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June 28, 2018

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

May 31, 2018

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

Letter of Intent

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

Tbilisi, May 31, 2018

Dear Ms. Lagarde:

1. **We remain committed to the policies detailed in our Letter of Intent and Memorandum of Economic and Financial Policies of March 27, 2017, updated on November 17, 2017.** Our policy agenda is based upon the Government's Four Point Reform Plan, which focuses on: (i) reforming education to promote adequate skills development, labor productivity and job creation; (ii) accelerating core infrastructure to leverage Georgia's strategic geographic location as a transit and tourism hub as well as improving connectivity between regions; (iii) improving the governance and efficiency of the government; and (iv) enhancing the role of the private sector as an engine for growth. The central bank's reform plan aims at strengthening monetary policy and enhancing the supervisory and regulatory framework and financial safety nets. Together with this ambitious reform package, we are committed to preserve macroeconomic and financial stability, as pre-requisites for sustainable and more inclusive economic growth.

2. **Robust economic growth provides an opportunity for steadfast implementation of our reform program.** Growth in 2017 was 5.0 percent, higher than the 3.5 percent projected at the time of the program approval. As anticipated, inflation has declined significantly in early 2018. The current account deficit has narrowed to 8.7 percent of GDP in 2017, from 12.8 percent of GDP in 2016, driven by growth in exports, tourism and remittances, and subdued import growth, reflecting in part fiscal measures. Supported by revenue measures and a strengthening recovery in 2017, higher revenues and contained current spending allowed us to increase capital spending and net budget lending by 2 percentage points of GDP while containing the fiscal deficit.

3. **We have hitherto met most of the conditionality under our IMF-supported program**. We have met all end-December quantitative performance criteria, and inflation has remained within the inflation consultation clause (ICC). Most structural benchmarks through end-March have been adopted. We marginally missed the indicative target on net primary expenses for end-December.

4. We request the modification of a quantitative performance criterion and the completion of the Second Review under the Extended Fund Facility and the release of the related purchase. Given the performance under the program so far, and the policies described in the enclosed Memorandum of Economic and Financial Policies (MEFP), we intend to purchase a further SDR 30 million from the Fund, bringing our drawings under this program to SDR 90 million. Our program will continue to be monitored through quantitative performance criteria, an indicative target, and an inflation consultation clause, both with end-June and end-December test dates, and continuous performance criteria. Consistent with our reform agenda, our program also envisages structural benchmarks. These are set out in Tables 1–3 of the Memorandum of Economic and Financial Policies (MEFP, Attachment I), and described with definitions in the attached Technical Memorandum of Understanding (TMU, Attachment II). Reviews will be conducted semi-annually. The Third Review will be based on end-June 2018 performance criteria and is expected to be completed on or after October 26, 2018. The Fourth Review will be based on end-December 2018 performance criteria and is expected to take place on or after April 12, 2019.

5. The attached MEFP, which updates and extends the previous ones, will enable us to achieve the objectives of our economic program. We will monitor progress continuously in consultation with the IMF, and we stand ready to take further measures if needed to reach our objectives. We will continue to consult with the IMF on the adoption of measures, and in advance of any revisions to policies included in this Letter of Intent in accordance with the IMF's policies on such consultation. We will also provide the IMF with the information it requests for monitoring program implementation. We authorize the IMF to publish this Letter of Intent and its attachments (including the MEFP and TMU), as well as the related Staff Report. These documents will also be posted on the official websites of the Georgian government after the approval by the IMF Board.

Very truly yours,

/s/
Dimitri Kumsishvili
First Deputy Prime Minister and
Minister of Economy and Sustainable Development

/s/
Mamuka Bakhtadze
Minister of Finance

/s/
Koba Gvenetadze
Governor of the National Bank of Georgia

Attachments:

1. Memorandum of Economic and Financial Policies (MEFP)
2. Technical Memorandum of Understanding (TMU)

Memorandum of Economic and Financial Policies (MEFP)

1. This memorandum reports on recent economic developments and updates the economic and financial policy agenda of the National Bank of Georgia (NBG) and the Government of Georgia to address medium-term economic challenges.

Macroeconomic Framework

2. Economic activity in 2017 exceeded our expectations, supported by our prudent policies and robust growth in our main trading partners. At 5.0 percent, growth in 2017 was much higher than anticipated at the time of the program approval (3.5 percent). Our current account balance has strengthened considerably due to vigorous growth in exports, tourism receipts and remittances. Stronger confidence in the economy resulted in an unprecedented level of FDI ($1.86 billion in 2017). As expected, inflation declined rapidly in early 2018, after being temporarily above the NBG's target in 2017 due to higher excise taxes and import prices. The strength of our current account allowed us to boost FX reserves above the program ceiling. The improved confidence in the Georgian economy and our larization measures have led to a decline in both deposit and loan dollarization. Continued reform implementation also resulted in Georgia ranking 9th in the World Bank's Doing Business Report and 5th in the Open Budget Survey. In March, Moody's upgraded our credit rating from Ba3 to Ba2, and Fitch Ratings improved the credit outlook from stable to positive.

3. Decisive program implementation and the dynamism of our economy have led to positive revisions to our economic outlook.

- We expect robust growth to continue in 2018 supported by a favorable external environment, domestic consumption, and public investment. We revised up our growth projection based on a more benign global outlook and remain vigilant about regional developments which could impact negatively our economy. Over the medium term, growth is expected to gradually increase due to the steadfast implementation of our structural reforms and continued growth in our main trading partners.
- Upward revisions to growth would translate into higher government revenues. This will allow us to accelerate infrastructure spending while slightly reducing our augmented fiscal deficits (see below).
- The current account is expected to marginally deteriorate in 2018 owing to accelerated capital spending and rising global fuel prices. The current account deficit is projected at 9.2 percent of GDP in 2018, before declining gradually to below 8 percent of GDP over the medium term. External financing will continue to rely mostly on FDI. The stronger external position will allow us to build international reserves over the medium term.

4. External competitiveness will be bolstered by the implementation of our reform agenda. Ambitious structural reforms, continued implementation of the EU-Georgia Association Agreement, and our commitment to deepening trade relations with the rest of the world, will create new business opportunities and support economic diversification. Further improvements to the business environment, including through a more effective tax administration, will help mobilize FDI in tradable sectors, improve competitiveness, and reduce external vulnerabilities.

5. Risks to the medium-term outlook are balanced. Upside risks stem from stronger domestic and external demand. Materialization of these risks leading to an overheating of the economy may require tightening macro policies. Downside risks are mainly related to regional developments, retreat from cross-border integration, and weaker growth in advanced economies. Materialization of fiscal risks could also put pressures on the public-sector balance sheet and call for additional consolidation. Our first line of defense against these risks include our commitment to sound macroeconomic policies, a flexible exchange rate, and a well-capitalized and liquid banking system. Georgia's IMF-supported program provides an additional anchor to help us cope with negative shocks.

Economic Policies

A. Fiscal Policy

6. The 2017 augmented fiscal deficit was lower than programmed. The 2017 augmented deficit (TMU definition) was GEL1,113 million or 2.9 percent of GDP, well below the program ceiling of GEL1,335 million (performance criterion) or 3.6 percent of GDP. Our fiscal performance reflected lower-than-expected losses from changes to the corporate income tax and cyclical gains. Consistent with our commitment under the program, part of the revenue over-performance was used to accelerate capital spending and to refund a higher amount of VAT claims. Unfortunately, we marginally exceeded the indicative target on primary current expenses by GEL28 million related to donor-financed projects.

