009	2010	2011	2016	2026
NPV of Debt-to-GDP Ratio								
Baseline	27	24	22	21	19	18	12	5
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	27	24	23	22	21	20	16	16
A2. Primary balance is unchanged from 2005	27	23	21	20	19	17	10	8
A3. Permanently lower GDP growth 1/	27	24	23	22	21	20	19	32
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2007-2008	27	25	25	24	24	23	20	20
B2. Primary balance is at historical average minus one standard deviations in 2007-2008	27	26	27	25	24	22	15	7
B3. Combination of B1-B2 using one half standard deviation shocks	27	25	26	24	22	20	14	6
B4. One-time 30 percent real depreciation in 2007	27	32	30	28	26	24	16	8
B5. 10 percent of GDP increase in other debt-creating flows in 2007	27	31	29	27	25	23	16	8
NPV of Debt-to-Revenue Ratio 2/								
Baseline	105	96	90	82	78	72	47	20
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	106	97	93	88	86	80	63	63
A2. Primary balance is unchanged from 2005	104	92	86	79	75	68	42	33
A3. Permanently lower GDP growth 1/	106	97	93	87	85	82	78	128
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2007-2008	106	102	102	97	96	92	81	80
B2. Primary balance is at historical average minus one standard deviations in 2007-2008	106	106	112	102	96	89	60	28
B3. Combination of B1-B2 using one half standard deviation shocks	106	103	105	95	90	83	55	25
B4. One-time 30 percent real depreciation in 2007	106	129	121	111	104	96	63	30
B5. 10 percent of GDP increase in other debt-creating flows in 2007	106	126	118	108	102	94	64	31
Debt Service-to-Revenue Ratio 2/								
Baseline	14	10	8	6	5	5	2	1
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	14	9	8	6	5	5	3	3
A2. Primary balance is unchanged from 2005	14	9	8	6	5	5	2	1
A3. Permanently lower GDP growth 1/	14	10	8	6	6	6	3	6
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2007-2008	14	10	8	7	6	6	4	4
B2. Primary balance is at historical average minus one standard deviations in 2007-2008	14	9	8	7	6	6	3	2
B3. Combination of B1-B2 using one half standard deviation shocks	14	10	8	7	6	6	3	1
B4. One-time 30 percent real depreciation in 2007	14	10	9	6	6	6	2	1
B5. 10 percent of GDP increase in other debt-creating flows in 2007	14	9	9	7	6	6	4	2

Sources: Country authorities; and Fund staff estimates and projections.
1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of 20 (i.e., the length of the projection period).
2/ Revenues are defined inclusive of grants.

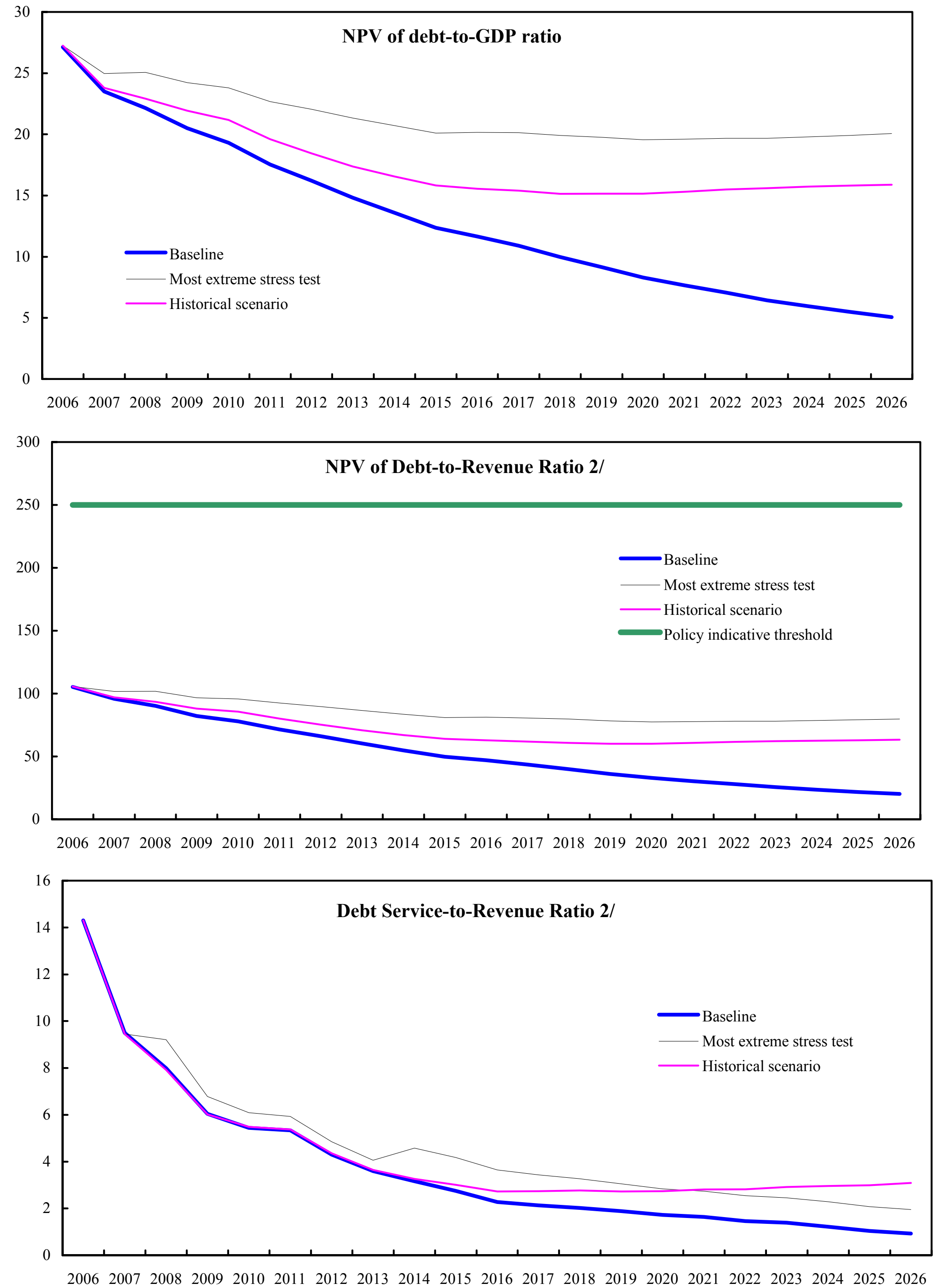
Table 2b. Georgia: Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt, 2006-26
(In percent)

