International Monetary Fund

Georgia and the IMF

Press Release:
IMF Executive Board Completes the Third Review of the Extended Arrangement under the Extended Fund Facility for Georgia

December 19, 2018

Country's Policy Intentions Documents

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

December 4, 2018

Appendix I. Letter of Intent

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

Tbilisi, December 4, 2018

Dear Ms. Lagarde:

1. **We remain committed to the policies detailed in our Letter of Intent (LOI) and Memorandum of Economic and Financial Policies (MEFP) of March 27, 2017, updated most recently on May 30, 2018.** Our vision for Georgia's economic development, detailed in our government program (Freedom, Rapid Development and Welfare), is based on free-market principles. Our policies aim at alleviating Georgia's structural challenges by introducing education reform, scaling-up core infrastructure (including at the municipality level), strengthening governance, supporting SMEs, facilitating entrepreneurship, and integrating further Georgia into the global economy. We remain committed to scaling-up our public investment to address structural bottlenecks in the economy and support inclusive growth. The central bank will continue strengthening the monetary policy framework and enhancing financial supervision, regulation and 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. **Strong and sustained economic performance will allow us to resolutely implement our reform program.** Preliminary estimates indicate that through September, economic growth averaged 4.9 percent (y/y) while inflation has remained close to our 3-percent inflation target. Robust growth of exports, remittances and tourism, have helped contain the current account deficit to 8.9 percent of GDP in 2018Q2, despite strong import growth fueled by domestic demand and higher commodity prices. A relatively supportive external environment has helped us purchase USD132.5 million in foreign exchange (FX) reserves so far in 2018. Higher-than-expected revenues, contained current spending, and delays in large capital infrastructure projects have resulted in a fiscal surplus through September. We are committed to address the delays in public investment encountered this year.

3. **We have hitherto met most of the conditionality under our IMF-supported program**. We have met all end-June quantitative performance criteria (QPCs), and inflation has remained within the inflation consultation clause (ICC). Most structural benchmarks (SBs) have been met for the third review; the creation of the pension agency, however, was implemented with a 2-week delay.

4. **We request the completion of the Third 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 MEFP, we intend to purchase a further SDR 30 million from the IMF, bringing

our drawings under this program to SDR 120 million. Our program will continue to be monitored through Quantitative Performance Criteria (QPCs), indicative targets, and an Inflation Consultation Clause (ICC), with end-June and end-December test dates, and continuous performance criteria. Consistent with our reform agenda, our program also envisages Structural Benchmarks (SBs). These are set out in Tables 1–3 of the MEFP (Attachment I) and defined in the attached Technical Memorandum of Understanding (TMU, Attachment II). Reviews will be conducted semi-annually. The Fourth Review will be based on end-December 2018 performance criteria and is expected to be completed on or after April 12, 2019. The Fifth Review will be based on end-June 2019 performance criteria and is expected to take place on or after October 25, 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 LOI in accordance with the IMF's policies on such consultations. We will also provide the IMF with the information it requests for monitoring program implementation. We authorize the IMF to publish this LOI 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/
Ivane Matchavariani
Minister of Finance

/s/
Giorgi Kobulia
Minister of Economy and Sustainable Development

/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)

Attachment I. 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. Georgia's economic growth has benefitted from our prudent policies and robust growth in our main trading partners. Through September, our economy has shown momentum, with growth averaging 4.9 percent, slightly higher than assumed in the 2018 Budget. Our current account balance has strengthened considerably in 2017-18 due to vigorous growth in exports, tourism receipts and remittances. Inflation has remained close to the central bank's inflation target in 2018. We surpassed the end-June NIR program target with some margin. The improved confidence in the Georgian economy and our larization measures have put dollarization on a downward trend. Continued reform implementation also resulted in Georgia ranking 6th in the 2019 World Bank's Doing Business Report and 5th in the 2017 International Budget Partnership's Open Budget Survey. Our credit rating has also improved, and we will strive to reach investment grade status by continuing to implement prudent macroeconomic policies.

3. We are maintaining prudent macroeconomic assumptions for our 2019 Budget and IMF-supported program.

a) We expect robust growth to continue in 2018 supported by domestic demand. For 2019, we forecast GDP growth of 4.6 percent and will remain vigilant about regional developments which could negatively impact 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.

b) Strong revenue performance and robust growth will generate additional fiscal space. This will allow us to accelerate infrastructure spending, undertake education reform, and address pressing social needs while maintaining medium-term fiscal sustainability (see below).

c) The current account is expected to marginally deteriorate in 2018-19 owing to rising global fuel prices and strong domestic demand. The current account deficit is projected at 9.0 percent of GDP in 2018 and 9.5 percent in 2019, and is expected to gradually decline to 8 percent of GDP over the medium term. External financing requirements are projected to gradually decline over the medium term. While external financing will continue to rely mostly on FDI, its share is expected to decline slightly over time, to be replaced by debt. A strong external position and FX interventions will help us reach an adequate level of the reserves by 2020.

