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Georgia: First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criterion—Staff Report; Staff Statement; Press Release; and Statement by the Executive Director for Georgia

In the context of the first review under the three-year arrangement under the Poverty Reduction and Growth Facility and request for a waiver of a performance criterion with Georgia, the following documents have been released and are included in this package:

- the staff report for the first review under the three-year arrangement under the Poverty Reduction and Growth Facility and request for waiver of performance criterion, prepared by a staff team of the IMF, following discussions that ended on October 24, 2004, 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 December 3, 2004. 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 December 20, 2004 updating information on recent developments.

- a Press Release summarizing the views of the Executive Board as expressed during its December 20, 2004 discussion of the staff report that completed the review and request.

- a statement by the Executive Director for Georgia.

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

Letter of Intent sent to the IMF by the authorities of Georgia*
Supplementary Memorandum of Economic and Financial Policies by the authorities of Georgia*

*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.

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

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INTERNATIONAL MONETARY FUND

GEORGIA

First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criterion

Prepared by the Middle East and Central Asia Department

Approved by Julian Berengaut and Carlos Muñiz

December 3, 2004

- Discussions for the first review under the PRGF arrangement were held in Tbilisi during July 23–August 2 and October 11–October 24, 2004. The staff team comprised Messrs. Neuhaus (head), van Selm, Billmeier (all MCD), Hajdenberg (FAD), and Staines (PDR). Mr. Gershenson (FIN) participated in the July mission and Mr. Ding (MCD) in the October mission. Mr. Christiansen, Resident Representative, assisted the mission. The team cooperated with overlapping World Bank missions.

- Georgia's three-year PRGF arrangement was approved on June 4, 2004 (EBM/04/53), releasing a first disbursement of SDR 14 million.

- Staff met with Prime Minister Zhvania, the Speaker of Parliament, the Ministers of Finance, Economic Development, and Energy, the President of the National Bank of Georgia, other senior government officials, and members of parliament.

- The attached letter from the authorities and their Memorandum of Economic and Financial Policies (attachments I and II) set out the authorities' economic program for the remainder of 2004 and 2005. The authorities have requested completion of the first review, a waiver for nonobservance of an end-June 2004 structural performance criterion (on issuance of a strategy paper to deal with electricity sector legacy debt), and modification of the quantitative performance criteria for end-2004 as indicated in attachment III.

- The authorities are preparing a Poverty Reduction Strategy Paper (PRSP) progress report that will be submitted to the Bank and Fund Boards by end-2004.

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EXECUTIVE SUMMARY

- **The economy has performed very well in 2004**. Growth has remained robust and inflation subdued, against the backdrop of steady remonetization. The improvement in economic fundamentals has brought down treasury-bill yields significantly and mitigated dollarization.

- **Performance under the PRGF-supported program has been encouraging, underpinned by strong fiscal results**. All quantitative performance criteria (PCs) and most indicative targets through September 2004 were met. Rapid growth in fiscal revenue—thanks to an anti-corruption drive and improved administration—has permitted a faster-than-expected clearance of domestic arrears. A waiver for nonobservance of a June structural PC on energy sector legacy debt is requested, since the issuance of a strategy paper to deal with that problem was delayed for technical reasons.

- **The authorities have set more ambitious quantitative PCs for end-December 2004** in light of the strong performance to date, and they have agreed upon indicative targets through June 2005, to be firmed up as PCs during the second review discussions early next year.

- **The new government has received strong donor support**, and in July, Paris Club creditors restructured Georgia's debt in arrears and maturities due from June 2004 to December 2006 on extended Houston terms.

- **Policy discussions focused on tax reform and the draft 2005 budget,** as well as the broad macroeconomic outlook for 2005 and the reform agenda going forward. Parliament is expected to vote shortly on a tax reform bill designed to streamline the tax code and encourage investment. In 2005, the authorities will seek to further consolidate the fiscal position, improve the quality of expenditure, and eliminate domestic arrears. Staff considered the proposed fiscal stance for 2005 as sound and consistent with macroeconomic stability, but cautioned about the implications of new expenditure initiatives for longer-term fiscal sustainability.

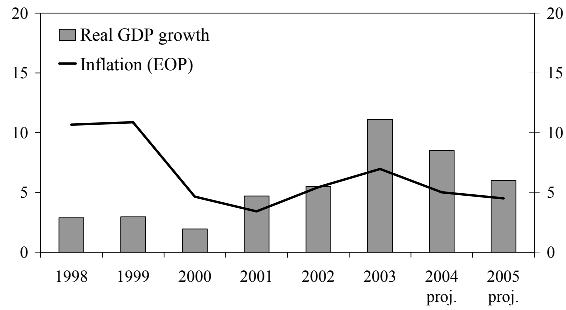
- **Structural reforms will continue to be geared toward consolidating the fiscal position, deepening financial sector reforms and, more generally, improving growth prospects, social protection and provision of basic services.** The authorities expect to articulate specific sector strategies in the coming months, ahead of the second review discussions in early 2005.

- **Despite important achievements so far, Georgia remains vulnerable to domestic and external shocks**. The main near-term risks might come from an unforeseen deterioration in the external environment, a rekindling of tensions over its breakaway provinces, or a weakening in domestic support for prudent macroeconomic policies and reforms that challenge vested interests.

I. Recent Economic Developments and Performance Under the Program

1. **Economic activity remained buoyant in 2004** (Table 1 and Figure 1). Preliminary estimates show output growth of 8.4 percent year-on-year during the first three quarters of 2004, led by manufacturing, telecommunications, and construction. However, this partly reflects the inclusion of previously unrecorded activities in the national accounts, as suggested by an unusually rapid increase in sales of the largest private companies.

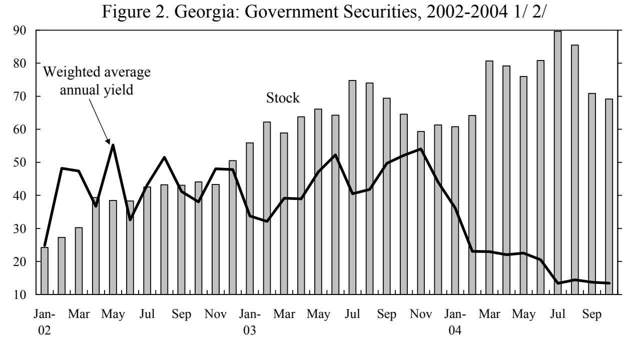
Figure 1. Georgia: Inflation and Real GDP, 1998-2005
(In percent)



Sources: Georgian authorities; and Fund staff estimates.

2. **Strong fiscal results have underpinned compliance with the program's quantitative performance criteria (PCs) and indicative targets through September 2004 (except for reserve money)** (Attachment III). Preliminary returns show an overall fiscal surplus on a commitments basis of 2.1 percent of GDP at an annual rate during the first three quarters of 2004, compared with a deficit of 1.8 percent during the same period in 2003 (Table 2). Thanks to a drive to curb evasion, tax receipts have risen by 37.3 percent year-on-year through October. Together with a one-off surge in non-tax revenue (partly stemming from monies collected from former government officials suspected of corruption), this has permitted a faster-than-expected clearance of domestic wage and pension arrears and a temporary buildup in government deposits at the central bank. In light of the half-year overperformance, parliament approved a supplementary 2004 budget in August, setting more ambitious limits for the fiscal deficit, while raising appropriations for defense, internal security and energy outlays. This fiscal turnaround and a related rebound in investor confidence have brought treasury-bill yields down to 14 percent in mid-November, from a peak of 77 percent in October 2003 (Figure 2).

Figure 2. Georgia: Government Securities, 2002-2004 1/ 2/



Sources: Georgian authorities; and Fund staff estimates.
1/ Compounded annual rate based on monthly rate for 3-month maturities.
2/ Outstanding stock of T-bills in millions of lari, end of period at settlement price.

3. **Parliament is expected to vote by end-2004 on the tax reform and tax write-off bills proposed by the government.** The tax code would be streamlined, reducing the number of taxes from 21 to 8, cutting the VAT rate from 20 percent to 18 percent and the payroll tax rate from 33 percent to 20 percent, and setting a flat 12 percent personal income tax rate replacing marginal rates between 12 percent and 20 percent. The revenue loss (estimated at 3½ percent of GDP) would be more than offset by raising excise tax rates on oil and tobacco products, liquor, and automobiles (with an annual yield of 0.9 percent of GDP), broadening the tax base by reducing exemptions and moving to power sector taxation on an

accrual basis (1.6 percent), and further enhancing revenue administration (1.3 percent); these latter gains largely reflect the full-year effect of reforms undertaken in 2004 (Box 1). To encourage legalization of the informal economy, a one-off tax write-off would be granted on undeclared tax obligations incurred by end-2003, and regularization of undeclared property would be authorized against payment of a one-time levy of 1 percent on the value of property.

Box 1. Georgia: Revenue Administration and Public Expenditure Management

In 2004, the authorities revamped tax and customs administration, securing impressive revenue gains. They also began to reform public expenditure management and treasury operations.

Revenue Administration

Measures already implemented include: (i) establishment of an excise tax inspectorate to bolster collections and a financial police; (ii) reduction in the number of inland tax and customs regional offices, accompanied by staff retrenchments; and (iii) integration of the Road Tax administration and the Adjaran tax organs into the national tax department. To encourage legalization of the informal economy, the government expects approval in 2004 of a one-time tax write-off bill.

In 2005, the authorities plan to: (i) re-register existing and register new taxpayers to pinpoint areas of non-compliance and establish recoverable amounts of tax arrears; (ii) establish arbitration courts to expedite resolution of tax disputes; (iii) align the Georgian customs code with international conventions and with EU and neighboring countries' legislation; and (iv) create a tax ombudsman to protect taxpayers' rights.

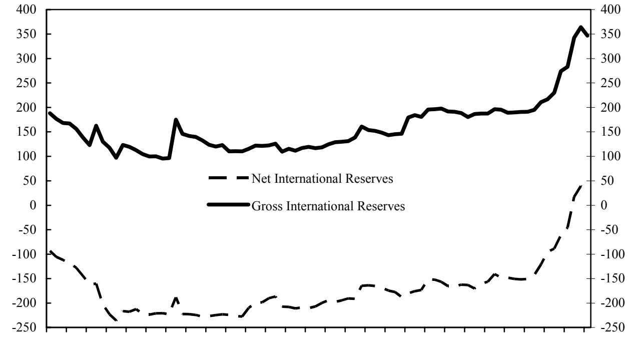
Treasury operations and public expenditure management

Measures already implemented include: (i) effective introduction of a single revenue treasury account and closure of revenue accounts at commercial banks; (ii) extension of commitments controls to extrabudgetary funds; and (iii) transfer of VAT refunds to the treasury, making them fully operational.

The authorities are developing a medium-term expenditure framework, strengthening links between sectoral strategies and the EDPRP; building up forecasting capacity in the Ministry of Finance; and enhancing the ability of spending units to set spending priorities and to cost and evaluate their programs. They also plan to introduce further treasury reforms to (i) establish a treasury single account; (ii) enhance cash planning and management systems; and (iii) review commitments controls procedures.

4. **Against the backdrop of steady remonetization, inflation has remained subdued** (7.7 percent in the 12-months to October, but only 3.1 percent at an annualized rate in the first 10 months of the year). Reserve money grew by 26.6 percent year-on-year in October, significantly overshooting the year-end target, while gross foreign reserves increased to US$347 million (2 months of projected non-pipeline imports)

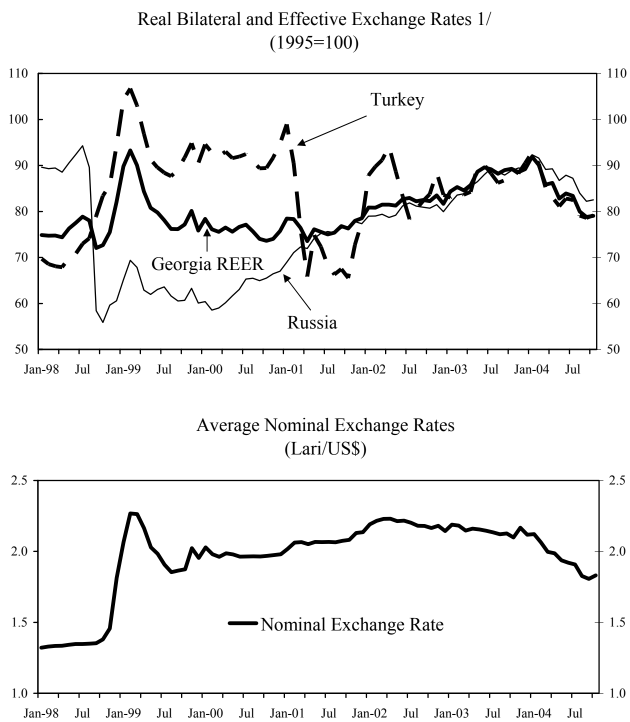
Figure 3. Georgia: International Reserves, 1998 - 2004
(Million US$)



Sources: Georgian authorities; and Fund staff estimates.

(Tables 3 and 4 and Figure 3). Leaning against a strengthening of the lari, the NBG conducted significant foreign exchange intervention well into the third quarter. The bulk of the intervention was unsterilized until early September, when the NBG began to curtail liquidity expansion through deposit and credit auctions, and subsequently through an effective increase in reserve requirements on foreign-currency deposits. Despite the NBG's intervention, the lari has appreciated by an estimated 13 percent both vis-à-vis the U.S. dollar and in real effective terms since end-2003 (Figure 4).

Figure 4. Georgia: Exchange Rate Developments, 1998-2004



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

5. **The health of the banking system has improved in recent years.** Closure of weak institutions has reduced the number of banks to 22, from 25 at end-2002. The share of banks rated CAMEL 3 or worse has fallen since early 2002 and the ratio of nonperforming to total commercial bank loans has dropped from 7.5 percent at end-2003 to 5.4 percent at end-October 2004 (Table 5). As of September 2004, however, 9 banks comprising one-tenth of total bank assets were rated CAMEL 3 or worse. To foster consolidation and create a sound basis for credit expansion, the authorities have announced a phased increase in minimum capital requirements of commercial banks from GEL 5 million to GEL 12 million (US$6.5 million at current exchange rates) by end-2008.[1]

6. **The new government has received strong international financial support (Tables 6-9).** The June donors' conference in Brussels yielded US$1.1 billion in aid pledges (of which two-thirds as grants). Major donors include the World Bank, which has pledged US$235 million, the United States (US$360 million), and the EU (US$160 million); the bulk of these resources would support investment and be disbursed by 2007. The U.S. Millennium Challenge Corporation is expected to decide in the first half of 2005 on Georgia's request for a sizable grant, including the timing and amount of the first disbursement. In July, Paris Club creditors restructured US$161 million in arrears and maturities due from June 2004 to

[1] Existing banks must raise capital by GEL 1.4 million a year, but new entrants' minimum capital is set at GEL 12 million from the outset.

December 2006 on extended Houston terms, with the understanding that Georgia would seek rescheduling on comparable or better terms from commercial and other official bilateral creditors. One-half of the arrears as of end-May 2004 is to be repaid over three years, while the remainder was rescheduled together with the future maturities just mentioned. Negotiations on bilateral agreements with Paris Club creditors are well advanced and the government has already approached other official non-Paris Club creditors to initiate discussions.

7. **The authorities have made progress with structural reform, albeit with delays** (Attachment IV). In the **energy sector**, they are pursuing a multi-pronged approach to reduce quasi-fiscal losses, rehabilitate and expand capacity, and tackle domestic legacy debt.[2] Electricity cash collection rates from major groups of customers have broadly trended up and collections under the Tbilisi gas utility's new management have begun to improve. Staff projects a decline in the energy sector's quasi-fiscal losses to 4.5 percent of GDP in 2004, from 4.9 percent in 2003 (Table 10). The authorities have made basic repairs to normalize power supplies and mitigate winter shortages, at a cost of US$17 million in 2004, and in June they secured approval of moratorium legislation for the sector's legacy debt. Preparation of a strategy paper dealing with this debt (a structural PC for end-June) was delayed for technical reasons until September (the authorities are requesting a waiver for noncompliance). In October, a consultant group financed by Germany's KfW started drafting legislation to establish a Debt Restructuring Agency (DRA). Besides preparing a reliable and updated database on legacy debts, the DRA is expected to propose specific modalities to settle them, possibly including cancellation of reciprocal claims of public entities, write-offs of unrecoverable debts, reduction in penalty interest and fines, and restructuring of certain debts. The government has announced an ambitious **privatization program** (see below), drawing in part on past audits of several major parastatals. In August, the government established a Civil Service Council tasked with coordinating **civil service reform**, and in October it defined the mandate of the council and its implementing arm (the Civil Service Bureau). Public employment has been reduced by 30,000 positions (23 percent of the public workforce) in 2004, mainly in the defense, internal security and finance ministries, and salary savings have been used to improve remuneration of remaining personnel. Furthermore, additional reforms in **tax administration and expenditure management** will continue to underpin fiscal consolidation.

8. **Living standards appear to be improving, yet poverty remains widespread** (Table 11). Half-year data show a declining share of the population living under the

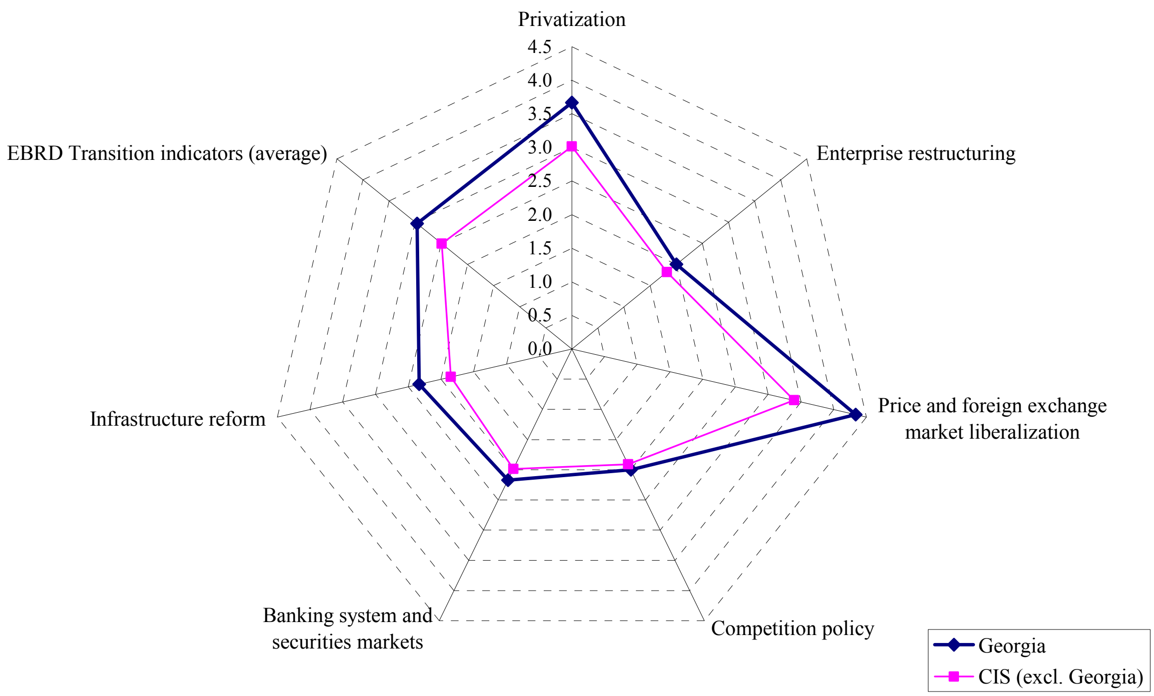
[2] At end-2002, legacy debt comprised an estimated GEL 1.1 billion in past obligations that cannot be serviced in light of the short- and medium-term cash flow prospects of the energy sector. The bulk of these obligations arose from low cash collection rates in the sector and from capitalization of penalty interest and fines (for details, see Chapter II of the 2003 Selected Issues paper on Georgia (IMF Country Report No. 03/347)).

minimum subsistence level (about US$30 a month) to 51.4 percent, from 55.7 percent in the first half of 2003. Income distribution measured by Gini consumption coefficients improved slightly in 2003 but changed little in the first half of 2004.