	Estimate	Projections						
	2006	2007	2008	2009	2010	2011	2016	2026
NPV of debt-to-GDP ratio								
Baseline	20	18	17	16	15	13	9	4
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2006-26 1/	20	19	18	17	17	16	11	4
A2. New public sector loans on less favorable terms in 2006-26 2/	20	19	18	17	16	15	12	7
A3. Current account deficit 5 percentage points higher than in the baseline in 2007-09 3/	20	24	23	22	17	16	11	4
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2007-08	20	19	18	17	15	14	10	5
B2. Export value growth at historical average minus one standard deviation in 2007-08 4/	20	21	25	24	22	21	14	6
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2007-08	20	21	22	21	20	18	13	6
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007-08 5/	20	23	23	22	21	19	13	6
B5. Combination of B1-B4 using one-half standard deviation shocks	20	22	26	25	23	21	15	6
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 6/	20	25	23	22	20	19	13	6
NPV of debt-to-exports ratio								
Baseline	78	70	63	59	56	53	43	22
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2006-26 1/	78	74	69	66	64	61	50	21
A2. New public sector loans on less favorable terms in 2006-26 2/	78	72	68	65	63	60	56	38
A3. Current account deficit 5 percentage points higher than in the baseline in 2007-09 3/	78	94	88	85	65	62	50	21
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2007-08	78	70	63	59	56	53	43	22
B2. Export value growth at historical average minus one standard deviation in 2007-08 4/	78	100	141	133	125	119	97	44
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2007-08	78	70	63	59	56	53	43	22
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007-08 5/	78	87	90	84	80	75	61	28
B5. Combination of B1-B4 using one-half standard deviation shocks	78	82	88	83	79	74	61	29
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 6/	78	70	63	59	56	53	43	22
Debt service-to-exports ratio								
Baseline	13	8	6	4	3	3	2	1
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2006-26 1/	9	7	7	5	4	5	4	3
A2. New public sector loans on less favorable terms in 2006-26 2/	9	7	6	5	4	4	4	3
A3. Current account deficit 5 percentage points higher than in the baseline in 2007-09 3/	9	7	7	5	5	6	7	4
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2007-08	9	7	6	4	4	4	3	2
B2. Export value growth at historical average minus one standard deviation in 2007-08 4/	9	9	10	8	7	7	8	5
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2007-08	9	7	6	4	4	4	3	2
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007-08 5/	9	7	7	5	5	5	5	3
B5. Combination of B1-B4 using one-half standard deviation shocks	9	8	7	5	5	5	5	3
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 6/	9	7	6	4	4	4	3	2

Source: Staff projections and simulations.

1/ 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. FDI is assumed to be four precentage points of GDP below the historical average, which is distorted as a result of pipeline construction and large-scale privatization.
2/ 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.
3/ All other key variables are at the same values as in scenario A1.
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/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.

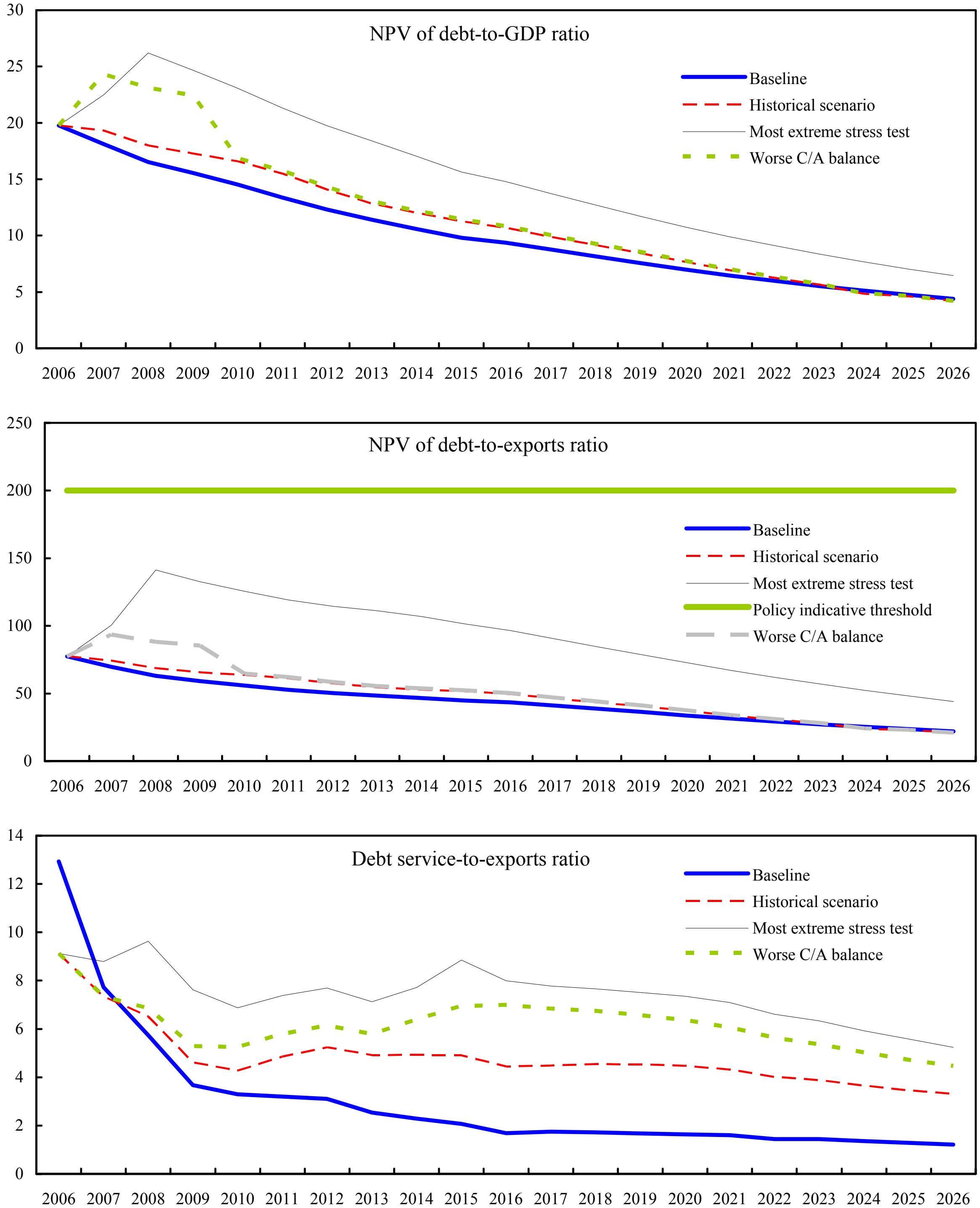
Figure 1a.Georgia: Indicators of Public Debt Under Alternative Scenarios, 2006-2026 1/