4. Our reform agenda will help bolster inclusive growth and external competitiveness. We will create new business opportunities and support economic diversification by: (i) reforming our education system; (ii) improving the business environment (establishing commercial chambers, improving revenue administration, updating our insolvency laws and commercial arbitration); and (iii) strengthening Georgia's connectivity, by scaling-up public infrastructure to facilitate uninterrupted passenger and cargo transportation, and deepening our trade relations with the rest of the world. These are a few of the ambitious structural reforms to be implemented by Georgia to help mobilize FDI in tradable sectors, improve competitiveness, and reduce external vulnerabilities.

5. While robust economic growth is expected to continue, downside risks to the outlook have increased. Downside risks are mainly related to regional developments, emerging market volatility, retreat from cross-border integration, and weaker global growth. Our structural reform agenda will mitigate medium-term risks associated with Georgia's high external debt, current account deficit and financial dollarization. In the meantime, our first line of defense against external risks is our commitment to exchange rate flexibility, sound macroeconomic policies to rebuild buffers and financial policies. Delays in infrastructure projects could lead to an unduly contractionary fiscal impulse. Georgia's IMF-supported program provides an additional anchor to help us cope with negative shocks. 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.

Economic Policies

A. Fiscal Policy

6. Significant fiscal overperformance was recorded during January-September 2018. Through June, the augmented fiscal balance (TMU definition) recorded a surplus of GEL278 million, compared to an adjusted deficit ceiling of GEL269 million under the program. This mostly reflected strong revenue collection (due to robust economic growth) and delays in public investment projects. Continued fiscal overperformance through September led to a surplus of GEL392 million. We are working with the International Financial Institutions (IFIs) to reduce the risk of further project delays in the future.

7. We will maintain fiscal prudence.

a) We remain committed to keep the end-December 2018 augmented deficit below the program ceiling of GEL1,150 million (2.8 percent of GDP). Given delays in project implementation and to avoid an excessive contraction, we have accelerated spending on investment projects.

b) For 2019, we are committed to an augmented deficit of GEL1,170 million (2.6 percent of GDP), with measures to be announced by mid-December 2018. We commit to achieving an augmented deficit of no more than GEL250 million by end-June 2019 (performance criterion). We will continue containing current primary spending (indicative target), although spending pressures are arising from pension reform and additional social spending. In particular, we will provide financial incentives to improve the quality of teachers, increase wages for well-qualified teachers and our targeted social assistance to address child poverty, and include incentives for a more gradual withdrawal of assistance that encourages beneficiaries to participate in the labor market. Stronger-than-programmed adjustment to current spending has created room for these permanent spending increases. Even so, to make some additional fiscal space, we are committed to take revenue measures yielding GEL150 million in 2019, of which about a third would be in permanent revenues. Moreover, we will continue to accelerate capital spending in 2019-20, but at a more moderate rate than envisaged at the time of the Second Review under the EFF.

c) 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 (structural benchmark, end-February 2019).

d) We aim to refund GEL400 million in value-added tax (VAT) credits in 2018, and GEL250 million in the first half of 2019. We will put additional efforts to increase VAT refunds above these levels; those additional refunds, should they materialize, will be accommodated under the program through an adjustor (see Technical Memorandum of Understanding (TMU), ¶14).

e) We stand ready to adopt additional measures, if needed, to keep the augmented deficit in line with the program. 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 will 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 in addressing fiscal pressures that could emerge. In coordination with donors, we are finalizing the design of a comprehensive education reform (see ¶29). 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 are strengthening 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 sustainability while undertaking our reforms. We will continue to create additional fiscal room for investment in both infrastructure and education. To achieve this, we will improve 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 strengthened, and the basic public pension will be increased (see below). In addition, we do not plan to extend the dividend distribution model of corporate income taxation to financial institutions until 2023, to avoid the resulting revenue loss (up to 0.5 percent of GDP) in the near term. However, in consultation with the IMF, we will consider moving the insurance sector to the dividend distribution model sooner. We stand ready to identify additional measures in coordination with the IMF, if needed, within the scope of our fiscal framework to achieve our deficit target, including on the revenue side.

