

Georgia: 2001 Article IV Consultation, First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, and Request for Waiver of Performance Criteria—Staff Report; Staff Statement; and Public Information Notice.

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2001 Article IV consultation with Georgia and First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, and Request for Waiver of Performance Criteria, the following documents have been released and are included in this package:

- the staff report for the combined 2001 consultation and First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, and Request for Waiver of Performance Criteria, prepared by a staff team of the IMF, following discussions that ended on **July 27, 2001**, with the officials of Georgia on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on October 11, 2001.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff statement of **October 26, 2001** updating information on recent economic developments.
- a Public Information Notice (PIN), **summarizing the views of the Executive Board as expressed during its October 26, 2001, discussion** of the staff report on issues related to the Article IV consultation and the IMF arrangement, respectively.

The document(s) listed below have been or will be separately released.

Financial System Stability Assessment
Letter of Intent sent to the IMF by the authorities of Georgia*
Recent Economic Developments Paper and Selected Issues Paper
Technical Memorandum of Understanding*

*May also be included in Staff Report

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

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GEORGIA

Staff Report for the 2001 Article IV Consultation, First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, and Request for Waiver of Performance Criteria

Prepared by the European II and Policy Development and Review Departments

Approved by John Dodsworth and Michael T. Hadjimichael

October 11, 2001

- Article IV discussions and discussions for the first review of the arrangement under the Poverty Reduction and Growth Facility (PRGF) were held in Tbilisi during April 25-May 9, 2001 and July 17-27, 2001. The staff team comprised Mr. Owen (head), Ms. Bassett, Mr. Mumssen, Mr. Weisfeld (all EU2), Mr. Fassina (FAD), and Mr. Ishikawa (PDR). Mr. Lane, resident representative, also participated in the discussions. The missions cooperated with World Bank missions, two FSAP missions, and one LEG mission.
- The missions met with President Shevardnadze, State Minister Arsenishvili, Mr. Basilia (economic advisor to the President), Mr. Managadze (President of the National Bank of Georgia), Mr. Nogaideli (Minister of Finance), other members of the government's economic team, parliamentarians, business people, members of the donor and diplomatic communities, and the press.
- Georgia's three-year arrangement under the PRGF was approved on January 12, 2001 (EBS/00/258). Executive Directors commended improvements in economic performance and policy implementation during 2000. They considered that the 2001 budget was a sound basis for fiscal adjustment, while noting the need for further improvements in tax administration and measures to strengthen governance. They supported Georgia's efforts to reschedule bilateral external debts under the aegis of the Paris Club.
- Under the arrangement, two disbursements of SDR 9 million each were made in January and March 2001. The first review, envisaged for May 2001, was delayed, following non-observance of end-March performance criteria. The authorities are now requesting completion of the first review and a disbursement of SDR 9 million.
- The last Article IV consultation was completed on April 21, 2000 (SM/00/53). Georgia accepted the obligations of Article VIII, Sections 2, 3, and 4, of the Fund's Articles of Agreement on December 20, 1996. Georgia's exchange system remains free of restrictions on payments and transfers for current international transactions.

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EXECUTIVE SUMMARY

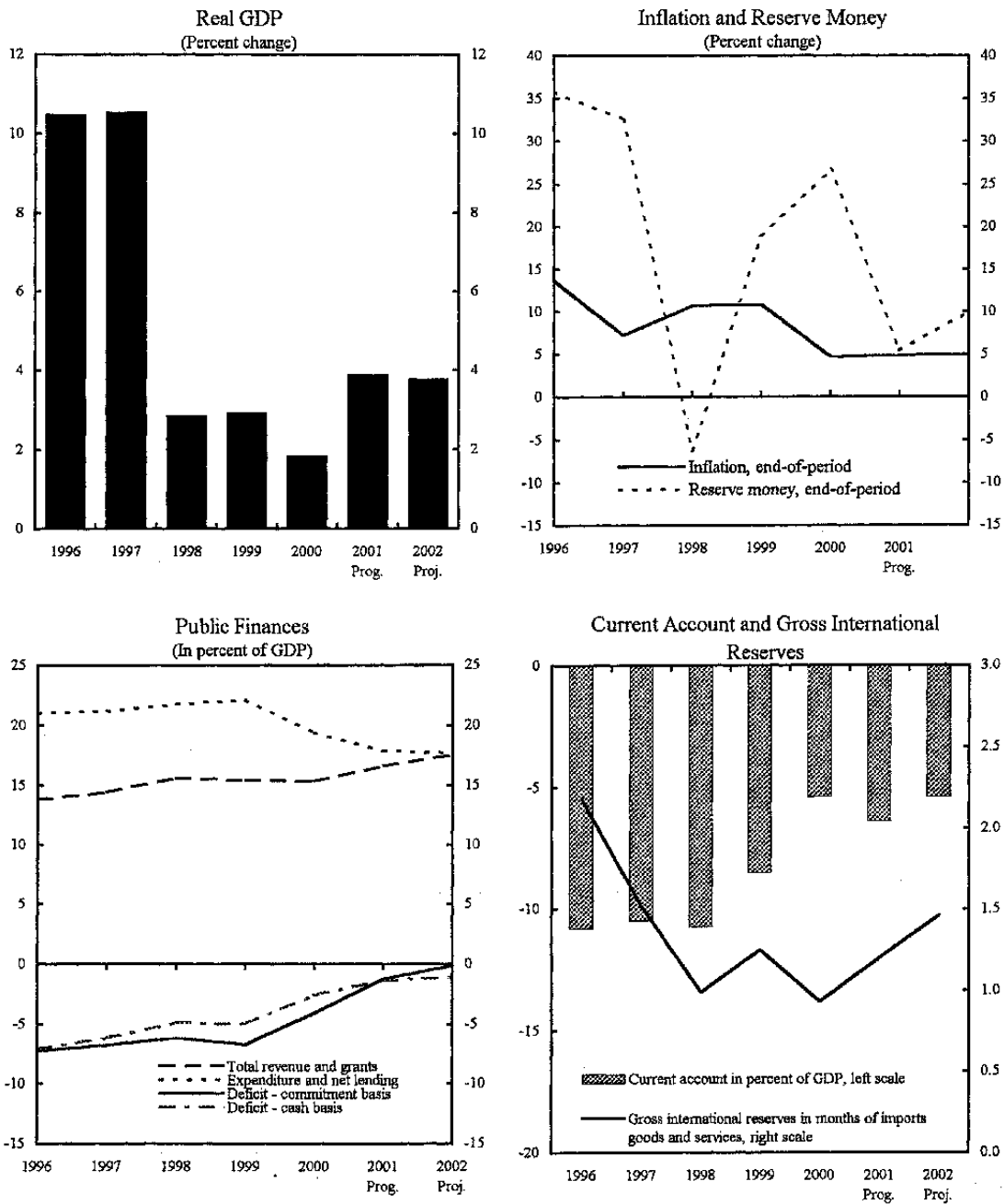
- Following power outages in the winter, GDP growth has picked up and is expected to be around 4 percent this year, despite weak external demand. Inflation has remained low, at 4¾ percent in the twelve months to August. The exchange rate depreciated by 4 percent against the U.S. dollar in the first quarter, following the crisis in Turkey, but has remained stable since then. Exports have declined significantly in the first half of this year, reflecting energy supply interruptions and weaker demand from Turkey. The prospect of further deterioration in the external environment following the events of September 11 increases the risks to the outlook, particularly to the balance of payments.
- Fiscal performance in early 2001 fell short of program objectives, and performance criteria on tax revenues and expenditure arrears were missed. However, monetary policy remained broadly on track. As a result of the fiscal slippage, the first review of the program was delayed.
- The macroeconomic program for 2001 was revised in May, to reflect shortfalls in fiscal revenues and downward revisions to external financing projections, due to delays in World Bank disbursements and the telecommunications privatization. Fiscal performance subsequently improved substantially, while monetary policy remained on track. Tax collections have increased, allowing clearance of expenditure arrears accumulated earlier this year. The staff will report on the observance of end-September macroeconomic targets in a supplement, prior to the Board discussion.
- The medium-term outlook remains challenging, given the need to reduce poverty and manage the country's high external debts. Georgia reached an agreement with the Paris Club in March 2001 on a rescheduling of principal payments falling due on bilateral debts in 2001 and 2002. Staff discussed with the authorities a debt sustainability analysis, indicating that Georgia will require additional rescheduling in 2003/04, possibly on concessional terms.
- Reforms in the fiscal and financial sectors are strengthening governance and transparency in areas critical to macroeconomic stability. Nonetheless, the recent FSAP missions highlighted the vulnerability of the banking sector to credit and foreign exchange risks. There has been little progress on energy sector reforms, and broader efforts to combat corruption are progressing only slowly. The authorities have prepared a draft of the full PRSP.
- The authorities have requested the completion of the first review and the disbursement of the third loan under the PRGF. They have requested waivers of three quantitative performance criteria for end-March and of one continuous performance criterion, and a rephrasing of future disbursements.

I. RECENT DEVELOPMENTS AND PERFORMANCE UNDER THE PROGRAM

1. **Economic growth accelerated in the second quarter of 2001, following a sharp decline in industrial production caused by power outages in the winter.** Preliminary data show GDP growth of about 5 percent during the first half of 2001, reflecting strong growth in some service sectors, especially transport, and a rebound in agriculture, following last year's drought. GDP growth for the year as a whole is projected at 4 percent, up from 1¾ percent in 2000 (Figure 1 and Table 1).
2. **The exchange rate has remained broadly stable and inflation low.** The Georgian lari depreciated by about 4 percent against the U.S. dollar during the first quarter of 2001 and was stable in the second and third quarters. The real effective exchange rate appreciated by 2¼ percent in the first half of 2001, mostly on account of the sharp depreciation of the Turkish lira in the wake of the financial crisis in Turkey (Figure 2). The stability of the exchange rate and relatively tight fiscal and monetary policies helped keep inflation under control. Consumer prices rose by 4¾ percent in the twelve months to August 2001. The inflation rate is projected to be about 5 percent at the end of 2001.
3. **The current account weakened from the beginning of 2001.** Last year, rapid export growth had reduced the current account deficit to 5½ percent of GDP. This trend was reversed in the first half of 2001, with customs data showing growing imports and shrinking exports. The recent deterioration in the trade balance was partly due to the industrial contraction in early 2001 and partly due to the economic crisis in Turkey. Turkey is Georgia's largest trading partner, alongside Russia, accounting for over 20 percent of exports and about 15 percent of imports.
4. **Fiscal performance in early 2001 fell short of program objectives.** Performance criteria on general government tax revenues and budgetary expenditure arrears for end-March and end-June 2001 were not observed (Table 2), due to a shortfall in tax collections during the first four months of the year. While some of the shortfall can be attributed to weaker than expected economic growth, continued problems in tax and customs administration, especially related to petroleum and tobacco products (revenues from these commodities fell well short of the indicative target), and a reduction in excise rates for domestically produced cigarettes that was not foreseen in the program also played a role. The cash deficit remained well below the program ceiling, reflecting lack of external and domestic financing. The commitments deficit was in line with the original program, as shortfalls in revenues and grants were offset by reductions in expenditure commitments on non-core items.¹

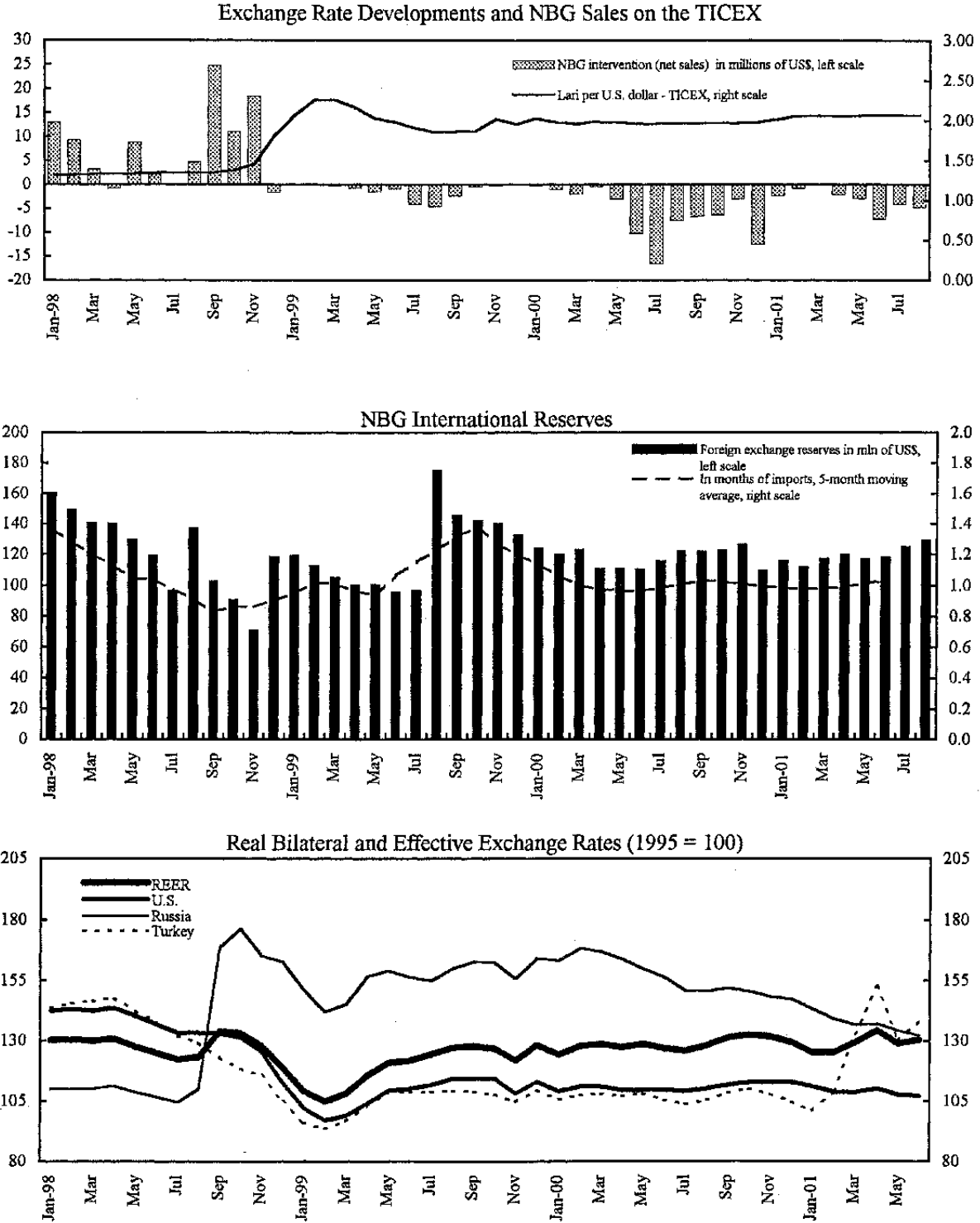
¹ Non-core expenditure refers primarily to procurement of goods and services and accounted for a little over 10 percent of current expenditure in 2000.

Figure 1. Georgia: Macroeconomic Indicators, 1996-2002



Sources: Georgian authorities; and Fund staff estimates.

Figure 2. Georgia: Foreign Exchange Market and International Reserves, 1998-2001



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

Table 1. Georgia: Selected Economic and Financial Indicators, 1996-2002

	1996	1997	1998	1999	2000		June 2001	2001		2002
					Orig. Prog. 1/	Actual	Actual	Orig. Progr. 1/	Rev. Prog. 2/	Prop. Prog. 2/
(Percentage change relative to previous year; unless otherwise indicated)										
National income and prices										
Nominal GDP 3/	57.4	20.6	8.7	12.4	9.5	5.1	10.6 4/	11.8	9.6	9.2
GDP at constant prices 3/	10.5	10.6	2.9	3.0	1.2	1.9	5.2 4/	3.8	3.9	3.8
Nominal GDP (millions of lari) 3/	3,847	4,639	5,041	5,665	6,035	5,955	3,081	6,748	6,525	7,125
Consumer price index, period average	39.3	7.0	3.6	19.1	4.3	4.0	6.1 4/	7.6	5.4	5.2
Consumer price index, end-of-period	13.7	7.2	10.7	10.9	6.8	4.6	6.2	5.9	4.9	5.0
General government										
Tax revenue	139.4	43.3	9.6	21.5	8.4	8.8	14.8 4/	18.1	13.1	12.9
Current expenditure	89.2	20.9	12.0	13.6	-4.7	-3.4	-6.2 4/	5.2	-2.6	7.5
External sector 5/										
Exports	15.0	18.4	-3.1	-0.3	9.2	...	...	9.5	-1.0	8.9
Imports	9.7	37.0	10.6	-11.8	7.7	...	...	5.9	7.1	6.3
Money and credit (end-of-period)										
Reserve money	35.9	32.6	-6.3	18.8	13.0	26.8	30.0	0.3	5.4	10.0
Credit to enterprises and households (banking system)	-14.8	38.0	38.0	33.5	17.1	17.5	15.6	2.5	12.3	10.3
Broad money (including forex deposits)	41.9	45.5	-1.2	20.7	23.1	39.0	32.2	4.3	14.8	17.7
Velocity, level 6/	15.0	12.4	13.7	12.7	11.0	9.6	...	10.5	9.2	8.5
Money multiplier, level	1.23	1.35	1.42	1.44	1.57	1.58	1.66	1.64	1.72	1.84
Gross international reserves 7/										
In months of imports of goods and services	2.2	1.5	1.0	1.2	1.2	0.9	1.0	1.6	1.2	1.5
In millions of U.S. dollars	158	173	118	132	136	109	119	199	149	193
Exchange rate, lari/U.S. dollar										
Period average	1.26	1.30	1.39	2.02	1.97	1.98	2.05	...	...	...
End-of-period	1.27	1.30	1.79	1.96	...	1.98	2.06	...	...	...
(In percent of GDP; unless otherwise indicated) 3/										
General government										
Total revenue and grants	13.8	14.4	15.6	15.4	15.0	15.3	15.8 8/	16.8	16.6	17.5
Tax revenue 9/	10.6	12.7	12.8	13.8	14.0	14.3	14.3 8/	14.9	14.8	15.3
Total expenditure and net lending	21.1	21.2	21.8	22.1	19.5	19.4	17.9 8/	18.8	17.9	17.6
Current expenditure	19.2	19.2	19.8	20.0	17.9	18.4	16.3 8/	17.1	16.3	16.1
Fiscal balance, commitment basis	-7.3	-6.8	-6.1	-6.7	-4.6	-4.1	-2.0 8/	-2.0	-1.2	-0.1
Fiscal balance, cash basis	-7.1	-6.1	-4.9	-5.0	-3.2	-2.6	-0.8 8/	-3.2	-1.4	-1.1
External sector 5/										
Trade balance	-11.5	-15.6	-18.9	-19.6	-19.0	-12.0	...	-17.8	-13.5	-12.8
Current account balance										
Excluding transfers	-13.7	-16.0	-16.6	-14.8	-13.7	-8.7	...	-12.4	-9.7	-8.8
Including transfers	-10.8	-10.5	-10.7	-8.5	-8.1	-5.4	...	-7.1	-6.4	-5.4

Sources: Georgian authorities; and Fund staff estimates.

1/ Based on the economic program supported by a three-year arrangement under the PRGF, approved on January 12, 2001.

2/ Reflecting revisions of 2001 program and proposed program for 2002, based on May and July 2001 mission findings.

3/ The nominal GDP series for 1996 to 2000 was revised in March 2001.

4/ Year-to-date outturn, relative to same period in the previous year.

5/ Series break between 1999 and 2000.

6/ Annual GDP divided by end-period M3.

7/ Gross reserves prior to 1999 exclude special account for external debt service.

8/ First half of 2001, as a share of first half GDP.

9/ Program definition. Includes general government tax revenue and special state funds (pension, employment, and road funds). Excludes privatization proceeds.

Table 2. Georgia: Quantitative Performance Criteria and Indicative Targets, 1999-2001 1/

	Stocks		Cumulative change from end-September 2000								
	end-Dec. 1999	end-Sep. 2000	end-Dec. 2000			end-March 2001			end-June 2001		
	Actual	Actual	Target	Adj. Tar.	Actual	Target	Adj. Tar.	Actual	Target	Adj. Tar.	Actual
(In millions of lari)											
1. Quantitative targets 2/											
Floor on general govt. tax revenue (including special funds) 3/	...	...	231.4	231.4	235.2	458.9	458.9	437.9	714.7	714.7	676.5
Ceiling on cash deficit of the general govt. (CDGG) 4/	...	...	72.3	44.1	44.0	110.4	78.6	44.7	152.4	109.6	69.0
Ceiling on domestic expenditure arrears of the general govt.	...	...	0.0	0.0	-0.7	-8.8	-8.8	30.7	-27.2	-27.2	15.4
Ceiling on net credit of the banking system to the general govt. (NCG) 3/ 5/ 6/	615.9	663.7	8.2	73.2	74.5	26.2	66.2	55.5	30.3	70.3	69.8
Ceiling on net domestic assets (NDA) of the NBG 5/	754.8	754.4	-4.5	60.5	65.7	15.0	55.0	61.3	7.2	47.2	76.8
(In millions of U.S. dollars)											
Floor on total net international reserves (NIR) of the NBG 5/	-223.2	-208.4	7.9	-24.6	-6.0	-4.6	-35.9	-19.7	7.2	-25.3	-15.4
Ceiling on contracting or guaranteeing			0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
A. short-term external debt (less than one year)	...	...	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
B. nonconcessional medium- and long-term external debt	...	...	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(In millions of lari)											
2. Indicative targets											
Reserve money	308.5	337.5	11.2	11.2	53.7	5.7	5.7	21.8	21.6	21.6	45.9
Cigarette and petroleum revenues	...	...	49.0	49.0	28.1	89.3	89.3	56.2	129.6	129.6	87.7
(In millions of U.S. dollars)											
3. Adjusters											
A. Net external non-project financing	...	...	7.3	...	-28.7	1.2	...	-30.1	15.7	...	-30.9
Privatization	...	...	0.0	...	0.0	0.0	...	0.0	0.0	...	0.0
World Bank SAC & ESAC	...	...	32.5	...	0.0	32.5	...	0.0	52.5	...	0.0
less: amortization 7/	...	...	25.2	...	28.7	31.3	...	30.1	36.8	...	30.9
Adjuster on NIR for deviations from external non-project financing projections 8/	...	...	...	...	32.5	...	...	31.3	...	...	32.5
(In millions of lari)											
Adjuster on NDA, NCG for deviations from external non-project financing projections 8/	...	...	...	...	65.0	...	...	40.0	...	...	40.0
B. External project financing	...	...	39.9	...	11.7	66.4	...	34.6	92.9	...	50.1
Adjuster on CDGG for deviations from external project financing projections 8/	...	...	...	...	28.2	...	...	31.8	...	...	42.8

Sources: Fund staff estimates.

1/ Section 1 of this table shows quantitative performance criteria under the PRGF-supported program that was approved on January 12, 2001 (Board document EBS/00/258). Some ceilings and floors are subject to possible adjustment, as indicated in footnotes 4 and 5, based on deviations from projections of external financing, reported in Section 3 of the table. Indicative targets are shown in Section 2. Continuous performance criteria are described in paragraph 53 of the MEEP.

2/ Based upon accounting exchange rates 2 lari/US\$ and 1.35 US\$/SDR.

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

4/ As described in the TMU, the macroeconomic program includes an adjuster for deviations from expected disbursements of external project finance (Section 3). The ceiling for the cash deficit of the general government for the end of a quarter will be adjusted upward (downward) by the full amount of the cumulative excess (shortfall) of external project financing, subject to a cap on cumulative upward adjustment of lari 80 million.

5/ As described in the TMU, the macroeconomic program includes an adjuster for deviations from expected net external non-project financing (Section 3), defined as the sum of all foreign-currency denominated privatization receipts and net disbursements under the World Bank's SAC and ESAC programs, minus government debt amortization payments. The ceilings for net credit of the banking system to the general government and net domestic assets of the NBG will be adjusted upward (downward) by the full amount of the cumulative shortfall (excess) of net external non-project financing, subject to a cap on upward adjustment of lari 65 million for the end-December 2000 ceiling and lari 40 million for the end-quarter ceilings in 2001, while the floor on net international reserves will be shifted downward (upward) by the full amount, subject to a cap on downward adjustment of US\$ 32.5 million.

6/ The stock excludes the recapitalization bond issued by the government to cover NBG losses in 1998.

7/ Amortization reflects principal repayments to bilateral creditors and EBRD. The outturn for the fourth quarter of 2000 includes US\$5.3 million in amortization as a result of a tripartite service contract in October 2000, which reduced Georgia's official debt to Turkmenistan by US\$6 million, with a subsequent payment by the Georgian government to a local company of lari 10.7 million.

8/ A positive figure reflects a shortfall in external financing. The adjuster is capped as described in footnotes 4 and 5.

5. **Monetary policy was broadly in line with program objectives.** There was a small deviation from the original program target for net domestic assets (NDA) of the National Bank of Georgia (NBG) at the end of March, largely due to longer than projected delays in external financing.² A larger deviation from the NDA target at the end of June was caused by valuation changes³ and by additional NBG credit to government. Net international reserves remained well above the program floor, as the NBG had been able to bolster its international reserves by higher than expected purchases of foreign exchange at the end of 2000. As a result, reserve money was above the indicative target, without a noticeable impact on inflation.

6. **The authorities revised their macroeconomic program in May 2001, and monthly monitoring targets were established through end-September.** The revised program, discussed further below and in the attached Letter of Intent (Appendix V), reflects shortfalls in fiscal revenues at the beginning of the year and downward revisions to financing projections, due to delays in World Bank disbursements and the telecommunications privatization.⁴ The full-year tax revenue target takes into account shortfalls through April, but assumes a return to program targets on a flow basis for the remainder of the year. The expenditure arrears clearance target has been revised down to require reversal of all arrears accumulation in early 2001 by September and repay a small amount of pre-2001 arrears by year-end. Given subdued inflation, the net credit to government target was revised upwards to compensate for some of the shortfall in external financing. The target for net international reserves was revised down by less than the projected shortfall in external financing, effectively absorbing the margin the NBG had built up under the program.

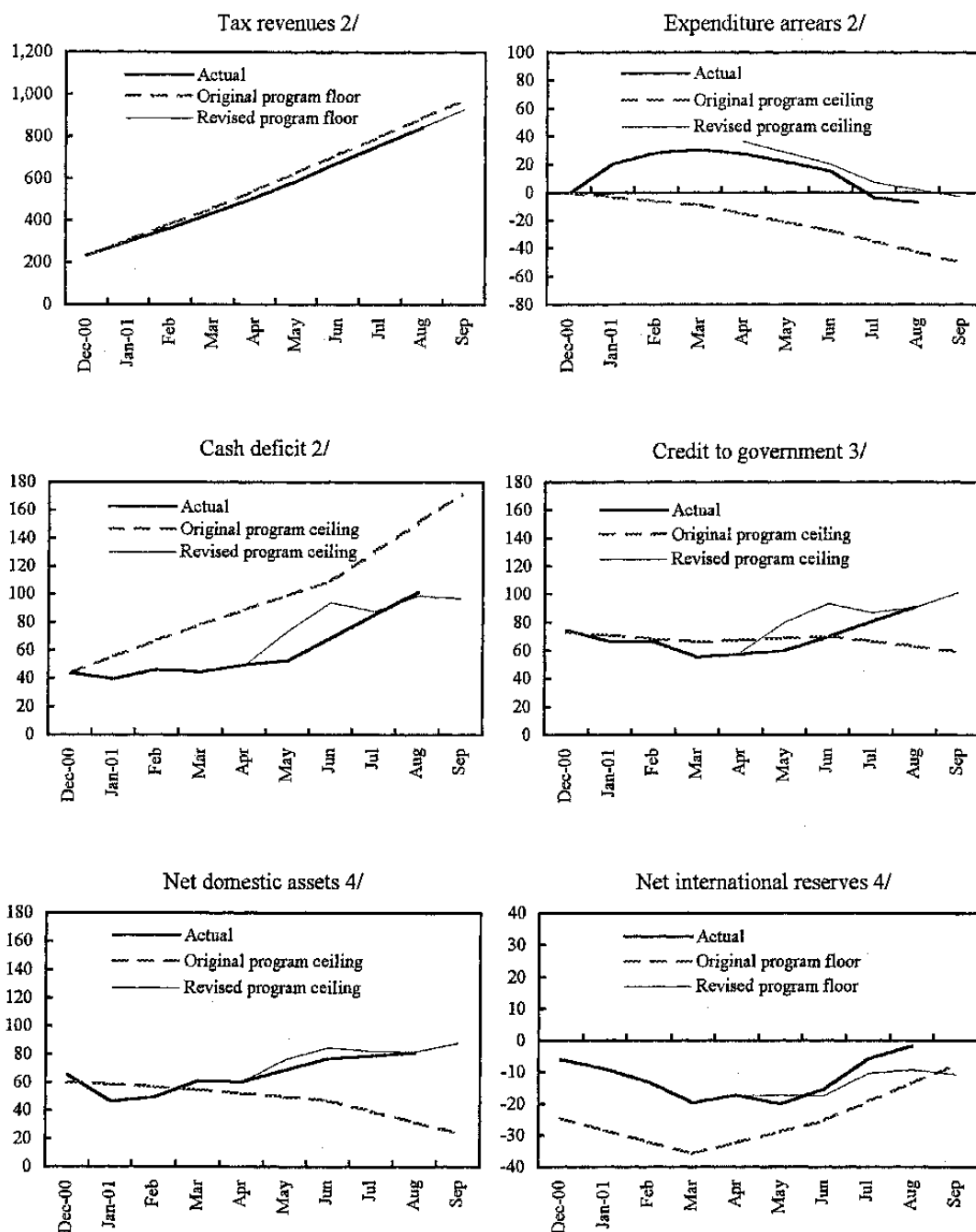
7. **Fiscal performance has been broadly in line with the revised program through end-August (Figure 3 and Appendix V, Table 1).** Tax collections improved from May

² NDA were lari 6 million above the program ceiling, mainly because the adjuster that compensates for shortfalls in external financing is capped at lari 40 million, below the actual shortfall of lari 65 million, which resulted from continued delays in implementing conditionality on World Bank structural adjustment loans (ESAC and SAC-III).