Source: Staff projections and simulations.
1/ Most extreme stress test is test that yields highest ratio in 2016.
2/ Revenue including grants.

Figure 1b. Georgia: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2006-2026

(In percent)



Source: Staff projections and simulations.

ATTACHMENT I: LETTER OF INTENT

September 13, 2006
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 2006 and 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. The memorandum proposes revised performance criteria for end-September 2006 and end-March 2007. 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 request hereby the completion of the fourth review under the PRGF arrangement and we request a waiver for nonobservance of a structural performance criterion for end-March 2006. The performance criterion required establishing and populating a database of all central government Legal Entities of Public Law (LEPLs). Unfortunately, misunderstandings led to the omission of several LEPLs from the database, but we have since corrected this omission.

Georgia will conduct discussions with the Fund for the fifth review of its program under the PRGF arrangement before end-December 2006.

Sincerely yours,

/s/
Zurab Nogaideli
Prime Minister of Georgia

/s/
Aleksi Aleksishvili
Minister of Finance

/s/
Roman Gotsiridze
President of the National Bank

ATTACHMENT II: MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

SEPTEMBER 13, 2006

Introduction

1. The government's economic program for 2006 and 2007, which is supported by a PRGF arrangement, aims to achieve poverty reduction through sustained, rapid, and equitable economic growth in an environment of low inflation. This supplemental Memorandum of Economic and Financial Policies reviews our progress with implementation of our program and describes our economic policies and strategy through the remainder of 2006 and early 2007.

Current Economic Developments and Performance

2. The favorable economic results for 2005 have continued in the first half of 2006 and we estimate that real GDP increased by more than eight percent compared with the same period in 2005. This growth is broad based and robust despite several external shocks. The cost of energy imports from Russia increased significantly this year. In 2005, we were able to import gas from Russia at $65 per thousand cubic meters, but this year the cost has risen to $110. Additionally, Russia has banned the importation of numerous Georgian commodities . While these actions have hindered economic growth this year, the momentum of our reform program has allowed the economy to continue its strong performance.

3. Price pressures intensified in the second quarter this year because of structural factors and excess liquidity, with 12-month inflation reaching double digits. Structural factors included higher world prices of energy and some other major commodities, increases in administrative prices on natural gas and electricity and greater-than-expected growth in the money multiplier causing 12-month growth in broad money to exceed 36 percent as of end-July.

4. Reforms in the tax and customs departments have yielded continued benefits. Revenue collection in the first half of 2006 again exceeded our projections in all tax categories. Nontax revenues were also higher than expected because of improved administration. Given the strong revenue performance, we requested approval of two supplemental budgets. The first was approved in May and the second in July. The supplemental budgets allow increased spending in the priority areas, including social issues, infrastructure rehabilitation, upgrading the defense capacity to NATO standards, and other local expenditures, e.g., election administration.

5. While we had committed, under the PRGF arrangement to resolve all GEL 149 million in arrears claims outstanding at end-2005, this has proven to be impossible as the task of verifying the claims has been more difficult than expected. We have continued the process of verifying these arrears. In the first six months of this year, we verified and cleared GEL 23

million in arrears. An additional GEL 36 million in claims have been verified and we are committed to clearing all verified arrears during 2006. We are also committed to resolving the status of all remaining arrears claims as quickly as possible.

6. The government has continued to improve the budget process by enhancing our medium-term expenditure framework (MTEF). Our MTEF consists of two parts, the Basic Data and Directions (BDD) and the detailed expenditure plans of government contained in the annual budget law. The BDD and our macroeconomic projections for 2007-10 were submitted to parliament in April for comment. The detailed spending plans of government for 2007 will be included in the draft budget for 2007 that will be submitted to parliament before 1st of October 2006.

7. We are continuing to develop tools for monitoring and assessing the performance of Legal Entities of Public Law (LEPLs). In the first quarter of 2006 we prepared a database that we thought covered all central government LEPLs (structural performance criterion for end-March 2006). However, subsequent examination revealed a small number of LEPLs that had been omitted from the database. As soon as this omission was realized, we added the additional LEPLs to the database. Given recent progress (described below), we hereby request a waiver for inadvertently missing this performance criterion.

8. Monetary policy was focused on countering inflation pressures and maintaining the stability of the lari through the first half of 2006. During 2005, reserve money increased only by 19.7 percent, which was well below the target envisaged under the program. In the first half of 2006, reserve money increased by 4.4 percent, less than the 7 percent projected under the program. As noted above, growth of the money multiplier was more rapid than projected. Consequently, broad money growth exceeded our projections. As a result, the twin goals of exchange rate and price stability have recently been in conflict. In recent months, we have further constrained the growth of reserve money in an effort to reduce price pressures, and we have modestly increased required reserves.

9. In the first half of 2006, the lari appreciated by 0.7 percent against the US dollar in real terms, while the nominal effective exchange rate depreciated by 0.8 percent over the same period. Against this background, the NBG was able to accumulate significantly more foreign exchange reserves than projected.