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

a) 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.

b) 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-December 2018 and end-June 2019 (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-December 2018 and end-June 2019 (performance criterion).

c) 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.

d) 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 operationalization of the new PPP framework) only under the following terms:

i. The guaranteed purchase period shall not be more than 8 months in each year;

ii. The guaranteed purchase tariff shall not be more than US 6c per kWh; and

iii. The cumulative installed capacity of these projects under negotiations will not exceed MW650.

e) Consistent with our program commitments, we conducted a fiscal risks analysis for the Namakhvani HPP Cascade Project and the Koromkheti HPP PPAs, which are outside of the terms mentioned above (since then, we decided not to pursue the Koromkheti project). 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 (planned capacity of MW433) are ongoing.

f) We are proposing to create a credit guarantee scheme (CGS) to support SMEs' access to finance. The CGS will 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. The specific characteristic of the CGS, including its size, will be determined in consultation with the IMF and other international partners. Plans for establishing an export credit agency (ECA) have been abandoned, but if they are retaken we will consult with the IMF on its characteristics before establishing it (see previous MEFP).

B. Structural Fiscal Policies

11. We will undertake fiscal decentralization to achieve greater government efficiency. Starting with the 2019 budget, local governments will keep 19 percent of all VAT proceeds. Concomitantly, the claw back clause requiring local governments to surrender additional revenues will be abolished, as it discouraged local governments to collect their own revenues. Efforts to build capacity at the local governments will be necessary to support adequate spending.

12. 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, supported by the Revenue Mobilization Trust Fund, that focuses on improving:

a) **Organizational structure.** Georgia's Revenue Services (GRS) headquarter was restructured into a function-based organization to modernize tax administration, with logical groupings of core functions – such as taxpayer service, returns filing and payment, audit, appeals, arrears management, policy and interpretations, and compliance management. We will continue building capacity of the GRS by adequately staffing the new HQ departments in line with international best practices and by empowering HQ to direct field operations. To this effect, we assigned deputy directors general their responsibilities in December 2018.

b) **VAT tax administration.**

   i. Stock of unrefunded VAT credits. We are committed to eliminate unrefunded VAT credits and, by end-2021, aim 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, Georgia Revenue Service (GRS), and GTS that proposed in May 2018 the necessary legal amendments or ministerial decrees to facilitate implementing the 2017 action plan. For the stock of existing credits, we are committed to risk-assess 100 percent of declarations (within the statute of limitations for audit) by mid-2020. A new specialized VAT unit in the GRS audit department was created (structural benchmark, end-June 2018) to review VAT declarations and to audit or take other compliance action where necessary.

   ii. 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 (structural benchmark, end-June 2019). 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.

iii. 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 that are within the three-year statute of limitations through a separate form.

c) **Compliance and audit yields.** 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 management system by July 2019. Once implemented, this will enhance audit timeliness and productivity, and take a systematic approach to terminating non-productive audits. We will ensure that an IT strategy and resources at the MoF are adequate for achieving these objectives.

d) **Filing compliance.** We established key performance indicators to help improve filing compliance. Initially developed for VAT, the program will be expanded to all tax categories. By end-2018,we will submit to Parliament legal amendments so that an unfiled declaration is no longer deemed to be a nil declaration where the MoF requires a declaration. We have set up and staffed a unit that deals with filing default and late filing for all revenue types.

e) **Taxpayer register.** By end-October 2019, we will clarify tax registration requirements, and give the GRS the mandate to enforce compliance and control of the registration process for all tax types, including the issuance and allocation of tax identification numbers. The proposed changes would not prevent a physical “one-stop” window for a business registration process, managed by the NAPR. In addition, the GRS will create and maintain a register of employees for tax administration purposes by better utilizing the information already received from taxpayers.

f) **Penalty regime**. The requirement for taxpayers to request a refund and their reluctance to do so has been a major bottleneck to reducing the outstanding stock of tax credits. To create a more effective and fair system and to remove a main deterrent preventing tax payers from requesting a tax credit refund, we committed to submitting to Parliament a more gradual penalty regime based on culpability (structural benchmark, end-December 2018). However, following FAD TA, we are of the view that additional work is needed to carefully calibrate the degree of discretion given to auditors in assessing culpability. We will continue working towards a penalty regime that reflects the degree of culpability and develop guidelines for assessing culpability. In the meantime, to avoid delays in the program objective of reducing the stock of outstanding VAT credits, we request reformulating the structural benchmark to (i) revising the penalty regime by incorporating materiality (i.e., the penalty will depend on the difference between the tax paid and the GRS assessment of what should have been paid) and (ii) approve changes to the tax code granting the GRS powers to pay out refunds without the need for a refund request (new structural benchmark, end-December 2018). These actions will help accelerate VAT refunds in 2019 and prevent a build-up of new VAT credits.