II. Policy Discussions and Program Through June 2005

9. The authorities expressed satisfaction with the strong improvement in economic fundamentals and the reforms initiated on several fronts. Going forward, the authorities expected agriculture, food processing, tourism and transit trade activities to be the leading growth sectors after oil and gas pipeline construction tapers off. Altogether, Georgia's transition process compared favorably with other CIS countries, as suggested by the latest EBRD's Transition Report (Figure 5). Staff encouraged the authorities to specify their reform agenda more fully in the coming months, ahead of discussions for the second PRGF review in early 2005.

Figure 5. EBRD Transition Indicators, 2004



10. Based on growth and inflation results to date, the outlook is for real GDP growth of 8½ percent and end-period inflation of 5 percent in 2004, with gross official reserves stable at 1.9 months of non-pipeline imports. For 2005, the budget assumes 6 percent output growth (partly driven by pipeline construction) and inflation around 5 percent. The external current account deficit would widen to 8.1 percent of GDP, from 7.5 percent in 2004, partly because of the full-year effect of higher world oil prices, and would be financed mostly by private

capital inflows. Gross reserves would remain unchanged relative to imports. The authorities are proposing modifications to the end-December 2004 quantitative PCs in light of the strong performance to date. Ahead of setting quantitative PCs for 2005 during the second review discussions early next year, they have also specified indicative targets for the same aggregates through end-June 2005 (Attachment III).

A. Fiscal Policy

11. The government has secured a faster than envisaged turnaround in its finances, from a commitments deficit of 2½ percent of GDP in 2003 to an estimated surplus of 0.7 percent in 2004 (versus a deficit of 1½ percent in the program). A sharp increase in tax receipts stemming from the anti-corruption drive and improved administration were major contributing factors, permitting some increase in expenditure and clearance of the bulk of domestic wage and pension arrears ahead of schedule (Table 2). Also, the government's room for fiscal maneuver has increased as a result of its strong parliamentary majority, constitutional amendments in February 2004 regarding budgetary procedures,[3] and a two-year suspension of severance payments for retrenchments from December 2003. The authorities plan to take important additional steps in 2005 and beyond, with international advice, to upgrade the legal and institutional framework for tax and customs administration, public expenditure management, and treasury operations (see Box 1 and paragraph 20 of the MEFP). FAD and the World Bank will assist on public expenditure management and a resident FAD treasury advisor will be stationed next year.

12. In 2005, the authorities are seeking to further consolidate the fiscal position, improve the quality of expenditure and clear the remaining domestic arrears (paragraph 14 of the MEFP). On the revenue side, assuming the tax reform bill before parliament is passed without major modifications, the tax effort would rise slightly to 18 percent of GDP (compared with the 17.3 percent target for 2005 projected at the inception of the program). On the expenditure side, a large number of budgetary organizations, especially in the education and culture sectors, will be transformed into *legal entities of public law* (LEPLs) under supervision of their line ministries (paragraph 20 of the MEFP); these entities, which currently employ 50,000 persons, will enjoy operational and financial autonomy, though still receiving budgetary transfers. Staff had originally proposed gradual tax cuts because of the large unmet needs for core spending, and also questioned the reduced progressivity stemming from the proposed flattening of personal income taxes. Staff also cautioned about potential moral hazard from the proposed tax write-off bill.

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[3] Parliament is now entitled only to an *up-and-down* vote on the budget and may be dissolved if it rejects the government's budget bill three consecutive times.

13. The central government wage bill allows for a large increase in remuneration from its low starting level.[4] Minimum wages would be brought to GEL 115 (about US$65) a month and salaries for middle- and upper-level officials would rise significantly to attract and retain competent civil servants and discourage corruption. The authorities will raise monthly pensions (which had been gradually increased from GEL 14 in recent years to GEL 18 in 2004) to GEL 28 (US$15) from January 2005, at an estimated cost of 0.8 percent of GDP a year, and they will also convert in-kind social benefits to vulnerable groups into cash. The authorities also envisage the introduction in late 2005 of a streamlined, means-tested poverty benefit targeted to the 600,000 most needy, which would cost about 0.7 percent of GDP a year when it becomes fully operational (paragraph 26 of the MEFP). Capital outlays would increase somewhat, with a significant foreign-financed component. The overall commitments deficit would be limited to 0.3 percent of GDP (the cash deficit to 1.9 percent), and domestic deficit financing (excluding privatization) would be modest.[5] Staff considered the proposed fiscal stance for 2005 as sound and consistent with macroeconomic stability, but cautioned about the implications of new expenditure initiatives for longer-term fiscal sustainability.

B. Monetary and Financial Sector Policies

14. The authorities viewed the faster-than-expected growth in monetary aggregates during 2004 mostly as demand-driven, prompted by the fiscal turnaround and the anti-corruption campaign under the new government. The officials also saw considerable scope for further financial deepening in Georgia, as the ratio of broad money to GDP was relatively low compared to strong performers in the region. However, recognizing the downside risk of missing their end-year inflation target, the NBG had decided to curtail liquidity expansion later in the year. The authorities noted that, if government deposits at the NBG were to be drawn down during the fourth quarter to the full extent allowed in the program, they stood ready to stabilize liquidity through credit and deposit auctions. The indicative monetary program for 2005, framed on conservative assumptions on remonetization and dollarization trends, limits reserve money growth to 18 percent during the year and keeps gross reserve coverage relative to imports broadly unchanged (Tables 3 and 4 and paragraph 16 of the MEFP). While additional capital repatriation may be expected as confidence rebounds and legalization of the informal economy continues, the NBG plans to limit its foreign exchange intervention to smoothing fluctuations, while further strengthening monetary control instruments with assistance from the Fund's Monetary and Financial Systems Department.

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[4] The minimum wage prevailing in 2003 was GEL 20 (US$9.30) a month, besides in-kind benefits that are being converted into cash. The government wage bill in Georgia is projected at 3.4 percent of GDP in 2004, which is low by regional standards.

[5] The resource envelope could be augmented if sizable asset sales under consideration materialize and agreement is reached on grants from the U.S. Millennium Challenge Corporation. The scope for receiving these monies in 2005 and their prospective use by the budget will be assessed during the second PRGF review in early 2005.

Staff urged the government to enhance the de facto autonomy of the NBG. It welcomed the decision to limit NBG credit to the government from 2005 onwards to treasury-bill purchases, and recommended the phased conversion of part of NBG claims on government into tradable securities, both for monetary policy purposes and to diversify investors' portfolio choices. Staff also endorsed the recommendations of a recent MFD advisory mission, including to improve the framework for liquidity forecasting, develop a secondary market for government securities, and equalize reserve requirements on foreign and local-currency deposits over time as dollarization abates (requirements are currently higher on foreign currency deposits). Furthermore, staff advised the authorities to start laying the foundations for the eventual introduction of a deposit insurance system.

C. Structural Reforms

15. The authorities indicated that, besides the above steps to strengthen the fiscal framework and modernize the financial system, the overarching goals of structural reforms under their Fund-supported program are to consolidate the fiscal position, as well as to enhance growth prospects, social protection and the provision of basic services. Energy sector reforms, in particular, would seek to reduce the sector's quasi-fiscal losses and provide reliable power supplies (paragraph 22 of the MEFP). Moreover, public sector operations would be overhauled through (i) divestiture or operational improvements in state-owned enterprises (SOEs); (ii) second-generation civil service reforms; and (iii) steps to improve governance, streamline the regulatory environment, and enhance the business climate (see Box 2 and paragraph 23 of the MEFP). The government has initiated discussions with the World Bank on a Poverty Reduction Support Credit (PRSC), focusing on improvements in governance and public sector operations; reforms in the energy sector; human development and social protection (including a reform of the pension system to be introduced in the next few years); and private sector development (Appendix II). Board consideration of the proposed PRSC is tentatively planned for July 2005.

16. In the energy sector, the authorities saw the extension of metering and the proposed increase in fines for electricity theft as factors helping enhance payments discipline (paragraph 22 of the MEFP). Several power rehabilitation projects are being completed, reducing the chronic need for winter power cuts, and repairs of a major dam starting in spring 2005 should further enhance power supplies. In all, staff sees scope for a further drop in quasi-fiscal losses to 3½ percent of GDP in 2005. Going forward, a review of the tariff methodology under way with World Bank assistance should eventually permit introduction of an updated tariff structure at cost-recovery levels by mid-2006.

17. Since the government's SOE strategy has evolved towards faster divestiture and deregulation, the Enterprise Management Agency is shifting from managing companies as going concerns to preparing them for privatization or, at least, private equity participation and management contracts. Performance-based contracts conducive to early privatization are being agreed with management of major companies and recommendations of recent enterprise audits pursued. The authorities envisage divestiture or liquidation of the bulk of the 1,800 public enterprises employing 180,000 persons during 2005-06. Most SMEs would

be sold as soon as feasible, while government articulates plans for handling larger companies in the energy, transport, and telecommunications sectors, in step with enabling legislative and regulatory amendments. The authorities are considering a streamlining of the regulatory framework for utilities and natural monopolies, but indicated that the energy sector regulatory body will continue to enjoy technical and operational autonomy, including in setting energy tariffs.

Box 2. Georgia: Business Climate and Governance Issues

The 2002 World Bank and EBRD Business Environment and Enterprise Performance Survey for Georgia identified corruption, tax policy and administration, customs administration, and frequent power outages as major weaknesses. A company survey conducted by the Georgia Enterprise Growth Initiative in spring 2004 confirmed these results, identifying the complexity and ambiguity of the tax code, corruption of Customs, and proliferation of business permits as the main hurdles. The latest Transparency International survey ranked Georgia 133 out of 146 countries in its 2004 *Corruption Perception Index*, scoring 2 on a scale from 10 (clean) to 0 (highly corrupt), but these results must be interpreted cautiously, since the latest index is partly based on surveys completed in 2002-03 under the previous government.

The main dimensions of the new government's drive to stamp out corruption have been prosecution of former government officials suspected of corruption; revamping of the tax and customs departments; and retrenchment of internal law enforcement agencies to rid them of corrupt agents and discourage bribe-taking. Moreover, the government has initiated a review of regulatory agencies and simplified tax and customs procedures.

Other actions already taken or envisaged in 2005 include:

- Passage of a tax reform, accompanied by improvements in the operations of the inland tax office and Customs (see Box 1);
- Implementation of an action plan to divest SOEs, regularly audit companies with annual turnover exceeding US$5 million, and simplify the regulatory environment;
- Implementation of second-generation civil service reforms (after retrenchment of 35,000 positions in 2004-05) to create a professional and well-remunerated civil service;
- Formulation of a judicial reform to expedite procedures and enhance the enforceability of contracts; and
- Steps to combat money laundering, including ratification of the Strasbourg Convention and creation of a Financial Monitoring Services agency to track large or suspicious transactions.

18. The authorities noted that significant downsizing in the civil service and sacking of corrupt officials since early 2004 had been the cornerstones of the drive to improve governance. The fiscal cost of retrenchments had been negligible as a result of 2003 legislation temporarily suspending severance payments. The new cabinet system chaired by a Prime Minister introduced early this year had improved coordination and expedited reforms. The authorities are now poised for second-generation civil service reforms. An additional 5,000 retrenchments are slated for 2005 and emphasis will be placed on creating a

professional and efficient civil service, upgrading remuneration and harmonizing it across all branches of the central government, and introducing norms and regulations that ensure transparency and accountability of officials.

D. Trade Policy

19. Georgia joined the World Trade Organization (WTO) in 2000, and the authorities reiterated their commitment to an open trade regime. They noted, however, that for a variety of reasons they needed more time to forge a consensus on trade liberalization and would therefore not be able to dismantle the 2002 protectionist measures as envisaged in the program (a structural benchmark for end-December 2004). Under the terms of Georgia's WTO accession, the number of tariff bands will be reduced in any event from 21 in 2004 to 16 as of January 2005. The government will establish an inter-ministerial working group later this year chaired by the Minister of Finance, tasked with preparation by early 2005 of a concept paper on trade liberalization and drafting of enabling legislation by April 2005 proposing a significant reduction in tariff bands and in the maximum tariff rate (paragraph 24 of the MEFP).

E. Other Issues and Program Risks

20. The authorities are preparing a status report on implementation of their poverty reduction strategy, which they plan to submit to the Boards of the Fund and the World Bank by end-December 2004. To foster transparency, they plan to participate in the Fund's General Data Dissemination System in the near future. Staff encouraged the authorities to request further STA assistance to improve price and national accounts data.

21. Despite the important achievements under the program described earlier, Georgia remains vulnerable to external shocks because of its high external debt burden and limited economic diversification. As it continues to tackle these issues, the main near-term risks in the outlook might come from an unforeseen deterioration in the external environment, a rekindling of tensions over Georgia's breakaway provinces, or a weakening in domestic support for prudent macroeconomic policies and reforms challenging entrenched vested interests. These risks could be eased to an extent by continued international efforts towards peaceful resolution of territorial disputes and, on the domestic front, by more systematic efforts to explain the rationale for the government's economic strategy.

III. Staff Appraisal

22. The new administration inherited a legacy of fiscal disequilibria, stalled reforms, and widespread corruption. Progress in addressing these issues in 2004 under the Fund-supported program has been impressive. All quantitative performance criteria and most indicative program targets through September have been met by wide margins, and the authorities are proposing modifications to the end-December 2004 targets to make them more ambitious. Thanks to prudent macroeconomic policies and a drive to strengthen tax enforcement, the fiscal situation has improved significantly, permitting a faster-than-expected clearance of

domestic arrears. Real GDP has risen rapidly (although partly because of increased legalization of the informal economy), inflation has been kept in check, and official foreign reserves have increased to a more comfortable level.

23. Despite some delays, the authorities have also made good progress in the structural area, starting to tackle deep-seated problems in the energy sector, retrenching the civil service, and announcing an ambitious privatization program. Georgia has received strong expressions of international support, including a Paris Club rescheduling on extended Houston terms, significant new aid pledges at a donors' meeting in mid-2004, and eligibility for grants from the U.S. Millennium Challenge Corporation.

24. Staff has reached understandings on the broad elements of the authorities' economic policies and reform agenda for 2005, including quarterly indicative targets through June 2005. The proposed fiscal stance (limiting the commitments fiscal deficit to 0.3 percent of GDP), in particular, would continue to underpin economic stability and foster sustained growth in a low-inflation environment. Macroeconomic and structural policies will be discussed in greater detail during the second program review in early 2005, and translated at that time into quarterly performance criteria and benchmarks.

25. Going forward, the government needs to define more clearly the public sector's role in the economy and the corresponding tax effort, and to communicate its vision more cogently to civil society. In light of pressing demands for enhancing social protection and infrastructure, staff had initially recommended that tax rates be cut gradually and questioned the reduced progressivity stemming from the proposed flattening of personal income taxes, although it recognized that lower rates would help in the fight against evasion. Staff had also cautioned about potential moral hazard from the proposed tax write-off legislation. The decision to introduce the cuts upfront in January 2005 constrains the longer-term spending envelope consistent with fiscal sustainability, although one-off privatization receipts and the new grant disbursements will likely provide some breathing space in the next few years. Tax cuts also highlight the need to persevere in strengthening tax and customs administration and further improving public expenditure management.

26. Prospects for significant official and private capital inflows in coming years call for greater exchange rate flexibility to enhance monetary control. Meanwhile, competitiveness should be safeguarded by productivity gains spurred by structural reforms and by wage moderation. The NBG has now developed a broad menu of indirect monetary instruments to which it can resort more effectively. It should also continue its commendable efforts to strengthen the financial system, including by closing weak institutions and encouraging mergers. Furthermore, longer-term macroeconomic stability and confidence would be bolstered by formalizing the NBG's de facto autonomy.

27. In the structural area, there is a need for a comprehensive strategy for second-generation reforms. This would also enhance domestic ownership and donor support and pinpoint capacity bottlenecks. Besides the ongoing initiatives to strengthen fiscal and financial institutions, the authorities are urged to continue reducing energy sector quasi-fiscal

deficits while expanding capacity, as well as retrenching employment and deepening the civil service reform. To enhance the investment climate, it will be important to ensure due process in prosecuting individuals suspected of irregularities, while reducing bureaucratic obstacles to private activities. Staff welcomes the decision to expedite privatization and stresses the importance of transparency in divestiture procedures and use of privatization receipts. The streamlining of the regulatory framework for strategic sectors or natural monopolies that is under consideration could play a positive supporting role, but care needs to be taken to ensure that regulatory bodies are technically competent and insulated from political pressures.

28. The government has indicated that, because of the heavy legislative and reform agenda during its first year in office, it will not be able to dismantle certain protectionist measures by end-2004 as envisaged in the program. In keeping with its strategy of fostering private sector-led growth and Georgia's integration into the world economy, the government would be advised, nonetheless, to forge a consensus for significantly reducing the number of tariff bands and the maximum tariff rates and to consider a move to a low uniform tariff, thereby also discouraging rent-seeking and easing customs administration.

29. The authorities should pursue their plans to introduce a targeted, means-tested poverty benefit with assistance from the World Bank as soon as sustainable fiscal resources are identified. The ongoing update of the poverty reduction strategy designed by the previous government will provide a timely opportunity to secure broad support from civil society, while continuing to improve the links between the PRSP and budgetary processes.

30. In sum, the authorities have made a very good start in strengthening Georgia's economic fundamentals and launching structural reforms. On this basis, together with sound indications regarding the main elements of the official macroeconomic and reform plans for 2005, staff supports the authorities' request for completion of the first review under the PRGF arrangement. Much remains to be done, nonetheless, and the government needs to persevere in its adjustment drive to continue eliciting strong domestic and international support. Given the large imminent tax cuts, it will be prudent to refrain from major new spending initiatives that could jeopardize longer-term fiscal sustainability, while further bolstering receipts through better tax administration and upgrading expenditure management. In the coming months, the authorities also need to forge a broad domestic consensus and flesh out a detailed roadmap for second generation reforms.