³ Program performance is evaluated at constant exchange rates of 2 lari/US\$ and US\$1.35/SDR, but movements in other currencies are not controlled for. The program for 2002 will control for a wider set of currencies.

⁴ Despite intensive efforts by the government to sell the local and long-distance telecommunications companies through international tender, investor interest has been muted.

Figure 3. Georgia: Performance under the Original Program and Revised Targets 1/
(In millions of lari, all data are cumulative from September 2000)



Source: Georgian authorities; and Fund staff estimates.

1/ The original program is based on quarterly targets from end-September 2000 (EBS/00/258). The revised program is based on monthly targets, from end-March 2001 (Appendix V, Table 1).

2/ General government.

3/ Net credit from the banking system to the general government.

4/ NBG.

onwards, helped by stronger economic growth.⁵ Continued shortfalls in cigarette excise collections were compensated by higher than expected revenues from VAT and pension fund contributions. The improved revenue performance and a squeeze on non-core expenditure commitments allowed the repayment of expenditure arrears accumulated in the beginning of the year, as well as additional repayments of pre-2001 arrears. The cash deficit remained close to the revised ceiling.

8. **The monetary program has also remained on track through end-August.** Net international reserves turned out US\$7½ million above the revised program floor. As a result, reserve money was somewhat above the indicative target, growing by 6 percent from December to August. The process of remonetization continued (Figure 4), with deposits growing by 21 percent in the twelve months to August 2001. However, dollarization has remained very high since the Russian crisis, with a share of foreign currency deposits of over 80 percent.⁶

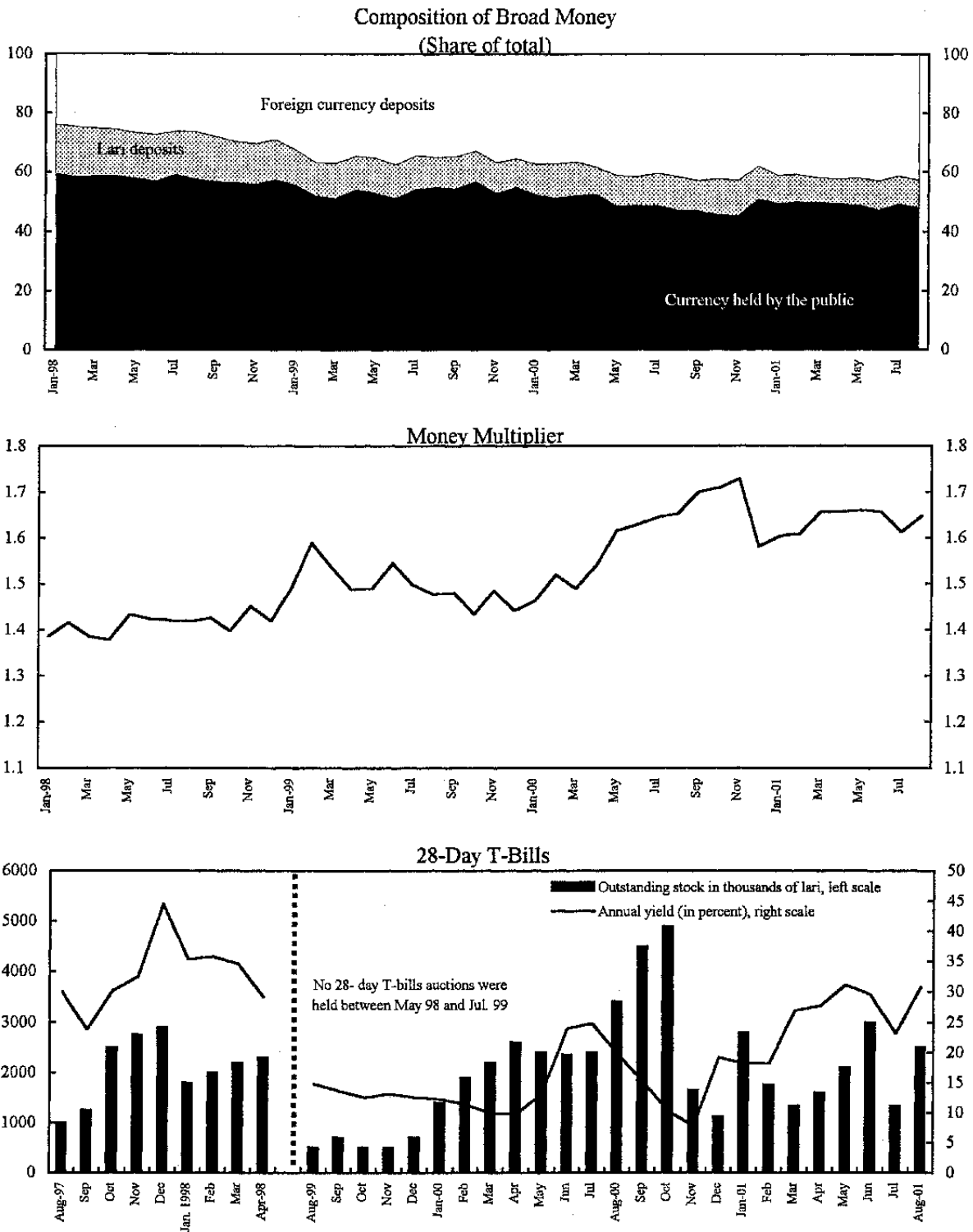
9. **Georgia became the second CIS country after Russia to reach an agreement with the Paris Club.** On March 6, 2001, the Paris Club agreed to reschedule principal payments due on Georgia's bilateral debts in 2001 and 2002 over 20 years, with a 3-year grace period and a graduated repayment schedule. The interest rate on previously rescheduled debt is to be no higher than 4 percent. Although the agreement was based on Houston terms, which are classified as nonconcessional, the low interest rate and the long repayment period effectively reduced the net present value of Georgia's bilateral debt (excluding arrears to Turkmenistan) by an estimated US\$56 million. Creditors also agreed that, in case of a financing need, they would consider an extension of the consolidation period through end-2003. So far, Georgia has reached bilateral agreements on comparable terms with 8 of 13 creditors and is requesting a four-month extension of the Paris Club deadline for concluding bilateral agreements, to end-December 2001.

10. **Structural benchmarks in the fiscal and financial areas have largely been implemented, albeit with some delays, but in the energy sector, the debt surcharge on the electricity tariff failed to receive parliamentary approval (Appendix V, Table 2).** In the fiscal area, two measures have been implemented fully, one will be completed prior to Board discussion of the review, and two have been largely implemented. A code of conduct will be adopted by tax and customs officials prior to the review. Procedures for granting customs exemptions have been tightened and a monitoring unit has been established. A VAT fraud monitoring unit has been established and legislation to strengthen the VAT refund system is to be included in the tax code amendments that will be considered by parliament

⁵ On the basis of limited information available to staff, there is no evidence that improved revenue performance reflects increased incidents of tax prepayments or delayed refunds.

⁶ See Chapter V of the Selected Issues paper for a fuller discussion.

Figure 4. Georgia: Monetary Indicators, 1997-2001



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

alongside the 2002 budget. Recording and control of expenditure commitments has been introduced in all budgetary entities except utilities and embassies. Expenditure arrears have been audited in all central budgetary organizations.

11. **Good progress has been made in implementing financial sector reforms.** Three structural benchmarks monitored under the program have been fully implemented and a fourth—amendments to the central and commercial bank laws—is expected to be implemented prior to Board consideration of the review. The NBG has issued new asset classification and provisioning regulations for commercial banks. Since February 2001, banks have been submitting their monthly reports to the NBG according to international accounting standards. The NBG has also issued conflict of interest regulations for banks. The NBG's supervisory capacity will be strengthened by the planned amendments to the central and commercial bank laws that will establish the primacy of banking law in bank-related matters.

II. POLICY DISCUSSIONS

A. Overview

12. **Policy discussions for the review focused on bringing the macroeconomic program back on track.** A mission in April/May agreed with the authorities on a revised program for 2001, taking into account the shortfalls in fiscal revenues at the beginning of the year and downward revisions to external financing projections. The authorities agreed with staff that the completion of the first review should be postponed until macroeconomic performance, monitored on a monthly basis during the second and third quarters of 2001, was back on track. In July, the mission and the authorities agreed on a draft Letter of Intent (Appendix V) that specifies policy objectives for the remainder of 2001 and sets out the broad macroeconomic objectives for 2002.

13. **The mission also reviewed progress on structural reforms and discussed medium-term challenges related to poverty reduction and external debt management.** It examined progress in banking sector reform, where a number of structural benchmarks under the PRGF-supported program have been implemented, and in the energy sector, where comparatively little progress has been made. It also reviewed progress in formulating a poverty reduction strategy and in efforts to fight corruption. The mission discussed with the authorities a debt sustainability analysis and strategies to strengthen Georgia's internal and external finances. Important goals include an improvement in tax collections and expenditure management, allowing more fiscal resources for targeted social spending; efforts to address corruption and strengthen governance; continued abstinence from non-concessional external borrowing by the state; additional debt rescheduling under the Paris Club; and growth-oriented structural reforms, especially in the energy sector.

B. Fiscal Policy

14. **The authorities and staff discussed the implications of the revenue shortfall at the beginning of 2001.** Staff recommended a package of revenue-raising measures, including increases in excise tax rates. However, the authorities were reluctant to introduce any tax measures ahead of the wider tax reform, now planned for 2002. They expressed their view that the revenue shortfall was temporary, largely related to weak administration and low GDP growth during the winter, and that revenues would recover quickly. The staff and the authorities agreed to retain the original tax collection flow targets for the remainder of the year and monitor progress through end-September, before recommending completion of the first review.

15. **Shortfalls in revenues and downward revisions to external financing projections necessitated a revision to the program for 2001 (Table 3).** If tax collection targets for remainder of the year are met, the revenue shortfall for the year as a whole would amount to a little over $\frac{1}{2}$ percent of GDP. In addition, delays in World Bank loans and telecommunications privatization would amount to a shortfall in external financing of over 2 percent of GDP, adding to some minor shortfalls in treasury bill financing, domestic privatization, and external grants. The revised macroeconomic program (a) reduces the target for arrears clearance by 1 percent of GDP, in line with the shortfall in privatization revenues, while still requiring repayment of all arrears accumulated in 2001 and poverty benefits from previous years; (b) allows additional credit from the NBG of about $\frac{3}{4}$ percent of GDP, representing a partial adjustment for the shortfall in World Bank financing;⁷ and (c) closes the remaining gap of just over 1 percent of GDP through cuts in expenditure commitments outside the social area. These changes imply a downward revision of the general government commitments deficit from 2 to $1\frac{1}{4}$ percent of GDP. Prior to the Board discussion, parliament is expected to approve revisions to the 2001 state budget to reflect these changes.

16. **The ministry of finance is preparing a wide-ranging reform of the tax code (Box 1).** The amendments, which would become effective from January 2002, are aimed at simplifying the tax system by focusing on larger tax payers and maintaining fewer taxes. Proposals include a reduction in the number of income tax brackets, the removal of many tax exemptions, the introduction of simplified and presumptive taxes for small enterprises and farmers, and the elimination of several "nuisance" taxes. Staff welcomed the thrust of the reform proposals, but expressed concern that the package would reduce tax revenues, unless additional tax-raising measures are identified. Staff also reiterated concerns that frequent changes to the tax code had in the past tended to undermine revenue collection and noted that

⁷ Despite this upward revision, the program targets a net *repayment* from the government to the NBG in 2001.

Table 3. Georgia: Consolidated General Government, 1997-2002

	1997	1998	1999	2000	2001		2002
	Actual	Actual	Actual	Actual	Original program 1/	Revised program 2/	Proposed Program 2/
(in millions of lari, unless otherwise indicated)							
Total revenue and grants	668.8	786.4	873.3	913.3	1,135.0	1,085.1	1,247.0
Total revenue	653.5	740.8	825.1	897.1	1,064.8	1,028.6	1,177.0
Tax revenue (including extrabudgetary funds)	587.1	643.6	782.3	851.5	1,005.3	963.0	1,087.0
o/w: VAT	205.5	219.7	248.1	289.8	329.0	338.6	...
Excises	52.7	38.7	118.5	90.2	144.0	118.5	...
Extrabudgetary revenue	102.5	117.5	133.1	144.8	160.4	160.5	...
Nontax revenue	66.3	97.1	42.8	45.6	59.5	65.6	90.0
Grants	15.4	45.7	48.2	16.2	70.2	56.4	70.0
Total expenditure and net lending	982.4	1,096.4	1,252.9	1,155.9	1,269.0	1,166.2	1,257.0
Current expenditure	890.5	997.3	1,132.5	1,094.2	1,151.6	1,066.1	1,146.0
o/w: Wages and salaries	155.5	176.7	190.8	180.1	168.6	170.9	...
Interest payment	85.1	114.8	159.0	178.4	150.2	143.7	...
Transfer and subsidies	103.4	119.3	142.2	166.7	138.7	122.8	...
Capital expenditure and net lending	91.9	99.1	120.4	61.7	103.0	92.9	101.0
o/w External project financing	31.0	67.0	83.3	60.1	97.6	89.3	90.0
Budget contingency	0.0	0.0	0.0	0.0	14.4	7.2	10.0
Overall balance (commitments)	-313.6	-309.9	-379.6	-242.6	-134.0	-81.1	-10.0
Adjustment to cash basis	28.4	64.0	97.6	89.0	-80.0	-7.0	-70.0
Net change in expenditure arrears	28.4	64.0	95.9	84.0	-80.0	-7.0	-70.0
o/w TMU definition	...	...	...	...	-80.0	-11.9	-70.0
Net other cash balance	0.0	0.0	1.7	5.0	0.0	0.0	0.0
Overall balance (cash)	-285.2	-246.0	-282.0	-153.6	-214.0	-88.2	-80.0
Total financing	285.2	246.0	282.0	153.6	214.0	88.2	80.0
Privatization	25.7	73.4	52.7	19.1	80.0	10.0	30.0
Domestic financing	161.6	97.9	131.9	133.0	20.0	-18.5	0.0
NBG	...	109.8	187.1	94.7	-28.1	-43.9	-20.0
Banks and non-banks (t-bills, deposits)	...	-9.7	15.1	9.2	20.0	-2.7	20.0
Commercial banks (other)	...	-2.1	0.0	-13.1	0.0	0.0	0.0
Off-set to NBG recapitalization bonds	...	0.0	-70.3	42.2	28.1	28.1	0.0
External financing	97.9	74.7	68.7	-8.4	114.0	96.7	50.0
Disbursements	111.2	100.2	138.4	58.6	177.6	148.0	130.0
Amortizations	-69.8	-115.4	-182.0	-210.9	-291.2	-266.7	-80.0
Changes in arrears (-, reduction) 3/	56.5	-73.6	112.4	132.0	-374.0	-16.0	0.0
Macroeconomic support 4/	0.0	163.5	0.0	11.8	601.6	231.3	0.0
Net US in kind loans	0.0	0.0	28.6	10.0	0.0	0.0	0.0
(in percent of GDP)							
Total revenue and grants	14.4	15.6	15.4	15.3	16.8	16.6	17.5
Total revenue	14.1	14.7	14.6	15.1	15.8	15.8	16.5
Tax revenue (including extrabudgetary funds)	12.7	12.8	13.8	14.3	14.9	14.8	15.3
Nontax revenue	1.4	1.9	0.8	0.8	0.9	1.0	1.3
Grants	0.3	0.9	0.9	0.3	1.0	0.9	1.0
Total expenditure and net lending	21.2	21.8	22.1	19.4	18.8	17.9	17.6
Current expenditure	19.2	19.8	20.0	18.4	17.1	16.3	16.1
Capital expenditure and net lending	2.0	2.0	2.1	1.0	1.5	1.4	1.4
Budget contingency	0.0	0.0	0.0	0.0	0.2	0.1	0.1
Overall balance (commitments)	-6.8	-6.1	-6.7	-4.1	-2.0	-1.2	-0.1
Adjustment to cash basis	0.6	1.3	1.7	1.5	-1.2	-0.1	-1.0
Net change in expenditure arrears	0.6	1.3	1.7	1.4	-1.2	-0.1	-1.0
Net other cash balance	0.0	0.0	0.0	0.1	0.0	0.0	0.0
Overall balance (cash)	-6.1	-4.9	-5.0	-2.6	-3.2	-1.4	-1.1
Total financing	6.1	4.9	5.0	2.6	3.2	1.4	1.1
Privatization	0.6	1.5	0.9	0.3	1.2	0.2	0.4
Domestic financing	3.5	1.9	2.3	2.2	0.3	-0.3	0.0
External financing	2.1	1.5	1.2	-0.1	1.7	1.5	0.7
Net US in kind loans	0.0	0.0	0.5	0.2	0.0	0.0	0.0
<i>Memorandum items:</i>							
Primary balance (in percent of GDP)	-4.9	-3.9	-3.9	-1.1	0.2	1.0	...
Central Government tax revenue (in percent of GDP)	...	8.9	9.7	9.8	10.1	10.2	...
Cigarettes and petroleum tax revenue (in percent of GDP)	...	...	2.1	1.8	2.4	2.1	...
Nominal GDP 5/	4,638.7	5,040.6	5,665.3	5,955.1	6,748.0	6,524.8	7,125.0

Sources: Georgian authorities; Fund staff estimates.

1/ Based on IMF Board document EBS/00/258, approved in January 2001.

2/ Reflecting revisions to 2001 program and proposed program for 2002, based on July mission findings.

3/ The accounting methodology for arrears to Turkmenistan for 2001 and 2002 was changed, pending an agreement between the two countries.

4/ Macroeconomic support in 2001 reflects the debt rescheduling agreed at the Paris Club in March 2001.

5/ GDP for 2001 under the original program is based on an old GDP series, all other GDP data are based on a revised series.

greater efforts should be made to strengthen tax and customs administration. The authorities felt that the proposed simplification of the tax system would free up administrative resources to improve tax collection.

Box 1. Tax Reforms Planned for 2002

In September 2001, the Ministry of Finance submitted a package of tax code amendments to parliament, to be implemented from January 1, 2002. The package, containing both policy and administrative measures, aims to simplify the tax code, by focusing on larger taxpayers and fewer taxes, and increase the tax base. Under the proposals:

- (a) Personal income tax rate bands are reduced from four to two (15 percent and 20 percent) and the non-taxable threshold is raised. The combined effect is an overall tax cut and an increase in progressivity.
- (b) The annual turnover threshold for mandatory VAT registration is increased fourfold, to lari 100,000 (US\$50,000), reducing the share of total number of enterprises subject to mandatory registration from 13 to 6 percent and the share of total turnover under VAT coverage from 95 percent to 90 percent.
- (c) The corporate income tax and the payroll tax are replaced by a "fixed" tax for enterprises in selected sectors and replaced by a "simplified" tax for companies with annual gross income below lari 100,000. The fixed tax scheme provides presumptive tax rates, differentiated according to nature of activity, location, population in the area of operation, and number of employees. Under the simplified tax scheme, enterprises pay 5 percent of their annual gross income.
- (d) In the agricultural sector, land taxes are increased by 10 percent in each category (from levels established in 1998). For most farms, this would be the only tax they would pay.
- (e) Almost all so-called nuisance taxes are eliminated, including the tax on economic activities; resort tax; hotel tax; advertisement tax; and tax on use of local symbols.
- (f) Most of the current exemptions from personal and corporate income tax, VAT, and land tax are removed.

The revised structure of the tax system, except for the complicated fixed tax and the elimination of the payroll tax for small tax payers, is broadly in line with FAD recommendations. In the absence of any compensatory tax increases, staff estimates that the current reform package would lead to a revenue loss of around ½ percent of GDP. Staff and the authorities will continue discussions in the context of the 2002 budget, with a view to ensuring that the package is at least revenue neutral. Staff will also recommend a simpler fixed tax, and the retention of payroll tax for small tax payers.

17. The authorities discussed with staff the broad fiscal parameters for 2002. Based on these discussions, staff has made preliminary projections for 2002. The ministry of finance has prepared a draft budget, which is currently being discussed within the government and will be subject to further discussions with a Fund mission in November. Assuming that the final tax reform package is at least revenue-neutral, the tax-to-GDP ratio could increase by ½ percentage point of GDP. The cash deficit would be about 1 percent of GDP, as net domestic financing would be constrained by a very small primary market for treasury bills

and by the need for the NBG to control money growth while bolstering net international reserves, thus leaving little room for additional credit to government. Expenditures in the social area have declined in recent years and are well below what would be required for progress in poverty reduction.⁸ The budget would provide for repayment of some pre-2001 arrears and for an increase in social spending commitments, including an expansion of family allowances. However, non-core expenditure commitments would need to be further curtailed.

C. Monetary and Exchange Rate Policies

18. **The monetary authorities reaffirmed their commitment to an inflation objective of 4-6 percent for 2001 and beyond.** They also indicated that they would maintain the floating exchange rate regime, with intervention mainly to purchase foreign exchange so as to achieve program targets for net international reserves. When market conditions permit, they would consider making additional purchases. Staff supported this policy, given the low level of reserves. However, the authorities agreed with staff that their ability to purchase foreign exchange may be constrained by spillover effects from the Turkish crisis or a more general deterioration in the external environment.

19. **The monetary program for 2001 was adjusted to reflect substantial shortfalls in external financing (Table 4).** Higher than programmed monetary growth in late 2000, without a noticeable impact on inflation, had provided room for an upward adjustment of the levels of reserve and broad money in 2001, allowing additional credit to government and higher foreign exchange purchases. The NBG agreed to issue additional credit to the government, repayable from future external inflows, on account of delays and likely shortfalls in World Bank financing. When it became apparent that there may be further shortfalls in external financing resulting from a delay in the telecommunications privatization, the NBG revised upwards its target for foreign exchange purchases in 2001, to US\$41 million, so as to offset about half of the shortfall in external financing, implying an end-year gross reserve target of US\$149 million (1¼ months of imports of goods and services). It felt that further credit to the government should be limited in order to allow for these additional purchases of foreign exchange. Staff agreed with this strategy, given the risk that delays in foreign financing could prove to be prolonged.

20. **The monetary program for 2002 aims to maintain low inflation, while achieving a further increase in net international reserves.** The central bank aims to purchase almost US\$70 million in foreign exchange in 2002, to reach a gross reserves target of US\$193 million (1½ months of imports) by year-end. The monetary program assumes tight fiscal policy, based on no net credit to the government from the central bank. Reserve money growth of about 10 percent would be consistent with an inflation rate of around 5 percent,

⁸ Chapter III of the Selected Issues paper provides an analysis of social spending in Georgia.

Table 4. Georgia: Accounts of the National Bank of Georgia and Monetary Survey, 1999–2002
(End-of-period stocks; in millions of lari; unless otherwise indicated)

	1999		2000		2001								2002
	Dec.	Dec.	Mar.	June		Jul.		Aug.		Sep.	Dec.		Dec.
	Act.	Act.	Act.	Rev. Prog. 1/	Act.	Rev. Prog. 1/	Act.	Rev. Prog. 1/	Act.	Rev. Prog. 1/	Rev. Prog. 1/	Orig. Prog. 2/	Prop. Prog. 1/
Accounts of the National Bank of Georgia													
Net foreign assets 3/	-440.3	-409.4	-456.4	-451.8	-447.7	-437.3	-428.6	-435.2	-420.2	-439.3	-390.7	-365.6	-337.6
Gold	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Foreign exchange reserves (including Dutch account) 5/	255.5	216.1	233.8	232.2	236.3	240.5	249.2	242.6	257.6	231.0	297.7	397.6	385.5
Use of Fund resources	-617.4	-549.8	-619.3	-613.0	-613.0	-606.8	-606.8	-606.8	-606.8	-599.3	-617.3	-666.6	-652.1
Other foreign liabilities	-79.5	-76.6	-71.8	-72.0	-72.0	-72.0	-72.0	-72.0	-72.0	-72.0	-72.0	-97.6	-72.0
Net domestic assets	748.8	800.6	815.7	839.2	831.2	836.8	833.6	836.4	835.4	843.8	803.2	757.8	791.3
Net claims on general government 4/	687.5	782.2	735.5	768.5	753.8	760.3	763.8	762.2	772.0	772.0	738.3	682.1	718.3
Loans	709.2	802.5	773.7	793.5	796.6	805.3	805.4	804.2	805.2	809.0	768.3	712.1	748.3
Deposits	-21.7	-20.3	-38.2	-25.0	-42.7	-45.0	-41.6	-42.0	-33.2	-37.0	-30.0	-30.0	-30.0
Claims on rest of economy	80.9	77.9	72.9	73.1	73.1	73.1	73.1	73.1	73.1	73.1	73.1	98.9	73.1
Claims on banks	1.9	4.0	-0.7	3.8	2.3	4.5	0.4	5.1	0.4	5.8	7.9	11.5	14.5
Other items, net 4/	-21.4	-63.5	8.0	-6.2	1.9	-1.1	-3.8	-4.1	-10.1	-7.1	-16.1	-34.7	-14.6
Reserve money (RM)	308.5	391.2	359.3	387.4	383.4	399.4	404.9	401.2	415.2	404.5	412.5	392.2	453.6
Currency in circulation (M0)	259.8	329.2	310.0	329.3	319.9	339.5	343.9	341.0	349.8	343.8	350.6	337.3	381.1
Required reserves	29.7	38.9	40.9	45.8	48.6	48.5	48.3	49.4	50.9	49.8	55.4	46.2	66.7
Balances on banks' correspondent a/cs	19.0	23.1	8.5	12.3	15.0	11.5	12.8	10.8	14.5	10.8	6.4	8.7	5.9
Memorandum items:													
Growth of reserve money (relative to end of previous year)	18.8	26.8	-8.1	-1.0	-2.0	2.1	3.5	2.6	6.1	3.4	5.4	0.3	10.0
Foreign exchange reserves (in mlns of U.S. dollars) 5/	132.4	109.4	116.9	116.1	118.2	120.2	124.6	121.3	128.8	115.5	148.8	198.8	192.8
Monetary Survey													
Net foreign assets 3/	-446.7	-422.2	-459.6	-458.1	-441.7	-432.3	-447.7	-431.1	-426.6	-436.2	-390.6	-344.5	-316.6
Net domestic assets	891.2	1,040.5	1,054.7	1,094.2	1,076.8	1,091.4	1,100.7	1,097.1	1,111.0	1,107.7	1,100.1	989.4	1,151.4
Domestic credit	1,080.9	1,282.8	1,224.3	1,285.0	1,261.4	1,282.0	1,295.3	1,293.7	1,318.4	1,309.3	1,318.7	1,217.2	1,378.6
Net claims on general government	686.2	766.2	719.2	757.0	733.4	750.7	744.6	754.6	754.7	766.3	738.4	687.9	738.4
Public borrowing from DMBs	13.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Credit to the rest of the economy	394.8	516.6	505.1	527.9	527.9	531.2	550.7	539.1	563.6	543.0	580.4	529.3	640.2
Other items, net	-189.7	-242.4	-169.6	-190.8	-184.6	-190.6	-194.6	-196.6	-207.4	-201.6	-218.6	-227.9	-227.1
Broad money (M3)	444.6	618.2	595.1	636.1	635.1	659.1	653.0	666.0	684.4	671.5	709.5	644.8	834.9
Broad money, excl. forex deposits (M2)	286.1	382.1	345.2	368.9	362.5	375.7	383.4	379.6	391.9	382.7	411.5	406.2	492.6
Currency held by the public	244.0	246.8	294.9	308.8	300.5	312.9	322.3	312.9	330.4	315.5	313.5	314.9	358.3
Total deposit liabilities	200.6	303.2	300.2	327.3	334.6	346.2	330.7	353.1	354.0	356.0	396.0	329.9	476.5
Memorandum items:													
Growth of broad money (relative to end of previous year)	20.6	39.1	-3.7	2.9	2.7	6.6	5.6	7.7	10.7	8.6	14.8	4.3	17.7
Growth of credit to the rest of the economy	30.5	30.9	-2.2	2.2	2.2	2.8	6.6	4.4	9.1	5.1	12.3	2.5	10.3
M3 multiplier 6/	1.4	1.6	1.7	1.6	1.7	1.7	1.6	1.7	1.6	1.7	1.7	1.6	1.8
M3 velocity 7/	13.7	10.7	9.7	9.6	10.3	...	...	...	...	10.1	9.9	11.2	9.2
Foreign exchange deposits in percent of total deposits	79.0	77.9	83.3	81.6	81.5	81.9	81.5	81.1	82.6	81.1	75.3	72.3	71.8

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

1/ Reflecting revisions to 2001 program and proposed program for 2002, based on July 2001 mission findings. Revised program targets for June, July, and August are adjusted for deviations from projected net external financing (see Appendix V, Table 1).