g) **Automatic access to third-party information**. Risk analysis relies on data to improve the effectiveness of a tax administration, allowing the targeting of resources towards areas of greater non-compliance. GRS has little direct access to risk-relevant databases held in other government agencies despite no legal impediment to gaining access to such data. Recently, MoF has requested from other ministries and agencies access to their databases for tax administration purposes. 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 (FMS) on suspicious transactions as defined in the law on facilitating the prevention of illicit income legislation. To this end, we will submit to Parliament changes in the legislation allowing the GRS access to the information received by the FMS from the Monitoring Entities, and put in place safeguards that protect the information from improper use (new structural benchmark, end-May 2019).

13. 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:

a) **Adopt a new PPP law and associated regulations.** Parliament approved a PPP law that includes sound elements following best international practices, with assistance from the World Bank (WB), the Asian Development Bank (ADB), the European Bank for Reconstruction and Development (EBRD), and the IMF. A government decree implementing the PPP law was adopted (structural benchmark, end-December 2018) and incorporated recommendations from the IMF (see previous MEFP for details). We are committed to issuing guidelines establishing the evaluation methodology for PPPs within the first half of 2019.

b) **Continue strengthening the Fiscal Risk Statement (FRS) accompanying the budget.**

   i. Building on the progress made in the 2018 FRS, the 2019 FRS will expand the analysis of fiscal risks stemming from PPPs and PPAs, and SOEs (structural benchmark, end-December 2018). For PPPs and PPAs, the 2019 FRS will disclose: (i) in addition to the NPV, the expected nominal cost per year for the lifespan of these projects, (ii) the expected nominal cost 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. In consultation with the IMF, the 2019 FRS will also include financial baseline projections and sensitivity analysis for major SOEs (largest 7 SOEs), covering the year of the FRS and the year after, which will be used as the basis for prospective sensitivity analysis.

   ii. For the MoF fiscal risks management unit, we commit to recruit additional staff by mid-2019 with practical corporate finance experience and to intensify the training of its existing staff in corporate finance.

c) **Strengthen the monitoring of SOEs.** To effectively supervise SOEs, we will ensure that the MoF and the Ministry of Economy and Sustainable Development (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 consultation with the IMF, we will (i) establish a complete inventory of SOEs with a clear determination of SOEs qualifying as public corporations and SOEs qualifying as general government entities under GFSM 2014 (new structural benchmark, end-September 2019); and (ii) adopt a government decree clarifying the mandate of SOEs that are public interest entities, governance and reporting requirements (new structural benchmark, end-November 2019).

d) **Improve the Public Investment Management Framework (PIMF).** A Public Investment Management Assessment (PIMA), conducted by the IMF in May 2018, identified weaknesses, particularly in project appraisal, selection, and management. We have developed a comprehensive action plan to address these weaknesses. We will strengthen MoF's role in public investment management. To this end, we created a dedicated public investment council at the MoF, where information on public investment projects will be centralized. This council 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 Medium-Term Budget Framework (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 by strengthening the public investment management methodology that guides project appraisal, selection and management and implement reporting and oversight requirements for public investment projects at the MoF (new structural benchmark, end-December 2019). By enhancing the monitoring of the project cycle, these measures would also help identify project implementation delays early in the process.

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

a) **Improve our fiscal rule to safeguard fiscal sustainability.** With IMF support, we reviewed our fiscal framework to support our medium-term fiscal sustainability while also granting flexibility in formulating fiscal policy over the economic cycle. We submitted to parliament a revised fiscal framework following IMF recommendations included in the TA report of November 2017 (structural benchmark, end-December 2018). The revised fiscal rule no longer includes an expenditure ceiling, which was procyclical and interfered with proper accounting practices. It applies to fiscal outturns, provides more clarity on definitions of aggregates and escape clauses, communication, transparency, and oversight. The revised fiscal framework will also help contain fiscal risks by including contingent liabilities from PPPs under the debt ceiling.

b) **Strengthen the Medium-term Budget Framework (MTBF).** The documentation accompanying the 2019 budget includes an analysis of revisions to the medium-term macroeconomic outlook and revenue projections. The 2020 budget will expand the discussion to compliance with respect to the fiscal rule, revisions of expenditure plans and will explain any projected breach of expenditure ceilings under the 2019 MTBF.