10. In March 2006, we submitted amendments to parliament that prohibit government borrowing from the NBG under any circumstances (structural performance criterion for end-March 2006). These amendments were approved by parliament on May 10, 2006. We also submitted amendments to parliament that remove ownership restrictions on commercial banks and thereby allowing an individual to own 100 percent of a bank (structural benchmark for end-March 2006). These amendments were approved by parliament on March 17, 2006.

11. On March 31, 2006, the executive board of the NBG approved a banking sector development strategy for 2006-09 (structural benchmark for end-March 2006). Subsequently, this strategy was discussed with commercial banks and the public at large. The strategy aims to increase the level of financial intermediation and the efficiency of the banking sector as a means of increasing confidence in banks. As a result, we expect the gross assets of the banking sector to reach 40 percent of GDP by end-2009 compared to 22 percent as end-2005. To increase the transparency of commercial banks' activities, the NBG has developed special transparency requirements that oblige the banks to publish specific information with predetermined frequency on the NBG's website and in the media.

12. On March 20, 2006, the NBG signed an agreement with government detailing the securitization of government's debt to the NBG (structural benchmark for end-March 2006). Under the terms of this agreement, the securities will be marketable and can be used to conduct open market operations. The government began converting the debt into securities in May and as of end-August, the NBG held a stock totaling GEL 48 million as marketable government bonds, while the remaining GEL 785 million will become marketable gradually every year until 2025. Furthermore, under the terms of the agreement the government debt to the NBG will be reduced every year and will be fully cleared by the end of 2029.

13. 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 government. Following consultation with the Fund staff, we have amended the proposed legislation. We will resubmit this legislation to parliament soon and will seek its passage by late 2006.

14. The goal of our privatization program is to transfer ownership of state enterprises and assets to the private sector. This process is progressing better than expected and it now appears that the privatization process will be largely completed by the end of this year. Whereas we expected privatization proceeds of about GEL 338 million this year, we now project that proceeds for the year will be around GEL 1.24 billion.

15. Our efforts to liberalize Georgia's trade regime continue to progress. In July, the Parliament approved a new customs code, which simplifies the customs administration procedures and is compatible with EU standards. Further, in July the Parliament approved the new law on customs tariffs. According to this law, the number of tariff bands will be reduced from 16 to 3. Beginning from September 1, 2006, the maximum tariff will be 12 percent instead of 30 percent. The 12 percent tariff shall be chiefly applied to food, agricultural produce and mineral products. Some agricultural products will be subject to a tariff of 5 percent only. For all other products, tariffs will be eliminated altogether.

16. Consistent with our efforts to restructure the Georgian economy and improve the investment climate, in May 2006 parliament passed a new labor code. The previous code was

adopted in 1973 and was an outdated model of employer-employee relationships. The new code reflects a more liberal and market-oriented approach and we hope will further support business development and job creation.

17. With recent agreements reached with Austria and Azerbaijan under the auspices of the 2004 Paris Club agreement, we have completed negotiations with all Paris Club creditors, and all non Paris Club creditors except Kazakhstan. Negotiations with Kazakhstan are underway, and we are cooperating with the Paris Club Secretariat in Paris to reach a satisfactory solution in line with our Paris Club commitments within the shortest possible time.

18. Poverty reduction continues to be a priority of this government. Beginning July 1, 2006, we started to administer a health insurance program for socially vulnerable families. Under this program, all families below the poverty line will receive basic health insurance that allows free consultation and essential medical treatment. We had hoped to begin implementation of our targeted poverty reduction program in June (end-June structural performance criterion for the fifth review). Unfortunately, we experienced problems with the registration process for intended beneficiaries and had to delay program implementation. These difficulties were resolved in July and the budget began making payments to vulnerable households in Tbilisi in August 2006. We will also begin making payments to vulnerable households outside of Tbilisi in September. We are confident that the program will be fully operational by the time of the fifth review. Our latest PRSP progress report was submitted to the IMF and the World Bank on August 25, 2006.

Economic Policies for 2006 and 2007

19. Georgia continues to experience wide-ranging economic change. Since the new government took office in early 2004, we have repeatedly demonstrated our commitment to transforming Georgia's economy from a moribund and corrupt one to a dynamic market-oriented system. We have also repeatedly demonstrated our commitment to maintaining macroeconomic stability. The government's economic reform program for 2006 and beyond aims at further improving macroeconomic performance in order to foster broad-based growth in support of poverty reduction. We believe that strong economic growth is the best tool for reducing poverty and fostering such growth lies at the heart of our economic reform program. Our aggressive program of privatization and efforts to enhance the private sector environment continue to yield results. We project real growth of GDP will be about eight percent this year and seven percent in 2007.

20. While we expect continued strong growth this year and in 2007, there are risks. Our domestic wine sector is developing new markets. Although the wine makers' efforts to reorient themselves will not be completed this year, we do not expect that the decline in wine exports shall hinder growth in a substantial way. Additionally, we may face a higher price for gas imported from Russia in 2007. We estimate an increase in the gas prices to the range of

$160-200 per thousand cubic meters from the current $110. In order to secure our energy supplies, we have reached an agreement with Azerbaijan to purchase additional gas from the newly operational South Caucasus Pipeline (SCP) starting from initial 60,000,000 cubic meters increasing up to 500,000,000 units within next 5 years. These additional supplies of gas will account for about 15 percent of domestic consumption in 2007, increasing up to 25% by 2011, and will result in an average gas price of between $140 and $170 in 2007. While this is a significant increase over current prices, it can be accommodated without substantially hindering economic growth.

21. We remain committed to keeping inflation in single digits but, given developments to date with regard to supply shocks, the money multiplier, and inflation through July, for the year as a whole we now project consumer price inflation of 10 percent, but are determined to contain 2007 inflation to not more than 6 percent. As noted above, we are taking steps to further slow the growth of monetary aggregates, including by raising the reserve requirements for commercial banks. As a result, we project the rapid growth of the money multiplier to slow significantly and broad money growth will be in line with program targets for 2006.