7. Fiscal prudence will continue in 2018. We remain committed to our end-June ceiling on the augmented deficit (GEL430 million) and aim for an augmented deficit of GEL1,150 in 2018 (performance criterion) or 2.8 percent of GDP. We will continue containing current primary spending (indicative target), by keeping it constant in real terms. To that end, we have introduced a new civil service law and a civil service remuneration law (structural benchmark, December 2017), to contain civil service costs, increase efficiency, and improve the link between performance and pay. Given our projected revenues, we aim to refund GEL400 million in value-added tax (VAT) credits, doubling the initial budget projection. Any additional refunds will be accommodated under the program through an adjustor (see Technical Memorandum of Understanding (TMU, ¶14). The augmented deficit ceiling incorporates higher capital spending in priority infrastructure with respect to the budget. In addition, we stand ready to adopt contingency measures, if needed, to keep the augmented deficit not above the 2018 program ceiling. In consultation with the IMF, we are committed to use revenue over-performance or additional savings in current spending toward high priority growth-enhancing net acquisition of non-financial assets, and any under-execution in investment towards a lower deficit.

8. **We are committed to appropriately account for emerging fiscal pressures in the budget, so that debt remains anchored at safe levels over the medium term.** We are committed to medium-term fiscal consolidation and remain proactive to address fiscal pressures. In coordination with donors, we will design a comprehensive education reform (see paragraph 29 below) that will be incorporated in our multi-year budgetary framework (MTBF) once resource needs are evaluated. The main fiscal costs from implementing the education reform are expected to be incurred only once infrastructure projects are finalized, providing space for higher education spending. We are committed to seek efficiency gains in the sector and, if needed, identify permanent fiscal measures to ensure that the reform is deficit neutral. While the budgetary effect of Public-Private Partnerships (PPPs) and Purchasing Power Agreements (PPAs) is intrinsically uncertain, some contingent liabilities stemming from PPPs/PPAs have a greater likelihood of materializing. The immediate effect of such risk events would mostly be felt by public enterprises, but any cost would eventually be passed on to the budget through lower dividends, delayed debt service payments, or a need for capital injections. With the assistance of IMF TA, we will strengthen our scenario analysis to estimate plausible fiscal costs associated with these activities and, in anticipation of risks that could materialize in the medium to long term, will prudently consider the need for additional fiscal measures to build precautionary buffers.

9. **We remain committed to medium-term fiscal consolidation while scaling-up public investment.** We aim to reduce the augmented cash deficit of the general government to 2.5 percent of GDP by 2020 while significantly increasing capital spending. To achieve this, we will continue rationalizing primary current spending (from almost 25 percent of GDP in 2016 to 20.4 percent of GDP by 2020) by improving the efficiency of the public administration including through (i) containing the wage bill and administrative expenses; (ii) improving the targeting of subsidies and of social assistance programs; (iii) reducing transfers and privatizing loss-making state-owned enterprises (SOEs); and (iv) improving performance-based budgeting. To support the vulnerable population, the existing social safety net will be maintained and the basic public pension will be increased (see below). In addition, we do not plan to extend the dividend distribution model to financial institutions until 2023, which would limit the revenue loss (up to 0.5 percent of GDP). However, we will consider moving sooner the insurance sector to the dividend distribution model, in consultation with the Fund. To achieve our deficit target, we stand ready to identify additional measures, if needed, in coordination with the IMF, including on the revenue side within the scope of our fiscal framework.

10. **We aim to reduce fiscal risks and remain committed to avoid domestic/external debt payment arrears.**

- We will not (i) accumulate any general government's external debt payment arrears outside those under negotiation (performance criterion); (ii) accumulate net domestic expenditure arrears of the general government (indicative target); or (iii) issue new public guarantees (performance criterion), or comfort letters.
- The Partnership Fund (PF) will continue to pursue only commercial objectives (providing minority equity or loan co-financing), will not run a cash deficit (performance criterion), or issue any new guarantees. New net borrowing of the Partnership Fund will be limited to $20 million at end-June and end-December 2018 (cumulative from the beginning of the EFF program, performance

criterion). We remain committed to maintain a non-negative cash position at the Partnership Fund by end-June and end-December 2018 (performance criterion).

- We will refrain from initiating any Public-Private Partnerships (PPPs), including Power-Purchasing Agreements (PPAs), until our PPP framework is operationalized. We are committed to reassess and implement, if needed, additional fiscal adjustment based on our fiscal risk profile.
- Taking into consideration existing fall-winter period power deficit, and except for the PPAs described in the next bullet, PPAs currently under negotiation will be permitted to proceed (prior to the new PPP law) only under the following terms:
  - The guaranteed purchase period shall not be more than 8 months in each year;
  - The guaranteed purchase tariff shall not be more than US 6c kWh; and
  - The cumulative installed capacity of these projects under negotiations will not exceed MW650. This adds MW150 to the previous cumulative capacity as the Koromkheti Hydro Power Plant (HPP, see below) will not be pursued.
- Consistent with our program commitments, we evaluated two PPAs under negotiation that are outside of the terms mentioned above (the Namakhvani HPP Cascade Project and the Koromkheti HPP). We prepared a fiscal risk analysis for these projects. The risk assessment updated the analysis of gross exposure of all signed PPA projects and these two large projects; and analyzed the net risk exposure with different demand, price and exchange rate assumptions. The risk assessment also described and quantified other risk-sharing contractual obligations (including, for instance, termination risk or construction risk). Negotiations of the memorandum of understanding (MoU) associated with the Namakhvani HPP Cascade Project (MW433) are ongoing, but the government decided not to pursue the Koromkheti HPP (MW150).
- We will continue to exercise fiscal prudence by containing potential fiscal risks stemming from our proposed export credit agency (ECA). We will coordinate with the IMF on preparing the charter of the agency to ensure that the agency will (i) only provide guarantees and insurances related to export operations; (ii) be subject to insurance regulation and supervision; and (iii) not receive explicit government guarantees. ECA's capital will be constituted by a $20-million equity injection by the Partnership Fund distributed over 3 years. A revolving fund for potential losses, totaling GEL50 million, will come from the state budget.
- We are also considering the possibility of creating a credit guarantee scheme (CGS) to support SMEs' access to finance. The CGS would be based on best international practices to limit fiscal risks. In particular, the CGS would be limited in size, targeted, easy to dismantle, transparently incorporated in the budget, and use market-based principles for its operations. We will work closely with our international partners, including the IMF, to elaborate a proposal.

B. Structural Fiscal Policies

11. We are strengthening our revenue administration to secure full compliance by all taxpayers and improve taxpayer services. Following the 2016 Tax Administration Diagnostic Assessment and follow-up IMF TA, we are implementing a 3-year plan that focuses on improving:

- **Organizational structure.** Georgia's Revenue Services (GRS) headquarter has been restructured into a function-based organization to modernize tax administration (structural benchmark, February 2018), with logical groupings of core functions – such as taxpayer service, returns filing and payment, audit, appeals, arrears management, policy and interpretations and compliance management. The transfer of all core HQ functions from field offices to headquarters was completed in May 2018. We will continue building capacity of the GRS by adequately staffing the new departments in line with international best practices.

