January 2004
IMF Country Report No. 04/26

Georgia: Ex Post Assessment of Georgia's Performance Under Fund-Supported Programs—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Georgia

In the context of the ex post assessment of Georgia's performance under Fund-supported programs, the following documents have been released and are included in this package:

- the staff report for the ex post assessment of Georgia's performance under Fund-supported programs, prepared by a staff team of the IMF. **The staff report was completed on December 24, 2003**. 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 Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its January 21, 2004 discussion** of the staff report.
- a statement by the Executive Director for Georgia.

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

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

GEORGIA

Ex Post Assessment of Georgia's Performance Under Fund-Supported Programs

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December 24, 2003

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I. Introduction and Overview[1]

1. **This report reviews Georgia's performance under the last two Fund-supported programs, covering the period 1996-2003.** It also discusses the key challenges that Georgia faces in realizing the goals of its recently finalized Economic Development and Poverty Reduction Program (EDPRP). Staff proposes to discuss the paper with the authorities during the negotiations on a new Fund-supported program scheduled for February 2004, with the main conclusions reflected in the staff report requesting the new arrangement.

2. **Georgia has faced daunting challenges since independence, in an environment rife with political tension, declining living standards, and severe economic dislocations.** Dwindling tax revenues in the first years of independence have reduced the government's ability to fund basic state functions, while the de facto secession of two provinces has undermined its control over the country's territory. In the face of these obstacles, Georgia has had to build basic national institutions and embark on fiscal consolidation and first-generation reforms, including privatization, land reform, and energy sector rehabilitation. While progress has been made in the context of the last two Fund-supported programs, the results fell short of expectations during the recent PRGF arrangement, leaving significant vulnerabilities still to be addressed. To accomplish this, Georgia will have to reinvigorate the reform process by aggressively tackling the country's pervasive corruption and increasing institutional capacity. The regime change following the November 2003 parliamentary elections has created both new opportunities and new uncertainties in this regard.

II. Survey of Performance Under the Previous ESAF/PRGF Arrangements

A. Goals of the Programs

3. **Both Fund-supported programs sought to achieve and maintain macroeconomic stability.** This was to be accomplished by strengthening the public finances, maintaining a prudent monetary stance, improving state property oversight and management, and advancing structural reforms, particularly in the financial and energy sectors. As discussed below, program results were positive in some of these areas but in others fell short of what was needed to strengthen the macroeconomic fundamentals.

B. Areas of Strong Progress

4. **Under the two Fund-supported programs, Georgia made notable progress toward macroeconomic stabilization (Tables 1, 2, and 3).** Under the 1996-99 program, this was evidenced by a strong economic recovery and a sharp reduction in inflation, particularly during the first half of the period. This momentum was subsequently disrupted by a

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[1] This paper was prepared by a team led by Mr. Neuhaus, and comprised Ms. Brukoff and Mr. Billmeier (all MCD), Mr. Almekinders (PDR), and Mr. Hajdenberg (FAD), with contributions from the rest of the Georgia team and Mr. Nicholas (World Bank).

weakening of the fiscal position, followed by the Russian crisis in 1998. Growth slowed and inflation accelerated (resulting from the collapse of the de-facto exchange rate peg and sharp depreciation of the lari) during the remainder of the period as a result of these shocks. At the inception of the 2001-04 program, growth had recovered and remained solid throughout the program period, although uncertainties remain regarding the sources of growth.[2] Consistently prudent monetary policy has reduced inflation substantially and delivered price stability in the context of the second arrangement.

5. **Georgia has broadly maintained a liberal trade and payments system.** Most trade and exchange restrictions and the state order system were eliminated prior to the 1996-99 program. Tariff rates during this period, comprising three bands of 0, 5, and 12 percent, were low both in comparison with other CIS countries and by international standards. The pursuit of a liberal trade regime culminated in Georgia's entry into the WTO in 2000. The country's ranking on the Fund's trade-restrictiveness index (based in part on the unweighted average tariff) improved from 2 in 2001 to 1 in 2003. However, the authorities adopted protectionist measures in late 2002 based on margins allowed under WTO accession that had the effect (not captured in the index) of increasing the weighted average tariff and the dispersion of tariffs.

6. **The authorities have made substantial progress in implementing financial sector reforms**. Under the 1996-99 ESAF, the NBG introduced new prudential regulations (including higher minimum capital requirements, tighter limits on insider lending, improved reporting and inspection procedures) and began to enforce more actively the suspension of licenses of problem banks. Still, public confidence in the system remained very low at end-2001 (M3/GDP stood at 11 percent and the currency/deposit ratio was 0.91) and substantial vulnerabilities remained, according to the findings of the Financial System Stability Assessment (FSSA). Under the 2001-04 program, the NBG implemented the main FSSA recommendations. The commercial bank law was amended to incorporate "fit and proper" criteria for bank managers and owners and to protect supervisors against legal liability arising from carrying out their responsibilities. Anti-money laundering legislation was also approved, although a key associated component to allow for the seizure and sale of property has yet to be adopted by parliament. Progressively stronger formal measures are now being employed for several problem banks, policies regarding approval and frequency of on-site inspections have been amended to increase NBG flexibility, and substantial organizational and staffing changes have been undertaken to increase the emphasis on risk-based supervision. These reforms translated into an increase in public confidence in the banking system, as reflected in a rise in M3/GDP to 13 percent, and a decline in the currency/deposit ratio to 0.69 as of end-October 2003.

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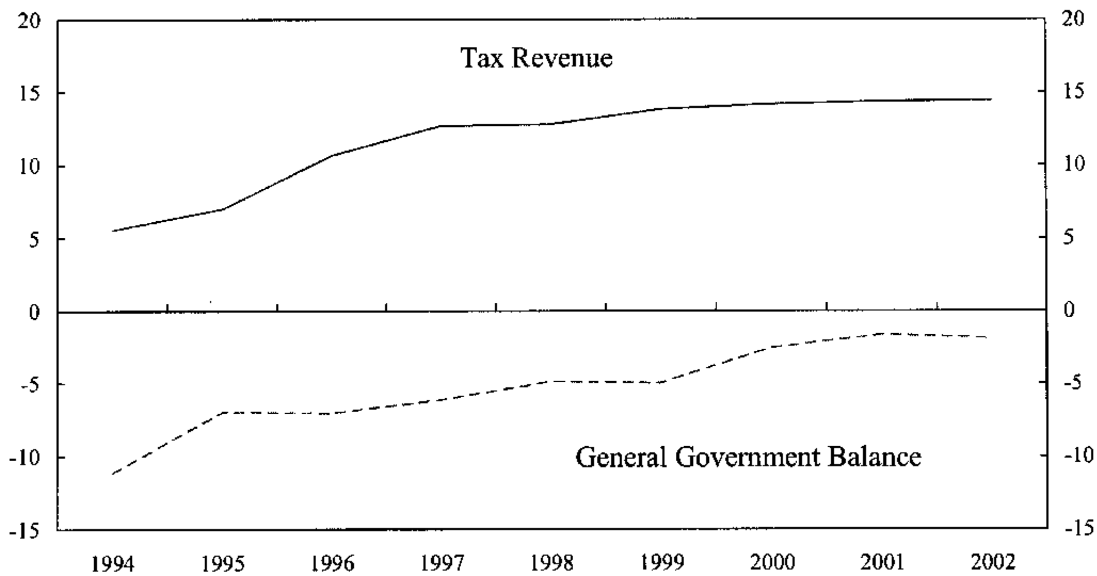
[2] A recent growth-accounting analysis indicates that recent higher rates of growth have not been underpinned by commensurate increases in labor and total factor productivity. See "Georgia: Medium and Long-Term Growth Prospects," Appendix VI of the staff report for the Article IV consultation (IMF Country Report No. 03/346).