c) **Follow the guidelines for new budget lending operations.** We adopted new guidelines governing budget lending operations (Dec. 2017) and prepared the 2019 State Budget applying the Government Fiscal Statistics (GFS) classification of equity injections and on-lending following the "reasonable commercial return test" -If the test is not met equity injections are treated as subsidies or capital transfers.

d) **Improve the quality of fiscal reports.** We included Legal Entities of Public Law's (LEPLs) revenues and expenditures in the budget documentation starting in the 2018 state budget. We have determined that all LEPLs should be classified as general government units, based on GFSM 2014 standards. We will upgrade our public finances presentation from GFSM 2001 to GFSM 2014 classification in the context of the 2020 budget.

e) **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

15. We are committed to our inflation targeting (IT) framework to maintain price stability. Inflation has remained close to the NBG's target of 3 percent since early 2018. 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 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.

16. We will maintain a flexible exchange rate regime to protect the economy against external shocks. The floating exchange rate regime continues to work well as a shock absorber to external shocks. Hence, FX interventions are limited to smoothing excessive exchange rate volatility and to build up international reserves. We will continue accumulating gross international reserves (GIR) throughout the program, which will be monitored by a floor on net international reserves (NIR, performance criterion). FX interventions of $50 million in 2018H1 enabled us to accumulate more reserves than envisaged under the end-June program floor. We will step up efforts to accumulate international reserves given that GIR are still below an adequate level according to the IMF ARA metric. Starting in 2019, we will support reserve accumulation through a preannounced rule-based and transparent FX options, which would facilitate FX purchases without interfering with the floating exchange rate regime. We are committed to our end-December 2018 adjusted NIR performance criterion currently estimated at$1,403 million (down from $1,550 million at the time of the second review due to lower external disbursements), and $1,456 million by end-June 2019.

17. We will continue strengthening the monetary policy transmission mechanism. We strengthened lari liquidity management and have extended open market operations to outright purchases of treasury securities since May 2018. Strengthened NBG's liquidity management helps promote maturity transformation in the banking sector. The interbank interest rates remain close to the policy rate. We will submit legal amendments to Parliament by end-2018 to support derivatives and repo transactions in line with best international practices.

18. 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 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 communication by issuing a manual for monetary policy operations in line with the IMF TA recommendations by March 2019.

D. Financial Sector Policy

19. Our policies will strengthen financial sector stability. As noted in previous MEFPs, we took significant steps to enhance our financial stability policy framework, regulation and supervision, including: (i) operationalizing macroprudential policy; (ii) strengthening capital requirements, including a countercyclical buffer and additional capital requirements for systematically important banks; (iii) allowing the NBG to supervise banking groups ; (iv) empowering the NBG to supervise and regulate micro-financial institutions, (v) improving consumer protection in financial operations; (vi) empowering the NBG to oversee credit bureaus; (vii) strengthening the operational framework of the Financial Stability Committee; (viii) introducing impairment guidelines and publishing macroeconomic forecasts and risk scenarios for IFRS 9 implementation; and (iv) establishing a deposit guarantee agency. 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.

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

a) A roadmap to transition to IFRS regulatory reporting was approved in June 2018. Ultimately, NBG aims to transfer banks' regulatory reporting to IFRS framework through EU standards (FINREP/COREP forms).

b) In May 2018, we introduced a 25-percent limit of banks' regulatory capital for loans to households with no verifiable income to limit households' over-indebtedness. To support sustainable household credit growth, we introduced limits on loan-to-value ratios (LTVs) and debt service payments-to-income (PTIs) by income group for retail loans, with more binding constraints for FX loans for unhedged FX exposures as they encompass higher risks; these limits will enter into effect in January 2019.

c) 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 directives. We plan to submit the law to Parliament by December 2018.

d) We introduced regulations on: (i) leverage ratios based on Basel principles and relevant EU regulations (structural benchmark, end-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, end-June 2018); and (iv) corporate governance in line with Basel principles (structural benchmark, end-September 2018). We will introduce regulations on net stable funding ratio in line with Basel III principles by September 2019.

e) With the help of IMF TA, we initiated regulation, supervision and oversight of non-bank financial institutions. The prudential regulatory framework for MFI's became operational in September 2018, while the non-prudential oversight of other lenders will become operational in January 2019.

f) With the support of IMF TA, we developed a macro-financial model tailored to 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 allows conducting macro stress tests. Improved tools for macro-financial analysis will help strengthen financial stability by operationalizing macroprudential policy.