- **Improving VAT tax administration.**

    - Stock of unrefunded VAT credits. We are committed to eliminate the issue of unrefunded VAT credits and aim by end-2021 to reduce by at least 50 percent the outstanding stock of those VAT credits that are within the limitation period for audit. To achieve this, we established a steering committee with representatives from the MoF, GRS, and GTS that proposed in May 2018 the necessary legal amendments or ministerial decrees to facilitate the implementation of the action plan adopted in 2017. For the stock of existing credits, we are committed to risk-assess 100 percent of declarations within the next two years. A new specialized VAT unit in the GRS's audit department has already been created (structural benchmark, June 2018) to review VAT declarations and to audit or take other compliance action where necessary. We are committed to having it fully operational by June 2018.

    - Automatic risk assessment and risk based auditing. All new VAT declarations will be risk-assessed under the automated system starting January 2019. We improved our automatic risk-assessment system to check all VAT declarations and will have a fully automated system by end-2018. Under this system, those 90 percent of new declarations with the lowest risk score will not be subject to further manual review by GRS and be immediately eligible for a refund, if requested by taxpayers and if there are no outstanding tax liabilities (new structural benchmark, June 2019). This 90 percent target will be achieved within six months from the start of the automated repayment system. The 10 percent of declarations with the highest risk score will be reviewed by the specialized VAT unit in the Audit Department to determine the appropriate compliance action.

    - Automatic refunding of new VAT credits. From January 2020, to further automate the refund system, all risk-assessed new credits approved by the system will be either offset against existing liabilities or refunded to the taxpayer, without the need for an explicit request for refund. The VAT declaration form will be changed accordingly. The option to offset the stock of existing credits against new liabilities will remain unchanged, and taxpayers will retain the option to request a cash refund of those stocks through a separate form.

- **Compliance.** We received IMF TA on enhancing compliance risk analysis and improving data management for new risk models. We are committed to increase audit capacity, efficiency, and impact on compliance. With IMF TA, we plan to use risk-based audits to identify non-compliant cases that are likely to produce higher yields. We will better manage the audit scope and develop audit plans to give a balanced coverage of tax categories. We will have a pilot audit case management system in early 2019. Once fully implemented, this will enhance audit timeliness and productivity, and implement a systematic approach to terminate non-productive audits.

- **Filing compliance.** We established key performance indicators to help improve filing compliance. Initially developed for VAT, the program could expand to all tax categories. By end-2018 the GRS will also improve the taxpayer register, submit to Parliament legal amendments so that an unfiled declaration is no longer deemed to be a nil declaration where the GRS requires a declaration, and set up an organizational unit that deals with filing default and late filing for all revenue types.
- **Penalty regime**. To have a more efficient and fair system, we will update our tax penalty regime. In consultation with the IMF, we will submit to Parliament a revised penalty regime with gradual tax-geared penalties depending on the degree of culpability (new structural benchmark, December 2018).
- **Automatic access to third-party information**. Risk analysis relies on data to be effective. It improves the effectiveness of a tax administration by allowing the targeting of resources towards greatest non-compliance. The GRS will be provided with automatic access to third-party information from appropriate government agencies, including information from: (i) the National Agency of Public Registry on real estate, rentals and leases, and on the Joint Stock Companies (JSC) partners and changes in company equity (tentatively by end-2018); (ii) municipalities, information on construction permits; and (iii) the Financial Monitoring Service on suspicious transactions as defined in the law on facilitating the prevention of illicit income legislation.

12. We are committed to contain fiscal risks to safeguard fiscal sustainability. We understand the importance of properly managing fiscal risks as an intrinsic part of prudent fiscal policy. We are carefully studying risks that could arise from state-owned enterprises (SOEs) and PPPs, including PPAs in the energy sector. At the same time, we recognize that PPPs and PPAs can play a pivotal role in Georgia's development by attracting investment, including FDI. In this vein, improvements in the relevant legislation are required to reap the benefits of further PPPs and PPAs. Hence, we are committed to:

- **Adopt a new PPP law and associated regulations.** We submitted a PPP Law to Parliament (structural benchmark, December 2017) that includes sound elements following best international practices (see previous MEFP for details), with assistance from the World Bank (WB), the Asian Development Bank (ADB), the EBRD, and the IMF. Parliament approved the new PPP law in May. We will consult with the IMF on secondary legislation, PPPs ceilings, and PPPs guidelines. The government decree implementing the PPP law will incorporate recommendations from the IMF, including on: (i) coverage, notably explicitly incorporating PPAs, to the coverage of the PPP law; (ii) definitions, specifically, of the principle of value for money (VfM); (iii) protecting the gatekeeper role of the MOF; (iv) a requirement for any PPPs agreed as a result of direct negotiations (except for those in the national security sector) to be fully transparent i.e. the PPP contract and its appendices to be published, including a summary of the project key financial indicators and the feasibility study, with PPP contracts in the energy sector above 100MW requiring an independent feasibility study; and (v) limiting the participation of public sector entities in institutional PPPs; (v) requirements regarding pre-feasibility studies and components thereof; and (vii) transparency of PPPs and the selection process. In consultation with the Fund, we will adopt the government decree implementing the PPP law (new structural benchmark, end-December 2018).

- **Continue strengthening the Fiscal Risk Statement (FRS) accompanying the budget.**
    - Our 2018 FRS reported fiscal risks on all existing PPP-associated liabilities; and expanded the analysis of SOE's contingent liabilities, including a quantitative reporting of quasi-fiscal operations (structural benchmark, end-December 2017). This analysis expanded the historical financial analysis of SOEs to five years, described historical trends of the size of the SOE sector relative to the economy, provided analysis of the factors driving the financial performance and position of both key individual and overall SOEs, and identified and evaluated major quasi fiscal activities.
    - The 2019 FRS will expand the analysis of fiscal risks stemming from PPPs and PPAs, and SOEs (new structural benchmark, December 2018). For PPPs and PPAs, the 2019 FRS will disclose: (i) in addition to the NPV, the total nominal value of the aggregate exposure per year for the complete lifespan of these projects, (ii) the aggregate total nominal exposure of the riskiest top 3/5/10 projects, by year for the period of the agreements, and their NPVs; and (iii) the total nominal net payments for the base case and alternative scenarios, and their NPVs. The 2019 FRS will also include financial baseline projections for major SOEs, covering the year of the FRS and the year after, which will be used as the basis for sensitivity analysis.
    - For the MoF fiscal risks management unit, we commit to recruit new staff with practical corporate finance experience and intensify the training in corporate finance of its existing staff.
- **Strengthen the monitoring of SOEs.** Our legislation already envisages that the largest SOEs – first and second category SOEs as defined by legislation – will be IFRS-compliant by October 2019, underlying our efforts to strengthen the capacity of the MoF and the MOESD to effectively supervise SOEs. We will ensure that the MoF and the MOESD collect comprehensive data on SOEs, including performance information, transfers between the state and SOEs and among SOEs, borrowing, guarantees and any litigation, at least, on an annual basis. In parallel, by December 2018, we will assess the need for legal and/or regulatory changes to institutionalize, standardize and centralize the powers for supervision of SOEs under the MOESD and MOF, with the aim of supporting adequate financial performance and control of SOEs.
- **Improve the Public Investment Management Framework (PIMF).** We will strengthen MoF's role in public investment management. To this end, we created a dedicated public investment unit at the MoF, where information on public investment projects will be centralized. This unit will evaluate investment projects based on cost/benefit analysis and other relevant analyses. This will help establish a single project pipeline, support adequate project evaluations, help prioritize investment projects and identify their financing, and integrate them within our MTBF. The PIMF will cover PPP-type projects to ensure they are prioritized and assessed alongside traditionally-procured projects. In coordination with the IMF, we are committed to strengthen further our PIMF following IMF TA recommendations on Public Investment Management Assessment conducted in May 2018.