C. Areas of Weak Progress

7. **Significant strengthening of the public finances did not materialize under the 1996-99 ESAF.** Some key elements of the fiscal reform did advance, albeit with delays. Important achievements under this program were the passage of the Tax and Customs Codes in 1997 and the expansion of the coverage of the Large Taxpayer Inspectorate, although the latter has been plagued by periodic removal of key taxpayers, often based on political considerations. In spite of these problems, both reforms contributed to a rise in revenue collections, from 10.6 percent of GDP in 1996 to 13.8 percent in 1999. However, the benefits of increased revenues were dissipated by weak expenditure management, characterized by ad-hoc procedures and the need for frequent budget sequestrations. Poor budget preparation along with the lack of appropriate commitment controls and cash management resulted in a large build-up of expenditure arrears, including on wages, pensions and social allowances which have yet to be repaid (see below).

8. **Progress in securing fiscal consolidation remained slow during the 2001-04 program.** The improving trend in tax revenue collection slowed considerably after the end of 1996-99 program and little further progress was made during the next arrangement (See Figure 1 below). With revenue rising modestly from 13.8 percent at end-1999 to 14.4 percent of GDP at end-2002 and no further improvement projected in 2003 (owing to a sharp drop in tax collection in the last quarter of the year), resources remain insufficient to cover Georgia's pressing social expenditure demands, and tax evasion and smuggling remain serious impediments to improving revenue mobilization. Grants and concessional lending have become increasingly scarce over the past two years, and the market for government securities remains shallow (see below). The August 2003 tax reform is encouraging, but its impact will only be felt from 2004. Meanwhile, the tax code continues to feature far-reaching sectoral exemptions. On the expenditure side, steps have been taken toward implementing a commitment control system and introducing a Treasury Single Account, and a new Budget System Law was approved in April 2003. However, little progress has been made in developing proper cash management procedures, and budget preparation still lacks the strategic framework required to turn the budget into an effective policy tool. Consequently, the reduction in the large outstanding stock of domestic arrears (about 4½ percent of GDP) has been slower than programmed. It should also be noted that two-thirds of these arrears are on pensions, wages, and other social payments, giving a regressive slant to budgetary execution in the course of both Fund-supported programs.

Figure 1. Georgia: Tax Revenue and Fiscal Balance, 1994-2002
(In percent of GDP)



Sources: Georgian authorities; and Fund staff estimates.

9. **Ongoing governance problems and pervasive corruption hampered program implementation in both arrangements.** During the first one, entrenched interest groups continued to hold sway over government decisions on tax policy and enforcement in key sectors, such as banking, fuel and energy, alcohol, and cigarettes. This severely limited the programmed improvements in revenue. Pervasive corruption also compromised the business climate, severely limiting domestic and foreign investment. Under the second arrangement, the authorities took some measures, including formation of a commission to prepare a national anti-corruption program, and the establishment of a monitoring agency to review progress in implementing the program (including representatives of NGOs and civil society). However, little headway was made in minimizing opportunities for corruption, particularly in relation to complex and arbitrary tax enforcement. Consequently, at the twilight of the Shevardnadze administration, corruption continued to be broadly perceived as resilient, with survey results indicating that bribery and crime had worsened and that businesses viewed corruption in Georgia as a greater obstacle than elsewhere in the CIS.

10. **Financial markets remain under-developed, limiting the availability of indirect monetary instruments.** There has been some progress in this regard in the context of the 2001-04 program. Treasury bill issuance was restarted and substantially expanded, with the outstanding stock rising from GEL 6 million at end-2000 to GEL 54 million at end-November 2003. However, the stock remains small (at 0.6 percent of GDP). In addition, the high risk premia demanded by the market in the vicinity of the November 2003 elections (which have since ebbed somewhat) made significant borrowing inconsistent with debt sustainability. Furthermore, tasks related to regularization of the auction calendar, extension

of maturities, and development of a secondary market remain outstanding. The NBG took steps in 2003 to revamp the interbank credit auction and improve liquidity forecasting and management, in line with IMF recommendations. Notwithstanding some improvements, the roster of indirect monetary instruments remains limited (namely, NBG interventions in the interbank credit auction and the use of banks' reserve requirements, supplemented in 2003 with the introduction of deposit auctions).

11. **External viability is yet to be achieved.** Despite poor data, it appears that the current account deficit (including grants) has narrowed by 4 percentage points over the past four years to 6 percent of GDP in 2002. However, international reserves remain low, and the slow improvement in domestic revenue mobilization has caused the servicing of the external debt to remain very burdensome.

12. **Significant challenges remain in improving the technical and financial viability of the energy sector despite certain critical reforms undertaken since 1996 and substantial donor involvement.** Achievements during 1996-99 include separation of the system into distribution, generation, and transmission and dispatch companies, establishment of an independent energy regulatory agency, privatization of the Tbilisi distribution company, and the start-up of operations of the wholesale electricity market. Even so, frequent power cuts continued to hamper private sector recovery and development at the close of this arrangement. Key factors undermining the financial position of energy firms at that time were domestic energy prices set below cost-recovery levels and extremely low payment collection rates over the program period.

13. **Expansion of these reforms during 2001-03 generated some positive outcomes, but financial and technical viability remains elusive.** To improve efficiency and payment discipline, the government signed management contracts with private companies for the wholesale electricity market, distribution utilities outside Tbilisi, the transmission and dispatch company, and gas distribution in Tbilisi. Recent data show an upward trend in cash collection for key segments of the electricity market, but distribution companies outside Tbilisi have yet to boost significantly receipts and transfers to the wholesale market (owing in part to resistance by governors and other local officials to management efforts to cut off non-paying customers). Tariffs, reduced below cost recovery levels in March 2003, have not yet returned to their previous levels. The wholesale electricity market has lagged in enforcing payments and allocating them transparently, due to technical, governance, and political problems. Similarly, the transmission and dispatch company has so far failed to reduce theft and technical losses and acted inconsistently on disconnections. Sectoral performance has been further undermined by erratic changes in taxation of energy companies and by the burden of old debts to suppliers and the government. In another recent development, UES, the private electricity distribution utility in Tbilisi, has signaled its support for substituting electricity imports from the Russian grid for power generated domestically, with potentially adverse balance-of-payments effects. This continued poor payment discipline is reflected in large quasi-fiscal losses in the energy sector, estimated at 5.9 percent of GDP in 2002.

14. **Privatization advanced slowly during both programs.** Although Georgia undertook significant privatization during the 1990s (virtually all small firms and over 1,000 medium and large ones were privatized), the program overlooked privatization of many large enterprises, with the exception of the Tbilisi electricity distribution company. State property management and divestiture received little donor attention during 2001-03. Some progress was registered in 2003 with the privatizations of the Azoti and Zestafoni Ferro plants and the introduction of private management in key electricity sector entities, as mentioned above. Other recent efforts in this area resulted in the establishment of an Enterprise Management Agency under the aegis of the Ministry of Economy. The near-term focus of this agency will be on improvement in the management of SOEs. It currently lacks resources to hire outside experts, but will approach donors for possible assistance.

D. Policy Implementation Lessons

Sources of progress under the arrangements

15. **The NBG has played a vital role in anchoring price stability, aided by its technical competence and de facto independence.** It has steadfastly adhered to prudent financial programs in spite of significant pressure to accommodate the fiscal cash requirements. Since the 1998 Russian crisis, the NBG has followed a managed exchange rate float, with asymmetric intervention limited to the buying side in light of the need to strengthen the precarious reserve position and mindful of evidence of a rapid pass-through from the exchange rate to domestic prices.[3] The NBG has been bolstered in these endeavors by strong political support for keeping inflation low and stable.

16. **Relations between staff and the authorities were cordial over the course of both programs, although uneven implementation raised questions about program ownership.** Discussions with the previous administration brought out few if any substantive policy disagreements, and collaboration at the technical level remained close and effective. This spirit of cooperation translated into strong performance by the NBG, but not by the Ministry of Finance, as evidenced by continued low revenue collections and poor budget execution. Why these positive interactions resulted in such limited implementation is not entirely clear. Lack of cohesion within the government apparatus played some role: policy-makers were ultimately unable to enforce agreed measures at the level of implementation (which was conducted by poorly paid civil servants, including those responsible for tax collection and regulatory enforcement). There are also indications that state capture was a factor; officials at the highest levels of the previous administration benefited, directly or indirectly, from their tolerance of tax evasion or from their support for policies favoring key interest groups at the expense of the broader economic reform agenda.