2/ Based on EBS/00/258.

3/ Data for 1999 and 2000 are at actual exchange rates; for March 2001 onward, net international reserves are valued at the program rate of 2.00 lari/US\$ and US\$/SDR 1.35.

4/ In March 1999 a 70.3 mil. government bond was issued to recapitalize the NBG for losses from revaluation of its net international reserves; in March 2000, 42.2 million was repaid and then it was fully paid off at end-March 2001.

The bond raises government liabilities and is offset by an entry in OIN; OIN also reflects a profit transfer to MoF of lari 20 million (lari 15 million assumed in the program) at end-March 2001.

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

6/ M3 divided by reserve money (RM).

7/ Annualized quarterly GDP divided by end-period M3.

assuming a decline in velocity and an increase in the money multiplier in line with trends since 1999.

D. External Sector

21. **Weak export performance in 2001 is expected to raise the current account deficit to 6½ percent of GDP in 2001.** This reflects both the loss of competitiveness resulting from the depreciation of the Turkish lira and weaker demand from Turkey and other countries affected by the global slowdown. The capital account is also likely to turn out weaker than projected, partly due to delays in telecommunications privatization and lower-than-expected World Bank disbursements. Gross reserves are therefore expected to increase less than originally assumed, reaching only 1¼ months of imports of goods and services by end-2001.

22. **Staff expressed concern about pressures to impose export bans on certain commodities.** In July 2001, parliament introduced a temporary ban on the export of timber through end-December 2001. The authorities pointed out that political pressures to ban exports of timber and scrap metal were based on concerns about illegal tree cutting and theft of metal. Parliamentary leaders stressed that the timber export ban would be removed as soon as the authorities introduced measures to stop illegal tree cutting. The authorities have now proposed such measures, in consultation with World Bank staff, and are seeking a reversal of the ban by parliament. Staff stressed the adverse consequences for the balance of payments if restrictions on the export of scrap metal, currently Georgia's largest export item, were introduced.⁹

23. **The authorities discussed with staff their plans to adjust the import tariff schedule.** Georgia has a relatively liberal trade regime and became a member of the WTO in June 2000. The Fund classifies Georgia as having an open trade regime, with a trade restrictiveness index of 2 (on a scale of 1-10). The authorities have submitted a proposal to parliament to alter the import tariff schedule, in line with Georgia's WTO commitment to reduce certain tariff rates, without increasing the tariff rate on any one commodity. Staff welcomed the proposed overall reduction in import protection, while advising against an increase in the number of tariff bands. The draft law now proposes to switch the tariff band schedule from 0, 5, and 12 percent to 0, 4, 9, and 12 percent.

24. **Georgia has made progress in reaching rescheduling agreements with bilateral creditors on Paris Club terms.** Final or draft agreements have been reached with Armenia, Austria, Azerbaijan, Iran, Netherlands, Turkey, Ukraine and USA. Most of these countries agreed on a reduced interest rate of 3 percent on the consolidated debts. Negotiations are

⁹ Timber accounts for 2 percent of Georgia's recorded exports, and scrap metal for at least 20 percent. As significant amounts of timber are thought to be smuggled out of the country, it is doubtful whether the export ban will be effective.

continuing with China, Kazakhstan, the Russian Federation, Turkmenistan, and Uzbekistan. Since the Paris Club agreement, two rounds of negotiations have been held with Turkmenistan, Georgia's largest bilateral creditor. At the end of 2000, Georgia owed Turkmenistan US\$157 million in maturities, due to be rescheduled on Paris Club terms, and US\$179 million in arrears. It is not clear how the remaining stock of arrears will be treated, as the Paris Club agreement did not constrain the terms of arrears clearance.¹⁰ Negotiations have focused on in-kind transactions, including contracts to service Turkmen aircraft, to reduce the debts. So far this year, Georgia has made in-kind debt service payments of US\$10 million to Turkmenistan through servicing aircraft.

25. Georgia delayed a number of interest payments in the context of bilateral negotiations and is requesting a waiver for non-observance of the continuous performance criterion on external arrears. It delayed a scheduled interest payment of US\$0.4 million to Armenia, due at the end of June, and withheld scheduled interest payments amounting to US\$0.06 million to Netherlands pending the resolution of legal issues.¹¹ Austria agreed to a request to delay a US\$0.7 million interest payment. These payments have now all been made. Georgia has also withheld cash interest payments due to Turkmenistan this year, but recent in-kind debt service payments exceed Georgia's scheduled interest obligations. Staff advised the ministry of finance to deposit future interest due to Turkmenistan in an escrow account (in foreign currency), if no agreement has been reached by the end of the extended Paris Club deadline. This would help to ensure Georgia's capacity to remain current on debt service, once an agreement is reached.

E. Medium-Term Outlook and Debt Sustainability

26. Staff discussed medium-term macroeconomic scenarios with the authorities (Appendix I). The staff's medium-term growth projection for 2001 to 2010 was revised down from 4¾ percent to 3¾ percent, partly reflecting slower than expected progress on structural reform. Revised medium-term balance of payments projections prepared by the staff show financing gaps from 2003 until 2007 (Tables 5-6).¹² The financing gaps in 2003

¹⁰ For purposes of illustration, the program assumes that arrears to Turkmenistan are repaid over 10 years, in equal installments.

¹¹ Including interest due on non-consolidated debts.

¹² The balance of payments data from 2000 onwards have been substantially revised, reflecting new NBG estimates for the current account (raising the level of exports, lowering the level of imports, and reducing the level of net service receipts and transfers); a delay in transit income from pipelines; an increase in pipeline-related foreign direct investment; more cautious assumptions about future loan disbursements and official grants.

Table 5. Georgia: Summary Medium-Term Balance of Payments, 1998-2010

	1998 Act. 1/	1999 Act. 1/	2000 Est. 1/	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
	Projection												
	(in millions of U.S. dollars)												
Current account balance (including transfers)	-388.5	-238.0	-161.7	-208.0	-188.2	-189.3	-266.4	-294.0	-251.8	-184.3	-126.6	-81.1	-48.8
Trade balance	-685.4	-549.3	-361.0	-439.5	-450.3	-464.4	-551.6	-578.2	-570.0	-556.8	-534.2	-528.6	-540.7
Exports	478.3	477.0	645.5	638.8	695.9	744.7	795.2	854.0	926.5	1,005.2	1,090.5	1,183.0	1,283.4
Imports 2/	-1,163.7	-1,026.3	-1,006.5	-1,078.3	-1,146.2	-1,209.1	-1,346.8	-1,432.3	-1,496.5	-1,561.9	-1,624.7	-1,711.6	-1,824.1
Services (net)	86.2	135.7	99.2	123.5	140.1	149.5	152.8	163.1	189.6	236.0	262.7	293.4	327.8
Nonfactor services, credit	242.1	261.6	490.4	514.7	554.7	589.9	640.5	690.0	751.9	832.5	890.0	955.9	1,030.6
Nonfactor services, debit	-273.2	-247.3	-405.5	-411.7	-439.7	-465.2	-509.3	-544.2	-576.1	-609.7	-643.3	-683.5	-730.8
Factor services, credit	193.3	206.1	88.7	95.5	104.7	113.1	121.3	129.4	138.1	147.4	157.0	167.2	178.7
Factor services, debit	-76.0	-84.7	-74.3	-75.0	-79.5	-88.2	-99.7	-112.2	-124.2	-134.2	-141.1	-146.2	-150.7
Interest payments	-42.2	-47.2	-47.5	-46.0	-48.1	-51.0	-54.0	-57.6	-61.7	-64.9	-66.7	-67.3	-67.0
Transfers	210.7	175.6	100.1	108.0	121.9	125.5	132.4	121.2	128.5	136.4	145.0	154.1	164.0
Capital account	247.9	79.2	90.0	97.1	86.0	159.9	255.2	283.8	267.6	233.5	184.8	155.1	136.4
Medium- and long-term loans	30.0	1.5	-74.8	-39.2	-51.1	23.0	6.8	23.6	28.8	24.0	18.7	-2.3	-23.2
Disbursements	111.9	95.5	34.7	103.1	124.0	129.0	126.8	139.0	147.6	149.8	156.9	165.8	177.5
World Bank	73.5	58.4	18.5	66.8	57.5	56.5	55.1	44.2	21.4	5.0	2.0	0.0	0.0
EBRD	8.8	4.2	6.2	8.1	21.8	18.7	5.8	0.0	0.0	0.0	0.0	0.0	0.0
IFAD	1.1	1.1	0.7	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Bilateral	28.4	12.1	9.3	8.1	8.7	16.0	26.2	0.8	0.0	0.0	0.0	0.0	0.0
Other (including commercial & uncommitted)	0.0	19.7	0.0	20.0	36.0	37.8	39.7	94.0	126.2	144.8	154.9	165.8	177.5
Amortization	-81.9	-94.0	-109.5	-142.2	-175.1	-106.0	-120.0	-115.4	-118.8	-125.8	-138.2	-168.1	-200.7
Foreign direct investment	221.0	61.7	152.6	102.6	99.1	103.3	212.9	223.1	198.4	169.2	125.7	112.9	120.6
Other (incl. commercial banks)	-3.1	16.0	12.2	33.7	38.0	33.6	35.5	37.2	40.4	40.3	40.4	44.5	39.0
Errors and omissions	15.9	94.2	7.8	15.9	--	--	--	--	--	--	--	--	--
Overall Balance	-124.6	-64.6	-63.9	-95.0	-102.2	-29.6	-11.5	-10.1	15.7	49.1	58.2	74.0	87.6
Financing	124.6	64.6	63.9	95.0	102.2	-23.0	-77.7	-76.7	-78.0	-72.1	-58.2	-74.0	-87.6
Use of Fund resources, net	36.2	23.8	-26.6	20.2	17.6	18.6	-51.1	-54.1	-46.6	-38.9	-37.5	-40.0	-30.7
Of which: purchases/disbursements	37.2	45.3	0.0	36.5	49.1	61.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Of which: repurchases/repayments	1.0	21.5	26.6	16.2	31.6	43.2	51.1	54.1	46.6	38.9	37.5	40.0	30.7
Increase in reserves (-)	54.9	-14.0	23.0	-39.4	-43.9	-41.6	-26.7	-22.5	-31.4	-33.3	-20.8	-34.0	-56.9
Change in arrears (+, increase)	-93.8	54.8	67.6	-179.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt and arrears rescheduling 2/	4.6	0.0	0.0	293.6	128.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Macroeconomic support from the EU	122.7	0.0	--	--	--	--	--	--	--	--	--	--	--
Financing gap	0.0	0.0	0.0	0.0	0.0	52.6	89.2	86.8	62.3	23.0	0.0	0.0	0.0
Memorandum items													
Current account deficit, including transfers													
(In percent of GDP)	-10.7	-8.5	-5.4	-6.4	-5.4	-5.1	-6.7	-6.8	-5.5	-3.7	-2.4	-1.4	-0.8
Gross international reserves 3/	118.4	132.4	109.4	148.8	192.8	234.4	261.1	283.6	315.0	348.3	369.1	403.1	460.0
(in months of imports of goods and services)	1.0	1.2	0.9	1.2	1.5	1.7	1.7	1.7	1.8	1.9	2.0	2.0	2.2
Debt service (after a new rescheduling)	91.5	107.9	116.1	90.3	126.2	200.2	225.1	227.1	227.1	229.6	242.4	275.4	298.4
(In percent of GNFS exports)	12.7	14.6	10.2	7.8	10.1	15.0	15.7	14.7	13.5	12.5	12.2	12.9	12.9
External debt	1,629.4	1,701.2	1,609.7	1,690.1	1,824.9	1,925.0	1,986.8	2,048.1	2,096.0	2,107.2	2,091.2	2,051.2	1,999.3
(in percent of GDP)	45.0	60.7	53.4	51.8	52.1	51.7	49.7	47.7	45.4	42.6	39.6	36.3	33.1

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

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

2/ Paris Club creditors agreed in March 2001 to reschedule principal falling due in 2001 through 2002 over 20 years, with a 3-year grace period. It is assumed that Georgia reaches agreement with Turkmenistan and reschedules US\$157 million in debt on comparable terms and US\$180 million in arrears over 10 years.

3/ Gross reserves in 1998 exclude special account for external debt service.

Table 6. Georgia: Indicators of Fund Credit, 2000–2009
(In million of SDRs; unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Outstanding Fund Credit	213.7	228.7	241.5	255.1	218.1	179.0	145.6	117.9	91.3	63.0
In percent of:										
Exports of goods and nonfactor services	25.5	26.8	26.4	26.2	21.0	16.1	12.1	9.0	6.5	4.2
Total public debt	18.0	18.3	18.1	18.2	15.1	12.1	9.7	7.8	6.1	4.3
GDP	9.6	9.5	9.4	9.4	7.5	5.8	4.4	3.3	2.4	1.6
Quota	142.2	152.1	160.7	169.7	145.1	119.1	96.9	78.4	60.7	41.9
Total obligations	23.2	14.9	25.4	33.5	38.6	40.2	34.2	28.4	27.1	28.6
In percent of:										
Quota	15.4	9.9	16.9	22.3	25.7	26.8	22.8	18.9	18.1	19.1
Exports of goods and nonfactor services	2.8	1.7	2.8	3.4	3.7	3.6	2.8	2.2	1.9	1.9
Total public debt	15.7	9.6	13.5	22.6	23.4	24.3	20.9	17.3	15.7	14.7
GDP	1.0	0.6	1.0	1.2	1.3	1.3	1.0	0.8	0.7	0.7
1. Principal	19.7	12.0	23.1	31.5	37.0	39.0	33.4	27.7	26.6	28.3
a. GRA Repurchases	19.7	9.3	9.3	9.3	9.3	4.6	0.0	0.0	0.0	0.0
b. PRGF/ESAF Repayments	0.0	2.8	13.9	22.2	27.8	34.4	33.4	27.7	26.6	28.3
2. Charges and interest	3.5	2.8	2.3	2.0	1.6	1.2	0.8	0.7	0.5	0.4
Obligations from existing drawings	23.2	14.8	25.3	33.1	38.2	39.8	33.8	24.4	15.9	10.3
(In percent of quota)	15.4	9.9	16.8	22.0	25.4	26.5	22.5	16.2	10.6	6.9
1. Principal	19.7	12.0	23.1	31.5	37.0	39.0	33.4	24.1	15.8	10.3
a. GRA Repurchases	19.7	9.3	9.3	9.3	9.3	4.6	0.0	0.0	0.0	0.0
b. PRGF/ESAF Repayments	0.0	2.8	13.9	22.2	27.8	34.4	33.4	24.1	15.8	10.3
2. Charges and interest	3.5	2.8	2.2	1.7	1.2	0.6	0.4	0.2	0.1	0.1
Obligations from prospective drawings		0.0	0.1	0.3	0.5	0.5	0.5	4.0	11.2	18.3
(In percent of quota)		0.0	0.1	0.2	0.3	0.3	0.3	2.7	7.5	12.2
1. Principal		0.0	0.0	0.0	0.0	0.0	0.0	3.6	10.8	18.0
a. GRA Repurchases		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
b. PRGF/ESAF Repayments		0.0	0.0	0.0	0.0	0.0	0.0	3.6	10.8	18.0
2. Charges and interest		0.0	0.1	0.3	0.5	0.5	0.5	0.4	0.4	0.3

Source: Georgia authorities; and Fund staff estimates.

and 2004 primarily reflect the expiration of the consolidation period under the Paris Club agreement at the end of 2002 and a reversal of financing from the Fund.

27. **In the absence of a further Paris Club rescheduling, Georgia will face a significant liquidity squeeze in 2003 and 2004, reflecting higher bilateral debt service payments, low fiscal revenues and low official reserves.** The Paris Club agreement has reduced the net present value of external debt to just over 100 percent of exports of goods and services, which could be considered sustainable under favorable macroeconomic assumptions. However, Georgia's low tax intake implies that the net present value of debt as a share of central government revenues remains above 250 percent.¹³ In the years immediately following the expiration of the Paris Club consolidation period, the state would have to spend much of its resources on debt service. Even under moderately optimistic macroeconomic assumptions, debt service in 2003 and 2004 would account for over 40 percent of fiscal revenues and over 75 percent of official reserves.

28. **Without further rescheduling, fiscal policy would be severely constrained by the external debt burden.** The medium-term analysis shows that there would be very little scope for an increase in fiscal spending until 2005 (Appendix I, Table 3). Even under moderately optimistic assumptions about GDP growth and fiscal revenues, the share of non-interest current expenditures in GDP would reach a very low level in 2003/04 and would return to pre-2000 levels only by 2006. The degree of expenditure restraint would most likely be inconsistent with social objectives. The primary surplus of the general government would rise from 1 percent in 2001 to 3 percent by 2004. The cash deficit would gradually fall from 1½ percent of GDP in 2001 to zero in 2004, reflecting negative net external financing and limited availability of net domestic financing, as the NBS would focus on building net international reserves through foreign exchange purchases.

29. The authorities therefore signaled that they would seek another round of Paris Club rescheduling, on Naples terms, for payments falling due in 2003 and 2004. This would reduce debt service obligations by almost US\$50 million in each year, freeing resources to allow a stabilization of non-interest current expenditures (Appendix I, Table 5). If the rescheduling is based on Naples terms, it would reduce the net present value of debt and would allow a stock of debt operation, which may become necessary in case the macroeconomic environment turns out to be less favorable than assumed under the program.

¹³ Georgia would not meet the HIPC fiscal criterion, because its central government revenues are currently well below 15 percent.

III. STRUCTURAL REFORM¹⁴

30. **The authorities expressed their determination to press ahead with fiscal reforms.** While progress has been made in a number of areas, including those monitored under the program (Appendix V, Table 2), many problems remain. The authorities noted that revenue collections remain far below their potential due to weak administration and widespread corruption. Reforms in the customs department have virtually stalled, after several changes at the top management level. The resignation of the minister of revenues in August 2001 has added to the uncertainty surrounding fiscal revenues.

31. **Discussions focused on monitoring and control of fiscal revenues and expenditures.** Staff expressed concern over the lack of transparency and control of transit accounts used for tax refunds. These accounts are used by the ministry of revenues to channel tax receipts back to taxpayers who overpaid in the previous month, before the taxes reach the treasury accounts. The ministry of finance intends to transfer full control over the tax refund system to the treasury in 2002. Staff also urged the authorities to implement new criteria for the identification of large tax payers and expressed concern about an earlier ad hoc decision to remove some large tax payers from the large tax payer unit. On the expenditure side, the ministry of finance plans to move towards itemized monthly expenditure planning and introduce full commitments recording by next year. Since June 2001, reform efforts have been supported by a Fund resident advisor to the treasury who will assist with revisions to the budget systems law; monitoring of expenditure arrears; and better monitoring and control of tax revenues, including problems with prepayments and refunds. The government expects the new budget system law to be approved by parliament by end-February 2002.¹⁵

32. **The authorities highlighted the challenges posed by a fragile banking sector.** The recent FSAP mission indicated that the system is exposed to considerable credit and foreign exchange risk (Box 3).¹⁶ The NBG recognized the need to strengthen bank supervision, although they felt that there had been some improvements, reflecting improved training and technical assistance. More rigorous inspections have exposed more clearly the fragile state of many banks, and licenses of six problem banks, including two medium-sized banks, have been revoked this year. However, three of these banks have continued operating after the revocation of licenses was suspended by the courts, highlighting the need to establish

¹⁴ Structural reforms monitored under IMF and World Bank programs are summarized in Box 2.

¹⁵ A forthcoming technical assistance mission from the fiscal affairs department will assist the authorities with the drafting of the budget system law.

¹⁶ Further discussion and quantitative indicators of the health of the banking sector are included in the FSSA and Chapter IV of the Selected Issues paper.

Box 2. Structural Reforms Covered by the IMF and World Bank

Structural measures under the PRGF-supported program focus on fiscal and banking sector reforms. Progress is also being monitored in the areas of governance, poverty reduction, and energy sector reform. Under the previous program, supported under the ESAF, the Fund also focused on fiscal and financial sector reforms and monitored reforms in a number of other areas, including energy tariff policy, trade policy, licensing, and land privatization.

- Measures in the fiscal area focus on **strengthening tax and customs administration and budgetary control**, given their importance for macroeconomic stability. Structural benchmarks include measures to control customs exemptions; improve the VAT refund system; audit the stock of expenditure arrears; improve commitments recording and control; apply standard expenditure control procedures to off-budget accounts.
- In the banking area, measures are aimed at **strengthening banking supervision**, including through new asset classifications and international accounting standards in banks and through legal amendments to strengthen the central bank's capacity to resolve problem banks
- The World Bank is taking the lead in the energy sector reform. The Fund is monitoring progress in **improving the financial viability of the sector and resolving its old debts**, in view of the potential risks to fiscal stability and external debt sustainability.
- In the area of governance, progress is being monitored on **implementing of the country's anticorruption strategy**. Structural benchmarks under the program focus on improving governance and transparency in the fiscal area and in the financial sector, including through introduction of a code of conduct for tax and customs officials and conflict of interest regulation for banks.

The World Bank is focusing its efforts in the social sector, public expenditure management, civil service, governance, poverty reduction, agriculture, and energy and public utilities. These reforms will be supported by the ongoing Structural Reform Support Credit, SAC III, and by a proposed SAC IV and a SATAC 3, as well as by sector-loans (Education APL, Health II, Professional Human Resource Development, Electricity Market Support, and the Energy Transit Institution Building Credit).

- Social sector reforms will focus on improvement of primary and secondary education, reform of health financing, and pensions.
- In the area of public expenditure management, the priority will be to ensure adequate budgetary provisions for core social expenditures, especially in health, education, and social safety nets. A **Public Expenditure Review** is planned for FY2002.
- **Civil service reform** will involve assisting ministries (transportation, finance, education, agriculture) to improve their structures. An IDF grant is supporting the civil service bureau of the State Chancellery in initiating broader reforms, and a Public Sector Reform Credit is being prepared.
- Measures to **support the government's anticorruption agenda** include reforms in public procurement and licensing, internal audit, the judiciary, privatization and health and education reform.
- Key reforms to be supported in the agricultural sector include land market development, irrigation, forest conservation, and privatization of the agro-processing industry.
- In the **energy and water sectors**, reforms are focused on expanding private sector involvement. Local distribution companies are to be restructured and privatized. Private management contracts are being offered for electricity transmission, dispatch, and the wholesale market. The World Bank is also funding advisors who should assist with resolving the energy sector's old debts. The Tbilisi Water utility will be put under lease management by end-2001. Assistance is also provided for negotiating and implementing pipeline agreements.
- The World Bank is taking the lead in supporting the country's **poverty reduction strategy** in the context of the preparation of the PRSP and through ongoing research on the incidence of poverty. The IMF is providing advice on the strategy's medium-term macroeconomic framework and budgetary implications.

Areas without IMF and World Bank involvement include non-road transportation infrastructure, and higher education reform.

Box 3. Findings of the Financial Sector Assessment Program (FSAP)

Two joint Fund-Bank FSAP missions visited Georgia in May and July/August 2001. Their main purpose was to identify the financial sector's vulnerabilities and provide a common platform for Bank/Fund policy advice and technical assistance. Although capital adequacy ratios and bank liquidity are well above minimum standards, and the reported level of nonperforming loans is low, the FSAP mission found that financial intermediation is underdeveloped, and that the banking system is vulnerable to credit and foreign exchange risks that are masked by deficiencies in reporting and supervisory practices. The securities and insurance markets and the payment systems, other than the interbank transfer system, are at an early stage of development. With a high level of dollarization of deposits and loans in the banking system, banks are exposed to considerable credit risk because of foreign-currency denominated lending to borrowers without a regular source of foreign exchange income. This exposes banks to an indirect form of foreign exchange risk, even if they do not have large open foreign exchange positions according to regulations. While the financial system was found to be relatively resilient to changes in interest rates and/or sudden withdrawals of deposits, there is considerable variability among banks in the degree of sensitivity to shocks.

The FSAP found that there are problems with the existing reported asset quality of banks (and over-reporting of capital), which are masked by deficiencies in reporting and supervisory practices. The NBG has now put in place new asset classification and provisioning regulations that will improve the reliability of bank soundness indicators. Inspections of about one-third of banking sector assets have revealed a substantial need for increases in provisions and have resulted in a decline in banks' capital, although none has fallen below the minimum capital adequacy ratio as a result of inspection. However, several of the largest banks not yet inspected would fall below the regulatory minimum CAR if their capital were to decline proportionally to those already inspected.

The mission examined compliance with a number of institutional codes and standards. With respect to compliance with IMF codes of transparency, the FSAP missions found that the NBG's monetary and banking supervision policies are very good. However, the legal framework governing the financial sector and compliance with Basle Core Principles need further improvement. A major shortcoming is that technical decisions by the NBG to withdraw banking licenses have been successfully suspended by the courts.

The NBG recently submitted to Parliament amendments to the National Bank Law and the Law on Commercial Banks that would address many of the shortcomings identified by the mission. The amendments would strengthen the powers of the NBG to license, regulate, supervise, administer, and liquidate banks; ensure the primacy of the NBG in its regulation of the financial sector; strengthen governance of banks, particularly in establishing "fit and proper" criteria for owners and managers; and protect NBG employees from civil and criminal liability. The FSAP missions also noted the need for further improvement in governance of the banking sector in order to adequately protect shareholder's rights, make financial statements more transparent, and improve confidence in the sector. Measures to safeguard against money laundering are currently inadequate, and the missions recommended the adoption of a program to put in place appropriate rules, policies and/or statutes in this area. A committee of the Council of Europe is expected to publish soon a report evaluating anti-money laundering measures in Georgia.

primacy of central bank and commercial banking law in bank-related matters. The NBG has used a cautious approach to closing medium-sized banks, reflecting in its view risks to public confidence in the financial sector and to the budget, given that some external liabilities of the banking sector are guaranteed by the government. Staff argued that more prompt resolution of banks would help to reduce potential fiscal costs. The authorities indicated that by end-December 2001, with assistance from MAE, they would adopt an analytical framework for resolution of insolvent banks, as recommended in the FSSA.

33. **Progress with reforms in the energy sector has been slow.**¹⁷ Electricity transmission is due to be brought under private management this year. The planned privatization of the remaining state-owned distribution companies is expected to improve collection ratios, but the process has been held back by the opposition of local governors to the consolidation of the regional companies. Furthermore, there has been little progress in discussions with creditors to resolve the large amount of old debts in the energy sector. Staff voiced concern about the potential fiscal implications of these debts, estimated at nearly US\$½ billion, and urged the authorities to devise a strategy that would not substantially increase the country's already high official external debt stock. Whereas the authorities had in the past agreed with World Bank advice that a debt surcharge on the electricity tariff could be a useful element in a strategy to resolve the sector's old debts (and agreed to include this measure as a structural benchmark in the PRGF-supported program), they now pointed to a total lack of political support for a debt surcharge, and doubted that it could raise sufficient revenues to contribute significantly to a resolution of the problem. The World Bank has recently provided funds for two advisors who will assist the authorities in formulating a new energy debt strategy. The staff noted that, while the debts were not posing an immediate threat to macroeconomic stability, they could not be neglected indefinitely, and that it would expect a revised strategy, commanding widespread support within government and parliament, to be agreed prior to the second program review.

34. **The authorities highlighted their efforts to intensify the fight against corruption.** Following up on the anti-corruption strategy published in late 2000, two presidential decrees have been issued, setting out specific short-term anticorruption measures to be implemented by government ministries and agencies (Appendix V, paragraph 14). An anti-corruption council, comprising representatives from government and civil society, has been set up to monitor progress in this area. It recently issued a report that was critical of the progress made, noting that a number of provisions were implemented in letter but not in spirit. Staff urged the authorities to strengthen implementation of the strategy.