13. We believe that accurate and transparent public financial management is a cornerstone of fiscal stability. Accordingly, we commit to:

- **Improve our fiscal rule to safeguard fiscal sustainability.** With IMF support, we initiated a review of our fiscal framework, including of our fiscal rules, with the aim of ensuring that they support our medium-term fiscal objectives towards sustainability while also granting flexibility in formulating fiscal policy over the economic cycle. We will submit to parliament a revised fiscal framework following IMF recommendations included in the TA report of November 2017(new structural benchmark, December 2018). The revised fiscal rule will apply to fiscal outturns, clarify definitions of aggregates and escape clauses, and enhance coverage, communication, transparency, and oversight.
- **Guidelines for new budget lending operations.** We issued such guidelines, requiring reasonable expectation of repayment of budget lending operations (structural benchmark, December 2017), in consultation with the IMF. We will prepare the 2019 State Budget applying the GFS classification of equity injections and on-lending, per the reasonable commercial return test and, if not met, these equity injections will be treated as subsidies or transfers.
- **Improve the quality of fiscal reports.** We will explain revisions to the medium-term budget estimates in the annual budget document. We have included LEPLs' revenues and expenditures in the budget documentation starting in the 2018 state budget. To expand the institutional coverage of fiscal reports, we will assess existing LEPLs by end-2018 and create rules for classifying them as general government units or non-general government units, based on GFSM2014 standards. We will upgrade our public finances presentation from GFSM 2001 to GFSM 2014 classification in the context of the 2019 budget.
- **Comply with international accounting standards**. In our efforts to improve fiscal transparency, starting in 2021, we will produce an annual consolidated general government sector financial report based on International Public-Sector Accounting Standards (IPSAS) basis.

C. Monetary Policy

14. We are committed to our inflation targeting (IT) framework to maintain price stability. After being temporarily above the NBG's inflation target in 2017 due to higher excise taxes and import prices, inflation has decreased significantly in early 2018 and is now close to the NBG's target of 3 percent. We will continue to abide by the Inflation Consultation Clause (ICC) under the program. As such, inflation developments will be monitored via dual consultation bands set symmetrically around the agreed forecast for headline CPI (Table 1). Should actual inflation be higher or lower than the inner consultation band of ± 2 percent, the NBG will consult with IMF staff on the reasons for the deviation and the policies to return to target. Should actual inflation be higher or lower than the outer consultation band of ± 3 percent, a consultation with the IMF Board will be triggered.

15. We will maintain a flexible exchange rate regime to protect the economy against external shocks. Foreign exchange interventions will be limited to smoothing excessive exchange rate volatility and to strengthen our reserve position. While the current level of gross international reserves is still below the level recommended by the IMF-composite metric (ARA), we will accumulate international reserves throughout the program, which will be monitored by a floor on net international reserves (performance criterion). Positive external developments in 2017 allowed us to accumulate more reserves than envisaged under the end-December program floor. This has enabled us to strengthen our external buffers and we therefore increase the end-June 2018 NIR performance criterion by $40 million to $1,490 million, and to $1,550 million by end-December 2018.

16. We will continue strengthening the monetary policy transmission mechanism. Improved confidence in the economy and our larization measures have led to a gradual decline in deposit and loan dollarization, but dollarization remains elevated. Improved lari liquidity facilities have strengthened NBG's liquidity management, promoting maturity transformation in the banking sector. The interbank market is working well, and interbank interest rates are close to the policy rate. We will submit legal amendments to Parliament to support derivatives and repo transactions in line with best international practices, including netting and close-out netting provisions. We plan to strengthen lari liquidity management by extending open market operations to outright purchases of treasury securities by mid-2018.

17. Monetary policy will be enhanced by improving our communication toolkit. We have requested IMF TA to strengthen our communication. We will continue publishing our quarterly monetary policy reports on a fixed pre-announced schedule in par with associated meeting with experts. Every second monetary-policy meeting will also continue to be followed by a press conference. We will further strengthen our communications by issuing a manual for monetary policy operations in line with the recent IMF TA.

D. Financial Sector Policy

18. Our policies will strengthen financial sector stability. As noted in the previous MEFP, we took significant steps to enhance our financial stability policy framework, regulation and supervision, including: (i) operationalizing macroprudential policy; (ii) introducing new capital requirements within Basel III framework; (iii) allowing the NBG to supervise banking groups; (iv) empowering the NBG to ultimately supervise and regulate micro-financial institutions, and (v) improving consumer protection in operations related to the financial sector. This will support the banking sector's ability to cope with shocks and improve financial intermediation. We will further strengthen: (i) the supervisory and regulatory framework; (ii) the financial stability policy framework; and (iii) the safety nets and the bank resolution framework for crisis preparedness. We will also step-up efforts to incentivize the use of the domestic currency and support the development of the domestic capital market.

19. We made progress on strengthening the financial stability policy framework, regulation and supervision.

- We submitted to Parliament legal amendments giving to the NBG oversight power for credit information bureaus (structural benchmark, December 2017). Parliament approved amendments by end-2017.

- As one of the main components of the financial stability policy framework, we started operationalizing macroprudential policy, and introduced a countercyclical capital buffer. Its goal is to limit excessive credit growth, which could lead to the buildup of systemic risks.
- We strengthened the operational framework of the Financial Stability Committee (FSC). Its main tasks include evaluating and analyzing financial stability risks and implementing macroprudential policy. The FSC meets once a quarter according to the preannounced calendar, and after each meeting, a press release is published. The press release outlines current trends and challenges in the financial system, and the decisions of the committee. Moreover, twice a year committee meeting is followed by a press conference. We also updated the NBG webpage, which now outlines our financial stability policy, objectives and tools. Our enhanced communication strategy will strengthen financial stability.
- In the context of implementing IFRS-reporting standards, we introduced impairment guidelines to help the financial sector establish proper credit loss calculation system following IFRS 9. Also, to ensure IFRS 9 implementation, we started publishing macroeconomic forecasts and risk scenarios. Financial institutions can use these scenarios as an input for calculating the expected credit loss. A roadmap to transition to IFRS regulatory reporting will be prepared by June 2018. Ultimately, NBG aims to transfer banks' regulatory reporting to IFRS framework through EU standards (FINREP/COREP forms).
- In line with FSAP recommendations, we issued regulations to phase in by 2022 additional capital requirements for systematically important banks (structural benchmark, December 2017).
- To increase transparency of Pillar 2 capital requirements (under Basel III regulation), we published General Risk Assessment Program (GRAPE) guidelines describing the general principles of risk-based supervision and the rationale behind capital add-ons.
- To promote responsible lending practices, we prepared guidelines to enhance the assessment of households' credit worthiness. The guidelines are currently being discussed with the industry. We will conduct a thorough analysis of households' lending practices –both for banks and non-bank financial institutions – to better understand the potential impact of these guidelines on households' indebtedness.

20. We will continue strengthening financial regulation and supervision. Our banking system has remained resilient after the 2014 external shocks due, in large part, to good regulation and supervision by the NBG.

- The NBG and the State Insurance Supervision Agency are working together on developing a supervision framework for financial conglomerates. We drafted the law on supplementary supervision of financial conglomerates in accordance with the relevant EU directive.
- We will introduce regulations on: (i) leverage ratios based on Basel Principles and relevant EU regulations (structural benchmark, September 2018); (ii) credit information bureaus (with the support of WB TA) to set requirements and limits, issue guidelines and apply fines, protect consumers and limit business-continuity risks; (iii) bank's real estate appraisal of collateral in line with International Valuation Standards (structural benchmark, June 2018); (iv) corporate governance

in line with Basel Principles (structural benchmark, September 2018); and (v) the net stable funding ratio in line with Basel III principles.