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[3] See, for example, W. Maliszewski's paper, "Modeling Inflation in Georgia" (IMF Working Paper 03/212).

17. **Fund technical assistance aimed at strengthening institutional capacity has been substantial, but the authorities' record on uptake and implementation has been mixed.** In many cases, TA from the Fund and other donors has helped bring key aspects of the legal and regulatory framework in line with best international practices. This was especially true regarding monetary and financial issues, but less so in the fiscal area. Here, while technical assistance did translate into a number of substantial improvements, much more needs to be done.

Impediments to program implementation

18. **The political environment was generally supportive of economic reform during 1996-99, but not during 2001-03.** In the earlier period, Georgia enjoyed relative political stability and consensus in support of reforms. The ESAF was widely owned by the authorities and supported by a reform-minded parliament. Support weakened in the run-up to parliamentary elections in 1999, which were generally viewed as rigged. Afterward, President Shevardnadze's political base became fragmented, and the reform process itself politicized, complicating prospects for passage of critical measures under the program.

19. **Governance and corruption problems hampered program implementation over the course of both programs.** This is illustrated by the recurrent difficulties in raising the country's low tax-to-GDP ratio, owing to weak and corrupt tax and customs administration and widespread smuggling. Meanwhile, frequent amendments to the tax code sparked by interest groups further undermined revenue collections. These problems contributed directly to the continued poor business environment and impeded the expansion of formal private sector activity.

20. **Program implementation also suffered from poor coordination among the economic team, limited institutional capacity, and high turnover of key economic officials since 1998.** This has limited the uptake of TA and impeded the development and regularization of institutional practices, particularly in the Ministry of Finance. As the effectiveness and cohesion of the economic team diminished, its ability to resist politically motivated and populist measures waned, resulting in an increase in tax advantages and misallocation of public resources.

21. **The legacy from the civil war of the early 1990s and subsequent political fragmentation has prevented the government from fully controlling the country's territory**. These factors impaired program implementation under both arrangements. Unpaid electricity consumption by breakaway Abkhazia has been a constant financial drag in the energy sector and threatens to become an open-ended budgetary liability in the absence of a lasting solution to the territorial dispute. In South Ossetia, the border with the Russian Federation is porous, complicating efforts to collect customs duties. Due to its unsettled relations with the central government, the autonomous province of Adjara has often withheld central government taxes collected on its territory. The ebb and flow of tensions in Georgia's relations with Russia have also limited the authorities' room for maneuver. The imposition of

a stringent visa regime by Russia has impeded cross-border commerce, while difficulties enforcing the country's mountainous border with Chechnya have strained relations between the two countries. The unsettled security situation and the government's stated push for Georgia's eventual membership in NATO have fanned recent increases in defense spending. More recently, the Adjaran leadership has not recognized the legitimacy of the interim administration and held talks in Russia that included the Abkhaz and South Ossetian leaders.

22. **Exogenous developments also complicated program implementation under both arrangements**, underlining Georgia's continued vulnerability to external shocks. Growth was fairly robust in the mid 1990s, but slowed considerably between 1998 and 2001, buffeted by the 1998 Russian crisis, severe droughts in 1998 and 2000, sharp increases in the price of imported energy in 2000, and the 2001 Turkish financial crisis.

E. Compliance with Program Conditionality

23. Both Fund-supported arrangements encountered significant implementation problems. Although resources under the 1996-99 program were fully disbursed, and all requests for annual arrangements and reviews were completed, virtually all took place with substantial difficulty and delay. These difficulties persisted under the 2001-04 program, but took the form of completion of less than half of the planned reviews (2 out of 5). More than half of the resources available under the program were left undisbursed. Nevertheless, macroeconomic projections underpinning these programs were generally sound (Table 1-2). Growth and inflation outcomes were better than staff projections in every year except 1998, when the impact of the Russian crisis on the Georgian economy was difficult to foresee.

24. **The monitoring framework under both Fund-supported arrangements included monthly quantitative targets and semi-annual quantitative and structural performance criteria and benchmarks.** Under both arrangements, there was substantial compliance with quantitative monetary targets, but observance of fiscal targets and structural PCs and benchmarks proved elusive (Tables 4-7). The target on tax revenue was breached continuously during 1996-99 and was met about half of the time during 2001-03, although not at the point of the first or second reviews. Targets on domestic expenditure arrears failed to stem their accumulation in either arrangement. Overall, six waivers for nonobservance of quantitative PCs were granted under the 1996-99 program and seven under the 2001-04 program.

25. **In an effort to strengthen program implementation (and consistent with the Fund's policy on streamlining conditionality), the total number of structural conditions was sharply reduced under the 2001-04 program,** falling to 32, from 63 during the 1996-99 program. The structural measures under the second program were carefully targeted at outcomes in the fiscal, financial, and energy areas deemed critical to maintaining macroeconomic stability and strengthening implementation capacity. However, this streamlining did not translate directly into strengthened program implementation. A number of these measures were met with considerable delay or not met at all. Overall, one structural waiver (needed on account of the delay in the adoption of the new Budget Systems Law) was

granted under the 2001-04 program, as opposed to seven waivers under the 1996-99 program.

F. Cooperation with the World Bank

26. **Cooperation with the World Bank has generally been close during both arrangements.** By the conclusion of the 1996-99 program, the Bank had undertaken three Structural Adjustment Credits (SAC) and an Energy SAC, which focused on strengthening tax administration and social safety nets, accelerating privatization, restructuring the financial sector, liberalizing trade, and rehabilitating the energy sector. There were some difficulties in coordinating Fund and Bank conditionality during this period, stemming from the Bank's decision to disburse at end-1998 despite the fact that the ESAF was off track, and from insufficient complementarities in some instances between specific structural conditionality in Fund and Bank programs. After SAC III completed disbursement in October 2002, no further adjustment operations have taken place in Georgia. The Bank's investment projects during 2001-03 were ongoing in health, education, agriculture, and forestry reform. Sector work continued, concentrated on energy sector reform, public expenditure management, and financial sector reform. Bank-Fund collaboration and coordination was strong in these areas.

III. Policy Challenges for the Medium Term

27. **There is broad agreement between staff and the interim authorities that the reform drive needs to be reinvigorated,** first to build on the strengths discussed above, and second, to address long-standing problems faced in the previous programs that have become roadblocks to faster growth and poverty reduction. There is also agreement that key requirements for achieving these goals are to broaden political support for this endeavor and to articulate clearly to the public the rationale for the government's strategy.

28. **Achieving these goals will depend on the new political context in which the arrangement will be introduced**. The dramatic events that followed the November 2003 parliamentary elections and culminated in President Shevardnadze's resignation have created both new opportunities and new uncertainties. The new political leaders have so far expressed support for breaking with the corruption that characterized the Shevardnadze regime. As a consequence, prospects are good for agreeing upon a successor program with a strong focus on combating corruption. However, it remains to be seen whether the new ruling coalition will be able to smooth the political and economic tensions with Russia and the Adjaran leadership mentioned earlier.

29. **There is good correspondence between the outstanding elements of the reform agenda and the priority areas identified in the EDPRP.**[4] The EDPRP strategy targets

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[4] Although the previous administration was responsible for drafting the EDPRP, its consultations with civil society were extensive; thus, it remains representative of a fairly broad social consensus.

progress in seven key areas in order to achieve rapid and sustainable economic development and a reduction in extreme poverty. Among these are governance, macroeconomic policies (particularly in the fiscal area), the business environment, and development of priority sectors such as energy. Each of these has its counterpart in the reform agenda outlined below. However, the new authorities' ability to carry forward this ambitious agenda depends critically on their ability to mobilize additional resources, which in turn hinges on establishing credibility in overcoming those roadblocks discussed above in order to make tangible progress toward creating an environment conducive to private-sector led growth.