Table 1. Georgia: Selected Macroeconomic Indicators, 2000-2005
(Per capita GDP: US$1,131)

	2000	2001	2002	2003	2004		2005	
					Program	Rev. Proj.	Program	Proj.
	(Annual percentage change, unless otherwise indicated)							
National accounts								
Nominal GDP (millions of lari)	6,013	6,638	7,448	8,565	9,422	9,758	10,388	10,809
Nominal GDP (US$ million)	3,043	3,202	3,392	3,984	4,382	4,879	4,556	5,843
Real GDP	1.9	4.7	5.5	11.1	6.0	8.5	5.0	6.0
Consumer price index, period average	4.0	4.7	5.6	4.8	5.8	5.8	5.0	4.8
Unemployment rate	10.3	11.1	12.3	11.6	...	12.4	...	11.8
Poverty rate	51.8	51.1	52.1	54.5	...	...	...	...
	(In percent of GDP, unless otherwise indicated)							
Investment and savings								
Investment	21.6	21.9	22.0	24.4	26.6	29.0	27.6	28.9
Public	1.0	1.8	2.0	1.7	3.2	2.4	3.2	2.8
Private	20.6	20.1	20.0	22.7	23.4	26.6	24.4	26.1
Gross domestic saving	17.3	15.5	16.2	17.2	17.0	21.4	18.0	20.8
Public	-3.0	-0.2	0.1	-0.7	1.6	3.1	2.5	2.5
Private	20.3	15.7	16.2	17.9	15.4	18.3	15.5	18.3
Savings-investment balance	-4.3	-6.4	-5.8	-7.2	-9.6	-7.5	-9.6	-8.1
Budgetary operations								
Total revenue and grants	15.2	16.3	15.8	16.2	19.0	20.8	19.7	20.4
Of which: Tax revenue	14.2	14.3	14.4	14.5	16.3	17.6	17.3	18.0
Total expenditure and net lending	19.2	18.3	17.8	18.7	20.5	20.0	20.3	20.7
Of which: Current expenditure	18.2	16.5	15.7	17.0	17.3	17.6	17.2	17.9
Primary balance	-1.0	-0.2	0.0	-0.4	0.5	2.3	1.1	0.8
Fiscal balance, commitment basis	-4.0	-2.0	-2.0	-2.5	-1.6	0.7	-0.6	-0.3
Net change in expenditure arrears	1.4	0.2	-0.4	1.4	-1.0	-2.6	-1.4	-1.6
Statistical discrepancy	0.1	0.1	0.5	-0.3	...	...	...	...
Fiscal balance, cash basis	-2.6	-1.6	-1.9	-1.3	-2.6	-1.8	-2.0	-1.9
Financing	2.6	1.6	1.9	1.3	2.6	1.8	2.0	1.9
Privatization	0.3	0.1	0.2	0.3	0.3	0.9	0.3	1.1
External 1/	0.0	1.9	1.8	1.0	2.0	0.8	1.3	0.4
Domestic	2.2	-0.4	-0.1	0.6	0.3	0.1	0.4	0.4
Adjustment for net withheld Adjara transfers 2/	0.0	0.0	0.0	-0.7	0.0	0.0	0.0	0.0
	(Annual percentage change, unless otherwise indicated)							
Monetary sector								
Reserve money	26.8	9.9	18.4	13.9	14.0	25.0	...	18.0
Broad money (including foreign exch. deposits)	39.0	18.5	17.9	22.8	19.5	27.0	18.2	21.0
Velocity of broad money, level	9.7	9.1	8.6	8.1	7.4	7.2	6.9	6.6
	(In millions of U.S. dollars, unless otherwise indicated)							
External Sector								
Exports of goods and services (percent of GDP)	36.0	30.4	30.2	33.2	28.6	35.5	29.5	31.9
Annual percentage change	48.2	-11.1	5.5	28.9	5.9	31.2	7.4	7.5
Imports of goods and services (percent of GDP)	45.3	42.5	40.1	45.6	43.7	49.0	44.3	46.7
Annual percentage change	9.3	-1.2	-0.2	33.7	13.5	31.8	5.5	14.1
Net imports of oil	104	123	131	180	...	242	...	278
Current account balance	-132	-205	-196	-286	-419	-368	-436	-475
In percent of GDP	-4.3	-6.4	-5.8	-7.2	-9.6	-7.5	-9.6	-8.1
External public and publicly guaranteed debt (percent of GDP)	51.3	51.7	52.4	46.2	43.4	36.8	43.4	30.3
Gross international reserves	109	161	198	191	208	320	235	366
In months of imports of goods and services (excl. pipeline imports)	1.0	1.4	1.8	1.5	1.5	1.9	1.6	1.9
Average exchange rate (lari per dollar)	1.98	2.07	2.20	2.15	...	...	...	...

Sources: Georgian authorities; and Fund staff estimates.

1/ External financing for 2004 includes debt relief from the Paris Club.

2/ For 2003, Adjaran claims on commercial banks that reflect withheld tax revenues are excluded from net financing to the government.

Table 2. Georgia: General Government Operations, 2003-2005

	2003 (new BSL clas.)		Q1-Q3		2004 Prog.		2004 Proj.		2005 Proj.		2005 Quarterly Profile			
	million lari	% of GDP	2003 Actual	2004 Prel.	million lari	% of GDP	million lari	% of GDP	million lari	% of GDP	Q1 Proj.	Q2 Proj.	Q3 Proj.	Q4 Proj.
Total revenue and grants	1,391	16.2	989	1,461	1,786	19.0	2,026	20.8	2,207	20.4	508	525	606	568
Total revenue	1,343	15.7	968	1,408	1,630	17.3	1,931	19.8	2,091	19.3	491	503	561	537
Tax revenue	1,245	14.5	912	1,244	1,539	16.3	1,721	17.6	1,946	18.0	433	475	532	507
Taxes on income	179	2.1	109	182	221	2.3	244	2.5	226	2.1	53	56	56	61
Taxes on profits	111	1.3	79	122	128	1.4	152	1.6	228	2.1	45	48	88	48
Social tax 1/	...	...	...	...	...	...	...	...	212	2.0	46	55	55	57
VAT	386	4.5	338	434	511	5.4	601	6.2	762	7.0	177	190	195	200
Customs duties	84	1.0	61	82	91	1.0	116	1.2	112	1.0	26	28	29	30
Excises	110	1.3	68	108	148	1.6	153	1.6	318	2.9	74	80	82	83
Other taxes	123	1.4	92	71	128	1.4	112	1.1	88	0.8	13	18	27	29
Nontax revenue	98	1.1	56	164	91	1.0	211	2.2	146	1.3	58	28	29	30
Of which: NBG profit transfers	15	0.2	15	12	12	0.1	12	0.1	30	0.3	30	0	0	0
Extrabudgetary revenue	254	3.0	167	246	311	3.3	344	3.5	...	...	...	...	...	...
Medical and pension funds 1/	199	2.3	133	192	264	2.8	276	2.8	...	...	...	...	...	...
Road fund 2/	55	0.6	34	53	47	0.5	68	0.7	...	...	...	...	...	...
Grants	48	0.6	21	53	156	1.7	95	1.0	116	1.1	17	22	45	32
Total expenditure and net lending	1,601	18.7	1,145	1,253	1,933	20.5	1,955	20.0	2,242	20.7	511	524	630	577
Current expenditure	1,453	17.0	1,034	1,109	1,632	17.3	1,721	17.6	1,935	17.9	453	450	531	501
Wages and salaries	269	3.1	170	222	315	3.3	327	3.4	439	4.1	110	110	110	110
Goods and services	173	2.0	111	157	193	2.0	240	2.5	362	3.3	70	75	126	91
Transfers and subsidies 3/ 4/	138	1.6	104	112	171	1.8	219	2.2	535	4.9	127	128	133	147
Of which: Energy commitments	30	0.3	29	25	25	0.3	51	0.5	51	0.5	10	10	16	15
Interest payments	178	2.1	130	109	189	2.0	150	1.5	123	1.1	28	32	32	31
Domestic	95	1.1	70	71	99	1.1	100	1.0	79	0.7	19	20	21	19
External	84	1.0	61	38	90	1.0	50	0.5	44	0.4	9	12	11	12
Extrabudgetary expenditures	341	4.0	250	263	378	4.0	391	4.0	...	...	...	...	...	...
Medical and pension funds 4/	288	3.4	216	237	337	3.6	331	3.4	...	...	...	...	...	...
Road fund 5/	53	0.6	34	26	41	0.4	61	0.6	...	...	...	...	...	...
Local government expenditures 6/	354	4.1	269	246	387	4.1	393	4.0	477	4.4	118	106	130	123
Capital expenditure 5/	70	0.8	52	117	209	2.2	199	2.0	244	2.3	44	61	81	58
Of which: Foreign financed	69	0.8	51	78	154	1.6	136	1.4	155	1.4	35	43	42	36
Net lending	78	0.9	58	27	92	1.0	35	0.4	62	0.6	14	12	19	18
Of which: Foreign financed	59	0.7	39	43	135	1.4	77	0.8	74	0.7	18	18	20	18
Overall balance (commitments)	-210	-2.5	-155	174	-147	-1.6	71	0.7	-35	-0.3	-3	1	-24	-8
Adjustment to cash basis	101	1.2	67	-179	-93	-1.0	-250	-2.6	-170	-1.6	-59	-106	-4	0
Net change in expenditure arrears (-, reduction)	124	1.4	59	-183	-93	-1.0	-250	-2.6	-170	-1.6	-59	-106	-4	0
Statistical discrepancy	-23	-0.3	8	5	0	0.0	0	0.0	0.0	0.0	0.0	0.0	0.0	0.1
Overall balance (cash)	-109	-1.3	-88	29	-240	-2.6	-179	-1.8	-204	-1.9	-62	-105	-29	-8
Total financing	109	1.3	88	-29	240	2.6	179	1.8	204	1.9	62	105	29	8
Privatization	30	0.3	25	16	25	0.3	86	0.9	115	1.1	33	37	20	25
Domestic	48	0.6	44	-132	31	0.3	14	0.1	47	0.4	14	25	5	4
Net NBG credit	27	0.3	14	-112	26	0.3	27	0.3	27	0.2	7	15	5	0
Net Commercial banks credit	26	0.3	16	-9	5	0.1	-15	-0.2	20	0.2	7	10	0	4
Nonbank (t-bills and other)	-2	0.0	14	-11	0	0.0	2	0.0	0	0.0	0	0	0	0
External	88	1.0	56	87	184	2.0	79	0.8	43	0.4	16	43	4	-21
Disbursements	137	1.6	87	144	283	3.0	220	2.3	216	2.0	40	85	50	41
Amortization	-159	-1.9	-106	-129	-212	-2.3	-141	-1.4	-174	-1.6	-24	-41	-46	-62
Changes in arrears (-, reduction)	109	1.3	75	-88	-109	-1.2	...	...	0	0.0	...	...	...	...
Macroeconomic support	0	0.0	0	160	222	2.4	...	...	0	0.0	...	...	...	...
Adjustment for net withheld Adjara transfers 7/	-56	-0.7	-37	0	0	0.0	0	0.0	0	0.0	...	...	...	...
Memorandum items:														
Overall balance excluding grants (commitments)	-258	-3.0	-176	121	-303	-3.2	-24	-0.2	-150	-1.4	-21	-21	-69	-40
Cigarette and petroleum tax revenue	138	1.6	97	190	259	2.8	259	2.7	461	4.3	107	115	118	120
Defense spending (cash basis)	...	...	...	77	79	0.8	176	1.8	140	1.3	...	...	...	...
Social spending (commitment basis)	652	7.6	...	...	746	7.9	743	7.6	918	8.5	219	214	241	243
Social spending (cash basis)	607	7.1	...	694	802	8.5	929	9.5	973	9.0	274	214	241	243
Domestic public debt	1,310	15.3	1,253	1,094	1,248	13.2	1,072	11.0	949	8.8	1,026	945	945	949
Domestic arrears	419	4.9	370	236	326	3.5	170	1.7	0	0.0	111	4	0	0
T-bills and debt to the NBG	890	10.4	883	919	922	9.8	902	9.2	949	8.8	915	940	945	949
Nominal GDP (millions of lari)	8,566	100.0	6,156	7,010	9,422	100.0	9,758	100.0	10,809	100.0	2,373	2,681	2,790	2,965

Sources: Georgian authorities and Fund staff estimates.
1/ The Road Fund and Social Security Fund will be eliminated in 2005. Revenue reported in previous years under medical and pension funds is being reported in 2005 as social tax.
2/ Taxes previously collected by the Road Fund have been eliminated.
3/ Excludes transfers from Central Budgets to local budgets.
4/ 2005 transfers and subsidies incorporate spending on health and pensions previously recorded under medical and pension funds.
5/ Starting in 2005 capital spending includes expenditure previously undertaken by the Road Fund and recorded as current spending.
6/ Includes transfers from Central Budget.
7/ In 2003 financing is adjusted by the sum of Adjaran deposits attributable to the withheld tax revenue that Adjara collects on behalf of the central government.

Table 3. Georgia: Accounts of the National Bank of Georgia, 2002-2005

	2002	2003					2004									2005 3/			
	Dec.	Mar.	Jun.	Sep.	Dec.		Mar. 2/		Jun. 2/		Sep. 2/		Dec.			Mar.	Jun.	Sep.	Dec.
	Actual 1/	Actual 1/	Actual 1/	Actual 1/	Actual 1/	Actual 2/	Estimate	Actual	Target	Actual	Target	Actual	Target 2/	Adj. Target 2/	Adj. Target 3/	Quarterly profile			
									(Annual percentage change)										
Net foreign assets	16.7	15.8	22.2	25.2	15.9	17.0	17.5	35.4	13.6	64.1	12.6	123.2	18.8	95.4	100.8	104.5	128.5	-17.6	4615.1
Net domestic assets	2.2	-0.3	-2.1	0.0	2.8	0.4	3.2	-4.6	5.3	-10.6	3.7	-25.7	2.2	-18.6	-15.4	-8.9	-1.7	12.9	3.2
Net claims on general government	2.3	1.8	1.4	2.2	3.5	3.5	6.7	-0.4	6.0	-7.1	4.7	-12.8	3.4	3.4	3.4	10.3	18.2	24.6	3.3
Claims on rest of economy	0.5	-1.5	1.1	0.8	0.5	0.4	2.8	2.7	0.1	0.0	0.0	0.4	0.0	0.3	0.0	0.1	0.2	-0.4	0.0
Reserve money (RM)	18.4	13.3	15.5	19.5	13.9	13.9	20.4	21.1	19.5	29.8	13.9	35.8	14.0	25.0	25.0	26.4	19.6	9.9	18.0
Currency in circulation (M0)	14.1	10.2	12.0	17.0	13.4	13.4	20.9	17.0	20.9	23.7	14.8	34.8	13.8	29.3	29.3	35.4	30.4	14.2	16.3
Required reserves	35.5	28.6	38.7	22.3	12.7	12.7	8.1	21.4	-1.2	-12.3	6.3	-9.7	17.4	3.8	3.8	-2.1	24.8	29.5	21.0
Balances on banks' correspondent accounts 4/	79.7	31.6	1.8	81.4	29.1	29.1	59.1	112.3	113.0	502.3	24.9	233.6	6.9	13.0	13.0	-17.6	-55.5	-47.1	46.0
									(In percent of lagged reserve money)										
Net foreign assets	14.3	13.8	19.4	19.4	9.5	13.2	14.6	29.5	10.3	48.4	7.9	77.8	10.7	54.2	47.7	38.6	21.7	-1.7	14.8
Net domestic assets	4.2	-0.5	-3.9	0.0	4.4	0.7	5.8	-8.4	9.2	-18.6	6.0	-41.9	3.4	-29.2	-22.7	-12.2	-2.0	11.6	3.2
Of which: Net claims on general government	3.9	3.0	2.4	3.6	5.2	5.2	10.1	-0.7	9.0	-10.7	6.6	-18.0	4.6	4.6	4.6	12.8	19.6	22.1	3.7
Reserve money (RM)	18.4	13.3	15.5	19.5	13.9	13.9	20.4	21.1	19.5	29.8	13.9	35.8	14.0	25.0	25.0	26.4	19.6	9.9	18.0
Of which: Currency in circulation (M0)	12.0	8.5	10.0	14.1	11.0	11.0	17.0	13.8	16.8	19.1	12.0	28.2	11.3	23.9	23.9	27.8	23.4	11.4	13.7
									(In millions of lari)										
Net foreign assets	-305	-318	-297	-266	-257	-329	-337	-264	-330	-137	-304	81	-267	-15	2	10	32	61	110
Gold	1	1	1	2	2	2	2	2	2	2	2	2	2	2	1	1	1	1	1
Foreign exchange reserves (including BIS account) 5/	407	380	372	389	362	413	388	461	406	598	406	791	446	699	601	585	622	659	685
Use of Fund resources	-628	-614	-584	-570	-535	-622	-605	-605	-615	-615	-590	-590	-593	-593	-500	-476	-492	-499	-477
Other foreign liabilities (net)	-86	-86	-86	-86	-86	-122	-122	-122	-122	-122	-122	-122	-122	-122	-100	-100	-100	-100	-100
Net domestic assets	814	809	802	817	837	909	927	858	933	793	931	667	929	740	723	741	753	760	745
Net claims on general government	756	743	757	770	783	783	793	740	803	703	806	671	809	809	809	816	831	836	836
Loans	777	792	791	805	817	817	828	816	837	811	841	817	844	844	844	851	866	871	871
Deposits	-21	-48	-34	-36	-35	-35	-35	-75	-35	-108	-35	-146	-35	-35	-35	-35	-35	-35	-35
Claims on rest of economy	84	81	84	84	84	118	118	118	118	118	118	118	118	118	97	97	97	97	97
Claims on banks	0	-5	0	2	6	6	7	8	7	0	7	-42	7	-101	-101	-104	-93	-76	-76
Other items, net	-25	-11	-39	-39	-36	2	9	-8	6	-28	0	-81	-5	-87	-83	-68	-82	-97	-112
Reserve money (RM)	509	491	505	550	580	580	591	594	604	656	627	747	661	725	725	751	784	821	855
Currency in circulation (M0)	417	399	408	445	473	473	482	466	493	504	511	600	539	612	612	631	657	686	711
Required reserves	72	74	85	83	81	81	80	90	84	74	89	75	96	84	84	88	93	98	102
Balances on banks' correspondent accounts 4/	20	18	13	22	25	25	28	38	27	77	27	72	27	29	29	31	34	38	42
Memorandum items:																			
Growth of reserve money (in percent, relative to end of previous year)	18.4	-3.6	-0.7	8.1	13.9	13.9	1.8	2.4	4.1	13.1	8.1	28.9	14.0	25.0	25.0	3.6	8.2	13.3	18.0
Foreign exchange reserves (in mlns of U.S. dollars) 5/	189	177	173	181	169	192	180	214	189	278	189	368	207	325	325	316	336	356	370

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

1/ Net foreign assets are valued at the program rate of 2.15 lari/US$, US$/SDR of 1.28 and US$/Euro of 0.90.

2/ Net foreign assets are valued at the program rate of 2.15 lari/US$, US$/SDR of 1.49 and US$/Euro of 1.27.

3/ Net foreign assets are valued at the program rate of 1.85 lari/US$, US$/SDR of 1.46 and US$/Euro of 1.21.

4/ Including overnight deposits from banks.