21. We will resume our Financial Stability Report (FSR) as a stand-alone publication. With IMF TA, we have already started working on the FSR. We will develop a macroprudential strategy document that anchors the financial stability function within the NBG. The publication of the new FSR (new structural benchmark, end-November 2019) will provide a forward-looking assessment of risks and vulnerabilities in the financial system, detailed analysis of private non-financial sector balance sheet, as well as the macro-prudential policy actions taken to mitigate risks.

22. We have made progress toward developing a sustainable finance framework. In September 2018, we held the Sustainable Finance Workshop in cooperation with the IFC and the Sustainable Banking Network (SBN), during which we agreed on NBG's next steps, including the publication of a sustainable finance roadmap in 2019. We are also working with the OECD on Environmental, Social and Governance (ESG) Reporting and Disclosure Principles for financial institutions.

23. We are strengthening financial safety nets.

a) We continue to cooperate with banks to strengthen their recovery plans.

b) 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 enhance crisis management, including clarifying the authorities' role and the decision-making process, and granting the NBG resolution authority. We will submit to Parliament legislative changes to implement effective ELA and resolution frameworks in line with international best practices (structural benchmark, end-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 trend decline in deposit dollarization. We recently further increased FX reserve requirements on short-term FX deposits from 20 to 25 percent, while reducing the reserve requirements on short-term local currency deposits from 7 to 5 percent. To further reduce FX risks for unhedged borrowers, we proposed to Parliament to increase from GEL100,000 to GEL200,000 the threshold under which only loans in local currency can be issued. Lending rules, which impose stricter payment-to-income and loan-to-value limits on FX retail loans, will further help internalize higher risks associated with FX borrowing and promote consumer protection (¶20, b).

25. We are committed to strengthening consumer protection, financial inclusion and literacy. Expanding financial education will help households have a better understanding of the risks associated to FX borrowing. The NBG i was awarded the 2018 Child and Youth Financial Inclusion Award. We are also actively promoting financial literacy and have recently partnered with the European Fund for Southeast Europe and the Export Development Association to develop and implement a financial education program for micro and small enterprises. We are also actively working with the Ministry of Education, Science, Culture and Sports to scale-up our SchoolBank project and help develop educational materials. In September 2018, to limit predatory lending, we reduced the maximum lending rate to 50 percent (from 100 percent) and the maximum penalty rate to 0.27 percent daily (from 0.41 percent daily) and introduced a cap on the accrued penalty (150 percent of outstanding overdue amount).

26. 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) A law establishing investment funds is expected to 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.

b) We will upgrade our infrastructure by having a single security settlement system for all Georgian securities with two participating central security depositories (CSDs), one for commercial bonds and shares, and another 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 end-2018.

c) We are committed to continue publishing a multi-year plan of government bond issuance to develop benchmarks along the yield curve to facilitate price discovery for private-sector bonds.

d) 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) We have clarified the taxation of publicly issued securities. We are committed to further improve our laws on taxation of financial instruments, specifically derivatives and investment funds.

E. Structural Reforms

27. Achieving more robust and inclusive growth will require steadfastly advancing our comprehensive structural reform agenda. We are counting on our partners to support our reform program, including the IMF, the WB, the ADB, the EBRD, the European Investment Bank (EIB), KfW Development Bank, Agence Française de Développement (AFD), and the European Commission. Our reforms aim at strengthening Georgia's connectivity, including through scaling-up infrastructure spending and trade initiatives, improving education and vocational training, the business environment, 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.

28. Scaling-up infrastructure and spatial planning is key to Georgia's development. Despite some delays, we aim to finalize the East-West highway by 2022, and the South-North corridor by 2023, with the help of our international partners. Additional infrastructure projects, including ports, 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.

29. We are working on a comprehensive education reform to improve job creation, productivity and wages. The lack of qualified labor force is reported as one of the most problematic factors for doing business in Georgia. At the same time, unemployment and underemployment remain high, suggesting skill mismatches in our labor force. With the help of our partners, we are designing 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 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.

30. Our funded pension pillar will become operational in 2019. This will improve the standards of living of our future retirees, promote savings and create an institutional investor for long-term lari assets. With the assistance of the WB and the ADB, we submitted to Parliament a law establishing a Pilar II pension system followed by the creation of an independent pension agency in August (structural benchmark, end-July 2018). In parallel, we are committed to formulate a private pension savings system (Pillar 3) in 2019.

31. We will continue to improve the business environment. We will establish a Business House by 2020 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 ensuring adequate protection of creditors rights, timely and efficient insolvency processes and effective rehabilitation framework in line with best international practices (new structural benchmark, end-July 2019). An efficient VAT tax system will also improve the business environment. In addition, we will apply regulatory impact assessments to analyze the possible impact of major policy decisions and protect the economy from undue costs. We are actively negotiating with the International Chamber of Commerce to establish a Court of Arbitration.