A. Macroeconomic Challenges

30. **Key macroeconomic challenges ahead are to achieve fiscal consolidation to underpin a prudent monetary stance.** An increase in the tax to GDP ratio of at least 4 percentage points over the next five years will be necessary to secure fiscal sustainability and unwind domestic arrears. This hinges on improving tax administration to reap the potential from excise taxes and customs duties.[5] The tax reform passed in August 2003, together with recent regulations overhauling VAT refunds, should simplify compliance, curb false claims, and facilitate tax enforcement, but the authorities will need to deepen the tax reform (if possible with TA from FAD), especially to dismantle exemptions (e.g., on the corporate income tax and VAT) that currently undermine the tax effort and protect interest groups. The broadened mandate of the Ministry of Finance, which includes strengthened investigative powers to curb evasion, and the seriousness and professionalism which the new fiscal authorities have displayed thus far bodes well for curtailing the interference from entrenched sectoral and business lobbies in enforcement efforts, including the operations of the large taxpayer inspectorate (LTI). Based on initial staff discussions with the interim administration, the most promising measures to achieve these results would appear to include (a) targeting anti-smuggling efforts at access routes to major population centers; (b) intensifying surveillance over small-scale ("tea-kettle") oil refineries; and (c) introducing far-ranging improvements in the Customs Department's personnel management and in its coordination with other government agencies. A more detailed and specific list of measures underpinning this effort will be discussed with the authorities in early 2004.

31. **Sustained and equitable growth also requires improved public expenditure policy and management.** The new budget systems law provides a useful framework for achieving these goals, but the authorities now need to formulate a timetable detailing its phased introduction into practice, and to transform this law into an organic one (i.e., which can only be overturned by a constitutional majority in parliament and cannot be superseded by regular laws) as soon as practicable. Budgetary design and implementation should be

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[5] Estimates by international donors suggest that an increase in revenue in the order of 4 percent of GDP would be feasible over the medium term by combating tax evasion, particularly of fuel excises and import duties, which currently yield revenue far below potential.

enhanced by using conservative assumptions to forestall future sequestrations, and by improving strategic planning and linkages with EDPRP priorities. To further improve budget execution, it will be necessary to make the single treasury account and new commitment controls fully operational and expand their coverage to extrabudgetary funds, while aligning cash management and accounting with best practice.

32. **Although the economy will be bolstered by construction activity and transit fees from energy pipelines, there are significant downside risks in the outlook.** As the one-off effects on growth of the Baku-Tbilisi-Ceyhan oil pipeline, the South Caucasus gas pipeline, and scrap metal exports begin to subside, sustained growth will depend on expanding opportunities for private sector activity, particularly with respect to agriculture and tourism which retain substantial untapped potential. Reviving these sectors will require improved access to regional markets (particularly Russia, whose strict border and visa regimes with Georgia have interrupted long-standing trade links) and significant improvements in the security environment to attract foreign tourists. In the meantime, Georgia will remain vulnerable to external shocks, given its high external indebtedness, low reserves, and limited export diversification. The latest debt sustainability analysis indicates that, notwithstanding a steady improvement in debt indicators anticipated over the coming years, external obligations will remain burdensome. Furthermore, stress tests point to the vulnerability to shocks such as sluggish export growth or a large currency depreciation. Accordingly, a concessional restructuring of bilateral debt in line with the Paris Club's new Evian approach would considerably improve debt indicators and the prospects for medium-term sustainability. Achieving these goals will also require a continued shift toward concessional financing, fiscal consolidation, and renewal of donor support. If the authorities adopt a strong reform program in 2004, a consultative group later that year could help mobilize additional assistance.

B. Structural and Second Generation Reforms

Governance issues and public sector reforms

33. **Going forward, bolder efforts will be needed to improve Georgia's business climate.** Major impediments include opaque regulations, erratic enforcement, sluggish administrative procedures, and frequent and unpredictable demands for bribes. To remove these, a two-pronged effort is needed to effectively fight petty corruption and large-scale corruption. Petty corruption should be combated by enforcing penalties, reforming the civil service (see below), and expanding private sector employment opportunities. Large-scale corruption must be curbed by reducing rent-seeking opportunities, reining in complicit law enforcement agencies, and imposing stiff criminal sanctions for corrupt practices by high-level government officials.

34. **Improved management of budgetary resources and state property will be essential to meet the rising demands for greater state intervention in the delivery of social services and safety nets outlined in the EDPRP.** Implementation of a civil service reform strategy will be critical in this regard. The strategy, prepared by the previous

government with donor assistance, called for a reduction by 20 percent during 2003-05 in the civilian workforce of the general government and ancillary public entities, mainly by attrition. The reform was also expected to include merger or elimination of ministries, an upgrade in entry-level pay, and differentiated increases for technical and managerial personnel to facilitate recruitment and reduce incentives for bribe-taking. A fuller costing of the reform will be necessary before it can be launched. The interim administration has signaled its commitment to a broad civil service reform, including to a rapid restructuring of the defense and security ministries, which would be desirable to realize fully the benefits of such an effort.

35. **More efficient mobilization of public resources will also depend on improving the management of public enterprises.** Following the conclusion of the three major SOE audits during the first half of 2004, the authorities will be expected to publish the results, implement the recommendations, expand the exercise to other SOEs, and make this audit process a regular requirement for all SOEs. The authorities will also need to focus on putting state companies on a solid footing under the aegis of the new Enterprise Management Agency.

Energy sector reforms

36. **In the energy sector, the authorities need to take a firm stance toward nonpaying customers, curtail widespread theft and fraud, and resist political pressures to deviate from tariffs based on cost-recovery criteria.** The interim government has asked for outside expert advice to reassess the notional tariff methodology used by the Energy Regulatory Commission (GNERC) which has not been fully applied since March 2003, as noted earlier. The government is also about to set up a Debt Resolution Agency with donor support to tackle the domestic debts of the energy sector, including verification and settlement of reciprocal claims and obligations of public agencies.

Trade liberalization

37. **As part of a comprehensive reassessment of tax policy by the new government (with outside TA) the authorities are expected to consider a move to a low uniform import tariff.** This should be accompanied by the introduction of a duty-drawback system and improvements in the VAT refund mechanism for exporters. Such an approach would significantly reduce distortions and rent-seeking opportunities, while helping curb smuggling and reduce the anti-export bias of the current trade regime.

C. Technical Assistance Needs

38. **Georgia will continue to require extensive technical assistance.** TA provided during previous programs by the Fund, the Bank, and other donors produced substantial improvements in the legal and regulatory framework for macroeconomic policy. Uptake of this advice has been strong in support of monetary and financial sector reform, but full realization of key fiscal reforms listed above will depend critically on further TA from FAD. The same is true in the area of statistics, where there has been considerable provision of TA,

but more will be needed in the areas of balance payments, national accounts, and government financial statistics. Additional TA will also be required to implement recently approved anti-money laundering legislation.

D. Relations with the World Bank

39. **The World Bank Board is reassessing its country assistance strategy to Georgia for the period FY04-FY06 in light of recent developments and plans of the new leadership.** The overall framework for the strategy will remain the EDPRP, with assistance focused particularly on (i) attaining faster and broad-based growth; (ii) developing human capital; (iii) strengthening public expenditure management; and (iv) improving governance and institutional capacity. The Bank intends to pitch lending levels, and the timing of any adjustment lending, to progress in improving governance. Looking ahead, the new authorities have underscored to the Bank the importance of providing adequate resources to maintain its central role in energy sector reform (in coordination with other donors) and to play a stronger role in such key elements of the medium-term strategy as civil service reform, state property management, and privatization.

IV. Future Fund Relations with Georgia

A. Rationale for a Successor Program

40. **Georgia continues to face a challenging reform agenda, as well as the need to rebuild foreign reserves and to reengage with stakeholders.** From this standpoint, early agreement on a robust successor program would be a vital component of the new government's efforts to rally strong international support. This would provide the basis for Georgia to secure a rescheduling of 2003 arrears and future maturities owed to the Paris Club. It would also facilitate the mobilization of grants and fresh concessional financing necessary to realize the growth and poverty alleviation goals articulated in the EDPRP while moving toward debt sustainability.