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

Table 4. Georgia: Monetary Survey, 2002-2005

	2002	2003					2004									2005 3/			
	Dec.	Mar.	Jun.	Sep.	Dec.		Mar. 2/		Jun. 2/		Sep. 2/		Dec.			Mar.	Jun.	Sep.	Dec.
	Actual 1/	Actual 1/	Actual 1/	Actual 1/	Actual 1/	Actual 2/	Estimate	Actual	Target	Actual	Target	Actual	Target 2/	Adj. Target 2/	Adj. Target 3/	Quarterly profile			
							(Annual percentage change)												
Net foreign assets	22.9	23.4	27.5	43.9	23.9	23.1	25.9	56.1	23.9	83.1	5.2	138.7	24.9	100.2	106.6	116.5	201.1	-16.2	721.5
Net domestic assets	4.4	3.2	4.4	9.8	11.4	9.0	8.2	0.9	9.0	-3.8	9.1	-7.8	10.1	0.1	2.6	9.8	16.1	20.2	12.8
Domestic credit	8.5	10.7	12.9	15.7	14.4	14.1	13.5	10.3	11.0	7.7	10.2	11.9	8.6	15.5	16.4	19.7	22.2	19.1	11.0
Net claims on general government	-1.5	-1.5	-0.1	3.9	7.3	7.3	10.5	8.9	9.8	2.4	8.8	-5.2	4.1	7.4	7.4	8.2	16.3	25.4	5.7
Credit to the rest of the economy	20.8	25.1	27.8	28.5	21.4	20.4	16.2	11.5	12.0	12.2	11.3	26.1	12.4	22.4	25.1	31.3	27.5	14.6	15.5
Broad money (M3)	17.9	17.0	20.8	32.1	22.8	22.8	23.3	26.1	22.1	27.9	12.7	25.3	19.5	27.0	27.0	25.6	24.6	17.7	21.0
Broad money, excl. forex deposits (M2)	14.5	10.3	11.3	20.0	14.1	14.1	20.9	22.0	24.1	32.1	15.9	40.9	18.0	35.7	35.7	38.7	36.3	22.1	29.1
Currency held by the public	12.0	7.7	8.6	15.7	13.0	13.0	20.5	15.6	22.3	24.8	15.3	30.6	13.1	24.1	24.1	32.5	28.4	17.7	21.0
Total deposit liabilities	23.2	24.9	30.7	45.2	30.9	30.9	25.4	33.6	22.0	30.0	11.0	21.9	24.1	29.1	29.1	21.3	22.1	17.7	21.0
							(In percent of lagged broad money)												
Net foreign assets	11.4	12.1	14.1	18.2	7.7	9.9	11.4	24.8	9.5	33.2	1.3	35.1	6.7	26.9	23.8	14.6	7.9	-1.1	8.4
Net domestic assets	6.6	4.9	6.7	13.9	15.1	12.9	11.9	1.2	12.5	-5.3	11.4	-9.8	12.9	0.1	3.2	11.0	16.8	18.8	12.6
Domestic credit	15.4	18.6	22.8	26.8	23.9	23.9	22.9	17.4	18.5	13.0	15.5	18.1	13.6	24.5	24.0	27.2	29.3	23.9	14.8
Net claims on general government	-1.5	-1.4	-0.1	3.4	6.1	6.1	8.4	7.2	7.7	1.9	6.1	-3.6	3.0	5.4	5.4	5.7	10.2	13.3	3.5
Credit to the rest of the economy	16.9	20.1	22.9	23.4	17.8	17.8	14.5	10.2	10.9	11.1	9.4	21.7	10.6	19.1	18.6	21.5	19.0	10.6	11.3
Other items, net	-8.8	-13.8	-16.1	-12.9	-8.8	-11.0	-11.0	-16.1	-6.0	-18.3	-4.1	-27.9	-0.7	-24.4	-20.8	-16.2	-12.5	-5.1	-2.2
Broad money (M3)	17.9	17.0	20.8	32.1	22.8	22.8	23.3	26.1	22.1	27.9	12.7	25.3	19.5	27.0	27.0	25.6	24.6	17.7	21.0
Currency held by the public	5.7	3.5	3.9	7.0	5.9	5.9	8.6	6.6	9.0	10.0	6.0	11.9	5.5	10.0	10.0	12.5	11.2	7.2	8.5
Total deposit liabilities	12.2	13.5	16.9	25.1	16.9	16.9	14.7	19.5	13.1	17.9	6.7	13.4	14.1	17.0	17.0	13.1	13.4	10.5	12.5
							(In millions of lari)												
Net foreign assets	-279	-302	-285	-186	-213	-285	-291	-172	-281	-62	-253	103	-214	0	16	23	47	78	128
Net domestic assets	1143	1188	1211	1240	1273	1345	1384	1289	1412	1247	1441	1218	1482	1346	1331	1380	1429	1476	1501
Domestic credit	1432	1467	1529	1573	1638	1672	1703	1654	1735	1683	1770	1798	1816	1932	1809	1843	1906	1969	2008
Net claims on general government 4/	714	710	723	729	766	766	784	773	794	741	794	691	798	823	823	837	861	866	870
Credit to the rest of the economy	719	757	806	844	872	906	919	881	941	943	976	1106	1018	1109	986	1006	1045	1102	1138
Other items, net	-289	-279	-318	-333	-365	-327	-320	-365	-323	-437	-329	-580	-334	-586	-478	-463	-477	-492	-507
Broad money (M3)	864	886	926	1054	1060	1060	1093	1117	1131	1184	1188	1321	1268	1347	1347	1403	1476	1555	1629
Broad money, excl. forex deposits (M2)	462	448	450	505	527	527	542	547	559	595	585	711	622	716	716	758	811	868	924
Currency held by the public	391	373	375	412	442	442	449	431	458	468	475	538	499	548	548	571	601	633	663
Total deposit liabilities	473	513	551	642	619	619	644	686	672	717	713	784	768	799	799	832	875	922	966
Memorandum items:																			
Growth of broad money (in percent, relative to end of previous year)	17.9	2.6	7.2	22.1	22.8	22.8	3.1	5.3	6.6	11.7	12.0	24.6	19.5	27.0	27.0	4.2	9.6	15.4	21.0
Growth of credit to the rest of the economy (in percent, relative to end of previous year)	20.8	5.3	12.2	17.4	21.4	20.4	1.4	-2.7	3.8	4.1	7.8	22.1	12.4	22.4	25.1	2.1	6.0	11.8	15.5
M3 multiplier 5/	1.7	1.8	1.8	1.9	1.8	1.8	1.9	1.9	1.9	1.8	1.9	1.8	1.9	1.9	1.9	1.9	1.9	1.9	1.9
M3 velocity 6/	8.6	...	...	...	8.1	8.1	...	...	...	...	...	...	7.4	7.2	7.2	7.7	7.3	7.0	6.6
Foreign exchange deposits in percent of total deposits	84.9	85.3	86.3	85.5	86.1	86.1	85.6	83.2	85.1	82.3	84.5	77.9	84.0	79.0	79.0	77.5	76.0	74.5	73.0

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

1/ Net foreign assets are valued at the program rate of 2.15 lari/US$, US$/SDR of 1.28 and US$/Euro of 0.90.

2/ Net foreign assets are valued at the program rate of 2.15 lari/US$, US$/SDR of 1.49 and US$/Euro of 1.27.

3/ Net foreign assets are valued at the program rate of 1.85 lari/US$, US$/SDR of 1.46 and US$/Euro of 1.21.

4/ The implied increase of net credit to the government from the banking sector in 2004 is higher than the corresponding figure in the fiscal accounts because the withdrawal of Maritime Bank's license in March 2004 resulted in unanticipated banking sector credit to the general government of GEL 45.55 million. While the resolution of this bank is in process, these deposits are not at the government's disposal.

5/ M3 divided by reserve money.

6/ Annual GDP divided by end-period M3.

Table 5. Georgia: Prudential Indicators of Commercial Banks, 1997–2004

(End-of-period)

	1997	1998	1999	2000	2001	2002	2003	Sep-04
Capital adequacy ratio (in percent)	30.6	34.9	38.5	36.7	33.1	21.9	20.3	19.3
Leverage ratio 1/	45.0	43.5	45.6	44.2	39.9	36.1	33.5	29.4
Nonperforming loans (in percent of total loans)	5.9	5.4	6.6	7.1	11.6	7.9	7.5	5.7
Specific provisions (in precent of total loans)	5.4	3.1	2.6	4.7	7.5	4.4	4.5	3.9
Loans collateralized by real estate (in percent of total loans)	…	…	…	…	30.2	33.3	31.9	32.5
Loans in foreign exchange in percent of total loans	44.5	64.8	71.8	81.4	81.4	83.8	87.7	86.7
Net foreign assets (in millions of lari)	33.0	13.7	-6.3	-12.7	3.7	25.0	42.5	19.3
Net foreign assets (in percent of total assets)	9.7	2.9	-1.1	-1.7	0.4	2.2	3.2	1.3
Net open foreign exchange position 2/	n.a.	18.1	15.2	15.7	6.9	9.3	8.5	5.8
Liquidity ratio (in percent)	37.8	44.5	40.3	36.8	38.5	45.4	43.3	47.2

Source: National Bank of Georgia.
1/ Definied as the ratio of total capital to total liabilities; an increase in the ratio indicates an improvement.
2/ Percent of Total Regulatory Capital.

Table 6. Georgia: Macroeconomic Framework, 1999-2008

	1999	2000	2001	2002	2003	2004		2005		2006	2007	2008
			Actuals			Program	Proj.	Program	Proj.		Proj.	
						(Percent change)						
Output, prices, money, and external trade												
Real GDP	3.0	1.9	4.7	5.5	11.1	6.0	8.5	5.0	6.0	5.0	5.0	5.0
Consumer price index (average)	19.1	4.0	4.7	5.6	4.8	5.8	5.8	5.0	4.8	4.0	4.0	4.0
Broad money (M3, lari)	20.7	39.0	18.5	17.9	22.8	19.5	27.0	18.2	21.0	19.8	14.9	13.1
Exports (US$)	-0.3	22.5	-19.1	16.9	32.1	6.2	45.5	7.2	9.0	8.5	7.5	6.3
Imports (US$) 1/	-13.0	-3.1	-2.3	3.5	33.9	15.5	34.3	5.0	15.1	1.9	-0.9	7.6
						(In percent of GDP)						
General government 2/												
Total revenues and grants	15.4	15.2	16.3	15.8	16.2	19.0	20.8	19.7	20.4	21.7	23.2	24.3
Tax revenues	13.8	14.2	14.3	14.4	14.5	16.3	17.6	17.3	18.0	19.0	20.0	21.0
Non-tax revenues	0.8	0.8	1.3	1.1	1.1	1.0	2.2	1.1	1.3	1.6	1.9	2.0
Grants	0.9	0.3	0.7	0.3	0.6	1.7	1.0	1.3	1.1	1.1	1.3	1.3
Expenditures and net lending	22.1	19.2	18.3	17.8	18.7	20.5	20.0	20.3	20.7	23.0	24.1	25.5
Current expenditure	20.0	18.2	16.5	15.7	17.0	17.3	17.6	17.2	17.9	20.3	21.5	22.9
Non-interest	17.2	15.2	14.7	13.8	14.9	15.3	16.1	15.5	16.8	19.1	20.3	21.8
Interest	2.8	3.0	1.8	2.0	2.1	2.0	1.5	1.7	1.1	1.2	1.3	1.2
Capital expenditure and net lending	2.1	1.0	1.8	2.0	1.7	3.2	2.4	3.1	2.8	2.7	2.6	2.5
Primary balance	-3.9	-1.1	-0.2	0.0	-0.4	0.5	2.3	1.1	0.8	-0.1	0.3	0.0
Overall balance (commitment basis)	-6.7	-4.0	-2.0	-2.0	-2.5	-1.6	0.7	-0.6	-0.3	-1.3	-1.0	-1.2
Net change in expenditure arrears 3/	...	1.4	0.2	-0.4	1.4	-1.0	-2.6	-1.4	-1.6	0.0	0.0	0.0
Overall balance (cash basis)	-5.0	-2.6	-1.6	-1.9	-1.3	-2.6	-1.8	-2.0	-1.9	-1.3	-1.0	-1.2
Financing	5.0	2.6	1.6	1.9	1.3	2.6	1.8	2.0	1.9	1.3	1.0	1.2
Privatization	0.9	0.3	0.1	0.2	0.3	0.3	0.9	0.3	1.1	0.3	0.2	0.1
Domestic financing	2.3	2.2	-0.4	-0.1	0.6	0.3	0.1	0.4	0.4	0.1	0.1	0.1
External financing (net)	1.7	0.0	1.9	1.8	1.0	2.0	0.8	1.3	0.4	0.9	0.7	1.0
Disbursements (incl. in-kind)	2.9	1.1	2.4	2.3	1.6	3.0	2.3	2.6	2.0	1.8	1.8	1.7
Amortization	-1.2	-1.1	-0.5	-0.5	-0.6	1.0	-1.4	-1.3	-1.6	-1.0	-1.1	-0.7
Adjustment for Net Withheld Adjara Transfers 3/	…	…	…	…	-0.7	…	…		…	…	…	…
Saving and investment												
Investment	22.0	21.6	21.9	22.0	24.4	26.6	29.0	27.6	28.9	26.6	23.9	24.4
Non-government sector 1/	19.9	20.6	20.1	20.0	22.7	23.4	26.6	24.4	26.1	23.9	21.3	21.9
Of which: FDI	2.2	5.0	2.5	3.8	8.4	8.0	9.0	8.0	7.9	5.4	2.4	2.5
Gross domestic saving	14.2	17.3	15.5	16.2	17.2	17.0	21.4	18.0	20.8	20.6	21.3	21.6
General government	-4.6	-3.0	-0.2	0.1	-0.7	1.6	3.1	2.5	2.5	1.4	1.6	1.4
Non-government sector	18.8	20.3	15.7	16.2	17.9	15.4	18.3	15.5	18.3	19.1	19.7	20.2
Current account deficit 1/	7.8	4.3	6.4	5.8	7.2	9.6	7.5	9.6	8.1	6.0	2.6	2.8
						(In millions of U.S. dollars; unless otherwise indicated)						
Gross official reserves of the NBG 4/	132	109	161	198	191	207	320	235	366	421	479	538
(In months of imports of non-pipeline goods and services)	1.3	1.0	1.4	1.8	1.5	1.5	1.9	1.6	1.9	2.0	2.1	2.2
(In months of imports of goods and services)	1.3	1.0	1.4	1.7	1.3	1.3	1.6	1.4	1.6	1.8	2.1	2.2
External debt, public and guaranteed												
External debt stock	1,691	1,560	1,655	1,776	1,840	1,902	1,796	1,977	1,769	1,756	1,756	1,758
External debt service, total	…	…	…	228	114	218	165	222	177	141	152	124
Memorandum items:												
Nominal GDP (in millions of lari)	5,665	6,013	6,638	7,448	8,565	9,422	9,758	10,308	10,809	11,804	12,890	14,075
Nominal GDP (in millions of US$)	2,803	3,042	3,201	3,392	3,984	4,382	4,879	4,556	5,843	6,491	6,947	7,436
External debt stock (public and guaranteed)/GDP	60.3	51.3	51.7	52.4	46.2	43.4	36.8	43.4	30.3	27.1	25.3	23.6
Domestic public debt/GDP	16.7	18.5	16.7	15.0	15.3	13.1	11.0	10.9	8.8	8.5	8.0	7.6
Exchange rate, average (Lari/US$)	2.02	1.98	2.07	2.20	2.15	…	…	...	…	…	…	…
M3-velocity	n.a.	9.7	9.1	8.6	8.1	7.4	7.2	6.9	6.6	6.0	5.7	5.5
Social sector expenditures (percent of GDP)	n.a.	8.3	8.3	8.0	7.6	7.9	7.6	8.3	8.5	8.9	9.3	10.0
Social sector spending, cash basis (percent of GDP)	n.a.	6.9	8.2	8.3	7.1	8.5	9.5	9.7	9.0	8.9	9.3	10.0

Sources: Georgian authorities; and Fund staff estimates.

1/ Large oil and gas pipeline projects are projected to increase investment and the current account deficit substantially in 2003-2006.

2/ For 2003, the classification of the new Budget Systems Law is used.

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

4/ International reserves are reported at current exchange rates and may differ from reserves at program rates as reported in the monetary accounts.

Table 7. Georgia: Summary Medium-Term Balance of Payments, 2000-2008 1/
(In million of U.S. dollars)

	2000	2001	2002	2003	2004		2005	2006	2007	2008
	Act.	Act.	Act.	Act.	Prog.	Proj.	Proj.	Proj.	Proj.	Proj.
Current account balance (including transfers) 1/	**-132**	**-205**	**-196**	**-286**	**-418**	**-368**	**-475**	**-390**	**-183**	**-209**
Trade balance	-397	-486	-439	-598	-771	-720	-893	-833	-719	-790
Exports (total)	584	473	553	730	691	1,063	1,159	1,257	1,351	1,437
Imports (total)	-982	-959	-992	-1,328	-1,461	-1,783	-2,052	-2,090	-2,070	-2,227
Of which: Gas and oil pipeline	0	0	-12	-193	-224	-250	-259	-156	0	0
Oil imports	-129	-150	-148	-204	228	-275	-316	-304	-303	-312
Services and income (net)	58	54	53	42	54	8	-19	-19	21	44
Services (net)	114	97	106	103	103	62	27	54	93	108
Factor income (net)	-56	-43	-53	-61	-49	-53	-46	-74	-72	-64
Of which: Interest (gross)	-50	-45	-42	-55	-50	-41	-38	-41	-42	-43
Transfers	207	226	190	269	299	344	437	462	515	538
Official transfers 2/	51	81	66	56	107	96	183	195	235	244
Of which: General government	0	17	26	25	73	62	62	73	90	96
Other transfers	156	146	124	213	192	248	254	267	281	294
Of which: Workers' remittances	77	78	72	166	187	197	209	219	230	241
Capital account	**67**	**115**	**106**	**276**	**396**	**456**	**476**	**403**	**258**	**301**
Public sector	-73	-47	-69	-36	23	-38	-30	12	45	70
Disbursements 2/	34	79	91	71	140	95	117	119	123	128
Of which: World Bank	19	64	61	44	84	64	65	65	66	67
Of which: Bilateral	9	12	17	21	38	28	46	47	49	51
Amortization	-107	-126	-160	-107	-117	-133	-146	-108	-78	-58
Private sector	141	162	175	312	373	494	506	392	213	230
Foreign direct investment	153	80	122	335	350	438	464	349	169	186
Of which: Gas and oil pipeline	0	0	15	240	280	280	324	195	0	0
Other private capital, net (incl. commercial banks) 3/	-12	83	53	-23	23	56	42	43	43	44
Overall Balance	**-65**	**-90**	**-90**	**-10**	**-22**	**89**	**1**	**13**	**75**	**92**
Financing	**65**	**90**	**90**	**10**	**22**	**-89**	**-1**	**-13**	**-75**	**-92**
Use of Fund resources, net	-26	22	-1	-48	-13	-13	-13	-8	-18	-32
Purchases/disbursements	0	34	29	0	42	41	41	41	20	0
Repurchases/repayments	-26	-13	-30	-48	-55	-54	-54	-49	-38	-32
Increase in reserves (-)	23	-52	-37	7	-17	-130	-45	-55	-58	-60
Change in arrears (+, increase)	68	5	0	51	-51	-52	0	0	0	0
Debt relief 4/	0	114	128	0	103	106	57	50	0	0
Paris Club rescheduling	…	114	128	0	52	43	57	50	0	0
Rescheduling of arrears	…	0	0	0	51	63	0	0	0	0
Financing gap	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
Memorandum items										
Nominal GDP (US$ millions)	3,044	3,201	3,392	3,984	4,382	4,879	5,843	6,491	6,947	7,436
Trade deficit, (percent of GDP)	13.0	15.2	12.9	15.0	17.6	14.8	15.3	12.8	10.4	10.6
Trade deficit, excl. pipeline-related imports, (percent of GDP)	4.3	6.4	5.4	2.3	4.4	2.4	3.7	3.6	2.6	2.8
Current account deficit, incl transfers (percent of GDP)	4.3	6.4	5.8	7.2	9.6	7.5	8.1	6.0	2.6	2.8
Current account deficit, excl. pipeline-related imports (percent of GDP)	4.3	6.4	5.4	2.3	4.4	2.4	3.7	3.6	2.6	2.8
Export growth (percent)	22.5	-19.1	16.9	32.1	6.2	45.5	9.0	8.5	7.5	6.3
Of which: Volume growth	25.7	-15.6	15.2	29.6	4.5	42.9	6.8	8.3	7.3	6.1
Import growth (percent)	-3.1	-2.3	3.5	33.9	15.5	34.3	15.1	1.9	-0.9	7.6
Nonpipeline-related import growth (percent)	-3.1	-2.3	2.2	15.9	14.0	35.1	16.9	7.9	7.0	7.6
Of which: Volume growth	-1.3	0.5	-0.7	3.3	7.0	23.6	16.3	8.1	6.3	6.7
Net oil imports	104	123	131	180	202	242	278	267	268	275
Gross international reserves 5/	109	161	198	191	207	320	366	421	479	538
(In months of imports of goods and services)	1.0	1.4	1.7	1.3	1.3	1.6	1.6	1.8	2.1	2.2
(In months of imports of non-pipeline goods & services)	1.0	1.4	1.8	1.5	1.5	1.9	1.9	2.0	2.1	2.2
Public and publicly guaranteed external debt (nominal)	1,560	1,655	1,776	1,840	1,902	1,796	1,769	1,756	1,756	1,758
(In percent of GDP)	51.2	51.7	52.4	46.2	43.4	36.8	30.3	27.1	25.3	23.6
External assistance to general government	34	96	118	95	213	157	179	192	214	224
Debt service from the budget (cash)	148	48	37	59	88	102	118	88	110	88
(In percent of exports of goods and services)	13.5	4.9	3.6	4.5	7.0	5.9	6.3	4.3	5.0	3.8

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 data prior to 2000.