- With the help of IMF TA, we have initiated regulation, supervision and oversight of non-bank financial institutions, depending on the source of the funding. The prudential regulatory framework for MFI's will be ready by June 2018, and we will introduce non-prudential oversight to other lenders effective January 2019.

21. We will continue improving analytical tools for macro-financial analysis with the goal of strengthening financial stability through macroprudential policy. With the support of IMF TA, we are developing macro-financial model tailored our economy. The model incorporates interlinkages between the real economy and the financial system, analyzes financial and macroeconomic risks scenarios and main policy trade-offs, and conducts macro stress tests. The model will be the backbone for our macroprudential policy design and serve as an instrumental tool for our renewed Financial Stability Report (FSR), which we plan to resume publishing in 2019. The FSR will include a forward-looking analysis of policies and risks.

22. We joined the Sustainable Banking Network (SBN) and thus expressed our willingness to support the sustainability of our financial system. We intend to raise awareness of sustainable finance. We are exploring best international practices and working to develop our roadmap to adopt sustainable finance principles. As a first step, we will publish the International Capital Market Association (ICMA) principles in Georgian and develop guidelines for green bonds and credits.

23. We are strengthening financial safety nets.

- We continue to cooperate with banks to strengthen their recovery plans. The deposit insurance agency became operational January 2018.
- Following international best practices, we will strengthen our capacity to act as lender of last resort by identifying legal amendments to prohibit unsecured lending by the NBG, to mandate a penalty rate for emergency liquidity assistance (ELA), and to clarify the role of the MoF to ensure an effective ELA framework. With TA support, we plan to revamp the banking resolution framework and to enhance crisis management, including clarifying the authorities' role and the decision-making process. Hence, we plan to revise the NBG law to state clearly the NBG's resolution authority. In this vein, we will submit to Parliament legislative changes to implement effective ELA and resolution frameworks in line with international best practices (new structural benchmark, May 2019).

24. We have taken steps to further enhance financial larization to reduce FX risks and improve monetary policy transmission mechanisms. We adopted a comprehensive plan in December 2016 (detailed in previous MEFP), which supported a decline in loan dollarization. Stronger confidence in the local currency has also led to a healthy decline in deposit dollarization. Accordingly, we will continue introducing larization measures, including prudential measures to help financial institutions continue internalizing FX-induced credit risks, promoting consumer protection practices, and expanding financial education so that households have a better understanding of the risks associated to FX borrowing.

25. Capital market development will support larization while reducing external vulnerabilities. The non-banking financial system is shallow in Georgia, limiting competition for savings and their efficient use within the economy.

- A law establishing investment funds will be submitted to Parliament by December 2018. In parallel, we are working on the legal and regulatory frameworks for other financial instruments, such as derivatives and securitization.
- We will upgrade our exchange infrastructure by having a single settlement system for all Georgian securities with two participating central security depositories (CSDs), one for commercial bonds and shares, and another one for government bonds. The new system will allow for delivery-versus-payments settlements in central bank money for all securities and full integration with the Georgian Stock Exchange and OTC trading platforms. We expect the system to be fully operational by the end of 2018.
- We published a multi-year plan of government bond issuance to develop benchmarks along the yield curve (structural benchmark, December 2017) to facilitate price discovery for private-sector bonds. We will continue with this practice going forward.
- We will also support the creation of primary dealers, and the foreseen mandatory third-party vehicle insurance will help develop the insurance sector.
- We will align our legal framework in the securities market with EU directives, and strengthen the legal underpinnings of insolvency and securities holding frameworks.

E. Structural Reforms

26. Achieving more robust and inclusive growth will require advancing our comprehensive structural reform agenda. We are counting on our partners to support our reform program, including the World Bank (WB), the Asian Development Bank (ADB), the European Bank for Reconstruction and Development (EBRD), the European Investment Bank (EIB), KfW Development Bank, Agence Française de Développement (AFD), and the European Commission. Our reforms aim at scaling-up infrastructure spending, and improving education and vocational training, the business environment, foreign trade relations, and land reform. We firmly believe that our reform program will boost long-term growth, diversify the economy, strengthen our external position, create jobs and reduce poverty. At the same time, targeted social assistance and health care will continue to protect the most vulnerable.

27. Scaling-up infrastructure and spatial planning is key to Georgia's development. With our international partners, we aim to finalize the East-West highway and the South-North corridor by 2020. Additional infrastructure projects, including ports, airports, and railways, will transform Georgia into a transport and logistics hub connecting Europe with Asia. We are also developing radial roads to better connect regions and urban and rural areas. To improve public investment efficiency and transparency, we have brought our public procurement process closer to international standards. Combined with the government's support for tourism development (including water and electricity infrastructure), Georgia will turn into a four-season tourist destination.

28. We are actively working on a comprehensive education reform to promote job creation. With the help of our partners, we will design a comprehensive education reform that will cover the following areas: (i) early childhood education; (ii) secondary education; (iii) vocational education and training; (iv) higher education; and (v) science and research. This reform is crucial to improve job creation, productivity and wages. The lack of qualified labor force is repeatedly reported as one of the most problematic factors for doing business in Georgia. At the same time, unemployment and underemployment remains high, suggesting skill mismatches in our labor force. This reform will entail, among other things, setting curriculum standards, a new teacher policy framework, and more effective vocational training and adult learning. We will encourage the participation of employers in the design of curriculum to better prepare the young for labor market demands. Finally, we will support job seekers with guidance on job selection, preparation and retraining.

29. We are committed to introducing a funded pension pillar in 2018, which will promote savings and create an institutional investor for long-term lari assets. With the assistance of the World Bank and the Asian Development Bank, we submitted to Parliament a law establishing a Pilar II pension system (structural benchmark, December 2017), to be followed by the creation of an independent pension agency (structural benchmark, July 2018). In parallel, we are committed to formulate a private pension savings system (Pillar 3) in 2018. Our basic public pension, which amounts to GEL180 per month, is marginally higher than the subsistence minimum. Hence, we will increase the basic monthly pension to GEL200 and GEL220 per month in 2019 and 2020, respectively. In consultation with the IMF, we will submit to Parliament legislation proposing a rule-based mechanism to index basic pensions (new structural benchmark, February 2019).

30. We will continue to improve the business environment. We will establish a Business House by 2019 to provide public services to enterprises under a one-stop shop. We also plan to introduce IFRS for corporations and to submit to Parliament a new insolvency law by April 2019, to support an adequate restructuring for viable non-financial corporations. An efficient VAT tax system will also improve the business environment. In addition, we will widely apply regulatory impact assessments to analyze the possible impact of major policy decisions and protect the economy from undue costs.

31. Land registration will be pivotal for rural and agricultural development. Land cadasters are important for protecting property rights, simplifying land transactions and providing collateral for borrowing. We have simplified land registration, especially for agricultural land plots, through a fee waiver program. We will assist citizens in searching for property ownership documents and facilitate dispute resolution through mediation. Currently, registered land plots amount to 1.8 million, where 25 percent of those were registered within the land reform launched on August 1, 2016.