41. **Renewed Fund involvement can capitalize on the window of opportunity presented by regime change in Georgia.** While a return to the flawed policies of the previous regime is considered highly unlikely, a muddling-through scenario that failed to elicit rapid domestic and international support would exacerbate the fiscal and external vulnerabilities and frustrate the expectations of improved living standards. Conversely, a strong, home-grown reform effort without rapid commensurate support from the Fund and other donors would be difficult to sustain and could ultimately produce a strong political and economic backlash.

B. Exit Strategy

42. **Looking ahead, a more prolonged Fund involvement beyond 2007 depends on progress in reform and fiscal consolidation, and the degree to which the country is exposed to exogenous shocks.** Given these uncertainties, the possibility of a fourth PRGF arrangement cannot be excluded. This question, in addition to a broader consideration of a

possible exit strategy for Georgia from Fund assistance, will need to be reassessed at the end of the new PRGF arrangement in light of upcoming Board decisions regarding Fund engagement with low-income countries.

Table 1. Georgia: Selected Economic and Financial Indicators, 1999-2004

	1999	2000	2001	2002	2003 Proj.	2004 Proj. 1/
	(Percentage change relative to previous year, unless otherwise indicated)					
National income and prices						
Nominal GDP	12.4	6.1	10.4	12.2	12.4	10.2
GDP at constant prices	3.0	1.9	4.7	5.3	7.0	5.0
Nominal GDP (millions of lari)	5,665	6,013	6,638	7,448	8,368	9,226
Consumer price index, period average	19.1	4.0	4.7	5.6	4.8	6.3
Consumer price index, end-of-period	10.9	4.6	3.4	5.4	7.0	4.8
Money and credit (end-of-period)						
Reserve money	18.8	26.8	9.9	18.4	15.3	10.2
Broad money (including foreign exch. deposits)	20.7	39.0	18.5	17.9	29.1	14.3
Gross international reserves						
In months of imports of goods and services (excl. pipeline imports)	1.3	1.0	1.4	1.8	1.5	1.6
In millions of U.S. dollars	132	109	161	198	183	209
	(In percent of GDP, unless otherwise indicated)					
Savings and investment						
Investment	19.2	18.2	18.5	18.4	23.4	26.6
Non-government sector	17.1	17.1	16.7	16.4	21.6	24.8
Gross Domestic Saving	11.5	13.7	11.9	12.4	13.3	16.7
Non-government sector	16.1	16.7	12.1	12.3	14.4	15.1
Current account deficit	7.8	4.4	6.5	6.0	10.1	9.9
General government						
Total revenue and grants	15.4	15.2	16.3	15.8	15.6	18.0
o/w Tax revenue	13.8	14.2	14.3	14.4	14.4	15.7
Total expenditure and net lending	22.1	19.2	18.3	17.8	18.4	18.3
o/w Current expenditure	20.0	18.2	16.5	15.7	16.6	16.5
Primary balance	-3.9	-1.0	-0.2	0.0	-0.7	1.7
Fiscal balance, commitment basis	-6.7	-4.0	-2.0	-2.0	-2.9	-0.2
Net change in expenditure arrears	...	1.4	0.2	-0.4	1.2	-0.7
Statistical discrepancy	...	0.1	0.1	0.5	0.5	...
Fiscal balance, cash basis	-5.0	-2.6	-1.6	-1.9	-1.1	-1.0
Financing	5.0	2.6	1.6	1.9	1.1	1.0
Privatization	0.9	0.3	0.1	0.2	0.3	0.2
External	1.7	0.0	1.9	1.8	0.9	1.0
Domestic	2.3	2.2	-0.4	-0.1	0.5	0.2
Adjustment for net withheld Adjara transfers 2/	0.0	0.0	0.0	0.0	-0.6	-0.4
External sector						
Trade balance	-19.1	-13.0	-15.2	-12.9	-17.6	-17.0
Trade balance excluding pipeline-related imports	-19.1	-13.0	-15.2	-12.6	-12.0	-11.8
Current account balance						
Excluding transfers	-14.3	-11.2	-13.6	-11.4	-16.5	-16.0
Including transfers	-7.8	-4.4	-6.5	-6.0	-10.1	-9.7
Net change in external arrears	2.0	2.2	0.2	0.0	1.2	-1.1
External debt	60.9	53.0	53.5	54.8	48.0	47.7

Sources: Georgian authorities; and Fund staff estimates.

1/ Assumes that current expenditures will be cut to eliminate the projected 2004 fiscal gap.
2/ For 2003 and 2004, deposits by the government of Adjara at commercial banks that reflect withheld tax revenues are excluded from net financing to the government.

Table 2. Georgia: Program Targets and Outcomes under the 1996-99 PRGF Program

	1996			1997			1998			1999		
	Program 8/	Outcome 9/	Outcome 10/	Program 11/	Outcome 12/	Outcome 10/	Program 13/	Outcome 12/	Outcome 10/	Program 14/	Outcome 15/	Outcome 10/
Real												
Real GDP Growth	8.0	...	10.5	10.0	...	10.6	10.0	...	2.9	2.0	...	3.0
Inflation (EoP)	23.1	...	13.7	12.0	...	7.2	6.0	...	10.7	12.9	...	10.9
Nominal GDP (in millions of lari) 1/	5,684	5,724	3,869	7,052	6,798	4,639	7,964	7,232	5,041	8,738	8,270 16/	5,665
General Government												
Fiscal Balance (in percent of GDP) 2/	-3.4	-4.5	-7.3	-2.8	-4.6	-6.8	-1.5	-4.3	-6.1	-1.8	-4.6	-6.7
Total Revenue (in percent of GDP) 3/	8.5	8.1	11.9	10.7	9.6	14.1	12.1	10.2	14.7	10.4	10.0	14.6
Tax Revenue (in percent of GDP) 4/	8.1	6.9	10.6	9.8	8.6	12.7	10.3	8.9	12.8	9.9	9.5	13.8
Money												
Broad Money, percentage change 5/	36.6	...	42.0	34.8	...	45.6	26.2	...	-1.2	17.4	...	20.7
Velocity 6/	20.0	22.3	15.1	20.4	18.7	12.4	17.2	19.6	13.7	20.2	18.6	12.7
Money Multiplier	1.3	...	1.2	1.3	...	1.4	1.5	...	1.4	1.5	...	1.4
External Sector												
Current Account Balance (in percent of GDP) 7/	-2.3	-6.0	-10.8	-2.7	-7.2	-10.5	-6.9	-7.9	-10.2	-5.3	-5.3	-7.8
Gross International Reserves (in months of imports)	2.7	...	2.5	2.5	...	1.5	2.3	...	1.0	2.5	...	1.3
Gross International Reserves (in millions of U.S. dollar)	159.0	...	158.0	170.0	...	173.3	210.0	...	118.4	213.0	...	132.4
External Debt (in percent of GDP)	28.4	30.0	44.6	27.0	29.4	42.3	29.8	32.3	45.1	43.3	42.0	60.9

Sources: various staff reports.

1/ GDP estimates for 1996-99 were substantially revised downward in January 2000, reflecting revised estimates for informal activities (see SM/00/53). Current staff estimates are therefore not directly comparable to program targets or to outcomes reported in staff reports drafted before the GDP revision took place.
2/ On a commitment basis.
3/ Excluding grants.
4/ Including extrabudgetary revenues.
5/ Including foreign exchange deposits.
6/ Annual GDP devided by end-period M3.
7/ Including official transfers.
8/ Based on the projections in the economic program supported by a three-year arrangement under the PRGF, February 12, 1996 (EBS/96/21).
9/ Based on the Request for the Third Annual Arrangement under the PRGF, July 13, 1998 (EBS/98/118).
10/ Current staff estimate reflecting the subsequent downward revisin in GDP described in footnote 1.
11/ Based on the projections in the economic program in the Request for Second Annual Arrangement under the PRGF, February 27, 1997 (EBS/97/29).
12/ Based on the Midterm Review Under the Third Annual Arrangement under the PRGF, July 12, 1999 (EBS/99/123).
13/ Based on the projections in the economic program in the Request for the Third Annual Arrangement under the PRGF, July 13, 1998 (EBS/98/118).
14/ Based on the projections in the economic program in the Midterm Review Under the Third Annual Arrangement under the PRGF, July 12, 1999 (EBS/99/123).
15/ Based on the Request for a Three-Year Arrangement under the PRGF, January 12, 2001 (EBS/00/258).
16/ Calculated from current staff estimate using average 1996-98 ratio of unrevised GDP to revised GDP.