2/ Incorporates projections of donor disbursements based on pledges at the donors' conference in Brussels, June 2004.

3/ Includes errors and omissions.

4/ Incorporates the agreement reached with the Paris Club creditors in July 2004 and assuming comparable treatment with non-Paris Club and commercial creditors. Under the agreement, half the external arrears accumulated to end-May and all current maturies from June 1 2004 to end-2006 are rescheduled on terms somewhat more generous than Houston terms. Half the accumulated arrears are to be repaid over the period 2004-06.

5/ The figures differ from those in Table 3 because they reflect actual, rather than program, exchange rates.

Table 8. Georgia: External Financing Requirements and Sources, 2000-2008
(In millions of U.S. dollars)

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Total requirements	**-265**	**-344**	**-387**	**-441**	**-555**	**-675**	**-547**	**-299**	**-298**
Current account deficit	-132	-205	-196	-286	-368	-475	-390	-183	-209
Capital outflows	-133	-139	-190	-155	-187	-200	-157	-116	-90
Scheduled public sector amortization 1/	-133	-139	-190	-155	-187	-200	-157	-116	-90
Total sources	**265**	**344**	**387**	**441**	**555**	**675**	**547**	**299**	**298**
Capital inflows	175	212	247	383	565	602	491	315	336
Foreign direct investment	153	80	122	335	438	464	349	169	186
Disbursements to public sector	34	49	72	71	70	97	99	102	106
Private sector net inflows 2/	-12	83	53	-23	56	42	43	43	44
Exceptional financing	**68**	**184**	**176**	**51**	**120**	**118**	**111**	**42**	**22**
IMF	0	34	29	0	41	41	41	20	0
World Bank	0	30	20	0	24	20	20	21	22
Macroeconomic support from the EU	0	0	0	0	0	0	0	0	0
Change in arrears, net (- decrease)	68	5	0	51	-52	0	0	0	0
Debt rescheduling obtained 3/	0	114	128	0	106	57	50	0	0
Change in reserves (- increase)	23	-52	-37	7	-130	-45	-55	-58	-60
Financing gap	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
Memorandum									
In percent of GDP									
Total requirements	-8.7	-10.7	-11.4	-11.1	-11.4	-11.6	-8.4	-4.3	-4.0
Total sources	8.7	10.7	11.4	11.1	11.4	11.6	8.4	4.3	4.0
Capital inflows	5.7	6.6	7.3	9.6	11.6	10.3	7.6	4.5	4.5
Exceptional financing	2.2	5.7	5.2	1.3	2.5	2.0	1.7	0.6	0.3
Change in reserves	0.8	-1.6	-1.1	0.2	-2.7	-0.8	-0.9	-0.8	-0.8

Sources: Georgian Statistics Department; National Bank of Georgia; and Fund staff estimates.
1/ Includes principal payments to the IMF.
2/ Includes errors and omissions.
3/ Assumes rescheduling of 2003 arrears in 2004 and of principal maturities falling due during 2004-06. Includes comparable treatment by non-Paris Club bilateral creditors.

Table 9. Indicators of Financial Obligations to the Fund, 2001-2010

(In millions of SDR)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Total Fund credit outstanding	228.6	228.0	194.3	185.3	176.6	171.2	159.3	137.2	115.0	93.9
In percent of quota	152.1	151.7	129.3	123.3	117.5	113.9	106.0	91.3	76.5	62.5
In percent of GDP	9.1	8.7	6.8	5.6	4.4	3.9	3.4	2.7	2.1	1.6
In percent of exports of goods and non-factor services	23.5	22.2	14.7	10.7	9.5	8.5	7.3	5.9	4.5	3.4
Disbursements (PRGF)	27.0	22.5	0.0	28.0	28.0	28.0	14.0	0.0	0.0	0.0
Total obligations from existing and prospective drawings	14.8	25.0	35.3	38.1	37.7	34.5	27.0	23.0	23.0	21.8
Principal (repayments/repurchases)	12.0	23.1	33.8	37.0	36.7	33.4	25.9	22.1	22.2	21.1
Charges and interest	2.8	1.8	1.6	1.1	1.0	1.1	1.1	0.9	0.8	0.7
Total obligations to the Fund										
In percent of quota	9.9	16.6	23.5	25.4	25.1	22.9	17.9	15.3	15.3	14.5
In percent of GDP	0.5	0.7	0.9	0.8	0.6	0.5	0.4	0.3	0.3	0.3
In percent of exports of goods and non-factor services	1.9	3.2	3.7	3.2	3.0	2.5	1.8	1.5	1.3	1.1
Net credit from the Fund	15.0	-0.6	-33.8	-9.0	-8.7	-5.4	-11.9	-22.1	-22.2	-21.1
Net resources from the Fund	12.2	-2.5	-35.3	-10.1	-9.6	-6.5	-13.0	-23.0	-23.0	-21.8

Sources: Fund Finance Department and staff estimates and projections.

Table 10. Georgia: Energy Sector Quasi-Fiscal Losses, 2001–2005

	2001	2002	2003	2004 Proj.	2005 Proj.
Power sector					
Quantity delivered (million kWh) 1/	6085	6434	6670	7381	7629
Cost (U.S. cents)	4.1	4.1	4.5	4.9	5.3
Tariff (U.S. cents)	4.1	4.1	4.2	4.6	5.0
Collection rate (percent) 2/	19.7	35.0	52.4	53.8	61.8
Generation cost (US$ million)	247.7	263.5	298.6	358.9	401.2
Billed amount (US$ million)	247.7	263.5	277.9	340.4	379.4
Collected amount (US$ million)	48.8	92.2	145.6	183.1	234.5
Total losses (US$ million)	198.9	171.3	152.9	175.8	166.7
Of which: price effect (US$ million)	0.0	0.0	20.6	18.5	21.8
Of which: non-payment effect (US$ million)	198.9	171.3	132.3	157.3	144.9
Total losses (percent of GDP)	6.2	5.0	3.8	3.6	2.9
Gas sector					
Tbilgazi: total losses (US$ million)	...	15.6	24.9	23.3	25.1
Other consumers: total losses (US$ million)	...	15.0	16.8	18.6	19.6
Total losses (percent of GDP)	...	0.9	1.0	0.9	0.8
Energy sector (power + gas sector)					
Total losses (US$ million)	...	186.8	177.8	199.0	191.7
Total losses (percent of GDP)	...	6.0	4.9	4.5	3.6
GDP (US$ million)	3202	3392	3984	4879	5843

Source: Fund staff calculations and estimates, based on data provided by the authorities and energy-sector entities (GWEM, GSE, AES, Tbilgazi, and GGIC).

1/ Quantity produced domestically and net imports less normative losses (15 percent in 2002 and 2003, 9 percent in 2004 and 2005).

2/ UDC collection rate for 2002 are based on Fund staff estimates.

Table 11. Georgia: Millennium Development Goals (In percent, unless otherwise specified)

	1990	1995	2001	2002
1 Eradicate extreme poverty and hunger	2015 target = halve 1990 $1 a day poverty and malnutrition rates			
Population below US$1 a day	...	...	...	15
Poverty gap at US$1 a day	...	...	...	9
Share of income or consumption held by poorest 20 percent	...	...	6.4	...
Prevalence of child malnutrition (percent of children under 5)	...	...	3.1	...
Share of population below minimum level of dietary energy consumption	...	45	26	...
2 Achieve universal primary education	2015 target = net enrollment to 100			
Net primary enrollment ratio (percent of relevant age group)	...	...	90.7	...
Percentage of cohort reaching grade 5	...	...	...	...
Youth literacy rate (ages 15-24)	...	...	...	...
3 Promote gender equality	2005 target = education ratio to 100			
Ratio of girls to boys in primary and secondary education	98.2	99.4	104.9	...
Ratio of young literate females to males (ages 15-24)	...	...	...	...
Share of women employed in the nonagricultural sector	...	...	...	...
Proportion of seats held by women in national parliament	...	6	7	7
4 Reduce child mortality	2015 target = reduce 1990 under 5 mortality by two-thirds			
Under 5 mortality rate (per 1,000)	29	29	29	29
Infant mortality rate (per 1,000 live births)	21	28	23	24
Immunization, measles (percent of children under 12 months)	99	61	73	73
5 Improve maternal health	2015 target = reduce 1990 maternal mortality by three-fourths			
Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	22	32	...
Births attended by skilled health staff (percent of total)	...	...	96.4	...
6 Combat HIV/AIDS, malaria and other diseases	2015 target = halt, and begin to reverse, AIDS, etc.			
Prevalence of HIV, female (ages 15-24)	...	...	0	...
Contraceptive prevalence rate (of women ages 15-49)	...	...	40.5	...
Number of children orphaned by HIV/AIDS	...	...	...	...
Incidence of tuberculosis (per 100,000 people)	...	...	89	85.4
Tuberculosis cases detected under DOTS 1/	...	15	48	49.6
7 Ensure environmental sustainability	2015 target = various (see notes)			
Forest area (% of total land area)	43	...	43	...
Nationally protected areas (percent of total land area)	...	2.7	2.8	2.8
GDP per unit of energy use (PPP $ per kg oil equivalent)	1.2	2.6	4.5	...
CO2 emissions (metric tons per capita)	2.8	0.4	1.2	...
Access to an improved water source (percent of population)	...	...	79	...
Access to improved sanitation (percent of population)	...	...	100	...
Access to secure tenure (percent of population)	...	...	...	...
8 Develop a Global Partnership for Development	2015 target = various (see notes)			
Youth unemployment rate (percent of total labor force ages 15-24)	...	...	20.1	...
Fixed line and mobile telephones (per 1,000 people)	98.9	102.3	174.9	233.5
Personal computers (per 1,000 people)	...	...	...	...
General indicators				
Population (in millions)	5.4	5.1	4.4	4.4
Gross domestic product (US$ billion)	5.1	2.1	3.2	3.4
GDP per capita (US$)	940	410	727	776
Adult literacy rate (percent of people ages 15 and over)	...	...	...	...
Total fertility rate (births per woman)	2.2	1.4	1.1	1.1
Life expectancy at birth (years)	72.3	72.5	73.2	73.3
Public and publicly guaranteed external debt (percent of GDP)	...	64.1	51.7	52.4
Investment (percent of GDP)	29.1	23.9	21.9	22.0
Trade (percent of GDP) 2/	85.6	67.9	72.9	70.3

Sources: World Development Indicators database, April 2004; Georgian State Department of Statistics; and Fund staff estimates.

Note: In some cases the data are for earlier or later years than those stated. The goal targets are the following: Goal 1: Halve, between 1990 and 2015, the proportion of people whose income is less than US$1 a day. Halve, between 1990 and 2015, the proportion of people who suffer from hunger; Goal 2: Ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling; Goal 3: Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education no later than 2015; Goal 4: Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate; Goal 5 target: Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio; Goal 6: Have halted by 2015, and begun to reverse, the spread of HIV/AIDS. Have halted by 2015, and begun to reverse, the incidence of malaria and other major diseases; Goal 7: Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources. Halve, by 2015, the proportion of people without sustainable access to safe drinking water; Goal 8: Develop further an open, rule-based, predictable, non-discriminatory trading and financial system. Deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term. In cooperation with developing countries, develop and implement strategies for decent and productive work for youth. In cooperation with pharmaceutical companies, provide access to affordable, essential drugs in developing countries. In cooperation with the private sector, make available the benefits of new technologies, especially information and communications.

1/ Directly observed treatment, short-course case detection and treatment strategy (World Health Organization).

2/ Trade is calculated as the sum of imports and exports of goods and non-factor services relative to GDP.

GEORGIA: FUND RELATIONS
(As of October 31, 2004)

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

II. **General Resources Account:**	**SDR Million**	**Percent of Quota**
Quota	150.30	100.00
Fund holdings of currency	157.24	104.62
Reserve position in Fund	0.01	0.01

III. **SDR Department:**	**SDR Million**	**Percent of Allocation**
Holdings	0.33	N/A

IV. **Outstanding Purchases and Loans:**	**SDR Million**	**Percent of Quota**
PRGF Arrangements	168.95	112.41
Systemic transformation	6.94	4.62

V. **Latest Financial Arrangements:**

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn SDR Million)
PRGF	6/4/04	6/3/07	98.00	14.00
PRGF	1/12/01	1/11/04	108.00	49.50
PRGF	2/28/96	8/13/99	172.05	172.05

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

	Forthcoming				
	2004	**2005**	**2006**	**2007**	**2008**
Principal	4.63	36.72	33.44	25.94	22.11
Charges/interest	0.49	0.82	0.58	0.43	0.31
Total	5.12	37.55	34.02	26.36	22.42

VII. **Safeguards Assessments:**

Under the Fund's safeguards assessment policy, the National Bank of Georgia (NBG) is subject to an assessment with respect to the PRGF arrangement that was approved on June 4, 2004 and is scheduled to expire on June 3, 2007. The safeguards assessment of the NBG is substantially completed and no significant vulnerabilities have been identified.

VIII. **Implementation of HIPC Initiative:**

Not applicable.

IX. **Exchange Arrangements:**

Since April 29, 1993, the Tbilisi Interbank Currency Exchange (TICEX), established by the NBG and a group of commercial banks, has conducted periodic auctions to determine the exchange rate of the domestic currency vis-à-vis the U.S. dollar. These auctions are conducted daily. Foreign exchange bureaus are allowed to buy and sell foreign currency bank notes. Georgia's exchange rate regime is classified as "managed floating."

X. **Article IV Consultation:**

The 2003 Article IV consultation was concluded on October 17, 2003.

XI. **FSAP Participation:**

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

XII. **Technical Assistance:**

See Table 1 of this Appendix.

XIII. **Resident Representative:**

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

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

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

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

Mr. Sharma was an FAD resident advisor and assisted the authorities in the development of a Treasury beginning in May 1997. Mr. Sainsbury, an FAD advisor, assisted the Ministry of Finance from June 1998 to November 1999. Mr. Chaturvedi was FAD resident advisor in

2001 and 2002 to assist the authorities in continuing the development of the Treasury and the Treasury Single Account, in revising the legislative framework, expenditure control systems, and budgeting issues. 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. A third, shorter visit took place in late 2003.

Table 1. Georgia: Fund Technical Assistance Missions, 2001-04

Subject	Type of Mission	Timing	Counterpart
	Fiscal Affairs Department (FAD)		
Public Expenditure Management	Assessment of Treasury system and preparing work plan for the resident advisor	Jun. 12-19, 2001	Ministry of Finance
Public Expenditure Management	Review of the draft Budget System Law	Mar. 14-Apr. 02, 2002	Ministry of Finance
Public Expenditure Management and Fiscal ROSC	Assessment of Treasury system and of observance of standards and codes	Jan. 16-30, 2003	Ministry of Finance
Public Expenditure Management	Assessment of Treasury System and implementation of Budget Systems Law	Sep. 29-Oct. 11, 2003	Ministry of Finance
Tax and Customs Administration	Assistance in taxation of excisable goods	Oct. 27-Nov. 13, 2003	Ministry of Finance
Tax Policy	Review of Tax Policy	June 8-21, 2004	Ministry of Finance
Public Expenditure Management	Assessment of Treasury system.	Nov. 8-23, 2004	Ministry of Finance
	Monetary and Financial Systems Department (MFD)		
Banking, foreign exchange reserve management, monetary programming, and research	Advisory	Feb. 26-Mar. 8, 2001	National Bank of Georgia
Payment Systems, Bank Supervision and Resolution, Internal Audit, Foreign reserve Management, and Research	Advisory	Oct. 23-Nov. 6, 2001	National Bank of Georgia
Payment Systems and Bank Resolution	Advisory	Mar. 11-19, 2002	National Bank of Georgia

Table 1. Georgia: Fund Technical Assistance Missions, 2001-04

Subject	Type of Mission	Timing	Counterpart
Accounting and Audit, Anti-Money Laundering, Bank Supervision, and Monetary Operations	Advisory	Sep. 24-Oct 9, 2002	National Bank of Georgia
Payment Systems	Advisory	June 16-20, 2003	National Bank of Georgia
Government Securities Market, Deposit Insurance, Anti-Money Laundering	Advisory	April 20-30, 2004	National Bank of Georgia
Monetary Operations, Banking Sector Competition	Advisory	Oct. 24-Nov. 5, 2004	National Bank of Georgia
Statistics Department (STA)			
National Accounts	Follow-up assistance	Mar. 26-Apr. 6, 2001	State Department of Statistics
Balance of Payments Statistics	Follow-up assistance	February 13-27, 2002	State Department of Statistics
Money and Banking	Follow-up assistance	March 2-15, 2002	National Bank of Georgia
Data ROSC	Assessment of observance of standards and codes	July 15-31, 2002	State Department of Statistics, National Bank of Georgia, Ministry of Finance
Balance of Payments Statistics	Follow-up assistance	May 20-June 3, 2003	State Department of Statistics
Government Finance Statistics	Follow-up assistance	Nov. 5-18, 2003	State Department of Statistics, Ministry of Finance
National Accounts	Follow-up assistance	April 26-May 7, 2004	State Department of Statistics
Legal Department (LEG)			
Tax Code	Follow-up assistance	Jan. 28-Feb. 9, 2001	Ministry of Finance, Tax Inspectorate of Georgia
Tax Code	Follow-up assistance	Jul. 13-24, 2001	Ministry of Finance, Tax Inspectorate of Georgia

GEORGIA: IMF-WORLD BANK RELATIONS

Partnership in Georgia's Development Strategy

1. The government's PRSP was presented to the Boards of IDA and the IMF in October and November 2003. An interim lending and economic sector work program for FY04 and FY05 was presented to the IDA Board in the context of the Reform Support Credit (RSC) program document in June 2004. A Country Assistance Strategy for FY06-09 is expected to be discussed by the Board in May 2005.

2. The Fund has taken the lead in assisting Georgia in improving macroeconomic stability and pursuing fiscal reforms. The World Bank has taken the lead in the policy dialogue on structural issues, focusing on: (i) strengthening public expenditure management; (ii) improving performance of the public sector; (iii) reducing corruption; (iv) deepening and diversifying sources of growth; (v) protecting the environment; and (vi) reducing poverty. Georgia is the second largest IDA borrower in the CIS, with borrowing of US$773 million for 37 operations. A range of instruments has been used to conduct the dialogue, including Structural Adjustment Credits. The most recent Adjustment Credit was the RSC which was approved last June, which supported urgent improvements in the areas of: (i) governance/ anti-corruption; (ii) public finance management; and (iii) energy sector bottlenecks. To deepen the assistance initiated with the RSC over the medium term, the first Poverty Reduction Support Credit (PRSC) is under preparation. Other support has come in the form of project support and Analytical and Advisory Assistance across a broad spectrum: education, health, social protection, energy, roads, water and sanitation, agriculture, agricultural research and extension, irrigation and drainage, forestry, environment, biodiversity, enterprise development, municipal development, judicial reform, and cultural heritage. A Public Expenditure Review (PER) was prepared in 2002, and a Trade Study in 2003. The PER will be followed by a series of annual programmatic PERs, the first of which is under preparation. A Country Procurement Assessment Report (CPAR) was prepared in 2002 and a Country Financial Accountability Assessment (CFAA) in 2003.