32. 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 30.5 percent (0.55 million) of those were registered within the land reform launched on August 1, 2016. We have also recently undertaken the creation of a farmer's registry and a geo-information land use system to ensure the rational use of agricultural land.

33. 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, Hong Kong Special Administrative Region and some CIS countries. 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, Israel, India, the Gulf Cooperation Council countries, and others.

34. We are strengthening our statistics to support strong economic policy-making. We started publishing quarterly unemployment figures (August 2018) and hours worked (October 2018). We reconciled the differences between the 2014 and the 2002 census results (June 2018), and published poverty figures (May 2018) and quarterly statistics on tourism. In October 2018, we published a survey on the structure of earnings by occupations and labor costs. We will 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 and quarterly GDP by expenditure in constant prices in 2020. This will provide a more detailed picture of the structural transformations in our economy. With help from IMF TA, we are expanding the coverage of the monthly producer price index (PPI) and developing a quarterly residential property price index (RPPI), both expected to be release in 2020.

F. Program Monitoring and Safeguards

35. 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.

36. The NBG continues to maintain a strong safeguards framework and internal controls environment. 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 2017–19

	2017				2018			2019
	End June	Outturn	End Dec.	Outturn	End June	Outturn	End Dec.	End June
Inflation Consultation Bands for CPI (in percent)								
Central point	6	7.1	5	6.7	3	2.2	3	3
Inner band, upper limit/lower limit	8/4	...	7/3	...	5/1	...	5/1	5/1
Outer band, upper limit/lower limit	9/3	...	8/2	...	6/0	...	6/0	6/0

Source: IMF staff estimates

Table 2. Georgia: Quantitative Performance Criteria and Indicative Targets for 2018 and end-June 2019

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

	2017					2018							2019
	End-December					End-June					End-December		Proposed End-June
	Target	Revised Target	Adjusted Target	Outturn	Status	Target	Revised Target	Adjusted Target	Outturn	Status	Target	Adjusted Target[1]	Target
Performance Criteria													
Ceiling on augmented general government deficit (program definition)	1,335	1,335	1,350	1,113	Met	430	430	169	-278	Met	1,150		250
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	1,363	1,387	Met	1,550	1,403	1,456
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	Met	0	...	0
Ceiling on new public guarantees (continuous criterion)	0	0	...	0	Met	0	0	...	0	Met	0	...	0
Ceiling on the cash deficit of the Partnership Fund	0	0	...	-22	Met	0	0	...	-2	Met	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	...	0	Met	20	...	20
Indicative Targets													
Ceiling on the accumulation of net domestic expenditure arrears of the general government	0	0	...	0	Met	0	0	...	0	Met	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	...	4,322	Met	9,035	...	4,600

[1] The NIR target is set at a program rate defined as the exchange rate on December 31, 2016, which for the GEL/US$ was 2.6468.

Table 3a. Georgia: Completed Structural Benchmarks

Measure	Date	Status
Financial Sector		
Financial Stability		
Introduction of LCR for commercial banks, with preferential treatment of GEL-deposits	End-September 2017	Met
Adoption of regulation on capital add-ons in CAR for systemically important banks	End-December 2017	Met
Submit to Parliament legislation giving NBG oversight power over credit information bureaus	End-December 2017	Met
Increase in minimum regulatory capital for commercial banks to GEL50 million, phased in by 2019	End-June 2017	Met
Capital Markets Development		
Publication of a multi-year calendar for government benchmark bonds	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	End-June 2017	Met
Deposit insurance		
Submission to Parliament legislation establishing deposit insurance as of January 1, 2018	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	End-September 2017	Met
Fiscal		
Submission to Parliament a 2018 budget consistent with the fiscal deficit in the Fund-supported program	End-December 2017	Met
Adopt a remuneration law for public civil service	End-December 2017	Met
Tax Administration		
Action plan to address accumulated outstanding VAT refunds in an orderly manner over time (including analysis, refund, set-offs, and write-offs)	End-September 2017	Met
Restructure the GRS headquarters into a function-based organization	End-February 2018	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	End-March 2018	Not Met 1/
Public-Private Partnership and Fiscal Risks		
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	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	End-December 2017	Met
Public Financial Management		
Issue guidelines for new budget lending operations requiring reasonable expectation of commercial returns	End-December 2017	Met
Pension Reform		
Submission of a pension law establishing a 2nd pillar pension system	End-December 2017	Met

1/ Amendments and decrees were proposed in May 2018.