22. As was true in 2005, our program for enhancing macroeconomic stability will require disciplined fiscal and monetary policies. It will also require careful coordination of policies and the development of monetary policy tools. In order to ensure that our objectives and macroeconomic policies are consistent and well understood, we are in the process of preparing a comprehensive macroeconomic strategy for the next five years. This strategy will complement the MTEF and other strategy documents, and will be developed in consultation with Fund staff.

Fiscal Policy

23. Our continued strong revenue performance in the first half of 2006 serves as the basis for our revised fiscal projections for the remainder of this year and 2007. For 2006, we project an overall fiscal deficit of GEL 341 million, or 2.5 percent of GDP. Financing of the budget will rely on external sources (e.g., World Bank and EBRD) and privatization proceeds. For 2007, as the inflow of privatization revenues decreases, we are projecting an overall fiscal deficit equivalent to 2.1 percent of GDP. However, financing will continue to be provided by privatization, borrowing on concessional terms and a modest drawdown of government deposits.

24. The amendment to the 2006 budget law that was approved by parliament in July assumes total revenues and grants equivalent to 24.9 percent of GDP and total tax revenues of 20.8 percent of GDP. In light of our revenue performance in the first half of 2006, we believe that total revenue this year will be higher than budgeted, despite the revenue loss associated with the loss of Russian markets for our exports of wine and mineral water, as

well as losses resulting from the enactment of new customs tariffs, which total GEL 40 million for customs tax and GEL 7 million for VAT.

25. The two supplemental budgets approved by parliament contain the major spending initiatives for this year and we will not approve additional expenditures this year. Indeed, to the extent feasible, we will aim to keep expenditures below the budgeted level in an effort to reduce inflation pressures. We are firmly committed to keeping the deficit at or below the target of GEL 341 million. This reflects our commitment to tighten the fiscal stance in order to reduce inflationary pressure. The revised budget deficit is 1.5 percent of GDP below what was targeted in our second supplement.

26. As noted above, we continue to process the stock of arrears from end-2005. Of the GEL 149 in arrears that were claimed as of end-2005, we expect to verify and pay GEL 59 million. When verifying arrears, we will give priority to those payments that will be most beneficial to low-income groups.

27. Despite the significant reduction of customs tariffs in 2007, improvement in tax administration and further legalization of the economy enable us to sustain the volume of tax revenues in 2007 at the projected level, i.e. at 21.5 percent of GDP. Total revenues and grants are projected to be GEL 3.8 billion, i.e. 24.5 percent of GDP. Reflecting the monetary policy objectives, the deficit on a cash basis shall not exceed 2.1 percent of GDP. Therefore, budget expenditures would represent 26.6 percent of GDP and be allocated chiefly to priority areas. Key priorities for 2007 remain rehabilitation of infrastructure, social, healthcare and education sectors. Budget parameters may undergo minor changes as a result of budget discussions in the Parliament.

28. The privatization process is ongoing and should be completed in 2007. The guiding principle for privatization is that the state should own only those properties that are essential for performance of the state functions. Thus far in 2006, we have privatized enterprises in the energy distribution, power generation and communication sectors. Originally, we estimated that proceeds from the sale of these assets would be about GEL 338 million or 2.6 percent of GDP. In the light of strong interest by international investors, we now expect total privatization proceeds for 2006 to be around GEL 1.24 billion, or 9 percent of GDP.

29. As part of our efforts to strengthen property rights and to make Georgia more attractive to foreign investment, we plan further improvements to revenue administration. In 2007, we plan to complete the merger of the Tax and Customs Departments and the Financial Police. This will result in significant efficiency gains and will improve service to taxpayers. We also plan to improve the tax refund process and, by January 1, 2007 to streamline the tax appeal system, thus increasing public confidence in the fairness of the tax administration. In the context of creation of a consolidated tax administration, we are preparing a strategy to modernize tax administration with the objective to build confidence and trust of taxpayers

with regard to improved tax services, also concerning tax administering and reliable tax-related investigation procedures.

30. As reforms in Public Finance Management Sector continue, we plan to go further with introducing the Government Finance Statistical Manual 2001 (GFSM 2001) budget classification. In particular, the state budget will use GFSM 2001 functional classification from 2007 and the economic classification from 2008. The full compliance with the GFSM 2001 will be progressively achieved by 2015 as defined in the Accounting Reform Strategy.

31. To mitigate potential fiscal risks of decentralizing LEPLs, we plan to issue new reporting guidelines and are currently in the process of finalizing these requirements. As part of this effort, we have included guidelines on budget preparation and management, and guidance for line ministries on analyzing reports from the LEPLs. We are also proposing legislation that will divide existing central government LEPLs into two categories, those that are part of the general government sector and those that are not for profit. Those LEPLs that are part of the general government sector will adhere to treasury guidelines for reporting, whereas the not-for-profit LEPLs will be subject to the guidelines currently under preparation. Throughout this process, we incorporated the useful comments provided by Fund staff as appropriate. These reporting requirements and guidelines will become effective by January 1, 2007 (structural performance criterion for end-December 2006).

Monetary Policy

32. A disciplined monetary program featuring a flexible exchange rate regime is central to our macroeconomic strategy for 2006 and beyond. We had hoped to limit inflation to 6 percent this year, but higher energy costs combined with several exogenous shocks and excess liquidity resulting from higher-than-expected growth in the money multiplier have made it difficult to meet our initial target. Consequently, and with great reluctance, we have revised upward our inflation target for the end-2006 to 10 percent. At the same time, projected growth in the money multiplier has been increased to 11 percent for this year. In light of these revised assumptions, we plan to limit reserve money growth to 14.7 percent and broad money growth to 27.4 percent.

33. For 2007, the NBG's primary objective will be to reduce inflation to not more than 6 percent. In that context, the NBG is now prepared to allow more volatility in the exchange rate by less intervention in the foreign exchange market to counter the market forces. However, the NBG will continue to intervene to avoid excessive fluctuations in the exchange rate.