3. Since Georgia joined IFC in 1995, it has committed $117 million of investments for eight projects. IFC has provided equity and credit to local and international companies, including investments by British Petroleum and other sponsors in the construction of the *Baku-Supsa Early Oil Pipeline* and the *Baku-Tbilisi-Ceyhan Pipeline.* IFC has also provided equity and long-term credit lines to TBC Bank and helped establish Georgia Microfinance Bank (now Procredit Bank). In the housing finance sector, IFC provided credit lines to the Bank of Georgia and TBC Bank for mortgage lending to residences and small and medium enterprises (SMEs). Other investment projects have been in electricity distribution (AES-Telasi), mineral water, and glass bottle production. IFC's Private Enterprise Partnership is implementing a technical assistance project to develop financial leasing, strengthen corporate governance practices, and assess the business environment for SMEs. The Foreign Investment Advisory Service (FIAS), a joint facility of IFC and the World Bank, carried out an Assessment of Administrative Procedures for Doing Business in 2003. FIAS finalized an

advisory project in July 2004 to assist the Government in its efforts to remove administrative obstacles to investment to improve the business environment for private businesses.

4. Table 1 summarizes the division of responsibilities between the two institutions. In a number of areas—for example, the social sectors, rural development, environment, infrastructure, and judicial reform—the Bank takes the lead in the dialogue and there is no related conditionality in the IMF-supported program. The Bank is also leading the dialogue on private sector development and energy, and Bank analysis serves as inputs into the Fund program. In other areas—the financial sector, public expenditure management, and civil service reform—both institutions have worked together. Finally, in areas like monetary policy and domestic customs revenue, the IMF takes the lead.

IMF-World Bank Collaboration in Specific Areas

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

5. In the **social sectors**, IDA updates Georgia's Poverty Assessment based on quarterly household data. IDA's focus has been to improve execution of budgetary expenditures for health, education and poverty benefits and to raise the efficiency in the use of scarce public resources. Through the Social Investment Fund credits, IDA is focusing in particular on areas with high poverty levels to provide basic infrastructure to the poorest communities. IDA is also supporting a dialogue with the government on social protection reform (safety nets, pensions, labor market institutions and policies).

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

7. In **health**, IDA credits support the government in improving health care financing, exploring risk-pooling options, introducing a new system of primary health care, and improving the focus of publicly-funded services to the poor and on priority public health interventions. SAC III and the SRS Credit have supported hospital restructuring. In addition, IDA will be engaged in policy work in health sector reform in the context of the Medium-Term Expenditure Framework (MTEF) and the upcoming PRSC.

8. In **infrastructure,** support is being provided through the Secondary and Local Roads Project, the Municipal Development and Decentralization Project and the Social Investment Fund Project. These projects provide financing at the community level for critical infrastructure needs, primarily for school and health facility heating and repair, small

hydropower schemes to provide electricity, drinking water and sanitation rehabilitation, as well as transportation infrastructure rehabilitation. IFC supported the privatization of Tbilisi electricity distribution through an investment in AES-Telasi, and IFC Advisory Services advised the Government on the management contract for UDC.

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

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

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

11. The Bank has been leading the dialogue on structural reforms, especially through SAC III and the recent RSC. Institution building and technical assistance have been supported through the Structural Reform Support Project. The Bank also leads in the areas of:

a) **Private Sector Development**. SAC III and the RSC supported improvements in the environment for private sector development, focusing on: (i) simpler and more transparent licensing; (ii) strengthening credit enforcement; (iii) more transparent government procurement; and (iv) reduced cost of entry for businesses. IDA has also been supporting private sector participation in other areas, such as energy, urban services and agriculture. The IMF has worked with the authorities to initiate audits of the 2002 accounts of three major state-owned enterprises.

b) **Energy**. The energy system is in poor condition, with unreliable supply, massive non-payment and unsustainable debts. IDA has been working with other donors, including the Fund, to introduce more private management and ownership, and to implement a series of short-term action plans and longer-term steps to improve the overall functioning of the sector. IDA has also provided additional funding to the power sector in 2004. The Fund has been focusing on reducing quasi-fiscal losses in the sector, especially through improved bill collections, while the pursuit of tariff policies at cost-recovery levels would be facilitated by a Bank-assisted review of the tariff policy methodology. The RSC supported a Strategic Action Plan for the Energy Sector.

c) **Public Sector Management**. The proposed PRSC would support, inter alia, administrative and civil service reform, improvements in public expenditure management and strengthening financial accountability. The proposed Public Sector Management Reform Project would provide technical assistance and capacity building in the first three areas. The Fund is providing technical assistance in support of tax and customs administration reform.

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

Areas of shared responsibility

12. The Bank and the Fund have been working jointly in the following main areas (supported by the Bank's RSC, SAC III and SRS Credits, several investment operations, and the Fund's PRGF—further assistance is anticipated from IDA's PRSC):

a) **Poverty Reduction Strategy**. Both institutions have been working closely with the government to support the development of the PRSP, through seminars and workshops, direct staff input, and donor coordination.

b) **Budget Planning and Execution.** The annual programmatic Public Expenditure Reviews and the proposed PRSC will provide the underpinnings for systemic changes in expenditure management and improvements in financial accountability. The Fund is focusing on treasury reform within the Ministry of Finance.

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

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

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

Affairs Department is now taking the lead in the areas of tax policy and tax and customs administration reform.

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

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

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

World Bank Group Strategy

13. The IDA Board recently approved a US$24 million Reform Support Credit, a US$20 million Secondary and Local Roads Project, and a US$3.6 million Electricity Market Support Project. The Bank continues its discussion with the government on a more comprehensive medium-term reform strategy that would be supported by a series of Poverty Reduction Support Credits and technical assistance operations such as the Public Sector Management Reform Program.

Table 1. Georgia: Bank-Fund Collaboration on Georgia

Area	Specialized Advice from Fund	Specialized Advice from Bank	Key Instruments
Economic Framework/ Management	Monetary policy, exchange rate, fiscal, and trade policies, economic statistics	Economic growth, economic statistics	*IMF:* PRGF performance criteria and benchmarks on monetary and fiscal targets. *IDA:* Macromonitoring; Trade and Transport Facilitation Project; Financial Sector Advisory Work; Policy Options Report; Reform Support Credit
Budget	Budget framework, tax policy and administration, customs, debt management, extra-budgetary funds	Budget management, Public Expenditure Review and Process-Based PER, Country Procurement Assessment, Country Financial Accountability Assessment	*IMF:* PRGF performance criteria on overall fiscal balance and revenue collection. *Bank:* Programmatic Public Expenditure Review; Support for PRSP Updates; Policy Options Report; Reform Support Credit

Table 1. Georgia: Bank-Fund Collaboration on Georgia

Area	Specialized Advice from Fund	Specialized Advice from Bank	Key Instruments
Public Sector Reform	Public asset management, audit of 3 problematic state-owned enterprises	Civil service reform (including pay and employment reform), anti-corruption agenda, decentralization	*IMF:* PRGF *IDA*: Public Sector Management Program; Reform Support Credit
Social/Poverty	Prioritization of expenditure cuts to protect social spending	Poverty analysis; reforms in education, health, social protection; support to community driven development	*IMF:* PRGF *IDA*: Support through IDA Credits for Education, Health and Social Investment Funds, Programmatic Poverty Assessment, SRS support for hospital restructuring, Pensions and Social Assistance Note, Policy work in health sector reform under the MTEF and PRSC.
Private Sector Development		*Costs of Doing Business* Surveys. Support for improved legislation and regulatory framework for private sector	*IDA:* Business Environment Study, Integrated Trade Development Strategy, Labor Market Study,; Reform Support Credit. *IFC:* investments and technical assistance.
Infrastructure		Private sector participation in infrastructure	*IDA*: Support though ongoing and proposed IDA Credits for Municipal Development, Roads, and Transport. *IFC:* investments and advisory services.
Energy		Reforms and sector improvements	*IDA:* Support through ongoing credits for Power, Energy Transit, technical assistance, and joint donor policy dialogue.
Rural development		Reforms in agriculture, irrigation, forestry and, environment	*IDA:* Support though Rural Infrastructure and Water Resource studies; ongoing rural Credits, and proposed Credits for Rural Development, Rural Telecommunications, Community Based Tourism.

GEORGIA: STATISTICAL ISSUES

1. The Fund has provided Georgia with substantial technical assistance in the compilation of macroeconomic statistics (Appendix I, Table 1). Despite improvements in the areas of national accounts, price, monetary, and government finance statistics, the quality of macroeconomic statistics remains poor, reflecting deficiencies in statistical methodologies, coverage, and availability of resources. Problems are particularly acute in the compilation of national accounts, balance of payments, foreign trade, and fiscal statistics. Nonetheless, the core statistical indicators compiled by the authorities are provided on a timely basis and are adequate to enable staff to monitor macroeconomic developments under the program. The authorities have indicated an interest in participating in the IMF's General Data Dissemination System (GDDS).

Real Sector

2. The quality of GDP estimates has improved, although the State Department of Statistics (SDS) still faces problems with compiling reliable national accounts. National accounts statistics follow the concepts and definitions of the *System of National Accounts 1993,* with GDP estimates by production and expenditure compiled annually and quarterly. Revisions of the national accounts by activity follow an established schedule. The SDS is discontinuing the issuance of flash estimates one month after the observation period, which were considered as unreliable. Preliminary estimates are available after four months, and a final estimate after 13 months. The *Report on the Observance of Standards and Codes* prepared by the IMF's Statistics Department (STA) in July 2002 found that data sources used for the compilation of national accounts statistics **were** inadequate. The coverage of the business register is not comprehensive because of the lack of economic census data. The coverage of units in terms of value added is relatively good for industry, satisfactory for transport and communications, and poor for agriculture, retail trade, construction, catering, and services. Administrative sources used to estimate the non-observed economy are limited, and data for imports and exports of services (taken from the balance of payments) are inadequate. The main weakness of the statistical techniques used for national accounts are the compilation of the constant price estimates as well as the assessment and validation of source data. Given the sizeable infrastructure investment underway, technical assistance will need to focus on refining statistical coverage of such projects. A technical assistance mission in national accounts in April/May 2004 concluded that the SDS data are generally sound, but proposed a number of improvements in the estimation of national accounts from the expenditure side.

Money and Banking

3. A March 2002 STA mission found that the authorities had implemented many of the recommendations made by the December 2000 mission, but in a piecemeal manner that left a number of methodological problems unresolved. To address them, the mission advised the NBG (1) to break down resident data beyond the subsectors of "general government" and "the rest of the economy," in order to provide more disaggregated information about the

sectoral distribution of credit; (2) to incorporate all Fund-related accounts transparently in the central bank survey; and (3) to distinguish restricted deposits of insolvent banks from the deposit liabilities that qualify for inclusion in broad money. The mission also reviewed implementation of the NBG's new chart of accounts (introduced January 1, 2001) and associated changes in procedures for compiling monetary statistics to ensure error-free data classification. In July 2002, an STA mission visited Georgia to conduct the data ROSC. It found that most elements in the data quality assessment framework for monetary statistics were fully or largely observed, and recommended improvements in the statistical coverage of non-bank depository corporations and the provision of documentation on metadata. It also recommended increased transparency regarding access by governmental agencies to monetary statistics prior to their release to the public.

Government Finance

4. The fiscal accounts are presented on a cash basis for reporting purposes. Classification broadly follows the analytic framework of *GFSM 1986*, but the concepts and definitions of revenue, expenditure, and financing differ from the international standard in significant respects. In addition, the central treasury and line departments employ differing accounting systems. Specifically, the treasury adopts a single-entry cash basis, whereas line departments and other budgetary organizations typically employ a Soviet-era system. The single-entry system hampers the treasury's capacity to reconcile bank statements and hinders the reporting of information on accounts payable. Another statistical issue concerns the limited budget classifications available for expenditure. Discrepancies can arise when matching budget appropriations with the classified expenditure because the locally developed structure of expenditure codes changes frequently. Consequently, statistical performance and reliable budget reporting could improve once the treasury adopts internationally accepted accounting standards, including a unified treasury general ledger that is maintained on a double-entry cash basis. There are substantial differences in the classification systems of different government subsectors, including the extrabudgetary fund and the social security fund. Bridge tables linking national classification codes and *GFSM 2001* codes were established by a GFS mission in 2003 and were used in 2004 in reporting GFS for use in the GFS Yearbook. In accordance with recommendations of the 2003 GFS mission, a migration path leading more fully to data compilation in accordance with *GFSM 2001* needs to be approved soon.

Balance of Payments

5. The authorities have started to implement the recommendations of the previous technical assistance missions (February 2002 and May 2003) and of the 2002 data ROSC mission. In particular, the SDS is now using "mirror statistics" to estimate trade flows as well as data from consumer expenditure surveys to estimate some major imports of goods. At the same time, the Customs Department of the Ministry of Finance has improved data collection on trade flows by computerizing clearance procedures in 60 percent of customs offices and initiating the compilation of trade statistics by its Goods Monitoring Division. However, SDS has made little progress, if any, on improving staffing arrangements and preparing

documentation on the sources and methods for balance of payments compilation since the Data ROSC mission. The May 2003 mission focused on identifying new data sources and made arrangements for the provision of additional information for compilation of the balance of payments. With the assistance of SDS staff, the mission prepared a first draft of the metadata, including a description of the data sources and the methods for data processing and estimation. The mission also identified several problems in the direct investment data collection system, made recommendations on its improvement and elaborated a new methodology to estimate reinvested earnings. It also identified errors in the presentation of data on reserve assets and other assets and liabilities of the NBG and recommended corrective actions.

Georgia: Core Statistical Indicators
(As of October 29, 2004)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base 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	10/21/04	10/21/04	9/30/04	9/30/04	9/30/04	10/27/04	9/04	7/04	Q2/04	9/04	Q2/04	9/04
Date received	10/25/04	10/25/04	10/4/04	10/4/04	10/15/04	10/28/04	10/11/04	8/6/04	8/10/04	10/21/04	8/03/04	10/10/04
Frequency of data	D	D	M	M	M	W	M	M	Q	M	Q	M
Frequency of reporting	W	W	M	M	M	W	M	M	Q	M	Q	M
Frequency of publication	M	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 (e-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 restriction

December 3, 2004

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
700 19th Street N.W.
Washington, D.C. 20431

Dear Mr. de Rato:

This Supplementary Memorandum of Economic Policies updates our Memorandum of Economic and Financial Policies (MEFP) dated May 12, 2004, which describes the economic policies supported by the International Monetary Fund as Trustee under a three-year Poverty Reduction and Growth Facility (PRGF) arrangement. The attached memorandum proposes revised performance criteria for end-2004 and outlines our broad macroeconomic objectives and policies for 2005. These policies are consistent with our Economic Development and Poverty Reduction Program (EDPRP), presented to the IMF and World Bank in October 2003. We will submit our EDPRP Progress Report by end-December 2004.

The Government of Georgia believes that the policies set forth in the attached memorandum are adequate to achieve the objectives of the program, but it will take any other measures that may become appropriate for this purpose. The government will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultation. We request hereby the completion of the first review under the PRGF arrangement and in this connection, we propose the modification of the quantitative performance criteria for end-2004 (as indicated in Table 1 of the attached MEFP). Further, we request a waiver for nonobservance of the end-June 2004 structural performance criterion on submission of a strategy paper on domestic legacy debt in the electricity sector, which was issued with a delay for technical reasons.

Sincerely yours,

/s/

Mikheil Saakashvili
President of Georgia

/s/

Zurab Zhvania
Prime Minister

/s/

Zurab Nogaideli
Minister of Finance

/s/

Irakli Managadze
President of the National Bank of Georgia

GEORGIA—SUPPLEMENTARY MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES FOR 2004-05

A. Introduction

1. The government's economic program for 2004-06, which is supported by the PRGF arrangement approved by the IMF Executive Board in June 2004, aims to achieve sustained, rapid, and equitable economic growth in an environment of low inflation. This update of our Memorandum of Economic and Financial Policies reviews progress to date in the implementation of the program and describes our broad economic strategy through end-2005.

B. Recent Developments and Performance under the Program

2. The government's economic policies have strengthened macroeconomic fundamentals and improved growth prospects. Recorded real GDP increased by an estimated 8.4 percent year-on-year in the first nine months of 2004, driven by buoyant activity in the manufacturing and construction sectors, as well as the inclusion of previously unrecorded activities. Inflation has remained at 7.7 percent for the 12 months ending October 2004. Gross official foreign reserves increased to US$347 million as of end-October, equivalent to 2 months of non-pipeline imports. For the year as a whole, we project output growth of 8.5 percent, end-period inflation of around 5 percent and gross reserve coverage of 1.9 months of non-pipeline imports.

3. All quantitative performance criteria for end-June 2004 were met (Table 1). Results for end-September indicate that the program remains solidly on track and the original program targets for end-December could be met by wide margins. Deviations from the end-September indicative target for reserve money stemmed mainly from faster-than-expected remonetization, including sizable foreign exchange intervention by the National Bank of Georgia (NBG), which initially was largely unsterilized.

4. Fiscal consolidation, supported by decisive efforts to reduce tax evasion and improve expenditure management, lies at the heart of our economic program. Thus far, the results have been particularly encouraging. Tax revenue of the general government increased by 37.3 percent year-on-year during the first 10 months of 2004, well in excess of expectations. The supplementary budget passed by parliament in August 2004 recognized these achievements and set more ambitious targets for the commitments and cash balances of the general government. At the same time, it approved higher appropriations for defense, security and energy transfers, and faster clearance of domestic arrears. For the year as a whole, we now expect an overall commitments surplus of 0.7 percent of GDP (compared with the original deficit of 1.6 percent in the program) and a cash deficit of 1.8 percent (versus the original deficit of 2.6 percent). Tax receipts are now projected at 17.6 percent of GDP, up from the original goal of 16.3 percent, and we expect to reduce domestic arrears by some GEL 250 million (2.6 percent of GDP) versus the original objective of GEL 93 million.

5. A major drive to strengthen tax and customs administration has played a key role in our improved fiscal performance. We have bolstered tax administration by reorganizing the State Tax Department, strengthening the Large Taxpayer Inspectorate, and establishing an Excise Tax Inspectorate and a Financial Police. In addition, customs administration has improved significantly as a result of steps to curtail smuggling by modernizing border checkpoints and procedures, and reorganizing the central and regional structure of customs.

6. The tax reform that we expect to be approved by parliament in December represents an important step toward making the tax system more equitable and creating a more favorable business climate. The number of taxes was reduced from 21 to 8, the rates of the VAT and payroll taxes were cut, and a flat 12 percent personal income tax rate replaced marginal rates ranging from 12 to 20 percent. To offset the revenue loss from the tax cuts, excise tax rates were raised, several exemptions were abolished, and efforts to improve revenue administration are being intensified. Moreover, a one-time write-off of any undeclared taxes outstanding as of January 1, 2004 that we expect to be approved by parliament in December, accompanied by the ongoing strengthening of tax enforcement mentioned above, is expected to foster the legalization of economic activities and clean the slate for new investment going forward.

7. On the expenditure side, we have continued to improve budgetary design and execution under the framework of the Budget Systems Law that took effect in January 2004. In particular, we have introduced a treasury single revenue account; taken important steps towards performance-oriented budgeting and increased transparency in the budget process; and extended the application of commitment controls to extra-budgetary funds. We have also introduced a new system for tax refunds (especially for the VAT) that allows for timelier processing of claims. Moreover, we are improving the medium-term budgetary framework with emphasis on full integration with our poverty alleviation goals and development of a Medium- Term Expenditure Framework that should help allocate expenditure to strategic priorities and underpin fiscal consolidation.