35. **Structural reforms in other areas have been slow, clouding the medium-term growth outlook.** The authorities acknowledged that weak governance and widespread corruption remain important obstacles to private sector development and investment. Georgia lacks a competitive export industry that could generate growth, the largest single export item currently being scrap metals. Despite a liberal regime towards foreign direct investment, there are relatively few investment opportunities that could attract foreign investors.

36. **The authorities discussed a draft of the full PRSP with World Bank and Fund staff in July.** A recent poverty update prepared by the World Bank noted that poverty increased unambiguously over the period 1997-2000. GDP growth was positive during this period, but agriculture, which employs over half of the population, declined. The government

¹⁷ See also Chapter VI of the Selected Issues paper.

pointed to the difficulties in providing an effective social safety net, partly because social benefits are not well targeted and partly because of fiscal constraints that have led to sizeable arrears on wages and pensions.¹⁸ Their strategy is based on laying the institutional foundations for private sector development and economic growth, which should reduce poverty in the medium term. Staff welcomed efforts to move forward in preparing the PRSP, but stressed the need to make progress on prioritizing and costing of the measures, given the fiscal constraints, and analyze the social impact of the proposed reforms. While the authorities had initially indicated that they wished to complete the paper by November 2001, World Bank and IMF staff stressed the need to allow enough time to prepare a fuller analysis and provide for a thorough participatory process.

IV. PROGRAM MONITORING

37. **The authorities have requested the disbursement of the third loan of SDR 9 million under the arrangement, on the basis of performance in the second and third quarters of 2001, progress on structural reforms monitored under the program, and the strength of the revised macroeconomic program set out in the letter of intent dated October 9, 2001 (Appendix V).** This requires Board approval of the first review and of waivers for nonobservance of performance criteria on tax revenues, expenditure arrears, and net domestic assets of the NBG for end-March 2001, as well as on non-accumulation of external arrears. Staff indicated that it would recommend the completion of the first review after all prior actions laid out in Attachment A of the letter of intent (Appendix V) had been implemented. The loan disbursement schedule would be revised so that the fourth loan would become available upon observance of end-December performance criteria and completion of the second review under the arrangement (Table 7). The revised phasing of loans implies that Georgia will miss two disbursements of SDR 9 million each in 2001, which would be made up at the end of the three-year program.

38. **A number of small modifications to the Technical Memorandum of Understanding (TMU) are proposed to clarify certain aspects of program monitoring.** The TMU would be amended to: (a) define more precisely the adjustment mechanism for deviations from projections of external financing, in order to clarify the program treatment of debt amortization related to offsets or grants; (b) define more precisely the term "external debt;" (c) define more precisely budgetary arrears monitored under the program; and (d) specify caps on adjusters for performance criteria for end-December 2001.

39. **The quality and coverage of economic statistics remains weak (Appendix IV).** The NBG has introduced a new methodology for balance of payments data from 2000 onwards that estimates unrecorded trade based on partner country data, bringing the data closer to Fund staff estimates. However, significant uncertainties remain with respect to

¹⁸ See also Chapter III of the Selected Issues paper.

Table 7. Georgia: Disbursements Under the 3-year PRGF-Supported Arrangement

Loan	Amount	Program 1/		Proposed re-phasing 2/	
		Disbursement	Based on	Disbursement	Based on
1	SDR 9 million	Jan-01	Approval of PRGF		
2	SDR 9 million	Mar-01	Dec-00 PCs		
3	SDR 9 million	Jun-01	Mar-01 PCs and first review	Nov-01	Mar-01 PCs and first review
4	SDR 9 million	Sep-01	Jun-01 PCs	Mar-02	Dec-01 PCs and second review
5	SDR 9 million	Dec-01	Sep-01 PCs and second review	Jun-02	Mar-02 PCs and third review
6	SDR 9 million	Mar-02	Dec-01 PCs	Sep-02	Jun-02 PCs
7	SDR 9 million	Jun-02	Mar-02 PCs and third review	Dec-02	Sep-02 PCs and fourth review
8	SDR 9 million	Sep-02	Jun-02 PCs	Mar-03	Dec-02 PCs
9	SDR 9 million	Dec-02	Sep-02 PCs and fourth review	Jun-03	Mar-03 PCs and fifth review
10	SDR 9 million	Mar-03	Dec-02 PCs	Sep-03	Jun-03 PCs
11	SDR 9 million	Jun-03	Mar-03 PCs and fifth review	Dec-03	Sep-03 PCs and sixth review
12	SDR 9 million	Sep-03	Jun-03 PCs	Dec-03	Sep-03 PCs and sixth review
<i>Memorandum items:</i>					
	Loans, in millions of SDR			108.0	
	2001			27.0	
	2002			36.0	
	2003			45.0	

1/ Based on EBS/00/258.

2/ Proposed re-phasing based on May and July 2001 mission findings and attached letter of intent (Appendix V).

services, non-interest factor income, private transfers, foreign direct investment, and short-term loans. A recent revision of the historical GDP series has improved the quality of the quarterly data, according to the findings of a STA mission in March/April 2001. However, there is no up-to-date expenditure side breakdown of GDP.

40. The second review is scheduled to take place in February 2002, with a focus on tax reform, strengthening the banking sector, and energy sector reform. A mission in November 2001 will seek to agree with the authorities on a policy memorandum specifying the macroeconomic program and structural benchmarks for 2002.

V. STAFF APPRAISAL

41. **Georgia's medium-term economic goals are to reestablish fiscal and external sustainability and reduce poverty.** The key policies to achieve these goals are fiscal consolidation and revenue mobilization—supported by international assistance, including debt rescheduling—and structural reforms to support employment-intensive growth. Over the past year, there has been significant progress on fiscal consolidation, albeit with some slippage relative to program targets, and a start has been made to address the external debt problem. Growth is rebounding from the effects of winter power shortages, and has been surprisingly buoyant so far in the face of external weakness. There has also been progress on reforms of fiscal and financial institutions. However, other structural reforms have moved slowly, particularly in the key energy sector, and corruption remains a serious obstacle to private sector development. Concern about the outlook for debt sustainability and poverty reduction would be heightened in the event of a further worsening of the external environment.

42. **The conduct of monetary policy has remained sound, helping to keep inflation at around 5 percent.** The flexible exchange rate regime has served well and remains appropriate, given Georgia's low reserves and vulnerability to external shocks. Despite the pressures from the Turkish crisis, there has been only a modest depreciation of the lari, while the authorities have continued to meet program targets for net international reserves. Should external pressures continue or intensify, the authorities should maintain their policy of not intervening to support the lari, while keeping a close watch on growth of the monetary aggregates and inflation. Given the uncertainties about the external environment and the prospects for foreign disbursements, the authorities' focus on building net foreign assets is justified, leaving little room for any new central bank credit to the government next year.

43. **Fiscal consolidation achieved over the past year has been impressive, but has relied too much on spending cuts and not enough on revenue mobilization.** The reduction in the commitments deficit from nearly 7 percent of GDP in 1999 to 1¼ percent projected for 2001 marks a clear break with the past. It has allowed the government to clear expenditure arrears accumulated since mid-2000, and pay poverty and refugee benefits in full during 2000 and 2001. The draft budget for 2002 signals a continuation of these trends. Nonetheless,

revenues remain much too low to avoid a severe squeeze on non-interest spending, especially in the social areas.

44. **Fiscal consolidation has been supported by important measures to strengthen public expenditure management and improve fiscal transparency.** The authorities are encouraged to maintain the momentum in this area, including by bringing the revenue accounts and refund mechanisms fully under the control of the treasury, implementing full commitments accounting, and bringing extra-budgetary revenues and accounts of ministries under treasury control as soon as possible.

45. **More effort is needed to mobilize higher revenues, particularly in the customs department.** Corruption and smuggling have continued to undermine revenue collections, as demonstrated by persistent shortfalls in revenues from cigarettes and petroleum products. Efforts to undertake a comprehensive reform of customs have been hampered by frequent changes in senior customs personnel and lack of leadership. A strong commitment to reform in this area could release substantial resources to help relieve the constraints on non-interest spending and support PRSP objectives to improve the social safety net.

46. **Care is needed to ensure that proposed reforms of the tax code do not undercut the objective of revenue mobilization.** The comprehensive tax code amendments currently under discussion in parliament include very welcome measures to simplify the system and reduce exemptions, which should support the efforts of the tax administration to raise collections. The authorities are encouraged to ensure that the overall package is at least revenue neutral and resist strongly any attempts during parliamentary discussion, or subsequently, to reinstate exemptions and privileges. In the past, the evolution of the tax code has been excessively influenced by vested interests.¹⁹ A stable tax code, based on the authorities' current proposals, would make an important contribution to improving the environment for business investment and development.

47. **The steady remonetization of the economy has been supported by progress in reforms to strengthen the banking system, even though the FSSA reveals that significant vulnerabilities remain.** The authorities should make full use of the strengthened regulations, accounting practices, and legislation implemented under the program to further strengthen banking supervision and ensure prompt resolution of non-viable banks in future. They are encouraged to work closely with MAE to develop and implement an analytical framework for resolving insolvent banks, as recommended in the FSSA.

48. **Despite improvements in macroeconomic performance, growth remains insufficient to make a significant dent on poverty.** Growth has been weak since the Russian financial crisis in 1998, and poverty has been increasing. Widespread corruption and

¹⁹ See Chapter II of the Selected Issues paper.

the power of vested interests have discouraged private sector development and investment, including foreign investment. While the authorities' poverty reduction strategy rightly highlights employment-intensive growth as the key to poverty reduction, the government has not acted decisively enough yet to address the main obstacles to growth. The authorities' medium-term scenario includes a cautious projection of growth, albeit faster than in recent years, which will sharply constrain their ambitions in the area of poverty reducing spending.

49. **Measures to combat corruption, restructure the energy sector, and privatize key enterprises must be accelerated in order to underpin faster growth and poverty reduction.** Some measures have been taken to implement the anti-corruption strategy but, as the recent report of the anti-corruption council demonstrates, too often these have been implemented in letter but not spirit. The continued weakness of tax revenues, delays to privatization, especially in the energy sector, and pressures for trade restrictions indicate the powerful role of vested interests. The current public debate in Georgia on how to tackle corruption is healthy, but with investors being driven away by the difficult business environment, Georgia cannot afford to delay any longer before taking decisive actions in this area. The government is urged to continue to resist strongly the pressures for trade restrictions, which would further undermine medium-term growth prospects. The authorities should also intensify efforts to improve macroeconomic data. While the provision of data required for surveillance and program monitoring is adequate, significant problems remain with the quality of balance of payments data, and with the timeliness of official financing and expenditure commitments data.

50. **With only modest growth prospects, Georgia's efforts to restore its solvency will require continued international support, including further concessional lending and external debt rescheduling.** The staff therefore welcomes Georgia's agreement with Paris Club creditors in March, and the subsequent progress it has made in reaching bilateral rescheduling agreements with its creditors, including several non-Paris Club members. Nonetheless, on the basis of the revised medium-term scenarios presented here, it is very likely that a further Paris Club rescheduling, possibly on concessional terms, will be needed in 2003/04, to address serious liquidity problems at that time. The external debts of the energy sector pose an additional risk to sustainability, and the staff strongly urges the authorities to develop an effective strategy, broadly supported within government, parliament and civil society, to address this problem.

51. **The prospect of a deterioration in the external environment following the terrorist attacks on September 11 implies that near-term risks to macroeconomic stability have increased.** While a further slowdown of the world economy would have a limited effect on growth and trade in Georgia, there is a risk that a potential drop in foreign direct investment may lead to significant gaps in the balance of payments. In addition, any intensification of the Turkish crisis could lead to a depreciation of the lari against the U.S. dollar, which would raise the debt service burden and undermine the near-term fiscal position.

52. **The authorities' achievements in the areas of macroeconomic management, fiscal consolidation, and fiscal and financial sector reforms warrant continued Fund support, despite the risks that continued slow growth could threaten macroeconomic sustainability and the poverty reduction effort.** Although there have been setbacks, the authorities have demonstrated, through meeting monthly macroeconomic targets consistently since end-April, a strong commitment to the program's macroeconomic objectives. They also have a good record of implementation of program structural benchmarks, which focus on strengthening governance and transparency in fiscal and financial institutions. While acknowledging the resistance from vested interests, the government has indicated that it remains firmly committed to moving ahead with anti-corruption and other structural measures. On this basis, the staff recommends completion of the first review under the PRGF-support arrangement, and approval of the waivers of performance criteria requested by the authorities.

53. The staff recommends that the next Article IV consultation with Georgia be held on the standard 12-month cycle.

MEDIUM-TERM MACROECONOMIC SCENARIOS AND DEBT SUSTAINABILITY

A. Origins of External Debt in Georgia

1. From independence to end-1994, Georgia accumulated US\$1 billion in external debts (Table 1). About 45 percent of these debts were incurred as a result of unpaid gas imports from Turkmenistan during 1993-94. Close to 20 percent arose from the conversion of correspondent accounts with other CIS countries, mainly Russia. Another 15 percent was owed to the European Union and about 10 percent to Austria. International financial institutions accounted for just below 5 percent of total external debt.

2. By end-1994, it was already clear that Georgia would not be able to meet its external debt service obligations, given nearly exhausted official reserves and a collapse in fiscal revenues. Gross reserves of the central bank stood at US\$42 million at the end of 1994, less than 20 percent of external debt service due in the following year. General government revenues, excluding grants, amounted to only US\$55 million in 1994, or less than 7 percent of GDP.

3. The Fund organized meetings of donors and creditors in June 1995, urging the authorities and creditors to normalize financial relations and reschedule Georgia's bilateral debts. Between 1995 and 1998, Georgia negotiated 11 separate rescheduling agreements with its bilateral creditors, on the basis of a 4 percent interest rate and grace periods ranging from two to five years.

4. In the meantime, Georgia's stock of external debt continued to rise, reaching US\$1.7 billion by the end of 1999, before stabilizing at that level. Most of the additional debt accumulated after 1994 reflected concessional lending by multilaterals, aimed at supporting Georgia's efforts to promote macroeconomic stabilization and structural reform. In the four years to end-1998, the IMF disbursed US\$267 million, most of it through the ESAF. During the same period, the World Bank disbursed US\$320 million, all IDA-based loans. With hardly any bilateral loans forthcoming, this changed the composition of debt considerably. The share of bilateral loans outstanding shrank from 81 percent of total debt at the end of 1994 to 53 percent at the end of 1998, while the share of multilateral loans rose from 19 percent to 47 percent in the same period.

5. The inflow of multilateral loans and bilateral rescheduling agreements did not prevent short-term liquidity problems. While Georgia remained current on its interest obligations and rescheduled amortization payments to most bilateral creditors, it began running up arrears on principal repayments to its largest creditor, Turkmenistan, immediately after the expiration of the grace period in early 1998. The rescheduling terms agreed with Turkmenistan implied amortization payments of US\$79 million per year from 1998 to 2002 and interest payments starting at US\$14 million in 1998, amounting to debt service obligations equivalent to 25 percent of central government revenues. By end-2000, Georgia still owed US\$337 million to Turkmenistan, including US\$179 million in arrears.

6. The nature of the debt problem in the year 2000 was not too different from the situation in 1994, despite concessional multilateral lending and bilateral debt rescheduling. The main vulnerability continued to be liquidity, as near-term debt service obligations accounted for a high share of fiscal revenues and gross reserves. The liquidity problem partly reflected the short repayment period negotiated with Turkmenistan, but was also the result of a slower than expected macroeconomic recovery. While GDP growth during the second half of the 1990s was broadly in line with projections, fiscal improvements fell short of expectations.

7. Despite a gradual increase in tax collections, government revenues were only about 15 percent of GDP in 2000 (10 percent excluding local budgets), among the lowest in the CIS. Scheduled debt service in 2000 (mostly on bilateral debt) amounted to over 55 percent of central budget revenues, and external arrears accounted for another 35 percent of revenues. In addition, persistent external imbalances in the 1990s and the sale of foreign exchange in the wake of the Russian crisis had prevented any significant increase in gross reserves, despite rapid inflows of multilateral loans. At the end of 2000, gross reserves of the central bank stood at only US\$109 million, covering just over half of scheduled external debt service due in 2001 (excluding arrears of US\$179 million).

8. In the PRGF-supported program for 2001-2003, the authorities committed themselves to pursue four goals to address the debt problem. The first was to achieve a substantial fiscal adjustment, by drastically reducing the commitments deficit, repaying domestic expenditure arrears, and raising fiscal revenues, mainly through reforms in tax and customs administration. The second was to accelerate structural reforms that support growth and poverty reduction. The third was to continue to work with international institutions and donors to attract low-interest loans and grants, while not contracting any new nonconcessional debt. The fourth was to pursue debt rescheduling under the aegis of the Paris Club.

B. Paris Club 2001: Projected Debt and Debt Service

9. Following the approval of the PRGF-supported program in January 2001, Georgia reached an agreement with Paris Club creditors on March 6, 2001, to reschedule principal payments falling due over the next two years.¹ The agreement consolidates principal maturities falling due between January 1, 2001, and December 31, 2002 on loans contracted before November 1, 1999. Maturities on bilateral and commercial debt falling due within this consolidation period are to be repaid over 20 years, with a 3-year grace period and a

¹ Participants at the Paris Club were Austria, Georgia, Netherlands, Russia, Turkey, and the United States. Observers at the meeting were France, Germany, Italy, and Japan, as well as the IMF, IBRD, EBRD, UNCTAD, and OECD.

graduated repayment schedule.² The first repayment, due in 2005, will amount to 1.17 percent of the total restructured principal and the last repayment, in 2021, will amount to 12.88 percent of the total. Official development aid credits are to be repaid in equal installments over 20 years, after a 10-year grace period.

10. According to the Paris Club agreement, the interest rate on previously rescheduled loans should not exceed the current rate, which is 4 percent for all of Georgia's debts that were subject to prior bilateral rescheduling agreements. The interest rate on the commercial credits is to be determined bilaterally, at an appropriate market rate.

11. During the discussions, Georgia requested an extension of the consolidation period to cover the third year of the PRGF-supported arrangement, in light of revised projections about oil pipeline receipts and the impact of Turkish crisis.³ Paris Club creditors signaled their willingness to consider an extension of the consolidation period if there is a financing need in 2003. The extension would be conditional on whether Georgia implements fully the agreement reached at the Paris Club meeting in March 2001; satisfactory relations are maintained with Paris Club creditors' countries and the IMF; and Georgia successfully completes the first two years of the PRGF-supported program.

12. While the terms of the 2001 Paris Club agreement for Georgia, so-called "Houston terms," are considered nonconcessional, the agreement has a grant element of around 30 percent. Crucially, it enables Georgia to reduce its near-term debt service obligations substantially. Assuming successful implementation of the agreement with all Paris Club members and non-members, principal payments due in 2001/02 would be reduced by a total of US\$240 million. Roughly 80 percent of the total reduction would come from non-Paris Club members, in particular from Turkmenistan, which was due to receive US\$157 million in principal repayments during the 2-year period.

13. The debt service profile resulting from the implementation of the Paris Club agreement is shown in Table 2.⁴ The average debt service to export ratio for 2001/02 is projected to fall by more than half, to below 10 percent, and increase only slightly in

² The agreement was more generous to Georgia than was assumed in the PRGF-supported program in that it stretches repayment over 20 years, rather than 10 years, and sets a graduated repayment schedule. This implies repayments from 2005 to 2007 would be only 15 percent of what was assumed in the PRGF-supported program.

³ The PRGF-supported program, negotiated in October 2000 and approved in January 2001 assumed a 2-year consolidation period.

⁴ The impact of the rescheduling on total debt service depends on what agreement will be reached on repayment of the US\$180 million arrears to Turkmenistan. We assume here repayment in equal installments over 10 years.

subsequent years. Given the relatively low interest rate in the context of a nonconcessional rescheduling, the net present value of end-2001 debt was effectively reduced by US\$56 million, or more than 10 percent of the total stock of bilateral maturities (excluding arrears to Turkmenistan). However, there remains a hump in debt service in 2003 and 2004, with an average debt service to export ratio of 14 percent and an average debt service to fiscal revenue ratio of 41 percent.

14. Following the Paris Club meeting, Georgia has begun the process of negotiating debt rescheduling agreements with its bilateral creditors on terms comparable to those described above, including with non-Paris Club creditors Armenia, Azerbaijan, China, Iran, Kazakhstan, Turkmenistan, Ukraine, and Uzbekistan. So far, agreements have been reached in principle with Armenia, Austria, Azerbaijan, Iran, Netherlands, Turkey, USA, and Ukraine. Most of these countries agreed to reduce the interest rates from 4 percent to 3 percent. Preliminary discussions were held with Russia and Turkmenistan, Georgia's largest bilateral creditors. Georgia is requesting an extension of the Paris Club deadline for bilateral discussions, from August 31 to December 31, 2001.

C. Medium-Term Macroeconomic Framework

15. This section describes a medium-term scenario for 2001 until 2010, based on the implementation of the 3-year PRGF-supported economic program, and assuming continued fiscal adjustment and structural reforms thereafter. This "program scenario" projects macroeconomic aggregates, with a focus on external debt indicators, under moderately optimistic assumptions about the external environment and policy implementation. We assume an average GDP growth rate of about 3¾ percent for the projection period and a stable export-to-GDP ratio (Table 3).⁵ While this is lower than the average GDP growth rate recorded over the six-year period that followed the post-Soviet slump in the early 1990s (5¼ percent), it is higher than growth rates seen since the Russian crisis (2-3 percent). Inflation is assumed to be stable, at around 5 percent, in line with monetary policy objectives. Financial sector development is assumed to lead to a steady reduction in M3-velocity, from 9½ in 2000 to 5 by 2010 and an increase in the money multiplier, from 1½ in 2000 to 2¼ by 2010. The real effective exchange rate is assumed to be constant.

16. Debt sustainability in Georgia depends to a significant extent on fiscal performance, in particular on efforts to improve tax collection. In the program scenario, we assume that the tax-to-GDP ratio for the general government grows by half a percentage point each year, in line with progress in recent years. This would increase Georgia's central government revenues (excluding grants) from 11 percent of GDP in 2001 to 14½ percent in 2010. It is

⁵ In a recent five-country debt sustainability analysis (Executive Board paper SM/01/36), Georgia's average growth rate for 2001 to 2010 was assumed to be 4¾ percent.

also assumed that the government repays domestic expenditure arrears of around lari 300 million (5 percent of 2000 GDP) during 2001 to 2005.

17. The current account deficit is projected to fall from 6½ percent of GDP in 2001 to just below 1 percent by 2010, with a temporary increase in 2004/05, reflecting oil and gas pipeline investments that lead to an acceleration of foreign direct investment and capital goods imports. Inflows of non-pipeline foreign direct investment are assumed to be in the range of 1½ to 2 percent of GDP per annum, in line with levels seen in the past. Foreign loan disbursements to the general government are assumed to be around US\$80 million per year (a quarter of which in adjustment credit and the remainder in project loans) and remain fully concessional, in line with current policy. Foreign loans to the private sector are projected to grow to about US\$85 million annually by 2010. It is assumed that Georgia receives about US\$20-30 million in non-project grants to the budget per year, broadly in line with current levels.

18. Gross reserves are projected to cover 1½ months of imports of goods and services by the end of 2002, when the Paris Club consolidation period ends. Reserves are assumed to remain stable at 1¼ months of imports between 2003 to 2005, when debt service is relatively high, and grow gradually thereafter, reaching 2¼ months of imports of goods and services by 2010. Given the low monetization of the economy, the projected pace of reserve accumulation implies a rate of growth in net international reserves that absorbs much of reserve money growth, leaving little room for increase in net domestic assets of the central bank (and therefore little room for domestic financing of the budget deficit).

19. Under these assumptions, the medium-term balance of payments shows annual financing gaps of up to US\$90 million in the period 2003 to 2007. In 2003, the gap reflects a US\$50 million increase in debt service, following the expiration of the Paris Club consolidation period. The gap increases further in 2004, as the IMF program expires. The gap gradually falls in subsequent years, reflecting improvements in the balance of payments.⁶ The financing gaps are assumed to be closed through exceptional balance of payments support repayable over 5 years, following a 5-year grace period.⁷

20. Table 3 shows that debt indicators under the program scenario deteriorate sharply in 2003, following the expiration of the Paris Club consolidation period at the end of 2002. Debt service rises by about 50 percent in 2003, absorbing 78 percent of gross official reserves and amounting to 42 percent of central government revenues. Liquidity remains equally tight in

⁶ This reflects primarily growth in exports of goods and services. Rising inflows of pipeline-related FDI is assumed to be largely offset by related capital imports.

⁷ Exceptional financing is assumed to derive partly from additional credit to the NBG and partly from additional financing to the private sector.

2004. Debt service indicators improve thereafter, thanks to growing fiscal revenues, growing official reserves, and a relatively positive macroeconomic environment. The net present value of the total debt stock, as a share of exports, declines gradually, from about 100 percent to below 60 percent in 2010, as no new non-concessional debt is assumed. The net present value of debt as a share of central government revenues, at over 300 percent in 2001, falls to below 150 percent by 2010.

21. The policy response to the liquidity squeeze in 2003/04 assumed in this scenario is continued fiscal tightening on the expenditure side. The fiscal deficit is reduced by 5 percentage points of GDP between 2000 to 2004, implying a primary surplus of 3 percent of GDP in 2004. Whereas general government tax revenues, as a share in GDP, would rise from 14¼ percent in 2000 to 16¼ percent by 2004, expenditure commitments would have to remain stagnant at 2 percentage points of GDP below their 2000 level (which in turn is 2 percentage points below previous years).

D. Debt Sustainability Under Alternative Assumptions

22. This section analyses the sensitivity of Georgia's external position to macroeconomic shocks. A "low case" scenario is constructed to highlight the country's vulnerability in case GDP and export growth fall short of expectations over a prolonged period and tax revenues do not grow as rapidly as assumed above (Table 4). Specifically, it is assumed that GDP and export growth are both lower by 1½ percentage points per year. This implies an average GDP growth rate of 2¼ percent and an average export growth rate of 6 percent (and a stable export-to-GDP ratio). The investment-to-GDP ratio is assumed to be 1½ percentage points below the program scenario and non-pipeline foreign direct investment is assumed to be halved. The tax-to-GDP ratio is assumed to be 1 percentage point below the program scenario, implying a two-year lag in the evolution of the tax-to-GDP ratio relative to the program scenario.

23. With lower export growth, the low case scenario produces current account deficits well above the program case. By 2010, the difference would reach almost 4 percent of GDP. It is assumed that the resulting gaps arising in the balance of payments are filled partly through lower reserve accumulation (subject to a minimum reserve level of 1 month of imports of goods and services) and partly through exceptional financing to the central bank, based on a 10-year repayment period, with a five year grace period and a 4 percent interest rate.⁸ This adds to the stock of public debt, and net international reserves of the central bank would remain negative throughout the program period. It is also assumed that the central

⁸ This assumption is somewhat artificial as it is not clear what type of exceptional financing would be available. Alternatively, one could assume that after reserves reach a critically low level, arrears would be accumulated.

bank effectively onlends the additional external financing to the government.⁹ This allows the government to offset the loss in tax revenues relative to the program case through higher fiscal deficits, rather than through expenditure cuts. As a result, private sector savings is far below the program case as export revenues by the private sector are effectively replaced by external financing which is onlent to the budget.

24. Table 4 shows that in the low case scenario, the net present value of debt remains at around 100 percent of exports of goods and services throughout the forecasting period. Liquidity problems emerge at the end of the consolidation period under the Paris Club agreement, as in the program case. However, the liquidity pressures are more pronounced and do not abate after 2004. Debt service remains at over 30 percent of central government revenues through the entire projection period. Moreover, given the impact of lower exports on the reserve level, debt service reaches over 125 percent of gross reserves by 2010.

25. The tighter liquidity situation in the low case scenario implies that Georgia is more vulnerable to shocks, such as a temporary real depreciation. For instance, a 25 percent depreciation in 2010 would imply a ratio of debt service to fiscal revenues of 30 percent in the program case, but 44 percent in the low case scenario.

26. There are a number of additional complications to the analysis. First, foreign investments in oil and gas pipelines may fall short of current projections. This would slow down the accumulation of reserves somewhat, although during the construction phase much of the positive impact of FDI on the balance of payments is offset by a related increase in capital goods imports. However, service revenues in the outer years would be lower and could reduce the level of exports of goods and services by up to 5 percent. Second, Georgia's state-owned energy utilities have external debts of over US\$200 million that are not guaranteed by the state, but may partly be assumed by the budget at some point. Third, arrears to Turkmenistan may be amortized more rapidly than assumed in this analysis. Given the liquidity squeeze in 2003/04, this may worsen the outlook for the near term.

E. Alternative Debt Strategies

27. The analysis of Georgia's medium-term macroeconomic prospects and external debt position points to serious medium-term liquidity problems. Even under moderately optimistic assumptions, as in the program case, there would be a severe liquidity squeeze on public finances during 2003 and 2004. Under a less favorable environment, as in the low case

⁹ With money supply determined by GDP and inflation assumptions, a shortfall in export revenues reduces central bank purchases of foreign exchange and related money emissions, which in turn opens room for credit expansion by the central bank. An equivalent assumption could have been that the balance of payments gaps would be financed by exceptional external financing to the budget.

scenario, the liquidity problems would be more severe and longer lasting. This raises questions about the appropriate mix of additional fiscal adjustment, structural reforms, new lending, and additional debt rescheduling.