Table 3. Georgia: Program Targets and Outcomes under the 2001-04 PRGF Program

	2000	2001		2002		2003	
	Outcome 7/	Program 8/	Outcome 7/	Program 9/	Outcome 7/	Program 10/	Proj. Outcome 7/
Real							
Real GDP Growth	1.9	3.8	4.7	3.5	5.3	4.8	7.0
Inflation (EoP)	4.6	5.9	3.4	5.6	5.4	4.8	7.0
Nominal GDP (in millions of lari)	6,013	6,748	6,638	7,264	7,448	7,989	8,368
General Government							
Fiscal Balance (in percent of GDP) 1/	-4.0	-2.0	-2.0	-1.1	-2.0	-1.2	-2.9
Total Revenue (in percent of GDP) 2/	14.9	15.8	15.6	15.8	15.5	16.7	15.1
Tax Revenue (in percent of GDP) 3/	14.2	14.9	14.3	14.7	14.4	15.9	14.4
Money							
Broad Money, percentage change 4/	39.0	17.8	18.5	18.8	17.9	14.6	29.1
Velocity 5/	9.7	11.2	9.1	9.0	8.6	8.1	7.5
Money Multiplier	1.6	1.6	1.7	1.8	1.7	1.8	1.9
External Sector							
Current Account Balance (in percent of GDP) 6/	-4.4	-7.1	-6.5	-6.2	-6.0	-14.7	-10.1
Gross International Reserves (in months of imports excl. pipeline imports)	1.0	1.6	1.4	1.7	1.8	1.8	1.5
Gross International Reserves (in millions of U.S. dollar)	109.4	199.0	161.1	192.6	197.7	218.0	183.0
External Debt (in percent of GDP)	53.0	59.1	53.5	54.2	54.8	52.6	48.0

Sources: various staff reports.

1/ On a commitment basis.
2/ Excluding grants.
3/ Including extrabudgetary revenues.
4/ Including foreign exchange deposits.
5/ Annual GDP devided by end-period M3.
6/ Including official transfers.
7/ Current staff estimate.
8/ Based on the economic program supported by a three-year arrangement under the PRGF, January 12, 2001 (EBS/00/258).
9/ Based on the economic program supported by a three-year arrangement under the PRGF, as updated in the Second Review, June 28, 2002 (EBS/02/117).
10/ Based on the economic program supported by a three-year arrangement under the PRGF, as updated for the second completion attempt of the Third Review, January 30, 2003.

Table 4. Georgia: Compliance with Program Targets (Performance Criteria and Benchmarks) under the 1996-99 PRGF Program 1/

	1996				1997				1998				1999	
	I	II	III	IV	I	II	III	IV	I 2/	II	III 3/	IV	I 4/	II
1. Performance criteria														
Floor on General Government tax revenue (including special funds) 5/	Not Met	Not Met	Not Met	Not Met	Not Met	Not Met	Not Met	Not Met	Not Met	Not Met	Waiver	Not Met	Not Met	Not Met
Floor on cigarette tax revenue 6/	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	Not Met	Not Met	Waiver	Not Met	Met	Met
Floor on petroleum products revenue	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	Not Met	Not Met
Ceiling on total domestic borrowing requirements of the General Government	n.a.	n.a.	n.a.	n.a.	Met	Met	Met	Not Met	Met	Not Met	Met	Met	Met	Met
Ceiling on net credit of the banking system to the General Government	Met	Met	Not Met	Not Met	Met	Met	Met	Met	Met	Not Met	Met	Met	Met	Met
Ceiling on net domestic assets of the NBG	Met	Met	Met	Not Met	Met	Met	Met	Met	Met	Met	Met	Not Met	Not Met	Met
Floor on total international reserves	Met	Met	Met	Met	Met	Waiver	Met	Met	Met	Met	Waiver	Not Met	Met	Met
Floor on net international reserves in convertible currencies	Met	Met	Met	Met	Met	Waiver	Met	Met	Met	Met	Waiver	Not Met	Met	Met
Ceiling on contracting or guaranteeing														
1. Short-term external debt (less than one year)	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met
2. Nonconcessional medium- and long-term external debt	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met
Ceiling on external arrears	Met	Met	Met	Met	Met	Met	Met	Met	Not Met	Met	Met	Met	Met	Met
Floor on external debt-service payments	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met
2. Financial benchmarks														
Reserve money	Not Met	Not Met	Not Met	Not Met	Met	Met	Not Met	Not Met	Not Met	Met	Met	Met	Not Met	Not Met
Excise tax revenue	n.a.	n.a.	n.a.	n.a.	Not Met	Met	Not Met	Not Met	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Minimum amount of health expenditures of the Republican Government	n.a.	n.a.	n.a.	n.a.	Not Met	Not Met	Not Met	Not Met	n.a.	Not Met	Not Met	Not Met	n.a.	n.a.
Domestic expenditure arrears of the government	Met	Not Met	Not Met	Not Met	...	Not Met	Not Met	Not Met	Met	Not Met	Not Met	Not Met	Not Met	Not Met

Sources: various staff reports.

1/ Outlined area denotes performance criteria test date.
2/ End of April
3/ End of October.
4/ End of May.
5/ Prior to July 1998 tax revenues was a financial benchmark.
6/ Prior to July 1999 cigarette revenues was a financial benchmark.

Table 5. Georgia: Compliance with Program Targets (Performance Criteria and Indicative Targets) under the 2001-04 PRGF Program 1/

	2000	2001				2002				2003		
	IV	I	II	III	IV	I	II	III	IV	I	II	III
1. Performance Criteria												
Floor on General Government tax revenue (incl. special funds)	Met	Waiver	Met	Met	Waiver	Met	Not Met	Met	Met	Met	Not Met	Not Met
Ceiling on cash deficit of the general government	Met	Met	Met	Met	Met	Not Met	Met	Met	Met	Met	Met	Not Met
Ceiling on domestic expenditure arrears of the general government	Met	Waiver	Met	Not Met	Waiver	Not Met	Not Met	Not Met	Not Met	Not Met	Not Met	...
Ceiling on net credit of the banking system to the General Government	Waived 2/	Met	Met	Met	Met	Met	Met	Met	Met	Met	Not Met	Not Met
Ceiling on net domestic assets of the NBG	Waived 2/	Waiver	Met	Met	Met	Met	Met	Met	Not Met	Met	Met	Met
Floor on total net international reserves of the NBG	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met
Ceiling on contracting or guaranteeing												
1. Short-term external debt (less than one year)	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met
2. Nonconcessional medium- and long-term external debt	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met
Ceiling on external arrears (Continuous)	...	Waiver	...	...	Waiver	...	...	...	...	...	...	...
2. Indicative targets												
Reserve money	Not met	Not Met	Met	Not Met	Not Met	Met	Met	Met	Not Met	Met	Met	Met
Cigarette and petroleum revenues	Not met	Not Met	Not Met 3/	Not Met	Not Met	Not Met	Not Met	Not Met	Not Met	Not Met	Not Met	Not Met

Sources: various staff reports.

1/ Outlined areas denote performance criteria test dates. Note that the Q3 2002 test date refers to the proposed third review, which was never completed.

2/ Disbursement of the second loan under the program was contingent on observance of end-December 2000 performance criteria. Two minor infractions were waived (see EBS/01/29).