8. Implementation of monetary policy has been complicated by large capital inflows during much of 2004, prompted by greater investor confidence and legalization of the informal economy in Georgia. In response, the NBG initially conducted largely unsterilized intervention while allowing greater exchange rate flexibility and smoothing fluctuations. Starting in September, the NBG began to sterilize its intervention through credit and deposit auctions, and in early October it increased reserve requirements on foreign currency deposits in order to moderate the growth in reserve money. By end-October, 12-month growth of reserve money had slowed to 27 percent from a peak of 36 percent in September. By that time, the currency had appreciated by about 13 percent both in nominal terms against the U.S. dollar and in real effective terms since end-2003. Dollarization has been mitigated somewhat, as evidenced by a decline in the share of foreign currency deposits in total deposits from 86 percent at the beginning of the year to 78 percent at end-October.

9. The recent surge in international oil prices is estimated to cost Georgia some 0.8 percent of GDP on a net basis in 2004 compared with the original program forecast.

Nevertheless, the external current account deficit is projected at 7½ percent of GDP in 2004, versus the original forecast of 9½ percent. This outturn reflects mostly a smaller than expected trade deficit, on the strength of a rapid increase in export volumes. Private capital inflows have been significantly stronger than expected, mainly due to increased business confidence and legalization of the economy.

10. International support for our reform effort has been strong. At the Brussels donors' meeting last June, Georgia secured US$1.1 billion in aid pledges for 2004-06, two-thirds of which in the form of grants. We are now working closely with our development partners to determine more precisely the timing and conditions for these disbursements. In July, Paris Club creditors restructured US$161 million in arrears and maturities due from June 2004 to December 2006 on extended Houston terms. Discussions with non-Paris Club creditors aimed at reaching rescheduling agreements on comparable terms are well underway.

11. We have made good progress in the area of structural reform. The structural performance criteria and most benchmarks through end-September 2004 envisaged in the program have been met, in some cases with a delay (Table 2). In the energy sector, we have continued to reduce quasi-fiscal losses by strengthening payment discipline and increasing cash collection rates for key customers. Consequently, we now project a decline in the sector's quasi-fiscal deficit to 4.5 percent of GDP, from an estimated 4.9 percent in 2003. Regarding the sector's legacy debt, legislation enabling a moratorium was passed in June and a Debt Restructuring Agency is being set up with assistance from Germany's KfW. The issuance of a strategy paper (a structural performance criterion for end-June) was delayed for technical reasons until September, but in the light of the progress we have made in tackling the legacy debt issues, we request a waiver for nonobservance of the end-June structural performance criterion.

12. In the area of civil service reform, government employment was reduced by some 30,000 positions in 2004, in the defense, internal affairs, state security, economic development, and finance ministries, and in the government chancellery. Legal provisions on severance payments were temporarily suspended for a two-year period in December 2003, so that the bulk of these retrenchments involved no severance payments. The savings in the wage bill have financed increased remuneration in the corresponding line ministries, including a phased increase in the civil service minimum wage to GEL 115 a month (equivalent to about US$65) in the course of 2004. A Civil Service Council (CSC) responsible for coordinating and overseeing civil service reform was established in August 2004 and regulations defining the mandate of the Council and its implementing arm (the Civil Service Bureau) were approved in October. The government has also taken steps to improve the management of state-owned enterprises (SOEs), including through implementation of the audit results of several major SOEs.

C. Economic Policies for 2005

13. The government is determined to further strengthen macroeconomic stability and intensify structural reforms geared to improving living standards in a low-inflation

environment. Accordingly, and reflecting our strong performance in the year to date, we propose a modification of the end-2004 quantitative targets under the program (Table 1). Based on the projected outturn for this year, the economic program for 2005 contemplates real GDP growth of 6 percent and inflation under 5 percent, keeping gross reserve coverage unchanged at 1.9 months of non-pipeline imports by end-2005. To achieve these objectives, the authorities will continue to pursue fiscal consolidation and a prudent monetary stance. We have identified indicative targets through end-June 2005 (see Table 1), in advance of the more detailed discussions on the program for 2005 that are scheduled for early 2005. In the structural areas, further significant steps will be taken to strengthen the financial system; improve the physical and financial performance of the energy sector; streamline the civil service; and create a favorable business climate, including through regulatory and legal reforms and an ambitious privatization program.

Fiscal policies

14. The 2005 budget that is expected to be passed by parliament by end-2004 seeks to limit the commitments deficit of the general government to 0.3 percent of GDP and the cash deficit to 1.9 percent, while fully eliminating domestic arrears by end-2005. The budget bill is premised on conservative assumptions on external assistance and privatization receipts, which will be reassessed at the time of the discussions for the second review under the PRGF arrangement in early 2005. Domestic deficit financing (excluding privatization) would be modest and any net NBG financing to the government, if necessary, will only be provided from 2005 onwards in the form of tradable securities. Tax receipts are projected at 18 percent of GDP. The government expects the 2005 revenue target to be met without difficulties on the strength of ongoing efforts to improve tax and customs administration. In any event, tax receipts will be treated as quantitative performance criteria in the 2005 economic program. Total expenditure is slated to increase somewhat, making room for an increase in minimum pensions (as discussed below), higher capital outlays to upgrade dilapidated infrastructure, and the introduction of means-tested poverty alleviation programs in late 2005. The 2005 budget reflects the priorities that have been identified in Georgia's Economic Development and Poverty Reduction Program (EDPRP).

Monetary and financial sector policies

15. The revised monetary program for 2004 envisions a modest tightening of monetary policy in the fourth quarter to forestall inflationary pressures. The program assumes reserve money growth of 25 percent for the year and broad money growth of 27 percent. Since the original end-year floor on net international reserves (NIR) and limit on the NBG’s net domestic assets (NDA) will likely be observed by wide margins, more ambitious targets for these aggregates have been set for end-December 2004 (Table 1).

16. The indicative monetary program for 2005, based on conservative assumptions on velocity and the money multiplier, targets inflation under 5 percent. To that end, it seeks to limit reserve money growth to 18 percent during the year and envisions a further buildup in foreign reserves. Indicative targets on the NIR and NDA of the NBG have been set through

June 2005. Performance criteria for end-June and end-December 2005 and indicative targets for end-September 2005 will be set at the time of the second PRGF review discussions in early 2005. To enhance monetary control, the NBG will limit its foreign exchange intervention to smoothing fluctuations, while strengthening its menu of monetary controls. The NBG will also seek to convert part of its claims on the government into tradable securities, as a first step towards gradually reducing these claims and discontinuing NBG lending to the treasury.

17. The NBG will intensify its efforts to strengthen supervision and foster competition in the financial system, with assistance from MFD. To enhance its efforts to combat money laundering, Georgia has ratified the Strasbourg Convention and set up a Financial Monitoring Services agency, which has been operational since January 2004.

Structural reforms

18. As noted earlier, the government launched a number of important structural initiatives during 2004, its first year in office. To add momentum to these reforms, we are discussing the way forward with our development partners and civil society, and are seeking expert technical assistance (including from the Fund) to draw on international best practices. Our focus will continue to be on key areas that bear on fiscal consolidation (such as energy sector reforms to reduce quasi-fiscal deficits, and further steps to strengthen tax administration and expenditure management), as well as on deepening financial sector reforms with MFD assistance. We expect to articulate specific sector strategies in the coming months, so that detailed actions to be implemented in cooperation with the Fund and other partners can be identified by the time of the second PRGF review discussions early next year.

Fiscal reforms

19. We will continue to upgrade the legal and institutional framework for tax and customs administration, public expenditure management and treasury operations, building on the important innovations introduced in 2004. More specifically, the Tax Department will conduct a campaign of re-registration of taxpayers and will focus on improving services to taxpayers and the tax declaration system. In addition, the Customs Department will continue with its administrative reorganization and will prepare for the introduction of the new customs code. Two extrabudgetary funds (the road fund and the social security fund) will be eliminated in the new fiscal year. Their activities will be taken over by the central government and financed from general revenue sources.

20. Drawing on the recommendations of a recent public expenditure management from the Fund's Fiscal Affairs Department (FAD), and in consultation with other donors, the government is developing a medium-term expenditure framework and will introduce a performance-oriented budget. In this context, Legal Entities of Public Law (LEPL) would come under the supervision of independent executive boards (with representation from relevant line ministries) that would be responsible for their financial operations. To prepare for the transition to greater independence and accountability, we will finalize operational

guidelines for converting budget organizations into LEPLs by mid-2005. These guidelines will stipulate that LEPLs should have separate accounts at the treasury and provide detailed financial and operational statements to their supervisory boards and to the Chamber of Control. During the year as a whole, we plan to convert some 3,500 central and local budget organizations into LEPLs, mainly in the education sector.

21. We will gradually incorporate into the budget the Development and Reform Fund, used to supplement the salaries of top civil servants. In 2005, 35 percent of the expenditures from this fund will be brought on budget, with a further 35 percent incorporated in 2006, and full incorporation in the 2007 budget. Meanwhile, we will continue to post the fund's expenditures periodically on the internet.

Energy sector

22. The overarching goal of energy sector reforms is to address capacity bottlenecks through emergency repairs and new investment, while seeking a decline in the sector's quasi-fiscal losses to 3½ percent of GDP in 2005 by strengthening payments discipline and reviewing the tariff methodology with World Bank assistance (as a prelude to the setting of cost-recovery tariffs). The envisaged Debt Restructuring Agency will propose specific modalities for orderly settlement of legacy debt (e.g., through cancellation of reciprocal claims and write-offs).

Public sector operations and the business climate

23. To improve growth prospects and the business climate, the government will streamline its operations and reduce its intervention in the economy. To that end, it will pursue a two-pronged approach, by (i) conducting significant SOE divestitures and improvements in the efficiency and accountability of those enterprises remaining in the public domain, and (ii) creating a professional and well-remunerated civil service. Transparent tenders for SOE divestiture will continue to be launched, with a broad goal of divesting the bulk of its 1,800 enterprises during 2005-06, which currently employ about 180,000 persons and which could generate net receipts of at least US$200 million. Supporting actions to improve the business climate (besides the tax reform) will include a zero-tolerance approach toward corruption and simplification of administrative procedures for opening and operating private firms. An additional 5,000 public employment positions will be retrenched in 2005, mainly in the defense and internal security workforce. Going forward, we envision the creation of common civil service rules across the three branches of government, competitive recruitment procedures, ethical codes of conduct, and clear guidelines for personnel training. We plan to prepare a report by end-June 2005 outlining guiding principles for civil service reform, including a plan to harmonize wage levels across budgetary organizations in 2005. To ensure fiscal sustainability, we will carefully assess the fiscal implications of the reform strategy, particularly with respect to increases in the wage and pension bills (for 2005, we will limit the wage bill to 4.1 percent of GDP, entailing a significant increase in remuneration permitted by the ongoing and planned retrenchments).

Trade liberalization

24. The government is committed to an open trade regime conducive to Georgia's integration in the world economy. However, because of a heavy legislative agenda in the coming months—including parliamentary discussion of the tax reform and 2005 budget bill—we have not yet been able to forge a domestic consensus on trade liberalization and thus will not be able to dismantle the 2002 protectionist measures as envisaged in the program (a structural benchmark for end-2004). Under the terms agreed by Georgia with the World Trade Organization, the number of tariff bands will be reduced from 21 in 2004 to 16 as of January 1, 2005. We have established an inter-ministerial working group in December, chaired by the Minister of Finance, and tasked it with the preparation of a concept paper on trade liberalization by February 15, 2005. It will also draft enabling legislation by end-April 2005, proposing a significant reduction in the number of tariff bands and in the maximum tariff rate (from 30 percent at present). Parliamentary approval would then be sought in time for making these measures effective from January 1, 2006. Meanwhile, we will request the WTO to conduct its first Trade Policy Review for Georgia. Our ongoing efforts to improve the business climate mentioned earlier should also contribute to the development of Georgia's international trade.

Poverty alleviation

25. The broad elements of Georgia's poverty reduction strategy are outlined in the EDPRP prepared in 2003, which was endorsed by the current administration. We are finalizing an EDPRP Progress Report in consultation with civil society and donors and will submit it to the Executive Boards of the IMF and the World Bank by end-2004. We will continue to strengthen the links between our poverty reduction strategy and the budgetary process.

26. To assist households living in extreme poverty, most of whom are headed by pensioners, we will increase the minimum pension to GEL 28 per month (equivalent to about US$15) beginning January 1, 2005. Additionally, we are preparing a means-tested poverty program that will complement the increase in minimum pensions by targeting households living in extreme poverty. While we originally planned to introduce this targeted benefit in early 2005, the complexity of developing the targeting mechanism will delay introduction to late 2005. Further, we will work with the World Bank to design a pension reform program.

Program monitoring

27. Completion of the second review under the PRGF arrangement, scheduled for April 2005, will require observance of the revised performance criteria for end-December 2004 shown in Table 1. The review will also focus on the government's fiscal consolidation strategy and on plans to broaden and expedite structural reforms, especially in energy and public sector operations and in trade liberalization.

Table 1. Georgia: 2004–2005 Quantitative Performance Criteria and Indicative Targets 1/

	Stocks 2/	Cumulative Change from End-2003											Cum. Change from End-2004	
	End-Dec. 2003	Mar. 2004			Jun. 2004			Sep. 2004			Dec. 2004		Mar. 2005 3/	Jun. 2005 3/
	Actual	Program estimates	Adj. prog. estimate	Actual	Performance Criteria	Adjusted target	Actual	Indicative targets	Adjusted target	Actual	Performance criteria	Rev. perf. criteria	Indicative targets	Indicative targets
							(In millions of lari)							
1. Quantitative targets 4/ 5/														
Floor on general govt. tax revenue (including special funds) 6/	1207.7	312.9		331.7	685.2		764.5	1101.0		1243.7	1538.5	1720.9	432.6	907.6
Ceiling on cash deficit of the general government 7/ 8/	109.5	81.2	57.4	63.0	151.6	77.1	18.3	179.5	71.5	16.5	240.4	178.8	62.1	167.3
Ceiling on domestic expenditure arrears of the general govt.	123.5	-6.3		-29.7	-25.8		-85.9	-52.2		-183.2	-93.4	-249.5	-59.0	-165.3
Floor on tobacco and petroleum revenues	133.9	39.0		40.9	92.8		101.6	174.5		189.7	259.2	259.2	107.2	222.6
Ceiling on net credit of the banking system to the general government (NCG) 8/	766.1	18.2		7.1	27.7		-25.6	27.4		-75.0	31.4	57.1	13.5	38.2
Ceiling on net domestic assets (NDA) of the NBG	909.0	18.4		-51.2	24.3		-116.2	21.5		-242.3	19.6	-169.1	18.2	30.4
							(In millions of U.S. dollars)							
Floor on total net international reserves (NIR) of the NBG	-153.1	-3.6		30.4	-0.2		89.3	11.9		190.6	28.8	146.1	4.1	15.8
Ceiling on contracting or guaranteeing of														
A. 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
B. 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
Ceiling on accumulation of external arrears	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														
Ceiling on reserve money	579.9	10.7		14.1	23.8		75.8	47.0		167.5	81.3	145.0	25.7	59.6
							(In percent)							
Average monthly cash collection rates (CCR)														
A. Electricity sector														
CCR from Direct Customers of the Georgian Wholesale Electricity Market	88.0	85.0		70.7	90.0		97.9	90.0		85.7	95.0	95.0	...	...
CCR from the General Government 9/	51.0 10/	95.0		70.6	95.0		111.5	100.0		121.9	100.0	100.0	...	...
CCR from customers of the major provincial distribution company (UDC)	19.0	18.0		18.6	20.0		22.9	27.0		...	35.0	35.0	...	...
B. Gas sector														
CCR from customers of Tbilgazi	22.8	25.0		21.8	29.0		60.8	34.0		56.2	40.0	40.0	...	...
							(In millions of lari)							
3. Baseline assumption on external project financing 7/	127.7	77.5		53.7	159.4		84.9	229.0		120.9	289.1	212.6	53.1	113.2

Sources: Georgian authorities and Fund staff estimates.

1/ Section 1 of this table shows quantitative targets for 2004 based on cumulative changes from end-December 2003 as well as March and June 2005 based on cumulative changes from end-December 2004. The ceiling for the cash deficit of the government is adjusted, as indicated in footnote 7, for deviations from projected external financing, reported in Section 3 of the table. Indicative targets are shown in Section 2. The continuous performance criterion for external arrears is defined in paragraph 23 of the TMU dated May 12, 2004.

2/ Year-to-date flows for tax revenues, cash deficit, expenditure arrears, and tobacco and petroleum revenues. Monetary outcomes reflect revaluations due to changed program exchange rate assumptions. Collection rates are for the fourth quarter of 2003.

3/ Year-to-date flows for tax revenues, cash deficit, expenditure arrears, and tobacco and petroleum revenues. Monetary outcomes reflect revaluations due to changed program exchange rate assumptions.

4/ Quantitative targets for 2004 are based on accounting exchange rates of GEL 2.15/US$, US$ 1.49/SDR, and US$ 1.27/EUR.

5/ Indicative targets for 2005 are based on accounting exchange rates of GEL 1.85/US$, US$ 1.46/SDR, and US$ 1.21/EUR.

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

7/ The program target on the cash deficit is adjusted for deviations from projected disbursements of external project finance (Section 3) as specified in the TMU agreed in February 2004, subject to a cap on the cumulative upward adjustment of GEL 100 million for 2004.

8/ In March 2004, the license of Maritime Bank was withdrawn, and the bank's assets and liabilities (including GEL 45.55 million in deposits of the Adjaran local government) were removed from the monetary survey. This led to an unanticipated increase in net banking system credit to the general government (NCG) and a higher-than-projected cash deficit as measured from "below-the-line." In assessing program performance in the first two quarters of 2004, NCG and the cash deficit as measured under TMU definitions have not been corrected for the effect of the closure of Maritime Bank.

9/ Preliminary results; they reflect a catch up of collections in June and September originally due in previous quarters.

10/ The cash collection rate from the General Government in the third quarter of 2003 was 95.4 percent.

Table 2. Georgia: Status of 2004 Structural Performance Criteria (*) and Structural Benchmarks

Action	Status	Comments
1. Select a consultant to conduct the review of the electricity tariff methodology. **End-June (*)**	Completed	
2. Issue a strategy paper to deal with internal electricity sector legacy debts. **End-June (*)**	Not observed	Issuance of the debt strategy paper was delayed to early September due to technical reasons.
3. Establish full commitment control for all payments by the Treasury for state ministries and line agencies; close all revenue transit accounts (thereby making the Treasury Single Account fully effective); and move the VAT refund accounting and payment to the Treasury (the tax administration services of the Ministry of Finance will remain in full control of verifying and approving VAT refunds). **End-June**	Partially completed	By end-June, full commitment control was in place for all state ministries and line agencies, but not for the Social Security and Road Funds. Full commitment control was extended to these extrabudgetary agencies in September 2004. In April, the authorities closed all revenue transit accounts in commercial banks and established a treasury single revenue account. The transit revenue accounts at the NBG have not been closed yet. Legal provisions to transfer the administration of the VAT refund mechanism are complete and refunds have begun.
4. Appoint new supervisory boards for the Madneuli mining and Elektrokavshiri state enterprises that will be guided by performance-based contracts, which will require them to exercise effective oversight of management to ensure improved transparency in the operations of these enterprises. **End-June**	Partially completed	Supervisory boards have been appointed for Madneuli and Elektrokavshiri. Performance-based contracts for the supervisory boards of both companies have not been issued yet.
5. Move the collection systems for payments to electricity distributors in major towns outside Tbilisi to banks or service centers. **End-June**	Completed	
6. Submit to parliament legislation enabling the NBG to disqualify auditors from performing bank audits and require auditors to disclose violations of laws, regulations, or significant misrepresentation of financial data to the NBG. **End-June**	Completed	Legislation was submitted to parliament in May 2004.