34. Given the greater-than-expected success of our privatization program, we plan to increase gross foreign reserves to about 2.9 months of imports of goods and services or about $1,030 million by end-2006. For 2007, gross international reserves will increase modestly to

$1,089 as the inflow of privatization proceeds ends. The NBG will limit its interventions in the foreign exchange markets in light of the priority objective of reducing inflation.

35. Under the terms of the agreement between the NBG and the government, the government debt to the NBG, totaling GEL 833 million will be gradually converted into marketable government securities. For 2006, the NBG received GEL 48 million in such securities with maturities of 1 to 3 years. The NBG plans to develop the secondary market for government securities as a means for enhancing its ability to conduct open market operations. In particular, the NBG will form an organized secondary market for the government securities and will regularly conduct open market operations. Furthermore, the NBG has finalized regulations for the issuance of certificates of deposit, has developed corresponding online trading software and will began issuing these instruments in late September.

36. The NBG plans several improvements to its bank supervision program. In recognition of the rapid domestic credit expansion over the past 18 months, we plan to intensify efforts to assess the true quality of the banks' loan portfolios and ensure adequate provisioning. Moreover, we will strengthen the evaluation of internal controls and audit at the banks to establish how effectively they are able to identify potential risks and mitigate these risks on time. The NBG also plans to develop amendments to the legislation to disqualify certain external auditors from bank examination and maintain a "black list" of external auditors. Furthermore, the NBG will be allowed to give specific assignments to the external auditors during the bank inspection and inform the NBG immediately about any discovered irregularities of material importance. The NBG will be allowed to request and obtain all reports and any other materials and information from the external auditor.

37. Consistent with our commitments under the PRGF arrangement, we submitted legislation to parliament in December 2005, aimed at strengthening legislation related to Fit and Proper criteria for bank owners, supervisors and managers. Unfortunately, action has not yet been taken on this legislation. The government and the NBG will take all steps necessary to ensure the passage of Fit and Proper legislation, consistent with international best practices, before end-2006, and we propose that this be a structural performance criterion for end-December 2006 under the program.

38. The rapid growth in commercial bank credits outstanding, while a welcome development, raise concerns about the potential for growing credit risks. To strengthen the NBG's ability to monitor these developments the NBG, in cooperation with commercial bank external auditors, will by end-2006 issue a decree obliging these auditors to include issues of relevance to the NBG in their audits and to report to the NBG (proposed structural benchmark). The NBG will also prepare a draft law on credit bureaus.

39. Further, the NBG plans to intensify its analysis of banking system risks in order to identify and correct for potential problems. For this purpose, the NBG plans to produce and

publish its first financial stability report in late August, 2006. Moreover, following the recommendations of the recent FSAP update mission, the NBG has started to collect data on asset prices and deposit and loan concentration; reached an agreement with the Ministry of Finance on the securitization of the government debt to the NBG; prohibited by law direct lending by the NBG to the government; adopted a comprehensive law on microfinance institutions and introduced regular meetings with commercial bank managers and supervisory board members.

40. The effectiveness of monetary policy depends largely on the transparency of the NBG and its actual policies and operations. The NBG is currently in the process of reinvigorating research and analysis activities. It is also publishing monthly monetary and fiscal reviews, and recently began publishing quarterly inflation reports. These reports will serve as a major communication tool with the public and will allow us to convey the message that the NBG's main goal is price stability and a more flexible exchange rate regime. Furthermore, the inflation reports will allow the NBG to explain to the public about the environment in which monetary policy is formulated and about its specific policy actions.

41. We recognize that reliable statistical data is critical for the effective policy formulation and implementation. As Georgia becomes a more open economy and macroeconomic risks stemming from the external sector increase, the reliability of the balance of payment data becomes crucial. Therefore, it has been agreed that the NBG will initiate an effort to improve the quality of balance of payments data and will be solely responsible for the collection and analysis of balance of payments statistics. As a first step, and in accordance with a recommendation of a recent IMF technical mission, responsibility for this data will be transferred from the Department of Statistics of Ministry of Economic Development to the NBG. Additionally, we will issue the necessary decrees and resolutions by end-September 2006 (a proposed benchmark), and will have the newly established unit in the NBG fully operational no later than end-December 2006.

Structural Reforms

42. 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.

43. For the purpose of increasing the quality of official statistics, we have developed relevant legislation taking into consideration the fundamental principles of official statistics and it will be patterned on the laws of UN and EU on official statistics, best European practices of legislation in the field of official statistics and other international acts.

Program Monitoring

44. Completion of the fifth review under the PRGF arrangement, scheduled for early 2007, will require observance of the structural performance criteria for end-September 2006 shown in Table 1 and the quantitative performance criteria for end-September 2006 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 energy, public sector operations, the business climate, and trade liberalization.

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

	Cumulative Change from End-December 2005								
	Mar. 2006		Jun. 2006		Sep. 2006		Dec. 2006		Mar. 2007
	Performance Criteria	Actual	Indicative Targets	Prelim.	Performance Criteria	Revised	Indicative Targets	Revised	Performance Criteria
	(In millions of lari)								
1. Quantitative targets									
Ceiling on cash deficit of the general government	34.7	3.0	65.4	155.0	138.2	252.0	345.6	342.0	393.0
Ceiling on net credit of the banking system to the general govt. (NCG)	0.0	-112.1	-17.7	-88.4	-50.7	-135.6	37.0	-872.4	-841.4
Ceiling on reserve money	42.9	-22.5	70.8	43.2	157.4	118.3	250.4	150.4	141.2
	(In millions of U.S. dollars)								
Floor on total net international reserves (NIR) of the NBG	1.8	16.3	40.2	61.2	118.7	134.5	151.6	559.8	526.2
Ceiling on contracting or guaranteeing of									
A. Nonconcessional medium- and long-term external debt	20.0	0.0	20.0	n.a.	20.0	20.0	20.0	20.0	25.0
B. Short-term external debt (less than one year)	0.0	0.0	0.0	n.a.	0.0	0.0	0.0	0.0	0.0
Ceiling on accumulation of external arrears	0.0	0.0	0.0	n.a.	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	39.5	-52.6	-3.5	-70.0	-62.2	-130.6	-30.1	-885.3	-832.3

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.