32. Deepening trade relations with the rest of the world is one of Georgia's key priority. As a small open economy, free trade agreements (FTAs) will help Georgia mobilize FDI in tradable sectors to improve competitiveness, reduce external vulnerabilities, and generate balanced growth. Georgia has FTAs with the EU (Deep and Comprehensive Free Trade Area), the European Free Trade Association (EFTA), the People's Republic of China, Turkey and the Commonwealth of Independent States countries. FTA negotiations were concluded with Hong Kong Special Administrative Region and an agreement is expected to be signed by June 2018. At the same time, we are negotiating with Turkey an expansion of the current FTA. We remain committed to pursue other FTAs with priority countries, including the United States, India, and others.

33. We are committed to strengthening our statistics as they serve as a precondition for strong economic policy-making. We are grateful for the technical assistance provided by the IMF in the areas of national accounts external sector statistics and financial and sectoral accounts. Unfortunately, due to technical issues related to the new census, we have not been able to start publishing quarterly unemployment figures in May 2017, but we will do so by September 2018. We will also broaden the coverage of employment statistics by publishing hours worked. In 2018, we will conduct a structure of earnings survey to have a detailed view of the earnings' structure by occupations and in terms of labor costs. We completed back-calculations for population figures to reconcile the differences between the 2014 and the 2002 census results. We plan to publish the new population data by April 2018. We will also start publishing national accounts based on NACE 2 sectoral classification by November 2019. Along with the migration to NACE 2 classification, we will compute GDP-based on supply and use tables (capitalizing on the TA provided by the IMF) and publish quarterly GDP by expenditure in constant prices. This will provide a more detailed picture of the structural transformations in our economy. In May 2018 we will publish updated poverty figures and in the first half of the year we will start publishing quarterly statistics on inbound tourism which, among other things, will further strengthen balance of payments statistics.

F. Program Monitoring and Safeguards

34. The program will be monitored through quantitative performance criteria, indicative targets, an inflation consultation clause and structural benchmarks. Semi-annual program reviews will be based on December and June test dates. All quantitative performance criteria and indicative targets are listed in Table 2, and structural benchmarks are set out in Table 3. The Technical Memorandum of Understanding is also attached to describe the definitions of quantitative PCs and the inflation consultation clause as well as data provision requirements.

35. The NBG continues to maintain a strong safeguards framework and internal controls environment. Since the last assessment and in line with IMF recommendations, we have submitted and Parliament has approved amendments to the NBG Organic Law on (i) Audit Committee's definition and mandate; (ii) specifying the Chief Internal Auditor eligibility criteria and grounds for dismissal and (iii) early appointment of external auditor for NBG. As required by the safeguards policy, we will continue to engage independent external audit firms to conduct the audit of the NBG in accordance with international standards.

Table 1. Georgia: Inflation Consultation Targets and Bands for 2017–18

	2017				2018	
	End June	Outturn	End Dec.	Outturn	End June	End Dec.
Inflation Consultation Bands for CPI (in percent)						
Central point	6	7.1	5	6.7	3	3
Inner band, upper limit/lower limit	8/4	…	7/3	…	5/1	5/1
Outer band, upper limit/lower limit	9/3	…	8/2	…	6/0	6/0

Source: IMF staff estimates

Table 2. Georgia: Quantitative Performance Criteria and Indicative Targets for end-December 2017 and 2018

(Unless otherwise indicated: cumulative from the beginning of the calendar year, millions of GEL)

	2017					2018		
	End-December					End-June		Proposed End-December
	Target	Revised Target	Adjusted Target	Outturn	Status	Target	Revised Target	Target
Performance Criteria								
Ceiling on augmented general government deficit (program definition)	1,335	1,335	1,350	1,113	Met	430	430	1,150
In percent of GDP	*3.7*	*3.7*	*3.7*	*2.9*		*1.0*	*1.0*	*2.8*
Floor on NIR of NBG[1] (end-period stock, million of U.S. dollars)	1,350	1,390	1,314	1,416	Met	1,450	1,490	1,550
Ceiling on the accumulation of external debt arrears of the Public Sector (continuous criterion) (million of U.S. dollars)	0	0	…	0	Met	0	0	0
Ceiling on new public guarantees (continuous criterion)	0	0	…	0	Met	0	0	0
Ceiling on the cash deficit of the Partnership Fund	0	0	…	22	Met	0	0	0
Ceiling on the new net borrowing of the Partnership Fund (million of U.S. dollars, cumulative from the beginning of the EFF program)	20	20	…	0	Met	20	20	20
Indicative Targets								
Ceiling on the accumulation of net domestic expenditure arrears of the general	0	0	…	0	Met	0	0	0
Ceiling on Primary Current Expenditures of the General Government (in mn lari)	8,685	8,685	…	8,713	Not Met	4,675	4,675	9,035

Source: IMF Staff

Table 3a. Georgia: Structural Benchmarks

Measure	Date	Status
Financial Sector		
Financial Stability		
Introduction of LCR for commercial banks, with preferential treatment of GEL-deposits (MEFP ¶19)	End-September 2017	Met
Adoption of regulation on capital add-ons in CAR for systemically important banks, (MEFP ¶20)	End-December 2017	Met
Submit to Parliament legislation giving NBG oversight power over credit information bureaus, (MEFP ¶19)	End-December 2017	Met
Increase in minimum regulatory capital for commercial banks to GEL50 million, phased in by 2019 (MEFP ¶19)	End-June 2017	Met
Capital Markets Development		
Publication of a multi-year calendar for government benchmark bonds (MEFP ¶23)	End-December 2017	Met
Monetary policy operations and communication		
Signing of a Memorandum of Understanding between the Ministry of Finance and the NBG on information sharing for liquidity forecasting purposes (MEFP ¶16)	End-June 2017	Met
Deposit insurance		
Submission to Parliament legislation establishing deposit insurance as of January 1, 2018 (MEFP ¶21)	End-June 2017	Met
Bank Resolution Framework		
Submit to Parliament amendments to NBG Law that will give it the authority to resolve a bank through a temporary administration at an early stage of a bank's financial difficulty, in line with good international practices as identified in the 2014 FSAP recommendations (MEFP ¶21)	End-September 2017	Met
Fiscal		
Submission to Parliament a 2018 budget consistent with the fiscal deficit in the Fund-supported program (MEFP ¶7)	End-December 2017	Met
Adopt a remuneration law for public civil service (MEFP ¶11)	End-December 2017	Met
Action plan to address accumulated outstanding VAT refunds in an orderly manner over time (including analysis, refund, set-offs, and write-offs) (MEFP ¶10)	End-September 2017	Met
Public-Private Partnership and Fiscal Risk		
Submission of a public-private partnership law to Parliament, establishing reporting and monitoring as well as requiring a ceiling on government exposure from such partnerships (MEFP ¶12)	End-December 2017	Met
Include all PPP and PPA liabilities, and expand the analysis of contingent liabilities from state-owned enterprises, reporting quasi-fiscal activity in the 2018 Annual Fiscal Risk Statement (MEFP ¶12)	End-December 2017	Met
Public Financial Management		
Issue guidelines for new budget lending operations requiring reasonable expectation of commercial returns (MEFP ¶13)	End-December 2017	Met
Pension Reform		
Submission of a pension law establishing a 2nd pillar pension system, and introducing indexation of basic public pensions (MEFP ¶27)	End-December 2017	Met

Source: IMF staff.