Table 2. Georgia: Status of 2004 Structural Performance Criteria (*) and Structural Benchmarks

Action	Status	Comments
7. Post the results of the audits of the 2002 accounts of Poti Port, Georgian Railways and Madneuli Mining Company, including the management letters in the official websites of the Ministry of Finance and the Ministry of Economy. **End-August**	Partially completed	The audit of the Railways was published on the website of the Ministry of Economy in November. Audits of Poti Port and Madneuli Mining are being finalized.
8. Secure parliamentary approval of enabling legislation to allow for provisional measures (i.e., freezing and seizure) and confiscation related to the anti-money laundering legislation. **End-September**	Pending	Enabling legislation will be submitted by the Ministry of Justice to parliament as part of a larger set of changes to the criminal code.
9. Initiate international audits of the Tbilisi Airport Authority and the state telecommunications company (Elektrokavshiri) by issuing tenders and selecting auditors. **End-September**	Completed	The audits of the 2003 accounts of Elektrokavshiri and the Airport Authority have been completed.
10. Secure parliamentary approval of amendments to the Budget System Law to align it with recent constitutional amendments and to implement the recommendations of the October 2003 FAD TA mission. **End-December (*)**	...	The Budget System Law was amended in February 2004. Additional amendments have been prepared in line with FAD recommendations.
11. Secure parliamentary approval of a Tax Reform, as specified in paragraph 15 of the MEFP dated May 12, 2004. **End-December (*)**	...	A draft tax reform bill was submitted to parliament on September 9, 2004.
12. Audit the stock of domestic expenditure arrears by verifying all claims on the state budget. **End-December**	...	The audits of pension and health sector arrears are complete. Audits of remaining arrears have begun.
13. Reverse the changes in foreign trade tariffs that were introduced in December 2002. **End-December**	...	
14. Refrain from issuing government guarantees on domestic loans. **Continuous (*)**	Completed to date.	No new guarantees have been issued.
15. Refrain from engaging in offset transactions to settle tax obligations or government electricity bills. **Continuous**	Completed to date.	No new offsets have occurred.

Statement by the IMF Staff Representative
December 20, 2004

1. The following information has become available since the issuance of the staff report. It does not change the thrust of the staff appraisal.

2. Twelve-month inflation in November was 4.1 percent. Reflecting continued foreign exchange intervention by the NBG, year-on-year growth in reserve money as of early December was around 36 percent. Gross official foreign reserves now stand at around US$380 million, compared with the revised end-year forecast of about US$320 million mentioned in the staff report. The NBG expects the end-year indicative target for reserve money (an increase of 25 percent) to be exceeded by about 5 percentage points. The monetary officials regard the persistent overshooting of reserve money targets since the program's inception as stemming from continued remonetization. They stress, however, that they are closely monitoring price performance and are prepared to tighten the monetary stance if inflationary pressures emerge. In recent weeks, the lari has further strengthened against the dollar, bringing the cumulative nominal gain since end-2003 to 15.4 percent. The real effective appreciation during that period amounted to 9.8 percent.

3. Fiscal performance has remained very strong, with tax receipts increasing by 43 percent year-on-year in November. The authorities plan to submit shortly a further supplementary 2004 budget to parliament, featuring a slight upward revision in the tax revenue target for the year and higher spending appropriations, including for additional arrears clearance beyond the amounts envisaged in the program.

4. The final vote on the tax reform bill is scheduled for December 21 and the new tax code will come into effect January 1, 2005. The main difference from the original bill described in the staff report is a delay in reducing the VAT rate from 20 percent to 18 percent, from January to July 2005, with a positive yield of 0.4 percent of GDP. The authorities said that other modifications from the original bill, including on the tax base and the rates of excise and property taxes, do not entail tangible deviations from their original revenue forecast. The authorities have indicated that they plan to submit a revised tax write-off bill to parliament soon after passage of the tax reform.

5. On December 10, the government sent to parliament a revised 2005 budget bill superseding the draft submitted last October. Compared to the headline numbers described in the staff report, the main innovations are summarized in Table 1. The overall cash deficit would now be capped at 2.2 percent of GDP (compared with the indicative limit of 1.9 percent set out in the authorities' MEFP). Nevertheless, domestic deficit financing (excluding privatization) would remain limited to 0.4 percent of GDP as discussed with the recent mission, thereby underpinning macroeconomic stability.

6. Regarding structural reforms, on December 1, the Prime Minister ordered the creation of an inter-ministerial working group on trade liberalization, chaired by the Minister of

Finance and including representatives from the Ministries of Finance and Economic Development. The implementation decree is expected to be issued shortly. The authorities sent to parliament in November several modifications to the anti-money laundering legislation. Passage of these amendments (a structural benchmark for September 2004) is now expected by March 2005.

7. The safeguards assessment of the NBG was completed on December 10. Staff found that the bank has made progress in addressing vulnerabilities identified during the 2002 assessment, and that adequate safeguards are in place in the core areas. The NBG was receptive to staff recommendations to strengthen internal audit and control procedures and indicated that it is already working to address these issues.

8. The authorities will shortly finalize a status report on the implementation of Georgia's PRSP, which they discussed with donors and domestic stakeholders. They plan to submit the document to Fund and World Bank staff in the next few weeks.

9. Georgia expects to conclude shortly the bilateral rescheduling agreements pursuant to the June 2005 Paris Club rescheduling of maturities coming due during the program period. The authorities have also contacted other official creditors to seek a rescheduling on comparable terms.

10. Results for Georgia from the recently-issued *Global Corruption Barometer 2004,* a survey of 64 countries conducted by the NGO Transparency International, are encouraging.[1] The responses rank Georgia among the top three countries in terms of the outlook for reducing corruption over the next three years.

[1] The Barometer complements Transparency International's other main indices (Corruption Perception and Bribe Payers), by polling *public* rather than *expert* opinion on corruption. For details, see www.Transparency.org.

Table 1. Georgia: Revised 2005 Budget Bill

	Staff Report		Revised Bill	
	million lari	% of GDP	million lari	% of GDP
Total revenue and grants	2,207	20.4	2,284	21.1
Tax revenue	1,946	18.0	1,987	18.4
Nontax revenue	146	1.4	162	1.5
External grants	116	1.1	135	1.2
Total expenditure and net lending	2,242	20.7	2,383	22.0
Of which:				
Current expenditure	1,935	17.9	1,992	18.4
Capital expenditure	244	2.3	313	2.9
Overall balance (commitments basis)	-35	-0.3	-99	-0.9
Net change in expenditure arrears	-170	-1.6	-142	-1.3
Overall balance (cash basis)	-204	-1.9	-241	-2.2
Total financing	204	1.9	241	2.2
Privatization	115	1.1	100	0.9
Domestic financing	47	0.4	47	0.4
External financing	43	0.4	94	0.9
Of which: Disbursements	216	2.0	268	2.5
Memorandum item:				
Nominal GDP (millions of laris)	10,809		10,809	

Source: Georgian authorities

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FOR IMMEDIATE RELEASE
December 21, 2004

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes First Review Under Georgia's PRGF Arrangement and Approves US$21.5 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) has completed the first review of Georgia's performance under the three-year Poverty Reduction and Growth Facility (PRGF) arrangement. In doing so, the Board approved a request for a waiver for the non-observance of the structural performance criteria with respect to the issuance of a strategy paper to deal with internal electricity sector legacy debt.

The IMF's Executive Board approved the three-year arrangement on June 4, 2004 (see Press Release No. 04/107) for an amount equivalent to SDR 98 million (about US$150.3 million). Completion of the first review will bring total disbursements under the arrangement to SDR 28 million (about US$42.9 million).

Following the Executive Board discussion, Mr. Takatoshi Kato, Deputy Managing Director and Acting Chair, stated:

"Economic performance under the Fund-supported program has been impressive in 2004, with robust growth and subdued inflation. Rapid gains in tax collections—thanks to an anti-corruption drive and improved revenue administration—have permitted an impressive turnaround in the fiscal position and a significantly faster-than-expected clearance of domestic arrears. The new government has received strong international support, and last July, Paris Club creditors restructured Georgia's debt in arrears and maturities due through December 2006 on extended Houston terms. The improvement in economic fundamentals has brought down risk premia on government securities and mitigated dollarization.

"The government has also made good progress in structural reforms, albeit with delays. It has strengthened the physical and financial viability of the energy sector, though further efforts will be needed to ensure reliable power supplies and reduce energy sector quasi-fiscal losses. As a first step toward creating a professional civil service, the government has reduced public employment by some 30,000 positions in 2004, and used the related salary savings to improve remuneration of remaining personnel. The authorities have also announced an ambitious privatization program and supporting steps to improve the business climate.

"The thrust of the authorities' economic program for 2005 is to further strengthen the fiscal position, especially by institutionalizing the improvements introduced thus far, enhancing the quality of expenditure, and eliminating domestic arrears. The authorities are also planning to add momentum to other reforms. The proposed overhaul of the tax code (to simplify the tax structure, broaden the tax base, and eliminate exemptions and low-yield taxes) should further enhance revenue administration and the business climate. Reforms in other areas will be geared towards further strengthening the financial sector and fostering productivity gains and social protection, so as to improve growth prospects and living standards. A prudent monetary stance, accompanied by greater exchange rate flexibility and wage moderation, is expected to keep inflation low and safeguard competitiveness," Mr. Kato said.

The PRGF is the IMF's concessional facility for low-income countries. PRGF-supported programs are based on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners, and articulated in a Poverty Reduction Strategy Paper, or PRSP. This is intended to ensure that each PRGF-supported program is consistent with a comprehensive framework for macroeconomic, structural, and social policies, to foster growth and reduction of poverty. PRGF loans carry an annual interest rate of 0.5 percent, and are repayable over 10 years with a 5 ½-year grace period on principal payments.

Statement by Jeroen J. M. Kremers, Executive Director for Georgia and Nikoloz Gigineishvili, Advisor to Executive Director December 20, 2004

On November 23, 2004, Georgia celebrated the first anniversary of its 'Rose Revolution'. In its first year in office the new government has made tremendous efforts to implement sound macroeconomic policies, revamp stalled structural reforms and dismantle systemic corruption. The progress in many areas, including fiscal performance, anti-corruption drive and law enforcement, has exceeded expectations, and backed by the new PRGF arrangement contributed to credibility and confidence building, both domestically and internationally. Furthermore, an environment conducive to investment and business development has started to emerge. The changing business climate and the improving public perceptions about the government's commitment to tackle long-standing problems lay the foundation for sustainable, equitable and private sector-led growth. However, the authorities realize that major challenges are still ahead. To make the early achievements lasting, they are to maintain the momentum and act resolutely on the structural and policy fronts in line with the objectives of the Economic Development and Poverty Reduction Program (EDPRP) of Georgia.

The performance under the Fund-supported program has been strong. All performance criteria have been implemented with noticeable over-performance in some areas, especially the fiscal. Tax revenues have increased by 3.5 percentage points of GDP within one year, significantly exceeding an already rather ambitious target of an increase by 1.6 percentage points. The authorities have proposed raising the fiscal targets. Helped by buoyant revenue collection, domestic arrears (wages, pensions and refugee benefits) are being paid well ahead of schedule. Moreover, the latter are projected to be fully cleared by mid-2005, as compared to the originally planned clearance by the end of the program period. While a structural performance criterion on issuance of a strategy paper on energy debts was completed with a short delay, it did in no way entail derailment of reforms in the sector. The authorities request a waiver for the non-observance. Based thus on compliance with the program requirements they request completion of the first review under the PRGF, which will signal to the international and business communities that Georgia is well on track on its ambitious reform agenda.

Fiscal performance

A turnaround in fiscal consolidation and management of public finances has been the centerpiece of the authorities' macroeconomic strategy. The efforts to strengthen the tax administration and the crackdown on corruption, smuggling and tax evasion have resulted in an increase of over 50 percent of tax revenues in nominal terms compared to 2003. The first time since the independence of Georgia, instead of the established pervasive practice of mid-year expenditure cuts, the budget figures were initially prudent allowing room for them to be revised upward. Reflecting EDPRP priorities, additional funds have been allocated for social spending, including arrears clearance, healthcare, education, the energy sector and infrastructure development. At the same time, global terrorism threats, the need to combat organized crime and to close loopholes on the state border have warranted larger outlays on law enforcement and security. The authorities are cognizant that the progress in budget execution leaves no room for complacency. They appreciate technical assistance from FAD and are determined to further strengthen the fiscal system through adoption of best international practices in policy implementation and reforms.

To promote a business-friendly environment, reduce temptations of tax evasion and smuggling, and facilitate private sector development, a profound tax reform is expected to be approved shortly. The new tax code is intended to streamline and optimize the tax structure and tax rates, and simplify administrative procedures. Thirteen out of twenty-one taxes will be eliminated and the rates of the personal income tax and the social tax will be lowered early next year. From July 2005, the VAT rate will also be reduced from 20 to 18 percent. As compensating measures, various tax exemptions have been abolished to broaden the effective tax base and excise rates have been increased. While increase in the tax revenue-to-GDP ratio was sizeable in 2004, at about 18 percent it still remains relatively low compared to some other countries in the region, leaving room for further improvements. The Georgian authorities are confident that with the persistent efforts to strengthen fiscal performance the overall effect of the tax reform would be at least revenue-neutral, if not revenue-enhancing. At the same time, the reduced tax rates will provide more breathing space to businesses and entrepreneurs. A one-time tax amnesty on undeclared tax obligations is intended to reduce informal activities and to allow companies and individuals to start from a clean slate. Acknowledging the danger of moral hazard, the authorities have clearly indicated that this is a one-off measure and that tax compliance will be strictly enforced.

The encouraging progress in revenue collection and faster than expected clearance of domestic arrears has allowed more flexibility in expenditure prioritization and prompted the authorities to increase pro-poor spending. In this regard, from the beginning of the next year, minimum pensions will be doubled and from the fourth quarter of 2005, targeted poverty programs will be introduced to better address the needs of the most vulnerable.

Parallel to administrative efforts, a number of structural measures have been taken to improve the effectiveness of the fiscal authorities. The tax and customs departments have been downsized and their structures optimized in an effort to form a more potent system for combating tax evasion and smuggling. An Excise Tax Inspectorate was formed to take sole responsibility over the taxation of excise goods, and financial police was created to assume responsibility for fighting economic and financial crimes. The tax and customs administrations of the Adjara region were integrated into the respective national authorities. In the treasury, full commitments control was introduced, more than 10 thousand transit accounts were closed and consolidated into a single revenue account, and an effective VAT refund mechanism was established. To further improve the link between fiscal policy implementation and national priorities, introduction of a multi-year budgeting framework is currently under consideration.

Monetary sector

Sound monetary management has continued to underpin macroeconomic stability. Inflation has remained low, banking system consolidation and the process of bank recapitalization have progressed steadily and financial deepening has advanced.

New challenges emerged in the new environment. The strong fiscal performance and rebounding investor confidence attracted foreign capital and sparked a process of de-dollarization. With price stability as the primary objective, the National Bank of Georgia (NBG) has managed to strike a balance between reserve money growth and exchange rate competitiveness. Given the low level of monetization and increasing demand for domestic currency, the NBG saw a scope for non-inflationary money growth. Consideration was also given to the fact that part of the increase in the lari liquidity was the result of de-dollarization and hence would not contribute to consumer demand. Currency appreciation went hand in hand with foreign exchange interventions intended to smooth exchange rate fluctuations, and to avoid potential overshooting and speculative attacks. Still being cautious, from the fourth quarter of 2004 the NBG started to actively use deposit and credit auctions, as well as deposit and credit standing facilities to sterilize part of its foreign exchange interventions. As an additional precautionary measure, the reserve requirements on foreign-currency deposits were also effectively increased from October 1, 2004. As a result of the prudent management, while reserve money growth exceeded the program projections, y-o-y inflation through November amounted to 4.1 percent. The real effective exchange rate appreciated by about 10 percent during the first 11 months of the year and the foreign exchange reserves almost doubled.

The development of financial markets was favorable. Reflecting growing trust in the new administration, treasury bill yields declined from 70 percent a year ago to 25 percent in June and further to 13 percent most recently. Interest rates on banking products and spreads between credit and deposit rates also came down. As a sign of improved confidence in the lari, deposit dollarization started to fall from 86 percent one year ago to about 78 percent in November 2004. The trend of de-dollarization is particularly important from the monetary policy point of view, since it creates more scope for active utilization of market instruments and efficient liquidity management.

The banking sector performed well with most financial and prudential indicators moving in the right direction. Credit volume increased, while the share of non-performing loans in the total portfolio declined. The level and the quality of bank capital continued to increase steadily in compliance with the statutory requirements, which mandate banking institutions to raise their capital to at least lari 12 million (in line with the European standard of at least Euro 5 million) by end-2008. Together with other regulatory and supervisory measures, this has facilitated the bank consolidation process and helped to filter out weak and financially non-viable banks.

Structural issues

Building public trust and changing perceptions about the business environment in Georgia are the key prerequisites for promoting private sector development and making the country an attractive place for investment. With this principal objective in mind, the Georgian authorities have embarked on an ambitious reform agenda. Fighting corruption, strengthening the rule of law and improving governance have been set as top priorities. Progress has been significant. The authorities managed to counter systemic corruption and damage deep-rooted organized crime. Widespread smuggling, tax evasion, bribery and other forms of power abuse are being pushed back, and all businesses are increasingly given fair opportunities to compete. A most encouraging development was the improved confidence of the public in the government. The recently published results of public polls by Transparency International confirm that 5 to 10 percent of respondents have actually paid bribes in 2004. There are no numbers for earlier years, but these were certainly much higher and quite possibly over 50 percent. Furthermore, 60 percent of the surveyed believe that corruption will decrease in Georgia over the next three year. The authorities are fully committed to further intensify their efforts in this direction and meet the expectations of the society.

The government has initiated a profound reform of the civil service. The goal is to transform the oversized and rigid public sector into a compact, efficient and transparent system with clearly defined objectives and functions. State regulations are intended to be minimized, with certain regulatory agencies abolished or merged, and licensing requirements considerably simplified. The painful process of downsizing has already started, and more than 30,000 state employees have been laid off mostly in law enforcement bodies, the state chancellery and the fiscal sphere. For consistency and continuity purposes, a Civil Service Council was formed in August 2004 and tasked to develop an overarching strategy for the reforms. One of the key elements will be restructuring the compensation and training systems to attract and retain professional staff and reduce incentives for corruption.

Large-scale privatization of state enterprises and rehabilitation of the energy sector are also high on the government's reform agenda. A privatization list includes about 400 state enterprises and properties. Some of them have already been sold or are being auctioned, while the majority is expected to go under the hammer in the course of the next year. In the energy sector, good progress was achieved in improving payment discipline throughout the country and in reducing quasi-fiscal losses. After completing reconstruction work, several hydropower plants will soon become operational, and rehabilitation of a thermo-power plant is also scheduled for the near future. Although with delay, the strategy paper on managing internal legacy debts in the energy sector was prepared, and the establishment of a Debt Resolution Agency should facilitate the orderly settlement of those debts.

In closing, on behalf of the Georgian authorities, we would like to thank staff and management for the Fund's dedicated work and continued financial and technical support. The authorities appreciate the staff report and as usual consent to its publication.