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.

Table 2. Georgia: Structural Performance Criteria (*) and Structural Benchmarks, 2006–07	
Measure	Timing
Adopt financial reporting guidelines for all not-for-profit LEPLs. (*) (MEFP, para 31)	End-December 2006
Enact legislation bringing Georgian Fit and Proper regulations in line with international best practices. (*) (MEFP, para 37)	End-December 2006
Submit to parliament a draft law on Official Statistics. (MEFP, para 41)	End-March 2007
Prepare a strategy for modernizing tax administration. (MEFP, para 29)	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. (MEFP, para 38)	End-March 2007

ATTACHMENT III: TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)

1. This memorandum sets out the understandings between the Georgian authorities and the IMF staff regarding the definitions of quantitative 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 September 13, 2006.

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 LEPLs. The public sector consists of the general government, and the National Bank of Georgia (NBG).

B. Definition of Domestic Expenditure Arrears

6. **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.

7. **Supporting material:** The treasury department of 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 and local governments. 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. The local budget department of the ministry of finance will provide to the IMF information on monthly spending by the local budgets.

C. Ceiling on the Cash Deficit of the General Government

8. **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 for more than 10 years. 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.

10. **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 nonbank 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.

D. Ceiling on Reserve Money

11. **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.

12. **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

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 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..

E. Floor on Net International Reserves of the NBG

15. **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.

16. **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)

17. **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).[9] 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.[10]

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[9] 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.

[10] 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

(Continued…)

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.

18. **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.

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

19. **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.

20. **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.

H. Non-Accumulation of External Arrears

21. **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.

(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."

22. **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.

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

23. **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).

24. **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.

Statement by the IMF Staff Representative
September 29, 2006

1. The following information has become available since the issuance of the staff report. These developments do not the change the thrust of the staff appraisal.

2. The authorities are reportedly on track to meet the indicative quantitative targets and performance criteria for end-September, although final data will not be available for several weeks. Fiscal and monetary performance through end-August appear to be broadly in line with program targets. Based on more recent daily data, reserve money is slightly below, and the cumulative deficit close to, their respective end-September ceilings under the program. The authorities have assured staff that all efforts will be made to meet the targets, including by restraining pressures to spend in late September ahead of local elections in early October.

3. The money multiplier increased in August, compared to program projections of a modest decline in the multiplier in the second half of 2006.

4. Staff has received the preliminary version of the 2007 budget that is being discussed at the government level. The budget that is adopted by government is to be submitted to parliament on October 2. The deficit in the draft is broadly in line with the authorities' commitments in the Memorandum of Economic and Financial Policies. However, the composition of expenditures differs significantly from the pattern discussed with staff; current expenditures are 1.7 percent of GDP lower than described in the staff report, and capital expenditures are 1.8 percent of GDP higher. The budgeted level of current expenditures reflects a slight decline in nominal terms from the 2006 projected level which, with the projected inflation, implies a more than 6 percent reduction in real current expenditures, primarily in local government expenditures. The authorities have informed staff that this reflects a careful policy decision.

5. The authorities have begun the process of expanding the coverage of the targeted extreme poverty from Tbilisi to the rest of Georgia, consistent with their stated intention to cover the entire country by September.

Press Release No. 06/209
FOR IMMEDIATE RELEASE
September 29, 2006

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Fourth Review of Georgia's PRGF Arrangement and Approves US$20.7 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) completed today the fourth review of Georgia's performance under the three-year program supported by the Poverty Reduction and Growth Facility (PRGF). In completing the review, the Board approved the authorities' request for a waiver for the nonobservance of the end-March 2006 structural performance criterion on the establishment and population of a database of all central government Legal Entities of Public Law.

The Executive Board approved the PRGF arrangement on June 4, 2004 (see Press Release No. 04/107) for an amount equivalent to SDR 98 million (about US$145 million). Completion of this review will enable Georgia to draw the equivalent of SDR 14 million (about US$20.7 million), bringing total disbursements under the arrangement to the equivalent of SDR 70 million (about US$103.6 million).

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

"Georgia's economy continues to perform well under the PRGF-supported program, bolstered by improvements in governance and the business environment, a fiscal turnaround that has enabled the government to clear most of the arrears accumulated in previous years, and a bold liberalization of the trade regime.

"The authorities have made impressive progress in structural reforms, and further efforts are underway in the financial and fiscal areas. In view of the rapid credit growth, financial sector reform is crucial for safeguarding the stability of the banking sector, including the authorities' plan to improve fit and proper legislation, in line with best international practices, and the adoption of AML-CFT legislation. Reforms to fiscal administration include the planned consolidation of tax and customs administration and the financial police, to enhance the predictability and efficiency of revenue administration and the quality of taxpayer services.

"The authorities' economic program for the rest of 2006 and 2007 aims to bring inflation back into single digits. In this regard, the government plans to limit demand pressures and money growth, in order to preserve hard-fought gains and avoid the entrenchment of inflationary expectations. Under the 2007 budget, the fiscal deficit will be reduced to just over 2 percent of GDP, and the National Bank of Georgia will limit interventions in the foreign exchange market to smoothing short-term fluctuations, making price stability the governing objective of its policies. Going forward, the government and the central bank should, if necessary, be ready to tighten fiscal and monetary policies beyond the levels now envisaged.

"In order to make structural reform a long-term success, the authorities will focus on sustaining recent reform efforts by strengthening institutions. With the privatization proceeds largely coming to an end in 2007, policies will also focus on mobilizing new and sustainable sources of financing," Mr. Kato said.

Statement by Jeroen Kremers, Executive Director for Georgia and Thomas Rookmaaker, Advisor to Executive Director September 29, 2006

General

Georgia's economic performance has been strong in many respects. At the macroeconomic level, the broad-based economic growth has continued to be high, as the projection for 2006 has risen from the initial 6.4 percent to 7.5 percent. The sustained high growth seems related to Georgia's impressive policy track record. In the recent Doing Business 2007 report of the World Bank and IFC, Georgia is presented as this year's top reformer. In the report's ranking, Georgia jumped 75 places to the 37th position of 175 countries, the biggest jump in the rankings in a single year since the report was launched four years ago. According to the report, doing business in Georgia in some respects is easier than in several advanced economies.