28. Fiscal adjustment under the PRGF-supported program is already ambitious, given the assumed improvement in fiscal revenues and the decrease of the general government deficit from over 6 percent in recent years to 4 percent in 2000, 1¼ percent in 2001, and close to balance in 2002 and 2003. While a permanent increase in the tax-to-GDP ratio and restrained growth in fiscal expenditures are key to long-term debt sustainability in Georgia, the degree of expenditure restraint required to maintain external solvency in 2003 and 2004 is probably inconsistent with social objectives, even under program assumptions. Current spending levels are already well below recent years and insufficient to finance the public investment and social spending needed to ensure high growth and a significant reduction in poverty. In addition, given the tight liquidity situation and the low level of reserves, any shock, such as a sudden depreciation or a delay in a large multilateral loan, could force the country into arrears, even if the fiscal stance is tightened further.

29. The scope for additional disbursements and privatization revenues is limited. The program scenario assumes World Bank lending and grants in line with recent years and no substantial increase in the allocation is expected for the near future. If anything, recent delays to World Bank disbursements highlight downside risks and it is not clear which donors would add to the US\$20-30 million of non-project ODA financing currently received by Georgia. Regarding privatization, Georgia has very few assets that are attractive for foreign investors. The industrial sector is small and loss-making and even the fixed line telecommunications provider has proved difficult to sell. An acceleration of structural reform would also not make a significant difference, as the main debt problem under the program scenario is a near-term liquidity problem in 2003/04, and it would take more than three years to achieve a significantly higher level of GDP and tax revenues.

30. In light of these constraints, it is likely that Georgia would return to the Paris Club soon. Under the moderately optimistic program scenario, flow rescheduling of maturities due to bilateral creditors in 2003 and 2004 could be sufficient to maintain debt sustainability. It would reduce debt service by a third during those two years and would allow to smooth out the path of fiscal expenditures until 2005. As shown in Figure 2, the ratio of debt service to central government revenues would fall significantly in 2003/04, from an average 41 percent to just over 30 percent, and the average ratio of debt service to reserves would fall from 76 percent to 57 percent.

31. While the terms of the rescheduling are not significant for the liquidity situation in 2003/04, they do matter for the net present value of debt and for debt service from 2005 onwards. Figure 2 and Table 5 show that Naples terms, followed by a stock of debt operation in 2005, would ease liquidity pressures significantly in 2005, reducing debt service from 34 percent of central government revenues to 24 percent (although an additional flow rescheduling of 2005 maturities, US\$45 million, could achieve a similar outcome). As

illustrated in Figure 1, Naples flow and stock treatment would also reduce the net present value of debt significantly, bringing the NPV-to-revenues ratio to below the HIPC threshold of 250 percent in the program case.

32. In the low case scenario, flow rescheduling, even on concessional terms, would not be sufficient to establish debt sustainability. Although the average ratio of debt service to central government revenues in 2003/04 can be reduced from 46 percent to 34 percent, it would remain at that relatively high level thereafter. The net present value of debt would remain above the HIPC threshold of 250 percent of central government revenues throughout the forecast period. By contrast, Naples flow rescheduling in 2003/04 followed by a stock of debt operation in 2005 would bring Georgia back on a more sustainable path (Table 5). However, even in this case, the net present value of debt would remain close to 250 percent of central government revenues (although the ratio of revenues to GDP would be too low for using this as a criterion for HIPC eligibility).

33. In summary, debt sustainability in Georgia requires not only a positive macroeconomic environment, but also continued fiscal and financial reforms, *and* continued concessional support from multilateral institutions and bilateral donors, including through additional debt rescheduling in the medium run. It should be noted that Georgia has made several steps in the right direction. By only assuming new debt on a concessional basis, Georgia has been able to contain the net present value of its debt. The 2001 Paris rescheduling has helped bring Georgia's external financing in order and alleviated the most imminent liquidity pressures. Improved tax collection has boosted central government revenues, although much more progress could be made in this area. In addition, the government will need to intensify its work with donors and the multilateral lenders to accelerate structural reforms that would lay the foundation for long-term growth. Continuing efforts along these four central pillars—Paris Club rescheduling, concessional lending and grants, fiscal improvements, and structural reforms—is the only credible debt strategy currently available to Georgia.

Table 1. Georgia: External Debt Outstanding, 1994–2001
(In millions of U.S. dollars)

	1994	1995	1996	1997	1998	1999	2000	2001	
								Q1	Q2
Total debt outstanding	1,003.9	1,216.7	1,357.2	1,512.4	1,629.4	1,701.2	1,609.7	1,632.6	1,617.6
Public and publicly guaranteed	1,003.9	1,216.7	1,357.2	1,512.4	1,629.4	1,676.1	1,591.7	1,615.5	1,600.6
Multilateral	193.2	364.5	520.3	655.5	764.7	829.2	793.4	811.2	803.4
World Bank	1.0	86.0	162.7	227.0	300.5	358.8	377.3	385.4	391.3
IMF	40.5	116.1	189.5	257.8	302.1	319.0	289.1	296.3	286.1
European Union	151.7	160.8	155.1	145.5	129.8	116.8	90.0	92.3	87.3
Other	0.0	1.6	12.8	25.2	32.3	34.7	37.1	37.2	38.7
Bilateral	810.7	852.2	836.9	856.9	864.7	846.9	798.2	804.3	797.2
BRO	655.9	684.3	634.5	638.3	618.7	593.6	559.0	559.0	559.0
Russia	156.3	167.1	175.4	179.3	179.3	179.3	156.9	156.9	156.9
Turkmenistan 1/	440.3	453.2	393.6	393.6	373.9	348.9	336.9	336.9	336.9
Armenia	18.1	19.7	19.6	19.6	19.6	19.6	19.6	19.6	19.6
Azerbaijan	15.0	15.7	16.2	16.2	16.2	16.2	16.2	16.2	16.2
Kazakhstan	24.1	26.7	27.8	27.8	27.8	27.8	27.8	27.8	27.8
Other	2.0	2.0	2.0	1.9	1.9	1.9	1.7	1.7	1.7
Non-BRO	154.8	167.9	202.4	218.6	246.1	253.2	239.2	245.3	238.1
Turkey	42.0	45.4	47.9	54.3	54.3	54.3	54.3	54.3	54.3
Austria	97.4	104.2	110.3	90.0	90.0	83.8	70.7	72.5	68.5
Germany	0.0	2.8	27.6	33.3	46.4	51.7	49.5	54.1	51.2
USA	0.0	0.0	0.0	19.9	34.7	42.5	42.2	42.0	42.0
Others	15.4	15.6	16.6	21.0	20.6	20.8	22.5	22.4	22.1
Private non-guaranteed	0.0	0.0	0.0	0.0	0.0	25.2	18.1	17.0	17.0

Sources: Georgian authorities; and Fund staff estimates.

1/ At end-2000, Georgia was in arrears to Turkmenistan in the amount of US\$179.5 million.

Table 2. Georgia: External Debt Service projections, before and after the Paris Club rescheduling, 2000–2010
(In millions of U.S. dollars)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Debt service before the Paris Club rescheduling 1/ 2/	183.6	202.2	243.8	175.3	182.1	161.5	146.5	135.4	124.6	126.9	119.7
Principal payments	136.1	158.5	206.7	142.5	152.4	135.4	123.8	115.8	107.8	112.8	108.1
Interest payments	47.5	43.7	37.1	32.8	29.6	26.0	22.7	19.6	16.8	14.1	11.5
Debt service after the Paris Club rescheduling 1/ 2/	183.6	90.3	122.4	185.0	191.8	174.0	159.8	149.5	139.6	142.7	136.5
Principal payments	136.1	44.3	78.2	142.5	152.4	138.3	127.6	120.5	113.6	119.6	116.3
Multilateral	31.1	33.8	58.6	72.1	81.2	66.8	61.0	56.8	65.3	71.6	65.6
IMF	26.6	16.2	31.6	43.2	51.1	54.1	46.6	38.9	37.5	40.0	30.7
World Bank	0.0	0.0	0.0	0.0	1.1	2.7	6.2	10.3	14.5	18.0	22.9
EU	0.0	13.2	18.7	18.9	19.0	0.0	0.0	0.0	6.2	6.3	6.3
Others	4.5	4.4	8.3	10.0	10.0	10.0	8.2	7.7	7.2	7.3	5.7
Bilateral	102.6	8.0	17.1	68.0	68.7	69.0	64.1	61.2	48.2	48.0	50.7
Paris Club	23.1	0.0	0.0	34.7	35.3	33.5	37.7	39.1	22.6	19.5	20.9
Non-Paris Club	79.5	8.0	17.1	33.3	33.4	35.4	26.4	22.2	25.7	28.5	29.8
Commercial	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	0.0	0.0	0.0
Interest payments	47.5	46.0	44.3	42.5	39.4	35.7	32.3	29.0	26.0	23.1	20.2
Multilateral	13.3	15.5	14.6	14.2	13.4	12.2	11.4	10.7	9.8	8.6	7.4
IMF	4.8	3.8	3.2	2.8	2.2	1.5	1.1	0.9	0.7	0.5	0.4
World Bank	2.8	3.0	3.5	3.9	4.4	4.8	5.0	5.0	5.0	4.9	4.8
EU	2.9	4.4	4.6	3.5	2.5	2.0	2.0	2.0	1.8	1.4	1.0
Others	2.8	4.4	3.4	4.1	4.3	4.0	3.3	2.7	2.2	1.7	1.3
Bilateral	33.4	29.7	29.1	27.8	25.7	23.3	20.7	18.3	16.3	14.5	12.7
Paris Club	13.1	12.0	12.4	11.9	10.6	9.3	8.0	6.5	5.3	4.5	3.7
Non-Paris Club	20.3	17.7	16.7	15.9	15.0	14.0	12.8	11.8	11.0	10.0	9.0
Commercial	0.9	0.7	0.6	0.5	0.4	0.2	0.1	0.0	0.0	0.0	0.0
<i>Memorandum items:</i>											
NPV of public and publicly guaranteed debt (P&PG) 1/											
Before the Paris Club rescheduling	1,110	1,061	989	993	944	873	802	728	659	585	514
After the Paris Club rescheduling	1,053	1,112	1,164	1,170	1,125	1,055	984	909	838	761	686

Source: Georgian authorities, and Fund staff estimates

1/ Excluding debt service on uncommitted loans.

2/ Arrears repayment to Turkmenistan is assumed at US\$8 million in 2001 and US\$17.1 million from 2002 to 2011.

Table 3. Georgia: Macroeconomic Framework, 1996-2010
Program scenario 1/

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
	Actuals					Program scenario									
(Percent change)															
Output and prices															
Real GDP	10.5	10.6	2.9	3.0	1.9	3.9	3.8	4.0	4.0	4.0	4.0	4.0	3.5	3.5	3.5
Consumer price index (end-of-period)	13.7	7.2	10.7	10.9	4.6	4.9	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
(In millions of U.S. dollars)															
External sector															
Current account balance	-329	-375	-389	-238	-162	-208	-188	-189	-266	-294	-252	-184	-127	-81	-49
Of which:															
Exports of goods and nonfactor services	511	661	720	739	1136	1153	1251	1335	1436	1544	1678	1838	1981	2139	2314
Imports of goods and nonfactor services	-867	-1368	-1437	-1274	-1412	-1490	-1586	-1674	-1856	-1976	-2073	-2172	-2268	-2395	-2555
(In percent of GDP)															
General government															
Total revenues and grants	13.8	14.4	15.6	15.4	15.3	16.6	17.5	18.1	18.5	18.9	19.5	20.2	20.7	21.2	21.7
Total revenues	11.9	14.1	14.7	14.6	15.1	15.8	16.5	17.0	17.5	18.1	18.8	19.4	19.9	20.4	20.9
Tax revenues	10.6	12.7	12.8	13.8	14.3	14.8	15.3	15.8	16.3	16.8	17.3	17.8	18.3	18.8	19.3
Non-tax revenues	1.3	1.4	1.9	0.8	0.8	1.0	1.3	1.3	1.3	1.4	1.5	1.7	1.7	1.7	1.7
Grants	1.8	0.3	0.9	0.9	0.3	0.9	1.0	1.0	1.0	0.7	0.7	0.7	0.7	0.8	0.8
Expenditures and net lending	21.1	21.2	21.8	22.1	19.4	17.9	17.6	17.3	17.5	18.8	20.5	20.9	21.5	21.8	22.1
Current expenditure (incl. budget contingency)	19.2	19.2	19.8	20.0	18.4	16.4	16.2	15.9	16.0	17.3	19.0	19.6	20.2	20.6	20.9
of which: interest	1.5	1.8	2.3	2.8	3.0	2.2	2.2	2.0	1.8	1.7	1.6	1.5	1.4	1.3	1.2
Capital expenditure and net lending	1.9	2.0	2.0	2.1	1.0	1.4	1.4	1.4	1.5	1.5	1.5	1.3	1.2	1.2	1.2
Overall balance (commitment basis)	-7.3	-6.8	-6.1	-6.7	-4.1	-1.2	-0.1	0.7	1.0	0.1	-1.0	-0.7	-0.8	-0.6	-0.4
Overall balance (cash basis)	-7.1	-6.1	-4.9	-5.0	-2.6	-1.4	-1.1	-0.3	0.0	-0.7	-1.0	-0.7	-0.8	-0.6	-0.4
Privatization	0.5	0.6	1.5	0.9	0.3	0.2	0.4	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2
Domestic financing	4.1	3.5	1.9	2.3	2.2	-0.3	0.0	0.6	0.2	0.3	0.4	0.3	0.3	0.1	0.0
External financing (net)	2.5	2.1	1.5	1.7	0.0	1.5	0.7	-0.7	-0.4	0.1	0.3	0.2	0.3	0.3	0.2
Disbursements (incl. in-kind)	2.5	2.4	2.0	2.9	1.2	2.3	1.9	1.9	2.0	2.0	1.9	1.7	1.6	1.6	1.5
Amortization 2/	0.0	-0.3	-0.5	-1.2	-1.1	-0.8	-1.2	-2.6	-2.5	-1.8	-1.6	-1.5	-1.3	-1.3	-1.3
(In percent of GDP)															
Saving and investment															
Investment	7.9	15.6	24.4	14.6	14.5	14.6	14.8	15.0	17.6	17.4	16.8	16.2	15.5	15.6	16.0
General government	1.9	2.0	2.0	2.1	1.0	1.4	1.4	1.4	1.5	1.5	1.5	1.3	1.2	1.2	1.2
Non-government sector	6.0	13.7	22.4	12.5	13.5	13.2	13.4	13.6	16.1	16.0	15.3	14.9	14.3	14.3	14.7
Gross domestic saving	-2.9	5.2	13.7	6.2	9.1	8.2	9.4	9.9	10.9	10.6	11.3	12.4	13.1	14.1	15.1
General government	-5.4	-4.8	-4.2	-4.6	-3.0	0.2	1.3	2.2	2.6	1.6	0.5	0.6	0.5	0.6	0.8
Non-government sector	2.5	9.9	17.8	10.7	12.2	8.0	8.1	7.8	8.4	9.0	10.8	11.9	12.7	13.5	14.3
Foreign savings (current account deficit)	10.8	10.5	10.7	8.5	5.4	6.4	5.4	5.1	6.7	6.8	5.5	3.7	2.4	1.4	0.8
(In millions of U.S. dollars; unless otherwise indicated)															
External debt and foreign exchange reserves															
External debt, total	1,357	1,512	1,629	1,701	1,610	1,690	1,825	1,925	1,987	2,048	2,096	2,107	2,091	2,051	1,999
NPV of external debt, P&PG 2/ 3/	...	...	...	...	1,110	1,112	1,164	1,212	1,239	1,271	1,305	1,296	1,296	1,285	1,260
as percent of 3-year average exports of goods and services	...	...	...	...	128.3	110.2	98.6	97.3	92.5	88.4	84.1	76.9	70.7	64.7	58.8
as percent of central government revenues, excl. grants	...	...	...	...	356.4	312.3	291.2	277.0	256.2	236.2	218.6	195.7	178.5	161.6	144.7
External debt service, total 2/	47	40	92	108	116	90	126	200	225	227	227	230	242	275	298
External debt service, P&PG 2/ 3/	47	40	92	108	113	88	119	183	194	181	172	167	172	195	210
as percent of exports of goods and services	9.2	6.0	12.8	14.6	10.0	7.6	9.6	13.7	13.5	11.7	10.3	9.1	8.7	9.1	9.1
as percent of central government revenues, excl. grants	17.4	11.2	24.5	37.9	36.4	24.6	29.9	41.9	40.1	33.7	28.9	25.1	23.7	24.5	24.2
as percent of official reserves	29.9	22.9	77.8	81.6	103.5	58.8	62.0	78.3	74.3	63.9	54.7	47.8	46.6	48.3	45.7
Gross official reserves of the NBG	158	173	118	132	109	149	193	234	261	284	315	348	369	403	460
(in months of imports of goods and non-factor services)	2.2	1.5	1.0	1.2	0.9	1.2	1.5	1.7	1.7	1.7	1.8	1.9	2.0	2.0	2.2
Memorandum Items:															
Nominal GDP (in millions of US\$)	3,046	3,575	3,620	2,803	3,013	3,262	3,505	3,725	3,996	4,297	4,612	4,950	5,287	5,647	6,032
Non-interest current expenditure, cash basis (percent of GDP)	17.7	17.4	17.5	17.2	14.0	14.2	14.9	14.8	15.1	16.2	17.3	18.0	18.7	19.1	19.5

Sources: Georgian authorities; and Fund staff estimates.

1/ The program scenario assumes implementation of the PRGF-supported economic program, continued structural and fiscal reforms, financial sector development consistent with a gradual rise in the money multiplier and a reduction in M3 velocity (to 5 by 2010), and continued external support by the World Bank and donors, net repayment of budgetary arrears of lari 320 million from 2001 to 2005, and no significant changes in the real exchange rate. Balance of payments gaps in 2003-2007 are assumed to be closed by exceptional financing, including to the central bank.

2/ Based on 2001 Paris Club agreement and assuming 10-year repayment of arrears to Turkmenistan. Historical figures on a cash basis. The net present value for 2000 is based on debt service obligations prior to the 2001 Paris Club agreement.

3/ Public and publicly guaranteed debt, excluding state-owned enterprises.

Table 4. Georgia: Medium-Term Scenarios, 1996-2010 1/ 2/

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
	Actual					Scenarios									
Output, exports, and prices															
(percentage change)															
<i>Program scenario</i>															
GDP, real	10.5	10.6	2.9	3.0	1.9	3.9	3.8	4.0	4.0	4.0	4.0	4.0	3.5	3.5	3.5
Exports of goods and services, US\$	5.5	29.5	8.9	2.5	53.8	1.5	8.4	6.7	7.6	7.5	8.7	9.5	7.8	8.0	8.2
Consumer price index (year-end)	13.7	7.2	10.7	10.9	4.6	4.9	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
<i>Lowcase scenario</i>															
GDP, real	10.5	10.6	2.9	3.0	1.9	3.9	2.3	2.5	2.5	2.5	2.5	2.5	2.0	2.0	2.0
Exports of goods and services, US\$	5.5	29.5	8.9	2.5	53.8	0.0	6.9	5.2	6.1	6.0	7.2	8.0	6.3	6.5	6.7
Consumer price index (year-end)	13.7	7.2	10.7	10.9	4.6	4.9	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
General government															
(in percent of GDP)															
<i>Program scenario</i>															
Tax revenues	10.6	12.7	12.8	13.8	14.3	14.8	15.3	15.8	16.3	16.8	17.3	17.8	18.3	18.8	19.3
Non-interest current expenditures (commitment basis)	17.7	17.4	17.5	17.2	15.4	14.2	14.1	13.9	14.1	15.6	17.5	18.1	18.9	19.3	19.7
Fiscal balance (commitment basis)	-7.3	-6.8	-6.1	-6.7	-4.1	-1.2	-0.1	0.7	1.0	0.1	-1.0	-0.7	-0.8	-0.6	-0.4
Primary balance (commitment basis)	-5.8	-4.9	-3.9	-3.9	-1.1	1.0	2.0	2.8	2.9	1.8	0.6	0.7	0.6	0.7	0.8
Fiscal balance (cash basis)	-7.1	-6.1	-4.9	-5.0	-2.6	-1.4	-1.1	-0.3	0.0	-0.7	-1.0	-0.7	-0.8	-0.6	-0.4
Privatization	0.5	0.6	1.5	0.9	0.3	0.2	0.4	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2
Domestic financing	4.1	3.5	1.9	2.3	2.2	-0.3	0.0	0.6	0.2	0.3	0.4	0.3	0.3	0.1	0.0
External financing (excl. privatization)	2.5	2.1	1.5	1.7	0.0	1.5	0.7	-0.7	-0.4	0.1	0.3	0.2	0.3	0.3	0.2
<i>Lowcase scenario</i>															
Tax revenues	10.6	12.7	12.8	13.8	14.3	14.3	14.6	14.8	15.3	15.8	16.3	16.8	17.3	17.8	18.3
Non-interest current expenditures (commitment basis)	17.7	17.4	17.5	17.2	15.4	13.7	13.5	12.8	13.8	15.4	17.4	18.2	19.1	19.5	19.7
Fiscal balance (commitment basis)	-7.3	-6.8	-6.1	-6.7	-4.1	-1.2	-0.3	0.5	0.0	-1.2	-2.6	-2.7	-3.1	-3.0	-2.8
Primary balance (commitment basis)	-5.8	-4.9	-3.9	-3.9	-1.1	1.0	1.9	2.7	2.1	0.8	-0.5	-0.6	-0.9	-0.7	-0.5
Fiscal balance (cash basis)	-7.1	-6.1	-4.9	-5.0	-2.6	-1.4	-1.3	-0.5	-1.1	-2.0	-2.6	-2.7	-3.1	-3.0	-2.8
Privatization	0.5	0.6	1.5	0.9	0.3	0.2	0.1	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1
Domestic financing	4.1	3.5	1.9	2.3	2.2	-0.3	0.6	1.1	1.4	1.8	2.1	2.3	2.7	2.6	2.5
External financing (excl. privatization)	2.5	2.1	1.5	1.7	0.0	1.5	0.6	-0.7	-0.5	0.1	0.3	0.2	0.3	0.3	0.2
Savings-investment balance (percent of GDP)															
(in percent of GDP)															
<i>Program scenario</i>															
Investment	7.9	15.6	24.4	14.6	14.5	14.6	14.8	15.0	17.6	17.4	16.8	16.2	15.5	15.6	16.0
Domestic Savings	-2.9	5.2	13.7	6.2	9.1	8.2	9.4	9.9	10.9	10.6	11.3	12.4	13.1	14.1	15.1
Foreign savings 3/	10.8	10.5	10.7	8.5	5.4	6.4	5.4	5.1	6.7	6.8	5.5	3.7	2.4	1.4	0.8
<i>Lowcase scenario</i>															
Investment	7.9	15.6	24.4	14.6	14.5	13.1	13.3	13.5	16.1	15.9	15.3	14.7	14.0	14.1	14.5
Domestic Savings	-2.9	5.2	13.7	6.2	9.1	6.2	7.6	7.6	8.1	7.4	7.7	8.4	8.8	9.4	10.0
Foreign savings 3/	10.8	10.5	10.7	8.5	5.4	6.9	5.7	5.9	8.0	8.6	7.6	6.2	5.2	4.7	4.5
External debt and reserves 4/															
(in percent)															
<i>Program scenario</i>															
NPV of external debt/exports goods&services (3-year ave)	n.a.	n.a.	n.a.	n.a.	128.3	110.2	98.6	97.3	92.5	88.4	84.1	76.9	70.7	64.7	58.8
NPV of external debt/central govt. revenues	n.a.	n.a.	n.a.	n.a.	356.4	312.3	291.2	277.0	256.2	236.2	218.6	195.7	178.5	161.6	144.7
External debt service/exports of goods&services	9.2	6.0	12.8	14.6	10.0	7.6	9.6	13.7	13.5	11.7	10.3	9.1	8.7	9.1	9.1
External debt service/central govt. revenues (excl. grants)	17.4	11.2	24.5	37.9	36.4	24.6	29.9	41.9	40.1	33.7	28.9	25.1	23.7	24.5	24.2
External debt service/official reserves	29.9	22.9	77.8	81.6	103.5	58.8	62.0	78.3	74.3	63.9	54.7	47.8	46.6	48.3	45.7
Gross reserves in months of imports of goods&services	2.2	1.5	1.0	1.2	0.9	1.2	1.5	1.7	1.7	1.7	1.8	1.9	2.0	2.0	2.2
<i>Lowcase scenario</i>															
NPV of external debt/exports goods&services (3-year ave)	n.a.	n.a.	n.a.	n.a.	128.3	110.8	100.1	100.2	98.8	99.2	100.3	98.7	99.6	100.3	100.2
NPV of external debt/central govt. revenues	n.a.	n.a.	n.a.	n.a.	356.4	326.1	311.2	307.3	294.5	284.7	279.5	269.2	269.1	267.8	263.7
External debt service/exports of goods&services	9.2	6.0	12.8	14.6	10.0	7.7	9.8	14.4	14.4	12.8	11.5	10.5	10.5	11.8	12.7
External debt service/central govt. revenues (excl. grants)	17.4	11.2	24.5	37.9	36.4	25.7	32.0	46.5	45.2	38.8	34.3	30.9	30.3	33.4	35.6
External debt service/official reserves	29.9	22.9	77.8	81.6	103.5	62.5	74.8	105.8	117.5	114.9	106.5	100.9	103.1	116.9	126.9
Gross reserves in months of imports of goods&services	2.2	1.5	1.0	1.2	0.9	1.1	1.2	1.3	1.1	1.0	1.0	1.0	1.0	1.0	1.0

1/ The program scenario assumes implementation of the PRGF-supported economic program, continued structural and fiscal reforms, financial sector development consistent with a gradual rise in the money multiplier and a reduction in M3 velocity, continued external support by the World Bank and donors, exceptional balance of payments support from 2003-2007, net repayment of budgetary arrears of lei 320 million from 2001 to 2005, and no significant changes in the real exchange rate.

2/ The lowcase differs from the program case in that GDP and export growth is 1.5 percentage points per year lower, the investment-to-GDP ratio is 1.5 percentage points lower, non-pipeline FDI is 50% lower, the tax-to-GDP ratio is 1 percentage point lower, and M3-velocity remains constant from 2002 onwards. The resulting shortfall in the current account in the lowcase is assumed to be financed through lower reserves accumulation, up to a floor of one month of imports, and through exceptional financing to the central bank (after 2003), repayable over 10 years, with 5 years grace.

3/ Current account deficit.

4/ Public and publicly guaranteed debt (excluding state enterprises). Debt service and net present values from 2001 onwards are based on the March 2001 Paris Club rescheduling agreement and assume amortization of arrears to Turkmenistan in equal installments over 10 years.