3/ The cigarette and petroleum indicative target for end June 2001 was met according to the first review, not met according to the second review.

Table 6. Georgia: Structural Conditionality under the 1996-99 PRGF Program

	1996			1997			1998/99		
	Prior Actions	Performance Criteria	Benchmarks	Prior Actions	Performance Criteria	Benchmarks	Prior Actions	Performance Criteria	Benchmarks
Exchange and trade system	2	0	0	0	0	0	3	0	0
Price liberalization	1	0	1	0	0	1	0	0	2
Tax reforms	1	0	1	5	1	3	1	2	1
Expenditure reforms	2	0	2	1	0	2	0	1	2
Public sector institutional reforms	0	1	2	0	1	1	0	2	2
Financial sector	3	1	2	2	0	1	2	0	2
Privatization and enterprise reform	0	0	2	0	0	2	1	1	0
Total	**9**	**2**	**10**	**8**	**2**	**10**	**7**	**6**	**9**
Met on time		2	8		1	5		2	3
Met with some delay		0	2		1	3		3	1
Met with considerable delay/Not met		0	0		0	2		1	5

Sources: various staff reports.

Table 7. Georgia: Structural Conditionality under the 2001-04 PRGF Program

	Program January 2001	First Review October 2001			Second Review June 2002			Third Review 1/	
	Prior Actions	Prior Actions	Performance Criteria	Benchmarks	Prior Actions	Performance Criteria	Benchmarks	Performance Criteria	Benchmarks
Fiscal Measures	4	1	0	5	1	1	1	1	1
Financial Sector		1	0	3	0	0	1	0	1
Energy Sector	1	0	0	1	1	0	0	0	2
Anti-Corruption	1	0	0	0	0	0	0	0	0
External financing and trade	1	0	0	0	1	0	0	0	0
Public administration reform		0	0	0	0	0	0	1	2
Total	**7**	**2**	**0**	**9**	**3**	**1**	**2**	**2**	**6**
Met on time			0	5		0	0	1	0
Met with some delay			0	**1**		0	1	1	4
Met with considerable delay/Not met			0	3		0	1	0	2
Waived			0	0		1	0	0	0

Sources: various staff reports.

1/ The Third Review was never completed.

Statement by Jeroen Kremers, Executive Director for Georgia
and Nikoloz Gigineishvili, Advisor to Executive Director
January 21, 2004

At the time of the last Board meeting on Georgia in October 2003, when the Executive Directors discussed the staff report on the Article IV Consultation, we could hardly imagine that in only three months time we would be representing Georgia on behalf of new authorities. In a peaceful revolution sparked by the irregular Parliamentary elections in early November 2003, new political forces came to power. The international community has immediately offered its assistance and support to the country, signaling that the world views the new authorities as democratically elected and expects from them implementation of market and stability oriented reforms and responsible policies. The Georgian authorities realize that the country is at a critical crossroads. They would like to assure the Board that the new government is committed to sound macroeconomic management in line with the best international practices and is prepared to vigorously promote the stalled reform agenda. They stand ready to closely cooperate with the Fund and look forward to the upcoming visit of the mission to start negotiations afresh in hopes of reaching an early agreement on a successor PRGF arrangement.

The Georgian authorities appreciate the staff report, which contains an accurate assessment of the country's performance under the last two Fund-supported programs and gives a well-balanced evaluation of successes and failures. They consent to the publication of the Ex Post Assessment report and the PIN. The authorities are well aware that the main challenges are yet to be addressed. Notwithstanding a daunting heritage of large macroeconomic imbalances, structural and institutional deficiencies, and undeveloped capacities, the new government is firm in its determination to cope with the outstanding issues in an expeditious, and at the same time constructive, transparent and democratic manner.

The Economic Development and Poverty Reduction Program (EDPRP), which was discussed by the boards of both the Fund and the Bank in October 2003, and viewed as a sound poverty reduction program, will remain the main strategy document of the country. It was the outcome of a broad participatory process involving not only the government, but also civil society, the private sector, donors and IFI's. Of course some aspects of the EDPRP may still undergo revisions intended to further enhance the document taking into consideration the recommendations of the joint Bank/Fund assessment as well as the new realities. But improving the business climate and creating an investment-friendly environment to promote equitable growth and increasing the welfare of the Georgian population as the main medium-term objectives of the EDPRP, will remain unchanged.

The authorities regret that the last PRGF program went off-track and expired with a large part of the approved funding un-disbursed, entailing shortfalls in other donor financing and delays with Paris Club negotiations. As indicated in the staff report, the weak fiscal performance and slow progress on the structural front were the major drawbacks precluding successful implementation of the program. As the lack of ownership was the key factor behind poor performance under the program, the new authorities stand ready to fully embrace reforms and provide the so needed political support.

Structural measures

A major problem is pervasive corruption, state capture and weak governance, which undermine efficiency of public and private sectors alike (though in different ways) and create tremendous obstacles for business development and growth. Poor fiscal performance, widespread smuggling and tax evasion, as well as energy sector issues and many other problems shattering the economy for a number of years, are also directly linked to this. Recognizing the pervasive nature of corruption, the newly elected president of Georgia, Mr. Saakashvili, has announced that fighting corruption will be his top priority, and that he and his government will not tolerate the offensive practices of the past. In fact, the interim government that came to power with the peaceful revolution has already taken a number of steps against smuggling and tax evasion by tightening control over the imports of major smuggling commodities, and closing some of the largest trade loopholes on the Georgian border. Law enforcement bodies have launched investigations of large fraud and corruption cases, and substantially intensified their efforts against shadow economic activities in an attempt to widen the effective tax base.

One of the most important measures in combating corruption and reducing rent-seeking opportunities, is a civil service reform. This was being contemplated by the previous authorities for some time already, though never actually initiated. The new leadership has expressed its commitment to thorough public sector reforms. The aim is to implement a substantial structural reorganization to make the system more efficient and apt to the needs, objectives and the capacities of the government. This will include the downsizing of the government and the restructuring of compensation and motivation schemes to attract highly qualified staff and to reduce incentives for corruption. As a first step of the reform to coordinate work and team responsibility of the government, the new president has already proposed constitutional amendments envisaging the introduction of the post of a prime minister.

Fiscal issues

The authorities are conscious that the state budget is in a severe condition and, therefore, place fiscal consolidation high on the agenda. The draft 2004 budget, sent to the parliament last October, has been recalled for revisions, and is expected to be resubmitted to the legislators soon after being discussed in detail with the Fund mission, which is scheduled to arrive in Georgia in early February. They are keen to be proactive in addressing the problematic issues on both revenue and expenditure sides, and, in a close dialogue with the Fund, are planning to take a fresh look at the tax system with a view to streamlining and optimizing its structure. The authorities do realize, however, that time might be needed before their efforts translate into visible improvements in revenue collection and fiscal management in general.

Noticeable progress has already been observed in some of the areas. For the first time in several years the regional administration of the Adjara province agreed to transfer lari 2.5 million of locally collected taxes to the center, which we hope might be a first step toward normalizing the fiscal relationship between the center and the region. Another positive development was that, in line with the Fund recommendations to improve expenditure management and control, a decision has been made to finally introduce a Single Treasury Account from April 1, 2004, and to close all transit accounts of Tax and Customs departments.

Monetary policy and financial system

Amid all the difficulties in fiscal and external sectors, the monetary policy stance has been consistently prudent. By maintaining low inflation and a competitive exchange rate, and by ensuring the steady development of the banking system, the National Bank of Georgia (NBG) has provided a key anchor to overall macroeconomic stability and growth. In a new political environment the central bank will follow the same sound, well balanced and cautious approach in pursuing its main objective of price stability. More efforts will be devoted to diversification of the monetary policy instrument mix to increase the liquidity management capacity and the flexibility of policy implementation.