The authorities are pleased that all quantitative performance criteria have been met. One structural performance criterion faced a delay of a technical nature, implying a request by the authorities of a waiver for nonobservance. This pertains to the performance criterion on the establishment of a data base to strengthen financial management of central government Legal Entities of Public Law (LEPL), which by now has been successfully accomplished.

Monetary policy

Although much has been achieved during the last few years, challenges remain. In July, inflation turned out significantly higher than expected – 12-month inflation reaching 14.5 percent – as a result of higher energy and gas prices, exogenous shocks and excess liquidity given the higher than expected money multiplier growth. At the same time, all monetary program targets were met, illustrating the unexpected character of these developments. To deal effectively with the risks involved, the authorities are committed to substantially reduce the growth of reserve money, lower the fiscal deficit, and reduce the interventions in the foreign exchange market. At the end of August, inflation decreased to 13.4 percent and inflation is expected to decline further in September. For 2007, the target will be to reduce inflation to some 6 percent. In this regard, the authorities plan to limit reserve money growth and broad money growth. Moreover, the NBG will limit its interventions in the foreign exchange market to allow more adjustment in the exchange rate. Interventions will only be used in order to avoid excessive volatility. To increase the effectiveness of monetary policy, improvements in the communication and transparency of the central bank have been pursued. The NBG is now publishing a quarterly inflation report, in addition to monthly monetary and fiscal reviews.

Fiscal policy

Over performance in the form of substantially higher revenues than expected made two supplemental budgets possible. In these budgets, expenditures were targeted at necessities, such as infrastructure rehabilitation, health care, and national security. The authorities do not intend to approve additional expenditures this year and aim to keep expenditures below the budgeted level to contain inflationary pressures. The overall fiscal deficit is programmed to decline from 2.5 percent GDP in 2006 to 2.1 percent GDP in 2007.

Improvements in tax administration will help sustain tax revenues in 2007, while the merger of the Tax and Customs Departments and the Financial Police will result in efficiency gains and improvement of service delivered to tax payers. Furthermore, the authorities are committed to gradually implement requirements of GFS 2001 in their budget.

As stated in the MEFP, drafted by the authorities and discussed in close consultation with staff, it proved impossible to clear all arrears so far, since verifying the claims turned out more difficult than expected. This year GEL 23 million in arrears has been cleared, and the authorities are committed to clear all verified arrears this year and to resolve the status of all remaining arrears as soon as possible.

External accounts

Higher prices for energy including oil, and the import ban by Russia contributed to the deterioration of the trade balance in the first half of 2006. In this light, the new South Caucasus Pipeline offers Georgia an opportunity to acquire gas at lower price levels.

A new customs code will improve the efficiency and effectiveness of customs services, including penalty provisions to deter tax avoidance. From September 1, Georgia's customs tariffs have been substantially reduced. Three categories now exist, with rates of 12 percent, 5 percent and zero percent (the previous system had 16 different rates of up to 30 percent). The zero percent rate applies to around 85 percent of all goods. The authorities intend to further lower the rates in 2007. Staff rightly states that Georgia now has one of the most open trade regimes in the world.

Foreign exchange reserves are projected to increase from 1.8 months of imports in 2005 to 2.9 months in 2006. This is partly the result of high privatization income. For 2006, income from privatization – which forms an important element of reforms – is projected to reach GEL 1.2 billion, three times the amount in 2005 and almost four times higher than programmed earlier. The DSA clearly shows that risks of unsustainable public and external debt are low.

All Georgian negotiations with the Paris Club and non-Paris Club creditors have been completed, except with Kazakhstan. The authorities hope to reach an agreement in line with the Paris Club commitments as soon as possible.

Investment climate

The Doing Business report mentioned above points to the many structural reforms that have been implemented: time limits for the issuance of permits have fallen, a ‘one-stop shop’ for building permits has been established, specialized commercial sections in the courts are now in use, and judicial corruption is more aggressively investigated. Furthermore, the new labor code and lower social security contributions paid on top of wages by businesses, have made Georgia the 6th easiest place to employ workers globally. This is part of a longer-term drive for reforms (in last year’s Doing Business report, Georgia was the number two top reformer) and the authorities are strongly committed to further improve Georgia’s position in the ranking by continuing their reform efforts. In addition, Georgia was praised for leading all transition countries in reducing the perception of corruption. Swift and bold reforms made this possible, for instance in the field of fiscal transparency and accountability.

Financial sector reform

Credit to the private sector continues to grow fast, albeit from a relatively low level. Nonetheless, credit growth contributes to economic development and, when carefully monitored, is welcome. In light of potential risks for commercial bank balance sheets, the authorities recognized the need for intensifying efforts to assess the quality of the banks’ loan portfolios and ensure adequate provisioning. To enhance the NBG’s monitoring, a decree will be issued end-2006 to ensure that external auditors will report to the NBG on their findings in commercial banks and include issues in their audit, that are relevant to the NBG. The two major banks, whose capital adequacy ratio recently dropped below the Basel norm, are closely scrutinized by the NBG. Furthermore, the NBG is in the process of following up on the recommendations of the recent FSAP update. A financial sector development strategy has been adopted by the NBG with the aim of enhancing financial intermediation.

Poverty reduction

Poverty reduction remains a key priority. The poverty rate has been reduced, but still remains high at 33.6 percent (first quarter 2006). To reduce poverty further, a program for basic health insurance has provided all families below the poverty line with free consultation and essential medical treatment. The targeted poverty reduction program was delayed given problems in the registration of beneficiaries, but has been started in Tbilisi and implementation is currently underway in the rest of the country. The program is now fully operational. Furthermore, the authorities are improving their statistical techniques in measuring poverty.

Finally, on behalf of the authorities, we would like to thank staff and management for their highly valued policy advice and dedication.