Table 5. Georgia: Medium-Term Scenarios Based on Additional Debt Rescheduling, 1996-2010 1/2/

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
	Actual					Scenarios									
Output, exports, and prices															
(percentage change)															
<i>Program scenario</i>															
GDP, real	10.5	10.6	2.9	3.0	1.9	3.9	3.8	4.0	4.0	4.0	4.0	4.0	3.5	3.5	3.5
Exports of goods and services, US\$	5.5	29.5	8.9	2.5	53.8	1.5	8.4	6.7	7.6	7.5	8.7	9.5	7.8	8.0	8.2
Consumer price index (year-end)	13.7	7.2	10.7	10.9	4.6	4.9	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
<i>Lowcase scenario</i>															
GDP, real	10.5	10.6	2.9	3.0	1.9	3.9	2.3	2.5	2.5	2.5	2.5	2.5	2.0	2.0	2.0
Exports of goods and services, US\$	5.5	29.5	8.9	2.5	53.8	0.0	6.9	5.2	6.1	6.0	7.2	8.0	6.3	6.5	6.7
Consumer price index (year-end)	13.7	7.2	10.7	10.9	4.6	4.9	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
General government															
(in percent of GDP)															
<i>Program scenario</i>															
Tax revenues	10.6	12.7	12.8	13.8	14.3	14.8	15.3	15.8	16.3	16.8	17.3	17.8	18.3	18.8	19.3
Non-interest current expenditures (commitment basis)	17.7	17.4	17.5	17.2	15.4	14.2	14.1	15.2	15.3	16.8	18.2	18.4	19.1	19.5	19.9
Fiscal balance (commitment basis)	-7.3	-6.8	-6.1	-6.7	-4.1	-1.2	-0.1	-0.6	-0.2	-1.0	-1.5	-0.8	-0.8	-0.6	-0.4
Primary balance (commitment basis)	-5.8	-4.9	-3.9	-3.9	-1.1	1.0	2.0	1.5	1.7	0.6	-0.2	0.5	0.4	0.5	0.6
Fiscal balance (cash basis)	-7.1	-6.1	-4.9	-5.0	-2.6	-1.4	-1.1	-1.6	-1.3	-1.8	-1.5	-0.8	-0.8	-0.6	-0.4
Privatization	0.5	0.6	1.5	0.9	0.3	0.2	0.4	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2
Domestic financing	4.1	3.5	1.9	2.3	2.2	-0.3	0.0	0.6	0.2	0.2	0.0	-0.4	-0.2	-0.3	-0.4
External financing (excl. privatization)	2.5	2.1	1.5	1.7	0.0	1.5	0.7	0.7	0.8	1.3	1.2	1.0	0.8	0.7	0.6
<i>Lowcase scenario</i>															
Tax revenues	10.6	12.7	12.8	13.8	14.3	14.3	14.6	14.8	15.3	15.8	16.3	16.8	17.3	17.8	18.3
Non-interest current expenditures (commitment basis)	17.7	17.4	17.5	17.2	15.4	13.7	13.5	14.2	15.1	16.6	18.1	18.5	19.4	19.7	20.0
Fiscal balance (commitment basis)	-7.3	-6.8	-6.1	-6.7	-4.1	-1.2	-0.3	-0.8	-1.3	-2.4	-3.1	-2.7	-3.1	-3.0	-2.8
Primary balance (commitment basis)	-5.8	-4.9	-3.9	-3.9	-1.1	1.0	1.9	1.3	0.8	-0.4	-1.3	-0.8	-1.1	-0.9	-0.7
Fiscal balance (cash basis)	-7.1	-6.1	-4.9	-5.0	-2.6	-1.4	-1.3	-1.9	-2.4	-3.2	-3.1	-2.7	-3.1	-3.0	-2.8
Privatization	0.5	0.6	1.5	0.9	0.3	0.2	0.1	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1
Domestic financing	4.1	3.5	1.9	2.3	2.2	-0.3	0.6	1.1	1.4	1.7	1.7	1.5	2.1	2.1	2.0
External financing (excl. privatization)	2.5	2.1	1.5	1.7	0.0	1.5	0.6	0.7	0.8	1.3	1.3	1.1	0.9	0.8	0.7
Savings-investment balance (percent of GDP)															
(in percent of GDP)															
<i>Program scenario</i>															
Investment	7.9	15.6	24.4	14.6	14.5	14.6	14.8	15.0	17.6	17.4	16.8	16.2	15.5	15.6	16.0
Domestic Savings	-2.9	5.2	13.7	6.2	9.1	8.2	9.4	9.9	10.9	10.6	11.3	12.4	13.1	14.1	15.1
Foreign savings 3/	10.8	10.5	10.7	8.5	5.4	6.4	5.4	5.1	6.7	6.8	5.5	3.7	2.4	1.4	0.8
<i>Lowcase scenario</i>															
Investment	7.9	15.6	24.4	14.6	14.5	13.1	13.3	13.5	16.1	15.9	15.3	14.7	14.0	14.1	14.5
Domestic Savings	-2.9	5.2	13.7	6.2	9.1	6.2	7.6	7.6	8.1	7.4	7.7	8.4	8.8	9.4	10.0
Foreign savings 3/	10.8	10.5	10.7	8.5	5.4	6.9	5.7	5.9	8.0	8.6	7.6	6.2	5.2	4.7	4.5
External debt and reserves 4/															
(in percent)															
<i>Program scenario</i>															
NPV of external debt/exports goods&services (3-year ave)	n.a.	n.a.	n.a.	n.a.	128.3	81.9	72.6	74.9	73.9	73.6	72.8	68.7	64.5	60.1	55.7
NPV of external debt/central govt. revenues	n.a.	n.a.	n.a.	n.a.	356.4	232.1	214.4	213.2	204.8	196.8	189.4	174.8	162.7	150.1	137.2
External debt service/exports of goods&services	9.2	6.0	12.8	14.6	10.0	7.5	9.6	10.1	10.1	8.3	7.2	6.5	7.2	7.9	7.9
External debt service/central govt. revenues (excl. grants)	17.4	11.2	24.5	37.9	36.4	24.3	29.9	30.8	29.9	23.8	20.2	18.1	19.6	21.1	21.0
External debt service/official reserves	29.9	22.9	77.8	81.6	103.5	58.2	62.0	57.5	55.5	45.2	38.4	34.4	38.5	41.7	39.7
Gross reserves in months of imports of goods&services	2.2	1.5	1.0	1.2	0.9	1.2	1.5	1.7	1.7	1.7	1.8	1.9	2.0	2.0	2.2
<i>Lowcase scenario</i>															
NPV of external debt/exports goods&services (3-year ave)	n.a.	n.a.	n.a.	n.a.	128.3	82.3	73.7	77.1	79.4	83.6	88.2	89.8	92.7	95.1	96.7
NPV of external debt/central govt. revenues	n.a.	n.a.	n.a.	n.a.	356.4	242.3	229.1	236.5	236.7	239.9	245.9	244.8	250.4	254.0	254.6
External debt service/exports of goods&services	9.2	6.0	12.8	14.6	10.0	7.6	9.8	10.5	10.7	9.1	8.2	7.7	8.8	10.3	11.3
External debt service/central govt. revenues (excl. grants)	17.4	11.2	24.5	37.9	36.4	25.4	32.0	34.1	33.8	27.6	24.3	22.7	25.4	29.4	31.7
External debt service/official reserves	29.9	22.9	77.8	81.6	103.5	61.8	74.8	77.6	87.9	81.7	75.7	74.1	86.7	102.9	113.2
Gross reserves in months of imports of goods&services	2.2	1.5	1.0	1.2	0.9	1.1	1.2	1.3	1.1	1.0	1.0	1.0	1.0	1.0	1.0

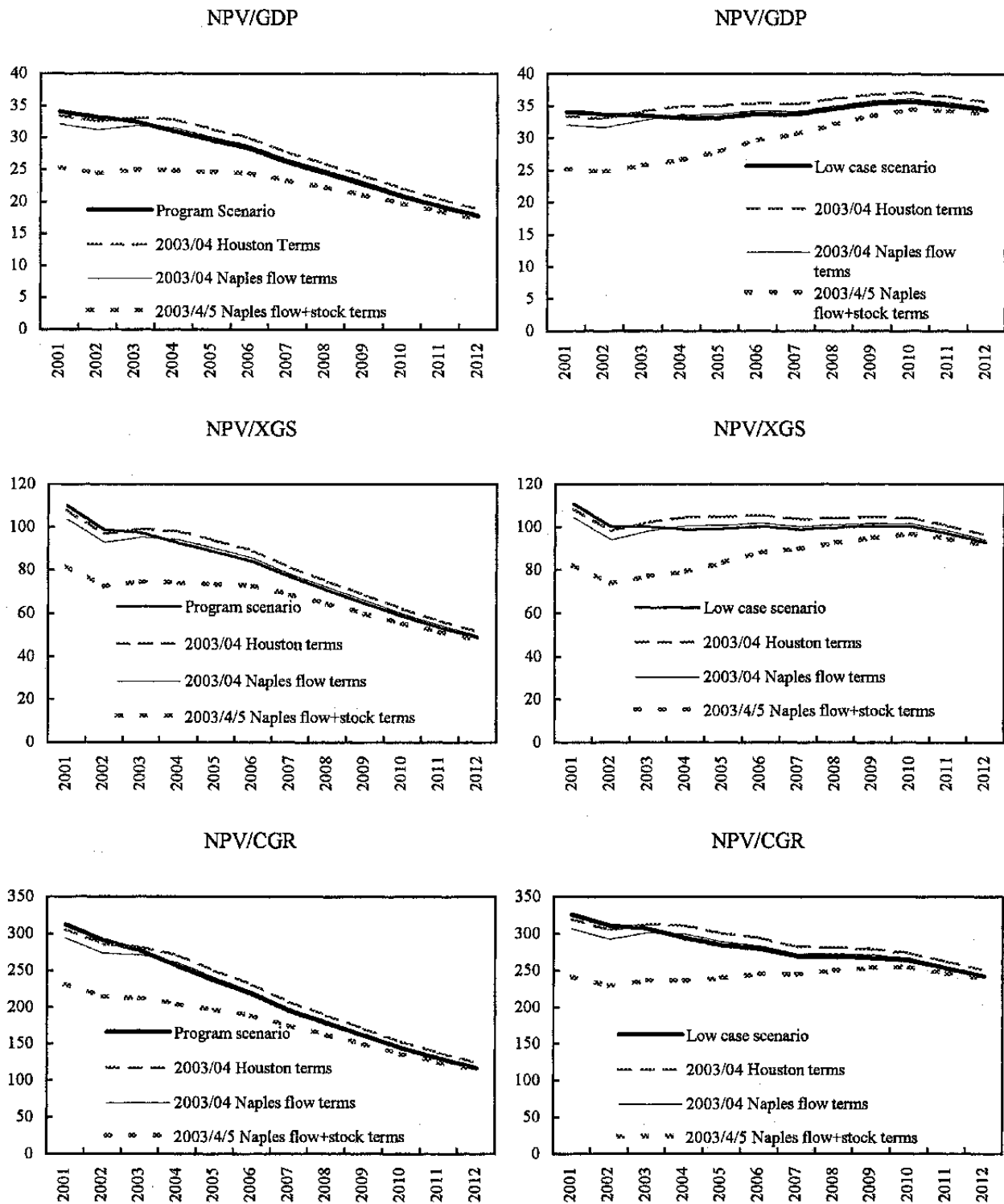
1/ Assumptions under the program scenario are identical to Table 4, except for an additional debt rescheduling of maturities due in 2003 and 2004 on Naples terms, and a stock of debt operation in 2005.

2/ Assumptions under the lowcase scenario are identical to Table 4, except for an additional debt rescheduling of maturities due in 2003 and 2004 on Naples terms, and a stock of debt operation in 2005.

3/ Current account deficit.

4/ Public and publicly guaranteed debt (excluding state enterprises). Debt service and net present values from 2001 onwards are based on the March 2001 Paris Club rescheduling agreement, plus additional flow rescheduling under Naples terms in 2003/04, followed by a stock operation in 2005, while assuming amortization of arrears to Turkmenistan in equal installments over 10 years.

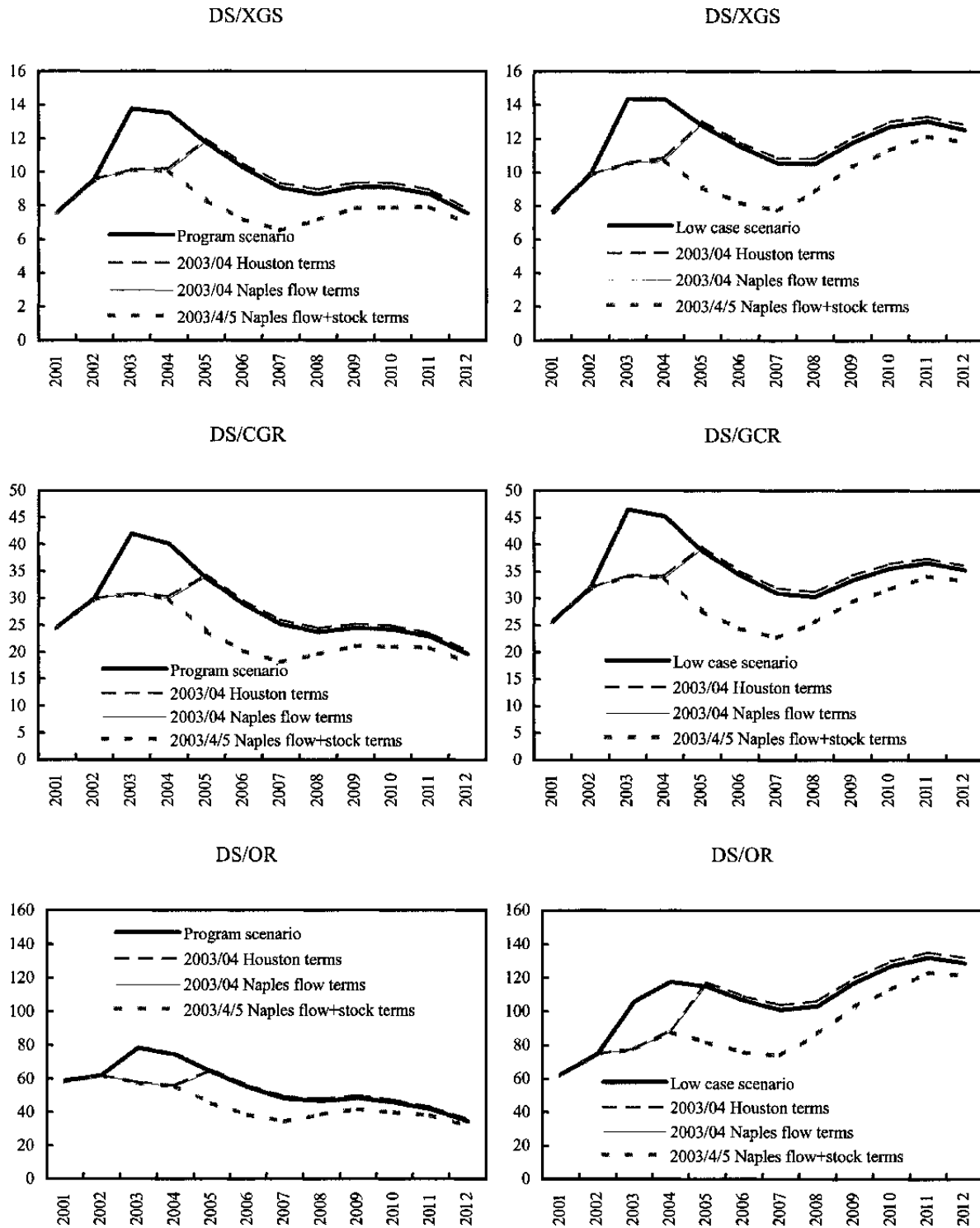
Figure 1. Georgia: Net Present Value of External Debt, 2001–2012 1/



Source: Georgian authorities; and Fund staff estimates.

1/ Net present value of public and publicly guaranteed debt, as a ratio of GDP, exports of goods and services (3 year average) and central government revenues (excluding grants). Net present values include uncommitted disbursements.

Figure 2. Georgia: Debt Service Ratios, 2001–2012 1/



Source: Georgian authorities; and Fund staff estimates.

1/ External debt service of public and publicly guaranteed debt, as a ratio of exports of goods and services, central government revenues (excluding grants) and official reserves. Includes debt service on uncommitted disbursements.

GEORGIA: FUND RELATIONS

(As of August 31, 2001)

I. Membership Status: Joined 05/05/1992; Article VIII

II. General Resources Account:	SDR Million	Percent of Quota
Quota	150.30	100.0
Fund holdings of currency	184.99	123.1
Reserve position in Fund	0.01	0.0
III. SDR Department:	SDR Million	Percent of Allocation
Holdings	0.53	N/A
IV. Outstanding Purchases and Loans:	SDR Million	Percent of Quota
Systemic transformation	34.69	23.1
ESAF arrangements	190.05	126.4

V. Financial Arrangements:

<u>Type</u>	<u>Approval Date</u>	<u>Expiration Date</u>	<u>Amount Approved (SDR million)</u>	<u>Amount Drawn SDR Million</u>
PRGF	1/12/01	1/11/04	108.00	18.00
ESAF	2/28/96	8/13/99	172.05	172.05
Stand-by	6/28/95	2/28/96	72.15	22.20

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

	Overdue	Forthcoming				
	<u>8/31/01</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>
Principal	0.0	5.1	23.1	31.5	37.0	39.0
Charges/interest	<u>0.0</u>	<u>0.8</u>	<u>2.1</u>	<u>1.6</u>	<u>1.1</u>	<u>0.6</u>
Total	0.0	5.9	25.2	33.1	38.1	39.6

VII. Safeguards Assessments:

Under the Fund's safeguards assessment policy, the National Bank of Georgia is subject to a full Stage One safeguards assessment with respect to the PRGF-supported arrangement approved on January 12, 2001, which is scheduled to expire on January 11, 2004. A Stage One safeguards assessment of the National Bank of Georgia is underway.

VIII. Exchange Arrangements:

The currency of Georgia is the lari, which became the sole legal tender in October 2, 1995. The lari replaced the coupon, which was introduced in April 1993. Since April 29, 1993, the Tbilisi Interbank Currency Exchange (TICEX), established by the NBG and a group of commercial banks, has conducted periodic auctions to determine the exchange rate of the domestic currency. On June 14, 1993, the NBG authorized the establishment of foreign exchange bureaus that are allowed to buy and sell foreign currency bank notes.

The frequency of the TICEX auctions was increased from weekly to twice weekly in late September 1994, to thrice weekly in April 1995, and to daily from January 1, 1996.

From September 1994 until December 7, 1998 intervention was a major factor in the evolution of the exchange rate. However, the difference between the TICEX rates and those at foreign exchange bureaus has become smaller over time. Since December 7, 1998, the NBG has only intervened to purchase foreign exchange, to bolster the international reserves. From May 1, 2001, foreign exchange transactions can be made by electronically.

IX. Article IV Consultation:

- (a) Georgia is on a 12-month consultation cycle.
- (b) The 1999 Article IV consultation was concluded on April 21, 2000.

X. FSAP Participation:

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

XI. Technical Assistance:

See Table 1 of this Appendix.

XII. Resident Representative:

The fourth resident representative, Mr. Dunn, took up his post on August 16, 2001, replacing Mr. Lane. Mr. Lane took up the post as resident representative on April 10, 1999, replacing Mr. Monroe. Mr. Monroe took up his post as resident representative on November 23, 1996, replacing Mr. Wang.

XIII. National Bank of Georgia:

Ms. Vance, MAE peripatetic banking supervision advisor to the NBG, commenced a series of visits to Tbilisi at the end of September 1997. Mr. Nielsen, an MAE advisor, provided technical assistance to the NBG during May 1998. Mr. Viksnins was an MAE peripatetic advisor to the NBG president starting in October 4, 1999. Mr. Fish, resident advisor on banking supervision, began his assignment on August 10, 1999. Mr. Bernard Thompson provided peripatetic technical assistance in accounting and internal audit in March and August 2000.

XIV. Ministry of Finance Resident Advisors:

The late Mr. Sharma was an FAD resident advisor and assisted the authorities in the development of a Treasury. He assumed duties on May 1, 1997. Mr. Sainsbury, an FAD advisor, assisted the Ministry of Finance from June 1998 to November 1999. Mr. Chaturvedi is FAD resident advisor to assist the authorities in continuing the development of the Treasury and the Treasury Single Account, in revising the legislative framework, expenditure control systems, and budgeting issues. He assumed duties on June 1, 2001 for one year assignment. Mr. Welling is FAD peripatetic advisor to assist the State Customs Department in preparing and introducing measures for the custom reform and modernization program. A series of two-month visits have been scheduled. Two visits took place in February-March and July-August 2001. The third visit is expected before end-2001, depending on progress achieved in introducing reforms.

Table 1. Georgia: Fund Technical Assistance Missions, 1997-2001

Subject	Type of Mission	Timing	Counterpart
Fiscal Affairs Department (FAD)			
Tax Policy	Taxation of Agricultural land, presumptive taxation of small businesses, and excises on alcoholic beverages	Feb. 3-17, 1998	Ministry of Finance, Ministry of Economy, and Tax Inspectorate of Georgia
Tax Administration	Advisory	Jan. 20-27, 1999	Ministry of Finance
Public Expenditure Management	Advisory	Jan. 27-Feb. 9, 1999	Ministry of Finance
Fiscal Federalism	Advisory	Mar. 16-30, 1999	Ministry of Finance
Tax Administration	Large Tax Payer Inspectorate	Mar. 27-Apr. 14, 2000	Ministry of Finance
Customs Reform	Customs Administration	Oct. 10-25, 2000	Ministry of Revenues (State Customs Department)
Public Expenditure Management	Assessment of Treasury system and preparing work plan for the resident advisor	Jun. 12-19, 2001	Ministry of Finance
Monetary and Exchange Affairs Department (MAE)			
Central Bank	Follow-up assistance	Jul. 13-23, 1998	National Bank of Georgia

Table 1. Georgia: Fund Technical Assistance Missions, 1997-2001 (continued)

Subject	Type of Mission	Timing	Counterpart
Exchange Rate Developments, Banking Supervision and Banking System Restructuring	Advisory	Dec. 9-17, 1998	National Bank of Georgia
Monetary Operations, Treasury Bill Markets and Banking Supervision	Follow-up assistance	Oct. 5-15, 1999	National Bank of Georgia
Accounting, banking, supervision and monetary operations	Advisory	Oct. 10-20, 2000	National Bank of Georgia
Banking, foreign exchange reserve management, monetary programming, and research	Advisory	Feb. 26-Mar. 8, 2001	National Bank of Georgia
IMF Institute (INS)			
Macroeconomic and financial policies	Course	Sep. 30-Oct. 11, 1996	Ministry of Finance, Ministry of Economy, National Bank of Georgia
Statistics Department (STA)			
National Accounts	Technical Assistance	Dec. 8-18, 1998	State Department of Statistics
Money and Banking Statistics	Technical Assistance	Jan. 14-27, 1999	National Bank of Georgia
Balance of Payments Statistics	Technical Assistance	Apr. 27-May 21, 1999	State Department of Statistics
National Accounts	Follow-up Assistance	Jul. 5-16, 1999	State Department of Statistics
Money and Banking	Follow-up Assistance	Sep. 16-29, 1999	National Bank of Georgia
National Accounts	Follow-up Assistance	Dec. 17-24, 1999	State Department of Statistics
Balance of Payments Statistics	Technical Assistance	Apr. 27-May 15, 2000	State Department of Statistics
Money and Banking	Follow-up Assistance	Nov. 30-Dec. 13, 2000	National Bank of Georgia
National Accounts	Follow-up assistance	Mar. 26-Apr. 6, 2001	State Department of Statistics
Balance of Payments Statistics	Follow-up Assistance	forthcoming	State Department of Statistics
Money and Banking	Follow-up Assistance	forthcoming	National Bank of Georgia

Table 1. Georgia: Fund Technical Assistance Missions, 1997-2001 (concluded)

Subject	Type of Mission	Timing	Counterpart
Legal Department (LEG)			
Tax Code	Follow-up Assistance	Mar. 2-7, 1997	Ministry of Finance, Tax Inspectorate of Georgia 1/
Tax Code	Follow-up Assistance	Apr. 20-May 10, 1997	Ministry of Finance, Tax Inspectorate of Georgia
Tax Code	Follow-up Assistance	Sep. 2-7 1997	Ministry of Finance, Tax Inspectorate of Georgia
Tax Code	Follow-up Assistance	Mar. 15-19, 1999	Ministry of Finance, Tax Inspectorate of Georgia
Tax Code	Follow-up Assistance	Oct. 15-28, 2000	Ministry of Finance, Tax Inspectorate of Georgia
Tax Code	Follow-up Assistance	Jan. 28-Feb. 9, 2001	Ministry of Finance, Tax Inspectorate of Georgia
Tax Code	Follow-up Assistance	Jul. 13-24, 2001	Ministry of Finance, Tax Inspectorate of Georgia

1/ Prior to 1997, the official name of the Tax Inspectorate of Georgia was the State Tax Service.

RELATIONS WITH THE WORLD BANK

(As of August 31, 2001)

1. Georgia joined the World Bank in August 1992 and the International Development Association (IDA) in August 1993. As of end-June 2001, the World Bank approved 23 investment and technical assistance credits and five adjustment operations, all with standard IDA terms, totaling SDR 469.0 million. A resident mission was opened in Tbilisi in August 1996.

2. A third Structural Adjustment Credit (SAC III) and an Energy Sector Adjustment Credit (ESAC), equivalent to SDR 44.3 million and SDR 18.1 million, respectively, were approved by the World Bank Executive Board on June 29, 1999. SAC III supports the government's reform program, including strengthening fiscal performance, ensuring budgetary provisions for core social expenditures, improving the legal and regulatory framework for the private sector, and completing the process of privatization and market liberalization. Key reform objectives of the ESAC include, enhancing financial sustainability and management of the energy sector, privatization, and increasing the poverty benefit for the socially most vulnerable. The first tranches of SAC III (SDR14.7 million) and ESAC (SDR 9.05 million) were released on July 27, 1999. A Structural Reform Support project (SDR 12.2 million) was approved on the same date to provide technical assistance on these reform measures, and included an investment component to support the Government's Hospital Restructuring program in Tbilisi.

3. On June 28, 2001, an Irrigation and Drainage Community Development project (SDR 21.3 million) was approved to revitalize the irrigation and drainage sub-sectors and to develop the institutional foundation for the sub-sector's long-term sustainability for the benefit of increased crop production, and subsequent improvement in farm family incomes. On May 3, 2001 an Electricity Market Support project (SDR 21.1 million) was approved to improve reliability and efficiency of electricity supply, and improve financial and corporate management in the wholesale electricity market. An Education project (SDR 19.9 million) was approved on March 20, 2001, as the first phase of a 12-year program that seeks to improve the quality of primary and general secondary education, and develop the policy and institutional framework for education in Georgia. On March 13, 2001 an Energy Transit Institution Building project (SDR 7.6 million) was approved to enhance Georgia's capacity to negotiate and implement oil and gas transit agreements in a manner that maximizes economic benefits and minimizes social and environmental costs.

4. To date, IFC has approved nine projects with total financing of US\$87 million. Among these, IFC approved a US\$30 million loan to the recently privatized electricity distributor of Tbilisi (AES/Telasi) to strengthen its electricity distribution network and to install new meters to improve collections. Also, four investments in the banking sector were approved: (i) a US\$3 million credit line and a 10 percent stake in TBC Bank; (ii) a US\$0.75 million equity investment to purchase a 20 percent stake in a new microfinance bank, the Microfinance Bank of Georgia; and (iii) a US\$3 million credit line to

TbilComBank; and (iv) a US\$3 million credit line in the Bank of Georgia to support mortgage-based financing for renovation and acquisition of residential and commercial real estate. IFC is also planning a technical assistance program in Georgia, as part of the recently instituted Private Enterprise Partnership. Georgia was added to IFC's Outreach Program in 1998, allowing the IFC to open a representative office, co-located with the World Bank.

GEORGIA RELATIONS WITH THE EBRD

(As of July 1, 2001)

5. As of July 1, 2001, the European Bank for Reconstruction and Development (EBRD) had signed 18 investments in Georgia with cumulative commitments totaling US\$197 million.¹ The EBRD's first operation, a power rehabilitation project, was signed in December 1994. Since then, the pace and composition of portfolio growth has varied significantly from year to year. After a number of public infrastructure projects in 1994-95, the portfolio became much more diverse in 1996-98, with seven private sector projects in the financial and industrial sectors. The ratio of private sector projects in the portfolio now stands at 60 percent.

6. Recent projects in the **power sector** include a government-guaranteed loan, signed in December 1998, to rehabilitate hydropower generation and transmission capabilities, as well as a loan to Tbilisi's newly privatized electricity distribution company AES-Telasi, signed in December 1999, to help strengthen and expand the electricity distribution network, install power meters, and reduce power transmission losses.

7. In the **transport sector**, a government-guaranteed loan to Georgian National Railways was signed in December 1998, to finance a program of infrastructure improvements on the Georgian section of the South-Caucasian railway line.

8. Recent projects in the **financial sector** include a convertible loan to Bank of Georgia, signed in June 1998, for on-lending to small and medium-sized enterprises, and a loan to MicroFinance Bank of Georgia, signed in March 2000, to encourage the development of micro and small enterprises. The EBRD has also issued guarantees under its trade facilitation program.

9. In the **industrial sector**, the EBRD signed private-sector loan projects with Ksani Glass Bottling Plant and Georgian Wine & Spirits in 1999. In May 2000, it signed loans to Frontera Caucasus Corporation, to support the commercial development of oil production in eastern Georgia.

¹ Evaluated at an exchange rate of US\$0.85 per euro.

10. The EBRD has provided **technical assistance** through 50 operations, with a total commitment of US\$ 8 million.

Table 1. Projects Signed by the EBRD

Project Name	Date of Agreement	Commitment Amount, US\$ millions 1/
Public Sector Projects		
Power Rehabilitation Project	December 1994	13
Tbilisi Airport Refurbishment	July 1995	6
Enguri Hydro Power Plant	December 1998	39
Trans-Caucasian Rail Link Project	December 1998	20
Private Sector Projects		
IBSB Georgia	September 1996	1
Georgia SME Credit Line (TBC Bank, TbilComBank, TbilcreditBank, Tbiluniversalbanki, Intellectbank)	December 1996–November 1997	9
Borjomi	June 1997	10
United Georgian Bank	November 1997	9
Absolute Bank	May 1998	2
Bank of Georgia Convertible loan	July 1998	7
Black Sea Fund	August 1998	1
Ksani Glass Packaging Factory	May 1999	8
Regional trade facilitation program (Bank of Georgia, TBC Bank, United Georgian Bank)	July 1999–December 2000	3
Georgian Wines & Spirits	September 1999	5
AES-Telasi	December 1999	30
Microfinance Bank	March 2000	3
Frontera Resources	May 2000	30
Baring Vostok Private Equity Fund	December 2000	2
Total		197

1/ US\$ amounts calculated at an exchange rate of 0.85 U.S. dollars per euro, as of June 30, 2001.