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

Third Review	Date	Status
Create a new specialized VAT unit focusing on validating VAT claims (MEFP ¶12).	End-June 2018	Met
Introduce regulation on bank's real estate appraisal in line with International Valuation Standards (MEFP ¶20).	End-June 2018	Met
Establishing an independent pension agency (MEFP ¶30).	End-July 2018	Implemented with a 2-week delay
Introduce regulation on leverage ratio based on Basel Principles and relevant EU regulation (MEFP ¶20).	End-September 2018	Met
Introduce regulation on banks corporate governance in line with Basel Principles (MEFP ¶20).	End-September 2018	Met
Upcoming		
The 2019 FRS will expand the analysis of fiscal risks stemming from PPPs and PPAs, and SOEs as described in the MEFP (MEFP ¶13)	End-December 2018	
Adopt the government decree implementing the PPP law following the recommendations of the FAD TA report (MEFP ¶13)	End-December 2018	
Submit to Parliament a revised penalty regime with gradual tax-geared penalties based on materiality and approve changes to the tax code granting the GRS powers to pay out refunds without the need for a refund request (MEFP ¶12)	End-December 2018	
Submit to Parliament a new fiscal rule framework consistent with IMF TA recommendations (MEFP ¶14)	End-December 2018	
Submit to Parliament legislation proposing a rule-based mechanism to index basic pensions (MEFP ¶30)	End-February 2019	
Submit to Parliament changes in the legislation allowing the GRS access to the information received by the FMS from the Monitoring Entities, and put in place safeguards that protect the information from improper use (MEFP ¶12)	End-May 2019	
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)	End-May 2019	
Submit to parliament the new insolvency law ensuring adequate protection of creditors rights, timely insolvency processes and effective rehabilitation framework (in line with best international practice) (MEFP ¶31)	End-July 2019	
90 percent of the VAT refund requests approved by the system will be automatically refunded, upon request, after offsetting against existing tax liabilities (MEFP ¶12)	End-June-2019	
Provide a complete list of the SOEs qualifying as public corporation according to GFSM2014. The assessment should be done in consultation with FAD's regional resident advisor (MEFP ¶14)	End-June-2019	
Adopt a government decree clarifying public corporations' mandate, government and reporting requirements, in line with recent FAD recommendations (MEFP ¶13)	End-November-2019	
NBG to publish a renewed financial stability report (MEFP ¶21)	End-November-2019	
Adopt the government decree implementing reporting and oversight requirements for public investment projects at the MoF (MEFP ¶13)	End-December-2019	

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 indicative targets. 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 (Tables 1, 2 attached to the Letter of Intent).

6. Performance criteria and indicative targets have been set for end-December 2018 and end-June 2019 (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 terms 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. Test date inflation is defined as the year-on-year percentage change of the monthly consumer price index (CPI) in the month of the test date as measured and published by the National Statistics Office of Georgia (GEOSTAT).

8. If test date inflation 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 test date 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)

	December 31, 2018	June 30, 2019
Disbursements of foreign-financed project loans	1214	760
Receipts from sale of non-financial assets	150	70
VAT refunds	400	250

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. Data for the period from the 16th day of the previous month to the 15th day of the current month will be provided by the Georgia Revenue Service by the end of each month on:

- Opening balance in taxpayer accounts (stock)
- New tax credits declared by taxpayers
- Tax credit balance adjustments made by GRS after desk check / audit and by taxpayers
- Tax payments to the budget
- Tax credits offset against tax liabilities
- Tax credit refunds paid in cash
- Other flows (residual)
- Closing balance in taxpayer accounts (stock)
- Closing balance amounts not eligible for a cash refund (stock)

g. Data for the previous month will be provided by the Georgia Revenue Service by the end of each month on:

- Number and GEL value of claims for cash refunds submitted by taxpayers, separately for VAT and other taxes,
- Number and GEL value of cash refunds paid, separately for VAT and other taxes
- Number and GEL value of cash refunds paid automatically (i.e., without manual check or audit), separately for VAT and other taxes.

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

[1] Arrears to Turkmenistan.

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

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, 387 million as of June 30, 2018 (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)

	December 31, 2018	June 30, 2019 [1]
Projected privatization revenue	0	0
Budget support grants from external donors and not related to project financing	45.7	40.6
Budget support loans, including bilateral and multilateral donors for budget support	166.4	165.6
Net issuance of the Eurobond from the general government	0	0
Disbursements of project loans and grants	306.8	179.4

[1] Cumulative from end-September 2018 to end-June 2019.

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.