Progress continued in the area of banking regulation and anti-money laundering and anti-terrorism financing activities. In order to strengthen the health and reduce vulnerability of the banking system, the National Bank of Georgia announced a gradual increase in the minimum capital requirement from the current level of lari 5 million (~USD 2.4 million) to the European standard of lari 12 million (~USD 5.6 million at prevailing exchange rates) by 2008. At the same time stricter limits on credit portfolios were introduced, including lower limits on single party borrowing. On the AML/CFT front, the Financial Monitoring Service (FMS) – a recently formed financial intelligence unit – issued a decree requiring a notary public to register and disclose the identity of each individual engaging in large transactions (of more than lari 20,000 in cash, and more than 40,000 in non-cash transactions) and to notify the FMS should any suspicion of connection to terrorism activities arise. The missing pieces of Anti-Money Laundering legislation have also been drafted by the NBG, and are expected to be discussed by the parliament in the near future.

Technical Assistance

The Georgian authorities are extremely grateful to the Fund and the Bank for the valuable technical assistance rendered over the years. The country has benefited significantly from the past TA and the new government is likely to seek further expertise from the IFI's, especially in the fiscal and anti-money laundering areas, but also in statistics and banking supervision.

In closing, we would like to thank staff and management for dedicated work and sound policy advice. On behalf of the Georgian authorities we would like to reconfirm their readiness for close and fruitful cooperation.

INTERNATIONAL MONETARY FUND
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FOR IMMEDIATE RELEASE
January 30, 2004

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

IMF Reviews Georgia's Performance Under Past Fund-Supported Programs

On January 21, 2004, the Executive Board of the International Monetary Fund (IMF) reviewed Georgia's experience with two Fund-supported programs since 1996, under the new guidelines on assessments of countries with a longer-term program engagement.[1]

Background

Georgia has faced daunting challenges since independence, in an environment rife with political tension, declining living standards, and severe economic dislocations. Dwindling tax revenues in the first years of independence have reduced the government's ability to fund basic state functions, while the de facto secession of two provinces has undermined its control over the country's territory. In the face of these obstacles, Georgia has had to build basic national institutions and embark on fiscal consolidation and first-generation reforms, including privatization, land reform, and energy sector rehabilitation. While progress has been made in the context of the last two Fund-supported programs, the results fell short of expectations during the recent Poverty Reduction and Growth Facility arrangement, which expired on January 11, 2004.

Executive Board Assessment

Executive Directors welcomed the opportunity to review—under the guidelines on assessments of countries with longer-term program engagement—Georgia's experience with two Fund-supported programs since 1996. Directors commended Georgia for the pursuit of sound macroeconomic policies and the progress made with some structural reforms over the past eight years. As a result, Georgia has made notable advances toward macroeconomic

[1] This PIN summarizes the views of the Executive Board as expressed during the discussion based on the staff report.

stabilization, liberalization of the trade and payments system, and implementation of substantial financial sector reforms.

Directors observed, however, that important program goals, including the strengthening of the public finances and sustained implementation of structural reforms, remain unrealized. They agreed that the weaknesses in program implementation and institutional capacity that had characterized both Fund-supported programs stemmed in large part from ongoing governance problems and pervasive corruption, the influence of vested interests, as well as limited program ownership by the authorities. Today Georgia remains a very poor country with significant macroeconomic vulnerabilities, as well as a large, unfinished agenda for transition to a market economy.

Directors welcomed the work done by the staff to pinpoint key policy challenges facing Georgia and draw lessons learned on program design, based on its review of the country's past performance under Fund-supported programs. They agreed that in order to sustain economic growth, encourage private sector development, and reduce poverty, the highest priority should be to tackle the root causes of poor governance and pervasive corruption, and to build institutions well equipped to undertake these tasks. At the same time, the authorities will need to address the key macroeconomic challenge of pushing ahead with fiscal consolidation—paying particular attention to strengthening revenue performance and improving public expenditure policy and management. Also critical will be determined implementation of the structural reform agenda, particularly with respect to the energy sector, civil service reform, state property management, and further trade liberalization. Actions to normalize relations with creditors and improve the business climate will also be important. In looking at lessons learned from the program experience in Georgia, some Directors felt that such an assessment could benefit also from broader treatment of program design and conditionality issues. Directors welcomed the fact that the new administration in Georgia had reviewed the staff's assessment and shared its conclusions.

Directors discussed possible modalities of future Fund engagement with Georgia. A few Directors, recalling the uneven policy implementation in recent years and the still weak institutional capacity, called for special attention to be paid to the challenge of establishing a firm track record of policy implementation in combination with strong and broad-based ownership. These Directors suggested that a staff monitored program could provide an appropriate framework for assessing policy implementation going forward. Most Directors, however, encouraged the staff to engage the new authorities in response to their request for a successor PRGF arrangement. Based on staff's findings, the Board will come back to consider a possible arrangement if it is founded on realistic, but sufficiently robust and credible, policy commitments designed to tackle the enormous challenges still facing the country. These commitments should include fiscal consolidation, bold measures to tackle corruption and governance weaknesses, and progress on the structural reform agenda. A few Directors suggested that prior actions in some of these areas should be considered.

Directors encouraged staff to work closely with the new administration, and in collaboration with the World Bank staff, to develop a program, taking into account the lessons learned on conditionality and program design from today's discussion and the earlier arrangements. They acknowledged that renewed Fund involvement would capitalize on the window of opportunity presented by political change in the country to underpin more rapid economic growth and poverty reduction, by providing much-needed support and by helping to mobilize foreign assistance.

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 and Financial Indicators, 1999-2003

	1999	2000	2001	2002	2003 Est.
	(Percentage change relative to previous year, unless otherwise indicated)				
National income and prices					
Nominal GDP	12.4	6.1	10.4	12.2	12.4
GDP at constant prices	3.0	1.9	4.7	5.3	7.0
Nominal GDP (millions of lari)	5,665	6,013	6,638	7,448	8,368
Consumer price index, period average	19.1	4.0	4.7	5.6	4.8
Consumer price index, end-of-period	10.9	4.6	3.4	5.4	7.0
Money and credit (end-of-period)					
Reserve money	18.8	26.8	9.9	18.4	15.3
Broad money (including foreign exch. deposits)	20.7	39.0	18.5	17.9	29.1
Gross international reserves					
In months of imports of goods and services (excl. pipeline imports)	1.3	1.0	1.4	1.8	1.5
In millions of U.S. dollars	132	109	161	198	183
	(In percent of GDP)				
General government					
Total revenue and grants	15.4	15.2	16.3	15.8	15.6
o/w Tax revenue	13.8	14.2	14.3	14.4	14.4
Total expenditure and net lending	22.1	19.2	18.3	17.8	18.4
o/w Current expenditure	20.0	18.2	16.5	15.7	16.6
Primary balance	-3.9	-1.0	-0.2	0.0	-0.7
Fiscal balance, commitment basis	-6.7	-4.0	-2.0	-2.0	-2.9
Net change in expenditure arrears	...	1.4	0.2	-0.4	1.2
Statistical discrepancy	...	0.1	0.1	0.5	0.5
Fiscal balance, cash basis	-5.0	-2.6	-1.6	-1.9	-1.1
Financing	5.0	2.6	1.6	1.9	1.1
Privatization	0.9	0.3	0.1	0.2	0.3
External	1.7	0.0	1.9	1.8	0.9
Domestic	2.3	2.2	-0.4	-0.1	0.5
Adjustment for net withheld Adjara transfers 1/	0.0	0.0	0.0	0.0	-0.6
External sector					
Trade balance	-19.1	-13.0	-15.2	-12.9	-17.6
Trade balance excluding pipeline-related imports	-19.1	-13.0	-15.2	-12.6	-12.0
Current account balance					
Excluding transfers	-14.3	-11.2	-13.6	-11.4	-16.5
Including transfers	-7.8	-4.4	-6.5	-6.0	-10.1
Net change in external arrears	2.0	2.2	0.2	0.0	1.2
External debt	60.9	53.0	53.5	54.8	48.0

Sources: Georgian authorities; and IMF staff estimates.

1/ For 2003, deposits by the government of Adjara at commercial banks that reflect withheld tax revenues are excluded from net financing of the government.