GEORGIA—STATISTICAL ISSUES

1. The Fund has provided Georgia with substantial technical assistance in the compilation of macroeconomic statistics (Appendix II, Table 1). Progress has been made in the area of national accounts statistics, in particular provisional revised GDP estimates were published in early 2001. In addition, improvements have been made in price, monetary, and government finance statistics. However, the quality of macroeconomic statistics remains poor, reflecting inter alia deficiencies in statistical methodologies, coverage, and inadequate resources. Problems are particularly acute regarding the compilation balance of payments statistics. Nonetheless, the core statistical indicators compiled by the authorities are produced on a timely basis and are adequate to enable the staff to monitor macroeconomic statistics under the program (Appendix V, Table 1).

Real Sector

2. A multisector statistics mission from the Fund's Statistics Department (STA) that visited Georgia in November 1997, found severe deficiencies in the compilation of national accounts statistics by the State Department of Statistics (SDS). With assistance from STA, the SDS subsequently improved the methodology for preparing its GDP estimates. In December 1999, a STA mission found the GDP estimates to be basically sound, although further improvements were deemed necessary. Provisional estimates were published in January 2000. The biggest change made to the figures was the revision of the estimates for informal activities which had been estimated at more than 40 percent of total GDP, but accounted for only about 25 percent after the revision, which is consistent with data for other transition economies. As a result of these changes in methodology, the revised estimates were some 34 percent below the previously published GDP estimates. In early 2001, the Georgian State Department of Statistics (SDS) again revised its GDP estimates. The changes consisted in an upward revision of spending on education and health and a downward revision of spending on financial intermediation. The largest change that was caused by this revision was a 3.6 percent upward adjustment of 1998 GDP. The GDP estimate for 2000 was revised downward by 1.3 percent. A STA mission conducted in March 2001 again found the revised data to be basically sound, but some improvements were recommended. For the first time, the SDS has now published an annual supply and use table for the year 1999 and intends to do so on a regular basis also for later years. STA sees no need for a follow-up mission to take place during the next couple of years.

Balance of Payments Statistics

3. The November 1997 multisector STA mission concluded that despite recent improvements, the quality of balance of payments statistics remained poor. A work program for the following 12 months was drawn up by the mission, including measures to develop sound methodologies for measuring international trade flows, and estimating services data using households surveys, migration statistics, travel debits of Georgians working abroad, and short-term financial assets flows, among others. The mission recommended that several new surveys be introduced by the SDS to improve estimates on services, including on

transport flows and on foreign direct investments. The 2000 STA mission recommended an action plan. Areas of highest priority included: (i) reconciliation of the trade data; (ii) refining the estimate of migration-related data; and (iii) collection of international investment position data. The NBG has introduced a new methodology for the BOP data from 2000 onwards that estimates unrecorded trade based on partner country data, bringing the data closer to the Fund staff estimates. However, significant uncertainties remain with respect to services, non-interest factor income, transfers, foreign direct investment, and short-term loans. The overall assessment is that there still is much room for improvements and training. In addition, increases of staff levels and greater coordination between the NBG and the State Department of Statistics would be desirable.

Money and Banking Statistics

4. A new chart of accounts was introduced at the beginning of 2001, which was an important step forward by the NBG in bank accounting reform. An STA mission that visited Georgia in January 2001 advised that groundwork for better monetary statistics in the future should be laid by introducing a residency-based differentiation of accounts in order to properly capture external claims and obligations, to reflect Georgia's growing integration with the rest of the world. The mission also noted the need to address several methodological problems: clarification of statistical residency criterion to commercial banks, adoption of a detailed subdivision of the resident sector, a full incorporation of Fund-related accounts, and a separate identification of restricted deposits and nonperforming loans. A country page was introduced in the February 2000 issue of the *IFS*.

Government Finance Statistics

5. Progress in this area during the last two years has been commendable, with the Georgian authorities implementing much of the recommendations of the multisector mission, and those of earlier (1995) GFS missions. The multisector STA mission recommended that the report forms used by various government units to report monthly budget execution data be customized according to the GFS classification categories. The mission also recommended that in addition to the functional classification that is currently in place, budgetary outlays be also classified according to the economic categories. A country page for Georgia, with data for 1997, was published for the first time in the 1998 issue of the Fund's *Government Finance Statistics Yearbook*.

Georgia: Core Statistical Indicators
(As of September 17, 2001)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/Basic Money	Broad Money	Interest Rates	Consumer Price Index	Exports/Imports	Current Account Balance	Overall Gov. Balance	GDP/ GNP	External Debt/Debt Service
Date of latest observation	9/17/01	9/14/01	9/11/01	9/11/01	7/31/01	6/30/01	8/01	7/01	Q1/01	7/01	Q2/01	6/01
Date received	9/17/01	9/17/01	9/14/01	9/14/01	8/15/01	9/04/01	9/11/01	9/17/01	8/8/01	8/21/01	8/17/01	7/01
Frequency of data	D	D	D	D	M	M	M	M	Q	M	Q	M
Frequency of reporting	D	W	W	W	M	M	M	M	Q	M	Q	M
Frequency of publication	D	M	M	M	M	M	M	M	Q	M	Q	M
Source of update	A	A	A	A	A	A	A	A	A	A	A	A
Mode of reporting	C,V,O (e-mail)	C,V,O (e-mail)	C,V,O (e-mail)	C,V,O (e-mail)	V,O (e-mail)	V,O (e-mail)	V,O (e-mail)	V,O (c-mail)	V, O (e-mail)	V,O (e-mail)	C,V,O (e-mail)	C,V
Confidentiality	C	C	C	C	C	C	C	C	C	C	C	C

Abbreviations:

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

Tbilisi, October 9, 2001

Mr. Horst Köhler
Managing Director,
International Monetary Fund,
Washington, D.C., 20431

Dear Mr. Köhler,

1. The Georgian authorities have held discussions with Fund staff for the 2001 Article IV consultation and the first review under the 3-year PRGF-supported arrangement, which was approved by the IMF's Executive Board on January 12, 2001. Based on these discussions, this letter reports on progress made in implementing the economic program set out in my letter dated December 6, 2000, and the attached Memorandum of Economic and Financial Policies (MEFP) and Technical Memorandum of Understanding (TMU). Moreover, for reasons discussed further below, we request waivers for end-March 2001 performance criteria on general government tax revenues, expenditure arrears, and net domestic assets of the National Bank of Georgia (NBG), as well as the continuous performance criterion on external arrears. On the basis of performance up to end-September 2001, implementation of prior actions outlined in Attachment A, and the policies described below, we request the completion of the first review under the program and disbursement of the third loan under the PRGF-supported arrangement.

2. Despite progress in implementing the macroeconomic policies and structural reforms set out in our economic program, not all objectives were achieved during the first quarter of 2001, primarily due to a shortfall in tax revenues. As a result, end-March performance criteria on general government tax revenues and expenditure arrears monitored under the program were missed. However, revenues recovered in the second and third quarters, due to a recovery in economic growth and improvements in collection ratios. This has brought macroeconomic performance back on track, based on revised quantitative indicators agreed with Fund staff in early May 2001 (Table 1). The revised program reflects the revenue shortfalls at the beginning of the year and prospective financing shortfalls throughout the year. Before the completion of the first review, parliament is expected to approve a revised budget for 2001 that reflects these shortfalls and reduces expenditure commitments accordingly.

3. Structural reforms in the fiscal, financial, and energy sectors are critical for maintaining medium-term macroeconomic stability. Progress has been made in implementing the specific reforms monitored under the PRGF-supported program, listed in Table 2. These reforms are also a key element in our efforts to strengthen governance. Further steps include specific short-term anti-corruption measures laid out in Presidential Decree No.95 and additional measures laid out in Presidential Decree No. 758. We have discussed with Fund

staff the progress we have made in preparing the full Poverty Reduction Strategy Paper (PRSP).

4. I am confident that the measures described below are adequate to achieve the broad objectives of the program. The government and the National Bank of Georgia will take any other measures that may become appropriate for this purpose. The government will continue to consult regularly with the Fund concerning additional measures that may become appropriate and will provide the Fund with such information as the Fund requests in connection with the progress of Georgia implementing the policies and reaching the objectives of the program supported by the PRGF arrangement. Georgia will conduct discussions with the Fund for the second semi-annual review of its program before February 2002.

Performance Under the Program

5. Macroeconomic indicators remain broadly in line with program assumptions. GDP growth is projected to accelerate from a rate of 1¾ percent in 2000 to 4 percent in 2001, as a result of an expected rebound in the agricultural sector, following last year's drought, and further growth in service sectors. The industrial sector contracted sharply in the first quarter, mostly owing to energy supply interruptions, but recovered strongly in the second quarter. Inflation remains in line with program projections, at 4¾ percent in the 12 months to August 2001. The exchange rate was broadly stable in the second and third quarters, after depreciating by 4 percent in the first quarter. The National Bank of Georgia has maintained a floating exchange rate regime, but has purchased foreign exchange, whenever market conditions permitted, in order to build its reserves. The improvement in the current account seen in 2000 is not expected to continue this year, given weak trade data for the first quarter and downside risks related to economic problems in Turkey and the introduction of a visa regime by Russia.

6. Under the original program approved in January 2001, cumulative targets for end-March and end-June on tax revenues and expenditure arrears were missed by significant margins, due a shortfall in fiscal revenues in the first quarter. The reasons for the shortfall included weaker than expected economic activity; continued problems in tax and customs administration, especially in the area of excise collections; and reductions in cigarette excise rates and automobile registration fees. The monetary program, by contrast, remained broadly on track, although there was a minor deviation from the net domestic assets target at the end of March, largely because of longer than expected delays in external financing. There was a larger deviation from the cumulative target under the original program on net domestic assets at the end of June, partly due to higher than programmed net credit to government and partly due to valuation changes. Net international reserves were well above the program floor, both at the end of March and at the end of June, despite shortfalls in external financing.

7. In addition, the continuous performance criterion on external arrears was breached, when Georgia did not make an interest payment of US\$0.4 million to Armenia on time, in the

context of bilateral debt negotiations, and after a payment of US\$0.06 million due to the Netherlands was withheld pending the clarification of legal issues. The government also requested a delay in US\$ 0.7 million in interest payments to Austria, to which Austria agreed. These payments have now been made. Georgia has not paid interest on principal arrears to Turkmenistan, pending a bilateral rescheduling agreement that would determine the appropriate rate of interest. Georgia has also not made any cash payments on scheduled interest due to Turkmenistan, but has made in-kind payments that exceed the amount of scheduled interest due in 2001.

8. Following the deviations from the original program in the first quarter of 2001, a revised program was developed with Fund staff in May (Table 1), reflecting revenue shortfalls during the first four months and prospective shortfalls in external financing for the year as a whole. An acceleration of economic growth and improvements in collection ratios helped bring tax revenues back in line with flow targets under the original program from June onwards. Overall macroeconomic performance, monitored on a monthly basis since end-March 2001, has been in line with the revised program through end-August.

Fiscal Policy

9. Before the completion of the first review, parliament is expected to approve a revised budget for 2001, in line with the revised macroeconomic program, to reflect weaker than expected tax revenues at the beginning of the year and a downward revision of external financing projections by about 2 percent of GDP (mainly related to World Bank disbursements and telecommunications privatization). For the year as a whole, the revisions imply general government tax revenues of 14¾ percent of GDP, up from 14¼ percent in 2000; current expenditure commitments of 16¼ percent of GDP, down from 18¼ percent in 2000; a commitments deficit of about 1¼ percent of GDP; clearance of expenditure arrears accumulated in early 2001; and additional payment of pre-2001 arrears of ¼ percent of GDP. Any deviations from projected external financing will continue to be accommodated through adjustments to net credit to government, subject to a cap on cumulative upward adjustment of lari 40 million.

10. The 2002 budget will reflect continued fiscal adjustment, with an increase in the tax-to-GDP ratio of ½ percent of GDP and a significant reduction in the commitments deficit. The cash deficit would be about 1 percent of GDP, reflecting limited external financing and no additional net credit from the NBG, so that it can control monetary growth while bolstering net international reserves. The budget would provide for a modest payment of pre-2001 arrears, all in the social area, which would be enhanced if external financing exceeded projections. Achieving a sustained improvement in tax and customs collections will be critical to ensure that social spending can grow. Apart from continued structural reforms in the fiscal area, we are planning to introduce a comprehensive reform of the tax code, with effect from January 2002, which would simplify the tax system and broaden the tax base by reducing exemptions. Although the reform would include cutting some tax rates, increasing of tax thresholds, and removing some taxes altogether, the reform will be designed to be at

least revenue-neutral, which will require the introduction of simplified and presumptive taxes for small and medium-sized enterprises and the removal of many exemptions

Monetary Policy

11. The NBG will maintain a prudent monetary policy, in line with revised program targets. Higher than expected foreign exchange purchases and monetary growth in late 2000, without a noticeable impact on inflation, have allowed room for an upward adjustment of the reserve money target for end-2001, while keeping the rate of growth of reserve money at 5½ percent for the year as a whole and 7½ percent during the second half of the year. The NBG has issued additional credit to the government, on account of delays in external financing, repayable from the proceeds of future external inflows. The NBG will maintain its policy of non-intervention in support of the exchange rate, while purchasing foreign exchange, whenever market conditions permit, to build reserves to a level covering about 1¼ months of imports of goods and services by end-2001. The monetary program for 2002 is based on a further increase in gross reserves, to 1½ months of imports, and on reserve money growth of about 10 percent, consistent with an inflation objective in the range of 4 to 6 percent.

Balance of Payments and External Debt Issues

12. The government is seeking to conclude bilateral debt rescheduling agreements in line with the Paris Club agreement reached on March 6, 2001. Under this agreement, principal payments on bilateral external debt contracted prior to November 1999 falling due in 2001 and 2002 would be rescheduled over 20 years, with a 3-year grace period and a graduated repayment schedule. As of September 30, final or draft agreements have been reached with eight creditors and discussions are continuing with five others. If no agreement is reached with Turkmenistan by the end of the Paris Club deadline, which we have asked to be extended to December 31, 2001, we will transfer interest payments due to Turkmenistan into an escrow account, until agreement is reached.

13. While the Paris Club rescheduling has allowed Georgia to close potential balance of payments and fiscal gaps in 2001, we recognize that the debt problem is long term in nature. In our discussions with Fund staff, we have reviewed revised medium-term macroeconomic scenarios and concluded that the policies laid out in the PRGF-supported program, with the focus on sustained fiscal adjustment, are critical for ensuring debt sustainability. In this context, we remain committed not to contract or guarantee any new non-concessional debt, as specified in the PRGF-supported program. In addition, we will continue to pursue fiscal and monetary restraint in line with program targets so as to keep external financing needs low. We will maintain a liberal trade regime and we are planning to reduce a number of tariff rates. We understand that any export bans on export items would undermine the rationale for financial support from the Fund. Following parliament's recent resolution imposing a moratorium on timber exports until the end of the year, we have submitted proposals to parliament to address the problem of illegal tree cutting through law enforcement measures.

We are working closely with parliament and the World Bank to ensure that effective measures are put in place and that legally cut timber can be freely exported. We are also actively seeking support from bilateral donors and multilaterals to enhance the availability of concessional project and non-project financing, in support of the PRGF-supported economic program. In this context, the government is committed to fulfill its obligations under the World Bank's SAC and ESAC programs, to release disbursements in 2001, as assumed in the revised budget.

Structural Reforms and Poverty Reduction

14. The discussions for the first review under the PRGF arrangement focused on progress in strengthening governance and fighting corruption. Ongoing reforms of fiscal and financial institutions, described in the paragraphs below, are helping to improve governance in areas that are critical for maintaining macroeconomic stability. In addition, Presidential decree No.95, effective from March 15, 2001, specifies short-term measures to combat corruption. These include measures to improve transparency, including by broadening financial disclosure, clarifying the role of government regulatory agencies, introducing internal audits of government agencies, and requiring publication of their expenditures. The newly established anti-corruption commission has published a progress report on the implementation of decree No.95. A second Presidential Decree, No. 758 was issued on July 27, 2001, with a focus on strengthening transparency in government agencies.

15. Table 2 summarizes progress in implementing the structural benchmarks I outlined in my letter, dated December 6, 2000, which are monitored under the PRGF-supported program. Given the critical role of fiscal adjustment in the macroeconomic program, structural benchmarks are focused primarily on this area. In order to strengthen governance in revenue raising agencies, we will adopt a code of conduct for tax and customs officials prior to the completion of the first review. To strengthen customs revenues, we have tightened procedures for granting customs exemptions, after the introduction of a monitoring unit. In addition, we have made progress in strengthening the VAT refund system and are monitoring refund claims and payments. We will issue a regulation that clarifies the selection criteria for the large tax payer inspectorate. On the expenditure side, we have introduced commitments recording and control in all budgetary organizations except utilities and embassies and are preparing to include utilities from the beginning of 2002. We have audited expenditure arrears in all central budgetary organizations.

16. We are continuing to reform the tax and customs agencies, as well as the treasury system. We will implement legislative and administrative changes to transfer full control over tax refund system to the treasury next year, including through closure of transit accounts controlled by the ministry of revenues. Our reform efforts are being supported by a Fund resident advisor to the treasury, who took up his post in June, 2001. He is helping with efforts to revise the budget system law; to monitor expenditure arrears; and to improve the monitoring and controlling of tax revenues, including by addressing problems with prepayments and refunds. To further strengthen fiscal governance and transparency,

Parliament is expected to approve the new budget system by end-February 2002, as a structural performance criterion. We remain committed to refrain from tax offset operations.

17. A second priority area is the continuation of structural reforms in the banking sector. The NBG has made progress in strengthening the sector, including by withdrawing licenses from six problem banks since the beginning of the year. The NBG has also issued new asset classification and provisioning regulations for commercial banks in order to improve the transparency of balance sheets and strengthen the NBG's ability to supervise the sector. Since February 2001, commercial banks have been required to submit their monthly reports to the NBG according to International Accounting Standards (IAS). The NBG has also issued conflict of interest regulations for banks, in order to strengthen governance and transparency in the financial sector. The NBG's supervisory capacity, especially in dealing with problem banks, will be further strengthened by amendments to the central bank and commercial bank laws, expected to be approved by parliament prior to the completion of the first review, that establish the primacy of banking law in bank-related matters. By end-December 2001, with technical assistance from the monetary and exchange affairs department, the NBG will develop an analytical framework for the resolution of insolvent banks, as a structural benchmark.

18. The energy sector remains a serious economic problem. Not only are frequent power outages hindering economic growth, but the high level of energy debts is threatening to undermine fiscal policy. We have embarked on an ambitious reform program, supported by the World Bank and other international agencies and donors, focused on private sector involvement. There was insufficient support in parliament to approve an amendment to the energy law we had submitted last year, which would have enabled the regulator to impose a debt surcharge on the electricity tariff. We are therefore revising our strategy for resolving the sector's old debts with technical assistance from the World Bank and will discuss the strategy with Fund staff prior to the completion of the second review.

19. In view of our efforts to combat poverty, we have made progress in preparing the full PRSP. The paper will outline priority reform areas and discuss funding and financial constraints. A first draft was shared with the World Bank, the IMF, and international donors. Non-governmental organizations, the media, and civil society are actively involved in the process. We expect that the budget for 2002 will be generally consistent with the main directions of the draft strategy, although the implementation of the strategy is expected to take more time. We will continue to seek technical assistance from multilateral institutions and bilateral donors in this effort.

Program Monitoring

20. Disbursement of the third loan under the PRGF-supported arrangement is requested upon completion of the first review, which will require implementation of prior actions outlined in Attachment A and waivers for end-March 2001 performance criteria on general government tax revenues, expenditure arrears, and net domestic assets of the National Bank

of Georgia (NBG), as well as the continuous performance criterion on external arrears. The PRGF-supported program will continue to be monitored under the terms laid out in my letter dated December 6, 2000, with the attached MEFP and TMU, subject to the following qualifications. New quantitative performance criteria have been established for end-December 2001, based on cumulative changes from end-March 2001 (Table 1). The TMU has been amended to define more precisely the adjuster for deviations from external financing, to clarify the program treatment of offset-based external debt amortization, to define more precisely the term "external debt," to define more precisely budgetary arrears monitored under the program, and to specify caps on adjusters for end-December 2001. The second review will take place at end-February 2002, with a focus on tax reform, strengthening the banking sector, and energy debt restructuring. We request that disbursement of loans under the PRGF-supported arrangement be re-phased so that the fourth loan would become available upon completion of the second review, based on end-December performance criteria, and the fifth loan would become available upon completion of the third review, scheduled for May 2002, based on end-March 2002 performance criteria.

Yours truly,

/s/

Eduard Shevardnadze

Table 1. Georgia: Quantitative performance criteria and indicative targets, March - December, 2001 1/

	Stocks 2/		Cumulative change from end-March 2001														Performance criteria	
			Track record														end-Dec.	
	end-Dec.'00	end-Mar.'01	end-April	end-May			end-June			end-July			end-Aug.			end-Sept.	end-Dec.	
	Actual	Actual	Actual	Target	Adj.T.	Actual	Target	Adj.T.	Actual	Target	Adj.T.	Actual	Target	Adj.T.	Actual	Target	Target	
(In millions of lari)																		
1. Quantitative targets 3/																		
Floor on general govt. tax revenue (including special funds) 4/	851.5	202.7	70.5	147.2	147.2	151.9	232.7	232.7	238.6	319.2	319.2	321.7	405.7	405.7	404.6	492.5	760.3	
Ceiling on cash deficit of the general govt. (CDDG) 5/	153.7	9.7	5.1	37.1	29.4	8.2	58.7	49.6	24.3	42.6	43.2	40.5	52.4	54.2	56.6	52.2	87.4	
Ceiling on domestic expenditure arrears of the general govt.	n.a.	31.4	-3.0	-2.0	-2.0	-8.8	-10.0	-10.0	-15.3	-23.3	-23.3	-34.0	-28.3	-28.3	-37.4	-33.3	-43.3	
Ceiling on net credit of the banking system to the general govt. (NCG) 6/ 7/	738.1	719.2	2.1	24.7	24.7	4.7	37.8	37.8	14.2	33.0	31.5	25.4	38.0	35.4	35.5	47.1	19.1	
Ceiling on net domestic assets (NDA) of the NBG 6/	820.1	815.7	-0.9	15.3	15.3	7.4	23.5	23.5	15.5	22.6	21.1	17.9	23.3	20.7	19.7	28.1	-12.5	
(In millions of U.S. dollars)																		
Floor on total net international reserves (NIR) of the NBG 8/	-214.4	-228.2	2.4	2.6	2.6	-0.3	2.3	2.3	4.3	8.8	9.5	13.9	9.3	10.6	18.1	8.5	32.8	
Ceiling on contracting or guaranteeing																		
A. short-term external debt (less than one year)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
B. nonconcessional medium- and long-term external debt	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(In millions of lari)																		
2. Indicative targets																		
Reserve money	365.9	359.3	3.9	20.5	20.5	6.9	28.1	28.1	24.1	40.1	40.1	45.6	41.9	41.9	55.9	45.2	53.2	
Cigarette and petroleum revenues	104.7	28.1	7.0	18.7	18.7	18.3	31.1	31.1	31.5	44.6	44.6	41.1	58.0	58.0	47.3	71.4	111.7	
3. Adjusters																		
Cumulative change from end-March 2001																		
(In millions of U.S. dollars)																		
A. Net foreign-currency non-project financing 8/																		
Projection			0.0	-0.8			-0.8			-1.5			-2.2			-3.9	23.7	
Outturn			0.0	-0.8			-0.8			-0.8			-0.9			n.a.	n.a.	
Adjustment to NIR target			0.0	0.0			0.0			0.8			1.3			n.a.	n.a.	
(In millions of lari)																		
B. Net external non-project financing of the general govt. 6/																		
Projection			0.0	-1.5			-1.5			-3.0			-4.4			-7.8	36.3	
Outturn			0.0	-1.5			-1.5			-1.5			-1.8			n.a.	n.a.	
Adjustment to NDA and NCG targets			0.0	0.0			0.0			-1.5			-2.6			n.a.	n.a.	
C. External project financing minus grants for debt operations 5/																		
Projection			8.4	16.5			24.6			19.5			27.6			25.6	40.5	
Outturn			4.1	8.8			15.6			20.1			29.4			n.a.	n.a.	
Adjustment to cash deficit target			-4.2	-7.7			-9.1			0.7			1.8			n.a.	n.a.	

Sources: Fund staff estimates.

1/ Section 1 of this table shows quantitative targets under the April-September 2001 track record agreed in May (and adjusted in July) and performance criteria for end-December 2001, based on cumulative changes from end-March 2001. Some ceilings and floors are subject to possible adjustment, as indicated in footnotes 5, 6, and 8, based on deviations from projections of external financing, reported in Section 3 of the table. Indicative targets are shown in Section 2. Continuous performance criteria are described in paragraph 53 of the MEFP (EBS/00/258).

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

3/ Based upon accounting exchange rates 2 lari/US\$ and 1.35 US\$/SDR.

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

5/ As described in the TMU, the program target on the cash deficit is adjusted for deviations from projected disbursements of external project finance minus grants for debt operations (Section 3C). The ceiling for the cash deficit of the general government for the end of a month will be adjusted upward (downward) by the full amount of the cumulative excess (shortfall) of external project financing minus grants for debt operations, subject to a cap on cumulative upward adjustment of lari 80 million.

6/ As described in the TMU, program targets on NCG and NDA are adjusted for deviations from projected net external non-project financing of the general government (Section 3B), defined as the sum of all foreign-currency privatization receipts and World Bank SAC&ESAC disbursements, minus external amortization payments by the general government (net of debt reduction grants). The ceilings for NCG and NDA will be adjusted upward (downward) by the full amount of the cumulative shortfall (excess) of net external non-project financing, subject to a cap on cumulative upward adjustment of lari 40 million.

7/ The stock excludes the recapitalization bond issued by the government to cover NBG losses in 1998.

8/ As described in the TMU, the program target on NIR is adjusted for deviations from projected net foreign-currency non-project financing (Section 3A), defined as the sum of foreign-currency privatization receipts and World Bank SAC&ESAC disbursements, minus foreign-currency amortization by the general government and the NBG (net of debt reduction grants). The floor on NIR will be adjusted downward (upward) by the full amount of the cumulative shortfall in net foreign-currency non-project financing, subject to a cap on downward adjustment of US\$32.5 million.

Table 2. Structural Benchmarks Under the PRGF-Supported Arrangement
Status as of end-September.

Fiscal Measures	Date Due	Status
1. Adoption of code of conduct for tax and customs officials.	April 1, 2001	Partly implemented: code of conduct prepared, and to be formally adopted as a prior action.
2. Implement simplified VAT refund system and monitor refunds claimed and paid.	April 1, 2001	VAT fraud monitoring unit established. Tax code amendments are to be included in tax reform package, effective January 2002.
3. Amend legislation and regulations to strengthen control on procedures for granting customs exemptions.	July 1, 2001	Implemented through regulations and transfer of responsibility for granting of exemptions to the ministry of finance.
4. Audit the stock of expenditure arrears	July 1, 2001	Completed in August.
5. Introduce commitments recording for contracts over lari 5,000 and strengthen commitments control.	July 1, 2001	Implemented, except for utilities and embassies.
6. Apply standard expenditure control procedures to off-budget accounts outside the treasury.	Jan. 1, 2002	To be applied to next year's budget.
Financial Sector Measures		
7. Issue new asset classification regulations for commercial banks.	Dec. 31, 2000	Done.
8. Issue conflict of interest regulation for banks.	Mar. 31, 2001	Done. Regulations issued in May.
9. Amend legislation to establish primacy of banking law in bank-related matters.	June 30, 2001	Not yet completed. Changes to central bank law and commercial bank law submitted to parliament, but not yet approved. See prior action.
10. Implement IAS in commercial banks comprising 80 percent of total banking sector assets.	Sep. 30, 2001	Banks have been submitting their monthly reports in IAS since February 2001.
Energy Sector Measures		
11. Impose debt surcharge of 0.3–0.7 tetri/kWh on the electricity tariff.	June 1, 2001	No progress, after legislation was sent to parliament.