Table 3b. Georgia: Structural Benchmarks, by Completion Date

Structural Benchmarks	Date	Status
Restructure the GRS headquarters into a function-based organization (MEFP ¶11).	Feb-18	Met
The steering committee will propose any necessary legal amendments or ministerial decrees to facilitate the implementation of the action plan to address outstanding VAT claims (MEFP ¶11).	Mar-18	Not met
Create a new specialized VAT unit focusing on validating VAT claims (MEFP ¶11).	Jun-18	In progress
Introduce regulation on bank's real estate appraisal in line with International Valuation Standards (MEFP ¶21).	Jun-18	In progress
Establishing an independent pension agency (MEFP ¶28).	Jun-18	Jul-18
Introduce regulation on leverage ratio based on Basel Principles and relevant EU regulation (MEFP ¶21).	Sep-18	In progress
Introduce regulation on banks corporate governance in line with Basel Principles (MEFP ¶21).	Sep-18	In progress
Proposed Structural Benchmarks		
The 2019 FRS will expand the analysis of fiscal risks stemming from PPPs and PPAs, and SOEs as described in the MEFP (MEFP ¶12)	Dec-18	
Adopt the government decree implementing the PPP law following the recommendations of the FAD TA report (MEFP ¶12)	Dec-18	
Submit to Parliament a revised penalty regime with gradual tax-geared penalties depending on the degree of culpability (MEFP ¶11)	Dec-18	
Submit to Parliament a new fiscal rule framework (MEFP ¶13)	Dec-18	
In consultation with the IMF, we will submit to Parliament legislation proposing a rule-based mechanism to index basic pensions (MEFP ¶30)	Feb-19	
Submit to Parliament legal amendments bringing the banking resolution framework, the role of the central bank as the lender of last resort, and crisis management in line with best international practice (MEFP ¶23)	May-19	
90 percent of the VAT refund requests approved by the system will be automatically refunded, upon request, after offsetting against existing tax liabilities (MEFP II 11)	Jun-19	

Source: IMF staff.

Attachment II. Technical Memorandum of Understanding (TMU)

1. This Technical Memorandum of Understanding (TMU) defines the variables subject to quantitative targets (performance criteria, inflation consultation mechanism and indicative targets) and describes the reporting requirements used to monitor developments under the Extended Fund Facility and methods to be used in assessing the program performance with respect to these targets. To this effect, the authorities will provide the necessary data to the IMF as soon as it becomes available.

A. Program Assumptions

2. For the purposes of the program monitoring, all foreign currency-related assets will be valued in lari at program exchange rates as specified below. Amounts denominated in other currencies will be converted for program purposes into U.S. dollar amounts using the cross-rates as of December 31, 2016, published on the IMF web site http://www.imf.org/.

Table 1. Georgia: Program Exchange Rates

	Currency Name	**Currency/US$**
SDR	Special Drawing Rights	0.7439
GEL	Georgian lari	2.6468
AUD	Australian dollar	0.7227
CAD	Canadian dollar	0.7419
EUR	Euro	1.0556

B. Institutional Definition

3. The **general government** is defined as comprising the central government and local governments, excluding Legal Entities of Public Law. The definition of the general government includes any new funds, or other special budgetary or extra-budgetary entities that may be created during the program period to carry out operations of a fiscal nature as defined in the IMF's Manual on Government Finance Statistics 2001 (GFSM 2001). The authorities will inform IMF staff on the creation of any such entities without delay. The general government coverage excludes state-owned companies and the Partnership Fund. The **public sector** consists of the general government, Legal Entities of Public Law and public financial and non-financial corporations, including the National Bank of Georgia.

4. **Supporting material:** The Treasury Department of the Ministry of Finance will provide to the IMF detailed information on monthly revenues of the general government within two weeks of the end of each month and monthly expenditures and arrears of the central government within four weeks of the end of each month. The Ministry of Finance will provide the stock of general government debt, broken down by currency and original maturity within one month from the end of each quarter. The

Treasury will provide, on a daily basis, the cash balances in all the accounts of the general government as of the end of the previous business day.

C. Quantitative Program Targets

5. The program will be assessed through performance criteria and an indicative target (Tables 2 attached to the Letter of Intent). Performance criteria are set with respect to:

- a performance criterion (ceiling) on the augmented cash deficit of the general government;
- an indicative target (ceiling) on the primary current spending of the general government;
- a performance criterion (floor) on the net international reserves (NIR) of the NBG;
- a continuous performance criterion (ceiling) on the accumulation of external debt arrears by the general government;
- an indicative target (ceiling) on new domestic expenditure arrears by the general government;
- a performance criterion (ceiling) on the new guarantees issued by the public sector;
- a performance criterion (ceiling) on the cash deficit of the Partnership Fund;
- a performance criterion (ceiling) on new net borrowing by the Partnership Fund.

In addition, the program will include a consultation clause on the 12-month rate of inflation.

6. Performance criteria and indicative targets have been set for end-December 2017 and end-June 2018 (the next two test dates). They are monitored on a cumulative basis from the beginning of the calendar year (except for (i) the NIR target, which is monitored in term of stock levels and (ii) the new net borrowing by the Partnership Fund, which is monitored since program approval), while continuous performance criteria are monitored on a continuous basis.

D. Inflation Consultation Mechanism

7. Inflation consultation bands around the projected path for inflation are set for each test date under the program. Inflation is identified as the 12-month percentage change of the consumer price index (CPI) as measured and published by the National Statistics Office of Georgia (GEOSTAT).

8. If the observed year-on-year inflation for the test dates falls outside the outer bands specified in Table 1 of the MEFP, the authorities will complete a consultation with the IMF Executive Board which would focus on: (i) the stance of monetary policy and whether the Fund-supported program remains on track; (ii) the reasons for the deviation; and (iii) the proposed policy response. When the consultation with the IMF Executive Board is triggered, access to Fund resources would be interrupted until the consultation takes place and the relevant program review is completed. In addition, if the observed year-on-year inflation falls outside the inner bands specified in Table 1 for the test dates, the authorities will complete a consultation with IMF staff on the reasons for the deviation and the proposed policy response.

E. Program Definitions, Adjustors, and Reporting Requirements

General Government

Ceiling on the Augmented Cash Deficit of the General Government

9. Definition: The **augmented cash balance of the general government** is defined as: revenues minus expense, minus net acquisition of non-financial assets (as defined by GFSM 2001) minus net budget lending (as defined below). A negative augmented cash balance is a deficit.

10. The **augmented cash balance of the general government** will be measured from the financing side at current exchange rates established by the NBG at the date of the transaction. Accordingly, augmented cash deficit of the general government will be measured by: i) net acquisition of financial assets (including changes in balances of the revenue reserve account), excluding net budget lending as defined by GFSM 2001; minus ii) net incurrence in domestic and foreign liabilities as defined in GFSM 2001.

11. Definition: Consistent with GFSM 2001, **net budget lending** is defined as the net acquisition of financial assets for policy purposes by the general government.

12. Adjustor: The ceiling on augmented cash deficit of the general government will be adjusted upward (higher deficit)/downward (lower deficit) by the cumulative total amount of foreign-financed project loan disbursements above/below the program amounts (Table 2), subject to a cap of $60 million per year.

13. Adjustor: The ceiling on the augmented cash deficit of the general government will be adjusted downward (lower deficit) by the cumulative amount of receipts from sale of non-financial assets above the program amounts (Table 2).

14. Adjustor: The ceiling on the augmented cash deficit of the general government will be adjusted upward (higher deficit)/downward (lower deficit) by the amount of VAT credits refunded in cash above/below the program amounts (Table 2).