**PRIOR ACTIONS FOR COMPLETION OF THE FIRST REVIEW
UNDER THE PRGF ARRANGEMENT**

1. Satisfactory macroeconomic performance relative to agreed quantitative targets through end-September.
2. Adoption by parliament of a revised budget for 2001 fully consistent with the revised macroeconomic framework described in this letter.
3. Adoption of a code of conduct for tax and customs officials.
4. Adoption by parliament of amendments to the central bank and commercial bank laws to establish the primacy of banking law in bank-related matters.

STRUCTURAL PERFORMANCE CRITERIA AND BENCHMARKS

Benchmarks

1. Adoption of an analytical framework for resolution of insolvent banks (December 31, 2001).
2. Apply standard expenditure control procedures to off-budget accounts outside the treasury (January 1, 2002).

Performance Criterion

1. Adoption, by February 28, 2002, of a budget system law that provides a sound legal framework for:
 - budget preparation, presentation and approval;
 - budget execution;
 - government borrowing and debt;
 - budget accounting, inspection, and auditing.

INTERNATIONAL MONETARY FUND

GEORGIA

Technical Memorandum of Understanding (TMU)

October 9, 2001

1. This memorandum sets out the understandings between the Georgian authorities and the IMF staff regarding the definitions of quantitative performance criteria and indicative targets for the arrangement supported under the Poverty Reduction and Growth Facility (PRGF) reported in Table 1 of the Letter of Intent (LOI) dated October 9, 2001, as well as respective reporting requirements. It also provides definitions and reporting requirements for the continuous performance criteria described in paragraph 53 of the Memorandum of Economic and Financial Policies (MEFP) attached to the Letter of Intent, dated December 6, 2000.
2. The quantitative performance criteria (ceilings and floors) and indicative targets listed in Table 1, Sections 1 and 2, of the LOI are defined as cumulative changes from end-March 2001. Some floors and ceilings are adjusted by cumulative deviations of certain external financing flows from projections (Table 1, Section 3), converted at an accounting exchange rate of lari 2 per U.S. dollar.¹ The program relies on adjusters that are symmetric and allow the substitution of net external non-project financing for net domestic credit to government (and net domestic assets of the NBG). However, any resulting increases in net domestic credit to government and net domestic assets of the NBG are subject to a cap. The program also allows for an automatic adjustment to the cash deficit target in case of deviations of external project financing from expectations, subject to a cap on upward adjustment.
3. While the adjustment mechanism is designed to accommodate unanticipated, temporary fluctuations in external financing, the caps imply that significant shortfalls in financing will require policy changes, including tighter fiscal policy, which would need to be considered in the context of a program review.

¹ For instance, if a disbursement of \$10 million originally projected to accrue in the first quarter is delayed until the second quarter of 2001, then an adjuster of \$10 million (lari 20 million) would apply to end-March targets, but not to end-June, when net external financing would have returned—on a cumulative basis—to the originally projected level. In practice, this means that a delay in external financing inflows can be compensated temporarily by higher domestic credit, but not permanently, implying a repayment to the NBG once the delayed disbursement accrues.

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

A. Floor on Tax Revenues

4. **Definition:** Tax revenues are defined as total tax collections by the State Tax Department and the State Customs Department, including tax revenues from the central government, local governments, and extrabudgetary funds. The tax revenues are recorded when these are paid into the treasury's revenue account(s) in the National Bank of Georgia (NBG). The tax revenues exclude the amounts retained by the revenue agencies for bonus payments.
5. **Adjustment clauses:** Once a change is made in accounting practices so that the bonus payments to the revenue agencies are included in the treasury's revenue account(s), the revenue targets will be adjusted upward by the applicable bonus share.
6. **Supporting material:** The Ministry of Finance (treasury) will provide data showing a detailed breakdown of tax revenues paid into the NBG revenue accounts (form 412) on a monthly basis within two weeks of the end of each month. The local budget department in the Ministry of Finance will provide additional information on revenue collections of local governments. The authorities will also provide data on any offset transactions on a monthly basis.

B. Indicative Target for Revenues from Cigarettes and Petroleum

7. **Definition:** This is defined as the total of customs duties, excise duties, and VAT collected by the State Tax Department and the State Customs Department on the domestic production and imports of cigarettes and petroleum products.
8. **Adjustment clauses:** None.
9. **Supporting material:** The Ministry of Finance will provide data with a break-down into the main categories of products on a monthly basis within two weeks of the end of each month.

C. Ceiling on Expenditure Arrears

10. **Definition:** Expenditure arrears are defined as a subset of arrears incurred by the general government on the following expenditure items: wages and salaries; pensions; health programs and invalid NGO programs; family allowances; stipend and food compensations; refugee allowances; transfers to SMIC; and transfers to the employment fund. Once sufficient progress is made on introducing commitments recording in the treasury, the measurement of arrears will be strengthened by applying the following principles for recording expenditure arrears: (a) the goods and services have been received; (b) these have been certified to conform to the order of the contract; (c) the bill for payment has been received; and (d) the bill has remained unpaid beyond the normal or agreed period of credit.

Until then, the net change in arrears will be estimated as the difference between actual cash spending and the monthly cash limits issued to spending units prior to the beginning of the month.

11. **Adjustment clauses:** None.

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

D. Ceiling on the Cash Deficit of the General Government

13. **Definition:** The cash deficit of the general government will be measured from “below-the-line”, equal to the total financing (domestic and external, plus privatization proceeds) received by the general government.² Privatization receipts consist of all gross proceeds received by the central and local governments. Domestic financing consists of all bank and non-bank financing to the general government. External financing is defined as the total of disbursements, macroeconomic support, net change in arrears, minus amortization. Disbursements include all project financing (capital expenditure and net lending) and balance of payments support (excluding grants) received by the budget. Amortization includes all external debt-related payments of principal; amortization to external creditors via third parties is accounted for at the time and in the amount of payment by the budget to the third party, rather than at the time of recognition of amortization by the external creditor.

14. **Adjustment clauses:** The ceiling will be adjusted to reflect cumulative deviations from program assumptions on **external project financing** for capital expenditure or net lending minus grants for debt operations (see Table 1, Section 3). The ceiling at the end of a quarter will be adjusted upward (downward) by the full amount of the cumulative excess (shortfall) of external project financing minus grants for debt operations. There will be a cap on cumulative upward adjustment of lari 80 million.

15. **Supporting material:** Data on privatization receipts will be provided by the Ministry of Finance (treasury) on a monthly basis within two weeks of the end of each month. The data will be consistent with the revenue account(s) in the NBG (form 412). Data on domestic

² Modest differences between the recorded financing and the cash deficit, calculated as expenditures plus net lending minus revenues and grants, can be attributed to check-float and smaller errors and omissions.

financing (bank and non-bank) will be provided by the NBG. Until further improvements in the NBG accounts, the treasury will provide information on Ministry of Finance guaranteed loans (including guaranteed amount, principal repayment schedule, and actual principal and interest payments). Data on external project financing and debt reduction grants will be provided by the Ministry of Finance in a table on project and grant disbursements by creditor, on a monthly basis within two weeks of the end of each month.

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

16. **Definition:** Net credit of the banking system to the general government includes net credit to the general government from the NBG and the deposit money banks. General government is defined in this context as the central government, local government, and extrabudgetary funds. Credit to the government includes: all loans to the general government, all treasury bills issued by the general government (including those purchased by the central bank), as well as all government-guaranteed loans from the banking system to other entities. Net credit to the government is credit to the government less deposits of the general government in the banking system. In addition, any accrued government interest obligations to the NBG would be reflected in net credit to the government. Government bonds issued to cover NBG losses are excluded from net credit to the government.

17. **Adjustment clauses:** The ceiling on net credit of the banking system to the general government will be adjusted to reflect cumulative deviations from program assumptions on **net external non-project financing** (see Table 1, Section 3), which is defined as the sum of all foreign-currency denominated privatization receipts and disbursements under the World Bank's SAC and ESAC programs, minus external amortization payments by the general government. Amortization payments are recorded at the time and in the amount of actual amortization-related payments made by the general government, net of grants or other support received to offset amortization payments. The ceiling at the end of a quarter will be adjusted upward (downward) by the full amount of the cumulative shortfall (excess) of net external non-project financing, subject to a cap on cumulative upward adjustment of lari 40 million.

18. **Supporting material:** The NBG will provide the monetary survey on a monthly basis within two weeks of the end of each month. The NBG will also provide information on the activities of the treasury bill market. The necessary information on net external non-project financing will be provided in a table on the NBG's foreign exchange flows (which includes details on inflows, outflows, and net international reserves) on a monthly basis within a week of the end of each month. The Ministry of Finance will provide additional information on the repayment of principal and interest on government-guaranteed loans from commercial banks on a monthly basis.

F. Ceiling on Net Domestic Assets of the NBG

19. **Definition:** Net domestic assets of the NBG are defined as the difference between net foreign assets and reserve money. Net domestic assets include net claims on government

(including loans and treasury bills purchased by the NBG, accrued government interest obligations to the NBG, less deposits of the government with the NBG.), claims on banks, claims on the rest of the economy (including the KfW loan), and other items net (including the NBG capital accounts, net unclassified assets, counterpart funds and exchange rate revaluation).

20. **Adjustment clauses:** The ceiling on net domestic assets of the NBG will be adjusted to reflect cumulative deviations from program assumptions on **net external non-project financing** (see Table 1, Section 3), which is defined as the sum of all foreign-currency denominated privatization receipts and disbursements under the World Bank's SAC and ESAC programs, minus external amortization payments by the general government. Amortization payments are recorded at the time and in the amount of actual amortization-related payments made by the general government, net of grants or other support received to offset amortization payments. The ceiling at the end of a quarter will be adjusted upward (downward) by the full amount of the cumulative shortfall (excess) of net external non-project financing, subject to a cap on cumulative upward adjustment of lari 40 million.

21. **Supporting material:** The NBG will provide data on its balance sheet, which includes data on its net domestic assets, on a monthly basis within one week of the end of each month. The necessary information on net external non-project financing will be provided in a table on the NBG's foreign exchange flows (which includes details on inflows, outflows, and net international reserves) on a monthly basis within one week of the end of each month.

G. Floor on Net International Reserves of the National Bank of Georgia (NBG)

22. **Definition:** Net international reserves (NIR) of the NBG in U.S. dollars are calculated on the basis of assets and liabilities of the NBG, using program assumptions of bilateral exchange rates (2 lari per U.S. dollar and 1.35 U.S. dollar per SDR). NIR of the NBG are defined as liquid, convertible currency claims of the NBG on nonresidents that are readily available. Pledged or otherwise encumbered assets, including but not limited to assets used as collateral (or guarantee for third party external liabilities) are excluded from reserve assets. Reserve liabilities include the use of Fund resources and any other liabilities of the NBG. The stock of NIR in period t is calculated as the stock of NIR in period $(t-1)$ plus the net inflow of foreign exchange in period t , the change in the value of gold stock at market prices in period t , and the change in the stock of liabilities to the IMF and other creditors in period t .

23. **Adjustment clauses:** The floor of net international reserves will be adjusted to reflect cumulative deviations from program assumptions on **net foreign-currency non-project financing** (see Table 1, Section 3), which is defined as the sum of all foreign-currency denominated privatization receipts and disbursements under the World Bank's SAC and ESAC programs, minus external amortization payments made in foreign currency by the general government and NBG. Amortization payments are recorded at the time and in the amount of actual amortization-related payments made, net of grants or other support received to offset amortization payments. For a shortfall (excess) of net external non-project

financing, the floor on NIR will be adjusted downward (upward) by the full amount, subject to a cap on cumulative downward adjustment of US\$32.5 million.

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

H. Ceiling on Contracting or Guaranteeing New Non-Concessional Medium- and Long-term External Debt by the Public Sector (with original maturity of 1 year or more)

25. **Definition:** The public sector consists of the central government, the National Bank of Georgia (NBG), and local authorities. Concessional external loans are defined as loans with a grant element of at least 35 percent of the value of the loan. The grant element is to be calculated by using currency-specific discount rates reported by the OECD (CIRRs).³ For maturities of less than 15 years, the grant element will be calculated based on six-month averages of commercial interest rates. For maturities longer than 15 years, the grant element will be calculated based on 10-year averages. This performance criterion applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274-(00/85) August 24, 2000) but also to commitments contracted or guaranteed for which value has not been received.⁴ Previously contracted non-

³ An electronic spreadsheet file that shows the relevant discount rates reported by the OECD (CIRRs) will be provided on a periodic basis by Fund staff.

⁴ The definition of debt set forth in No. 9 of the guidelines reads as follows: "(a) For the purpose of this guideline, the term "debt" will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows: (i) loans, i.e., advances of money to obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans and buyers' credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements); (ii) suppliers' credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and (iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property. For the purpose of the guideline,

(continued)

concessional external debt that has been rescheduled shall be excluded from the definition of "new debt" for the purposes of this performance criterion.

26. **Adjustment clauses:** None.

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

I. Ceiling on Contracting or Guaranteeing Short-Term External Debt by the Public Sector (with original maturity of 1 year or less)

28. **Definition:** The public sector consists of the central government, the National Bank of Georgia (NBG), and local authorities. This performance criterion applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274-(00/85) August 24, 2000), see footnote for Section H, but also to commitments contracted or guaranteed for which value has not been received.

29. **Adjustment clauses:** None.

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

J. Non-accumulation of External Arrears

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

32. **Adjustment clauses:** None.

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

the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair or maintenance of the property. (b) Under the definition of debt set out in point 9(a) above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt."

K. Non-introduction of exchange and trade restrictions

34. **Definition:** During the period of the arrangement the general government and the NBG will not impose or intensify restrictions on payments and transfers for current international transactions; will not introduce multiple currency practices; will not conclude bilateral payments agreements that are inconsistent with Article VIII; and will not impose or intensify import restrictions for balance of payments purposes.

35. **Adjustment clauses:** None.

36. **Supporting material:** The government and NBG will inform the Fund about any changes to the exchange and trade regime.

L. Indicative Target for Reserve Money

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

38. **Adjustment clauses:** None.

Supporting material: The central bank balance sheet is to be transmitted on a monthly basis, within one week of the end of the month.

Statement by the IMF Staff Representative
October 26, 2001

1. This statement provides information on developments since the staff report was issued (EBS/01/173, October 12, 2001). These developments do not change the thrust of the staff appraisal.
2. Consumer price inflation in September was lower than expected. The 12-month rate declined to 2¼ percent, well below the end-year target of 5 percent. The lari remained stable in September and the National Bank of Georgia (NBG) purchased US\$4½ million in foreign exchange, in line with the program. Gross international reserves of the NBG stood at US\$130 million at the end of September, equivalent to one month of imports of goods and services.
3. The staff considers that all prior actions stipulated in the Letter of Intent (Appendix V of the staff report) have been implemented:
 - **Macroeconomic performance at end-September was satisfactory.** Preliminary data indicate that all quantitative targets except the one on domestic expenditure arrears were observed at end-September, based on cumulative changes from end-March 2001 (Table 1).¹ Net international reserves were over US\$11 million above the floor. Tax revenues were strong in September, and the cumulative floor on general government tax revenue collection was exceeded by a small margin, despite a continuing shortfall in cigarette and petroleum revenues relative to the indicative target. The cash budget deficit, net credit to the government from the banking system, and net domestic assets of the central bank all turned out well below the September ceilings, reflecting a significant build-up of government deposits at the end of the month. This appears to be a result of an unusually marked bunching of tax payments at the end of the month. Following an accumulation of domestic expenditure arrears in September, the cumulative arrears ceiling was exceeded by a small margin of lari 2 million. Had the authorities used part of their margin of lari 19 million under the net credit to government ceiling and drawn down additional deposits, they could have avoided arrears accumulation and met the arrears target, while still observing the cash deficit ceiling. The authorities have assured the staff that the arrears accumulation in September was reversed in the early days of October. The outturns for end-September are therefore fully consistent with observance of end-December 2001 performance criteria.

¹ This table updates Table 1 of the Letter of Intent (Appendix V of the staff report). While estimates for end-September are subject to small revisions, the staff would not expect these to be large enough to alter its assessment that performance was satisfactory.

- **On October 23, 2001 parliament passed an amendment to the 2001 budget to bring it into line with the revised program.** While the budget amendment relates to the central government, it includes a table, for information, showing a revised general government budget for 2001 in line with Table 3 in the staff report.
- **The Minister of Revenues has informed the staff that a code of conduct has been adopted** and that all staff of the ministry have acknowledged in writing their receipt of the code.
- **On October 23, 2001 parliament passed amendments to the central bank and commercial banking laws** establishing the primacy of banking law in bank-related matters.

4. The stage one safeguards assessment of the National Bank of Georgia (NBG) was completed in early October. The assessment identified vulnerabilities in the internal control system of the NBG, and to a lesser degree in some other areas of control and governance within the NBG. The stage one report recommended that an on-site assessment be undertaken to confirm or modify the preliminary findings, and to recommend, ad referendum, measures to remedy them. The on-site assessment mission is scheduled for November 5-13, 2001 and a report is expected to be completed by mid-December.

Table 1. Georgia: Quantitative Performance Criteria and Indicative Targets, March-December, 2001 1/

	Stocks 2/		Cumulative Change from End-March 2001															Performance criteria End-Dec. '01
	End-Dec. '00	End-Mar. '01	Track record															
			End-May '01		End-June '01		End-July '01			End-Aug. '01			End-Sep. '01			End-Dec. '01		
Actual	Actual	Target	Adj.T.	Actual	Target	Adj.T.	Actual	Target	Adj.T.	Actual	Target	Adj.T.	Actual	Target	Adj.T.	Prelim.	Target	
(In millions of lari)																		
1. Quantitative targets 3/																		
Floor on general govt. tax revenue (including special funds) 4/	851.5	202.7	147.2	147.2	151.9	232.7	232.7	238.6	319.2	319.2	321.7	405.7	405.7	404.6	492.5	492.5	493.5	760.3
Ceiling on cash deficit of the general govt. (CDOG) 5/	153.7	0.7	37.1	29.4	8.2	58.7	49.6	24.3	42.6	43.2	40.5	52.4	54.2	56.6	52.2	60.0	48.7	87.4
Ceiling on domestic expenditure arrears of the general govt.	n.a.	31.4	-2.0	-2.0	-8.8	-10.0	-10.0	-15.3	-23.3	-23.3	-34.0	-28.3	-28.3	-37.4	-33.3	-33.3	-31.4	-43.3
Ceiling on net credit of the banking system to the general govt. (NCG) 6/ 7/	738.1	719.2	24.7	24.7	4.7	37.8	37.8	14.2	33.0	31.5	25.4	38.0	35.4	35.5	47.1	41.2	21.9	19.1
Ceiling on net domestic assets (NDA) of the NBG 6/	820.1	815.7	15.3	15.3	7.4	23.5	23.5	15.5	22.6	21.1	17.9	23.3	20.7	19.7	28.1	22.2	-0.4	-12.5
(In millions of U.S. dollars)																		
Floor on total net international reserves (NIR) of the NBG 8/	-214.4	-228.2	2.6	2.6	-0.3	2.3	2.3	4.3	8.8	9.5	13.9	9.3	10.6	18.1	8.5	11.5	22.9	32.8
Ceiling on contracting or guaranteeing																		
A. short-term external debt (less than one year)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
B. nonrecurrent medium- and long-term external debt	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(In millions of lari)																		
2. Indicative targets																		
Reserve money	365.9	359.3	20.5	20.5	6.9	28.1	28.1	24.1	40.1	40.1	45.6	41.9	41.9	55.9	45.2	45.2	45.4	53.2
Cigarette and petroleum revenues	104.7	28.1	18.7	18.7	18.3	31.1	31.1	31.5	44.6	44.6	41.6	58.0	58.0	48.3	71.4	71.4	61.0	111.7
Cumulative Change from end-March 2001																		
3. Adjusters																		
A. Net foreign-currency non-project financing 8/																		
Projection																		
Outturn																		
Adjustment to NIR target																		
B. Net external non-project financing of the general govt. 6/																		
Projection																		
Outturn																		
Adjustment to NDA and NCG targets																		
C. External project financing minus grants for debt operations 5/																		
Projection																		
Outturn																		
Adjustment to cash deficit target																		

Source: Fund staff estimates.

1/ Section 1 of this table shows quantitative targets under the April-September 2001 track record agreed in May (and adjusted in July) and performance criteria for end-December 2001, based on cumulative changes from end-March 2001. Some ceilings and floors are subject to possible adjustment, as indicated in footnotes 5, 6, and 8, based on deviations from projections of external financing, reported in Section 3 of the table. Indicative targets are shown in Section 2. Continuous performance criteria are described in paragraph 53 of the MEFP (EBS/00/258).

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

3/ Based upon accounting exchange rates 2 lari/US\$ and 1.35 US\$/SDR.

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

5/ As described in the TMU, the program target on the cash deficit is adjusted for deviations from projected disbursements of external project finance minus grants for debt operations (Section 3C). The ceiling for the cash deficit of the general government for the end of a month will be adjusted upward (downward) by the full amount of the cumulative excess (shortfall) of external project financing minus grants for debt operations, subject to a cap on cumulative upward adjustment of lari 80 million.

6/ As described in the TMU, program targets on NCG and NDA are adjusted for deviations from projected net external non-project financing of the general government (Section 3B), defined as the sum of all foreign-currency privatization receipts and World Bank SAC&ESAC disbursements, minus external amortization payments by the general government (net of debt reduction grants). The ceilings for NCG and NDA will be adjusted upward (downward) by the full amount of the cumulative shortfall (excess) of net external non-project financing, subject to a cap on cumulative upward adjustment of lari 40 million.

7/ The stock excludes the recapitalization bond issued by the government to cover NBG losses in 1998.

8/ As described in the TMU, the program target on NIR is adjusted for deviations from projected net foreign-currency non-project financing (Section 3A), defined as the sum of foreign-currency privatization receipts and World Bank SAC&ESAC disbursements, minus foreign-currency amortization by the general government and the NBG (net of debt reduction grants). The floor on NIR will be adjusted downward (upward) by the full amount of the cumulative shortfall in net foreign-currency non-project financing, subject to a cap on downward adjustment of US\$32.5 million.

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INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
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October 31, 2001

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2001 Article IV Consultation with Georgia

On October 26, 2001, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Georgia.¹

Background

In recent years, Georgia has struggled to address its deep-rooted economic problems. GDP growth has been lackluster since the Russian crisis in 1998, reflecting energy supply problems, two droughts, and uneven progress in structural reform. Poverty has remained widespread and the state's financial position has been too weak to offer an effective social safety net. Corruption has undermined both private sector development and fiscal stability. The country has one of the lowest tax-to-GDP ratios in the region and has accumulated a large stock of budgetary expenditure arrears, including on wages and pensions. Georgia has also been unable to service its external debts in full.

Since last year, Georgia has made progress in addressing some of the macroeconomic imbalances. Inflation was below 5 percent in the twelve months to August 2001, reflecting a prudent monetary policy and reduced domestic borrowing by the government. The rapid accumulation of budgetary expenditure arrears has been halted since mid-2000. The general government deficit was reduced from almost 7 percent of GDP in 1999 to 4 percent in 2000, and to below 2 percent in the first half of 2001, reflecting a sharp reduction in expenditure commitments and a modest improvement in tax revenues.

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the October 26, 2001 Executive Board discussion based on the staff report.

The floating exchange rate has been relatively stable over the last two years, although it depreciated by 4 percent against the U.S. dollar in the first quarter of this year, in the wake of the financial crisis in Turkey. The current account improved significantly in 2000, reflecting strong growth in exports of goods and services, although this trend was partly reversed in the first half of 2001. On March 6, 2001, Georgia became the second CIS country after Russia to reach an agreement with the Paris Club. Bilateral external debts due in 2001 and 2002 are to be rescheduled over 20 years, with a three-year grace period and a graduated repayment schedule.

Structural reforms in the fiscal area and in the financial sector have been accelerated over the last 12 months. Faced with a fragile banking system, the central bank's supervisory capacity has been strengthened. Public expenditure management and fiscal transparency have been improved, but serious problems remain in revenue collections, especially in the customs area. Some initial steps have been taken to address corruption, including through the establishment of an anti-corruption council and two presidential decrees. Other structural reforms have been slow, including in the energy sector, which remains burdened by old debts and low collection ratios. The government has prepared a first draft of a poverty reduction strategy, focused on setting the institutional foundations for private sector development and economic growth.

Executive Board Assessment

Executive Directors welcomed the recent increase in GDP growth, prudent macroeconomic policies that have helped to keep inflation low and the exchange rate relatively stable, and progress in lowering the external debt burden. Directors considered, however, that poor governance, corruption, and the size of the shadow economy remain serious obstacles to fiscal sustainability and private sector development. They emphasized the need for a determined and sustained assault on these problems in order to improve the medium-term outlook for debt sustainability, growth, and poverty reduction.

Directors welcomed the substantial improvement in fiscal performance since the last Article IV consultation, reflected in the significant reduction in the budget deficit on a commitments basis and no net accumulation of budgetary arrears since mid-2000. They noted, however, that this improvement relied primarily on expenditure cuts, for which Directors saw little further scope. Moreover, there is an urgent need to strengthen the social safety net, education, and health care. Directors therefore stressed that, to achieve fiscal viability over the medium term while establishing adequate basic social services, an immediate and effective revenue mobilization effort is needed. This effort should focus on improving tax administration, broadening the tax base, and curtailing tax exemptions. Directors urged the authorities to intensify reforms in the revenue collection agencies, particularly in the customs department, and to strengthen efforts to combat corruption and smuggling. They welcomed the planned 2002 reform of the tax code to simplify the tax system and widen the tax base, and encouraged the authorities to implement it with determination and, as a minimum, without allowing reforms to lead to any decline in revenues.

Directors commended the authorities for maintaining a prudent monetary policy, focused on achieving low inflation. They considered that the floating exchange rate regime remains adequate, given the low level of international reserves and the economy's vulnerability to external shocks. Directors supported the National Bank of Georgia's policy of purchasing foreign exchange in excess of its program targets when market conditions permit, while maintaining a close watch on developments in the monetary aggregates and inflation.

Directors welcomed the measures being taken to strengthen banking supervision and ensure prompt resolution of non-viable banks in the future. They noted the conclusion of the financial system stability assessment (FSSA) that the banking system remains weak and subject to considerable credit and foreign exchange risk. Directors, therefore, emphasized the need for strong supervision and encouraged the authorities to continue to work closely with the Fund to develop a framework for resolving insolvent banks.

Directors observed that Georgia's medium-term outlook remains challenging in view of widespread poverty and high external debt. They urged a greater effort to address the main structural obstacles to growth—emphasizing, in particular, the need for more effective implementation of measures to combat corruption and powerful vested interests, so as to improve the business environment and attract investment. Directors also urged the authorities to make progress on energy sector reform, with the support of multilateral agencies and foreign investors, to address the problems of low collections, large debts, and supply shortages.

Directors noted the risks to Georgia's balance of payments position associated with the downturn in the world economy and the continued economic problems in Turkey. They stressed the need to trim the external current account deficit and diversify exports in order to reduce external vulnerability.

Directors acknowledged that Georgia will continue to need concessional financing from multilateral lenders and bilateral donors for some time to come in support of the reform program and poverty reduction. They therefore welcomed the Paris Club debt rescheduling agreement reached in March 2001 and urged the authorities to conclude bilateral agreements on comparable terms.

Directors noted that, though the provision of data required for surveillance and program monitoring is adequate, the quality and timeliness of some data need to be improved.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Georgia: Selected Economic Indicators

	1997	1998	1999	2000
	(Percentage change, unless otherwise indicated)			
National income and prices				
Real GDP	10.6	2.9	3.0	1.9
Nominal GDP	20.6	8.7	12.4	5.1
Consumer price index, end of period	7.2	10.7	10.9	4.6
Monetary indicators				
Reserve money, end of period	32.6	-6.3	18.8	26.8
Broad money, end of period	45.5	-1.2	20.7	39.0
Money multiplier, level, end of period	1.35	1.42	1.44	1.58
Velocity, level 1/	12.4	13.7	12.7	9.6
Exchange rate and international reserves				
Exchange rate, lari per U.S. dollar, period average	1.30	1.39	2.02	1.98
Gross international reserves, end of period 2/				
In millions of U.S. dollars	173	118	132	109
In months of goods and services	1.5	1.0	1.2	0.9
	(In percent of GDP)			
General government				
Total revenue and grants	14.4	15.6	15.4	15.3
Tax revenue	12.7	12.8	13.8	14.3
Expenditure and net lending	21.2	21.8	22.1	19.4
Fiscal balance, commitments basis	-6.8	-6.1	-6.7	-4.1
Fiscal balance, cash basis	-6.1	-4.9	-5.0	-2.6
External sector				
Trade balance 3/	-15.6	-18.9	-19.6	-12.0
Current account balance 3/	-10.5	-10.7	-8.5	-5.4
External debt stock, end of period	42.3	45.0	60.7	53.4

Sources: Georgian authorities; and IMF staff estimates

1/ Annual GDP divided by end-period M3.

2/ Monetary authorities. Reserves prior to 1999 exclude special account for external debt service.

3/ Series break between 1999 and 2000.