Table 2. Georgia: Projected Financing for Cash Deficit of the General Government
(in millions of GEL, cumulative from the beginning of the calendar year)

	June 30, 2018	December 31, 2018
Disbursements of foreign-financed project loans	673	1214
Receipts from sale of non-financial assets	69	150
VAT refunds	200	400

Supporting Material:

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

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

c. Data will be provided at actual exchange rates.

d. Data on receipts from sales of non-financial and financial assets of the general government will be provided by the Treasury Department of the Ministry of Finance to the IMF on a monthly basis within two weeks of the end of each month.

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

f. Separately for VAT and non-VAT tax credits, data for the previous month will be provided by the Georgia Revenue Service by the end of each month on:

- Opening balance of tax credits (stock) and of new tax credits declared by taxpayers,
- Tax credit balance adjustments made by GRS after desk check / audit,
- Credit refunds paid in cash, offset against existing VAT liabilities, and offset against existing non-VAT liabilities,
- Other flows,
- Closing balance of tax credits (stock) and of tax credits older than three years (stock),
- Number of claims for cash refund received,
- Total amounts claimed for cash refund, and
- Number of refunds made, number of refunds made automatically and total amounts refunded automatically.

Ceiling on the Current Primary Expenditures of the General Government

15. Definition: primary current expenditures is defined as expense (as defined by GFSM 2001) on a cash basis, minus interest payments.

16. Supporting material: Data for monitoring expenditures will come from the accounts of the general government covered under the ceiling on the augmented cash deficit of the general government (including autonomous regions). The Ministry of Finance is responsible for providing reporting according to the above definition. Data on expense and net acquisition of non-financial assets of the general government should be reported to the IMF within four weeks after the end of the quarter.

Continuous Performance Criterion on Accumulation of General Government External Debt Arrears

17. Definition: Debt is defined as set forth in point No. 8 of the Guidelines on Public Debt Conditionality in Fund Arrangements (Decision No. 15688-(14/107) adopted on December 5, 2014. External debt is defined by the residency of the creditor.

18. For the program, **external payment arrears** will consist of all overdue debt service obligations (i.e. payments of principal or interest, considering contractual grace periods) arising in respect of any debt contracted or guaranteed or assumed by the central government, or the NBG, or any agency acting on behalf of the general government. The ceiling on new external payments arrears shall apply on a continuous basis throughout the period of the arrangement. It shall not apply to external payments arrears arising from external debt being renegotiated with external creditors, and more specifically, to external payments arrears in respect to which a creditor has agreed that no payment needs to be made pending negotiations.[1]

19. Supporting Material. The accounting of non-reschedulable external arrears by creditor (if any), with detailed explanations, will be transmitted on a monthly basis, within two weeks of the end of each month.

Continuous Indicative Target on Accumulation of General Government Domestic Expenditure Arrears

20. Definition: For program purposes, domestic expenditure arrears are defined as non-disputed (in or out-of-court) payment obligations whose execution term has expired and became overdue. They can arise on any expenditure item, including debt service, wages, pensions, and goods and services. Arrears will arise from non-debt liabilities that are not paid after 60 days of the contractual payment date or—if there is no contractual payment date—after 60 days of the receivable. Any wage, pension or other entitlement obligation of the general government that is not paid after a 30-day period from the date that they are due, is in arrears.

21. Supporting Material: The accounting of new domestic expenditure arrears (if any) will be transmitted within four weeks after the end of each month.

Guarantees

For the program, a **guarantee** of a debt arises from any explicit legal obligation of the public sector to service such a debt in the event of nonpayment by the recipient (involving payments in cash or in kind).

Partnership Fund

Ceiling on the Cash Deficit of the Partnership Fund

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

[1] Arrears to Turkmenistan.

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

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

Ceiling on New Net Borrowing by the Partnership Fund

25. **Definition:** Net borrowing by the Partnership Fund is defined as contracted debt liabilities minus principal repayments.

26. **Supporting Material:** The Ministry of Finance will provide to the IMF detailed information on the Partnership Fund's quarterly revenue, expenditure, and amounts related to new contracted debt and principal repayments, within four weeks of the end of each quarter.

Net International Reserves

Floor on the Net International Reserves of the NBG

27. **Definition: Net international reserves (NIR)** of the NBG in U.S. dollars are defined as foreign assets of the NBG minus the sum of foreign liabilities of the NBG, including all of Georgia's liabilities to the IMF. **Foreign assets of the NBG** include gold, gross foreign exchange reserves, Georgia's SDR holdings, and the reserve position in the IMF. Gross foreign exchange reserves of the NBG are defined as liquid, convertible currency claims of the NBG on nonresidents, including cash holdings of foreign exchange that are readily available. Pledged or otherwise encumbered assets, including (but not limited to) assets used as collateral (or guarantee for third party external liabilities) are excluded from foreign assets. **Foreign liabilities of the NBG** shall be defined as the sum of Georgia's outstanding liabilities to the IMF (at face value), Georgia's SDR allocation, and any other liabilities of the NBG (including foreign currency deposits of financial institutions at the NBG and currency swaps and foreign exchange forward contracts with financial institutions), excluding the foreign exchange balances in the government's account with the NBG. For program monitoring purposes, the stock of foreign assets and foreign liabilities of the NBG shall be valued at program exchange rates as described in paragraph 2 above. The stock of NIR amounted to $1, 416 million as of December 31, 2017 (at program exchange rates).

28. For the purpose of the program, **budget support grants to the general government** are defined as grants received by the general government for direct budget support from external donors and not related to project financing. **Budget support loans to the general government** are defined as disbursements of commercial loans and loans from bilateral and multilateral donors for budget support.

29. Adjustors. For program purposes, the floor on NIR will be adjusted

- Upward (downward) by the cumulative amount of any excess (shortfall) by any FX privatization revenue in foreign exchange above (below) the programmed amounts. Privatization receipts are defined in this context as the proceeds from sale, lease, or concessions of all or portions of entities and properties held by the public.
- Upward (downward) by the cumulative amount of any excess (shortfall) of budget support grants and loans compared to program amounts (Table 3).
- Upward/downward for any excess/shortfall related to net issuance of the Eurobond from the general government relative to program amounts (Table 3).
- Upward/downward by 75 percent for any excess/shortfall related to disbursements of the project loans and grants to the treasury single account at the NBG relative to the projected amounts (Table 3).

Table 3. Georgia: Projected Balance of Payment Support Financing
(in millions of U.S. dollars, cumulative from the beginning of the calendar year)

	June 30, 2018	December 31, 2018
Projected privatization revenue	0	0
Budget support grants from external donors and not related to project financing	6	45.7
Budget support loans, including bilateral and multilateral donors for budget support	130.8	166.4
Net issuance of the Eurobond from the general government	0	0
Disbursements of project loans and grants	114.1	306.8

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

Appendix to the TMU: The Partnership Fund

A. Organization and Operational Structure

Legal Structure and Corporate Governance

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

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

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

B. Corporate Mandate and Portfolio Management

Corporate Mandate

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

Portfolio Management Strategy

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

- The PF will participate only in commercially viable projects; and

- The PF's performance will be monitored on the basis of the following evaluation criteria: IRR, adjusted present value, sharp ratio, and risk adjusted return.

Project Development Methodology

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

Reporting and Auditing

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

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

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

Fiscal risks associated with the PF will be limited since:

- All liabilities of the PF are limited to its own balance sheet;
- The PF has its own revenue sources, namely: the dividends from its investments, the interest earnings from the loans its provides, the fees it charges on the guarantees it provides, and the proceeds of asset sales; and the PF may decide to borrow from credible financial institution with recourse to its balance sheet facility and without state guarantee.