April 2013
IMF Country Report No. 13/95

Georgia: First and Second Reviews Under the Stand-By Arrangement and Under the Standby Credit Facility Arrangement, and Request for Waiver of Nonobservance of Performance Criterion—Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Georgia.

In the context of the first and second reviews under the Stand-By Arrangement and under the Standby Credit Facility Arrangement, and request for a waiver of nonobservance of performance criterion, the following documents have been released and are included in this package:

- The staff report for the first and second reviews under the Stand-By Arrangement and Under the Standby Credit Facility Arrangement, and request for waiver of nonobservance of performance criterion, prepared by a staff team of the IMF, following discussions that ended on December 11, 2012 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 March 1, 2013. 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 Press Release summarizing the views of the Executive Board as expressed during its March 13, 2013 discussion of the staff report that completed the request and/or review.

- 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*
Memorandum of Economic and Financial Policies by the authorities of Georgia*
Technical Memorandum of Understanding*

*Also included in Staff Report

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

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GEORGIA

March 1, 2013

FIRST AND SECOND REVIEWS UNDER THE STAND-BY ARRANGEMENT AND UNDER THE STANDBY CREDIT FACILITY ARRANGEMENT, AND REQUEST FOR WAIVER OF NONOBSERVANCE OF PERFORMANCE CRITERION

EXECUTIVE SUMMARY

Following Georgia's first peaceful handover of power in its modern history, the new government plans to reinvigorate economic reforms while pursuing more socially balanced policies. To help structure these policies, the new authorities are keen to maintain the strong record of cooperation with the Fund, including by continuing with the SBA/SCF-supported program, which will expire on April 10, 2014. Fund credit of up to SDR 250 million (166.3 percent of quota) could be made available under these arrangements in the event of a significant worsening of external conditions, including a cumulative SDR 130 million upon completion of the first and second reviews.

Macroeconomic developments have been broadly positive, save for the current account deficit, which has remained higher than projected. Despite slowing in the second half of the year, in part due to uncertainties from the election and the political transition, growth is expected to have exceeded 6 percent in 2012, while inflation has continued to decline. However, the current account deficit has remained high, at around 12 percent of GDP, rather than falling below 10 percent of GDP as projected in the program.

All end-June and end-December performance criteria and all structural benchmarks were met except for the end-December performance criterion on the cash deficit of the Partnership Fund (PF). Despite spending pressures ahead of the election, the government met the fiscal deficit target comfortably. While the current account deficit proved higher than envisaged, reserve accumulation was in line with program objectives due to higher-than-expected capital inflows. However, the PF breached its zero deficit target because of a US$50 million disbursement made under the previous government to finance construction of a power plant. The new government has taken corrective actions to ensure that a similar breach will not happen again. The authorities are treating the program as precautionary and do not intend to draw funds at this review.

Macroeconomic policies aim at supporting growth while reducing the current account deficit over the medium term through continued fiscal consolidation, real exchange rate depreciation, and structural reforms to improve competitiveness. To reduce the fiscal deficit to

2.8 percent of GDP (compared to the 3 percent initially envisaged), while delivering on the government's promise to increase social expenditure, the 2013 budget focuses on streamlining and reprioritizing capital expenditure and on containing other current expenditures. External sustainability and the inflation targeting regime will be supported by exchange rate flexibility. Structural reforms will aim at improving the business environment and boosting competitiveness and will be supported by the creation of new privately financed investment funds.

Continued cooperation between the government and the NBG, together with support for NBG independence, will help program implementation. Measures announced by the NBG to improve transparency, including publication of additional information on macroeconomic forecasts underlying its monetary policy decisions, will help increase its accountability and strengthen monetary policy's effectiveness.

Macroeconomic prospects are more uncertain than usual with risks skewed to the downside. Growth could be lower than expected if the postelection slowdown persists. Lower private capital inflows, especially if FDI were to fall, could challenge external and financial stability. On the upside, possible opening of the Russian market to Georgian products, or completion of an EU free trade agreement, could boost exports.

Approved By
Juha Kähkönen and Vivek Arora

A staff team comprising Mark Griffiths (head), Mariana Colacelli, Edouard Martin (all MCD) and Ruo Chen (SPR) visited Tbilisi November 27–December 11, 2012. The mission was assisted by Azim Sadikov (resident representative) and Nia Sharashidze (resident representative office). The mission met with Prime Minister Ivanishvili, Minister of Agriculture Kirvalidze, Minister of Economy Kvirikashvili, Minister of Energy Kaladze, Minister of Finance Khaduri, National Bank Governor Kadagidze and other senior officials, as well as representatives of the private sector, labor unions, NGOs, and the donor community. Yuriy Yakusha (OED) participated in the discussions.

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INTRODUCTION

1. **Georgia has completed the first peaceful handover of power in its modern history.** The opposition six-party Georgian Dream coalition won a convincing, and unexpected, victory in last October's parliamentary elections. Prime Minister Ivanishvili's new government has taken office but its cohabitation with President Saakashvili, who remains in power until next October's presidential elections, has posed challenges. Although macroeconomic stability has been maintained, uncertainty has increased during the elections and the resulting political transition. While financial markets have recovered, FDI and credit growth have showed signs of weakening.

2. **The new government plans to reinvigorate economic reforms while pursuing more socially balanced policies.** It has expressed a strong commitment to transparency, accountability, and the rule of law, already taking steps to strengthen the independence of the judiciary. The government's economic priority is to reduce unemployment and poverty, which, despite strong growth over the last decade, remain relatively high, by generating sustained and inclusive private sector-led growth. To this end, it intends to improve the business environment, enhance social protection, better protect workers' rights, strengthen the country's inadequate antimonopoly regulation, and revamp the agricultural sector, which, on paper at least, represents about half of total employment.

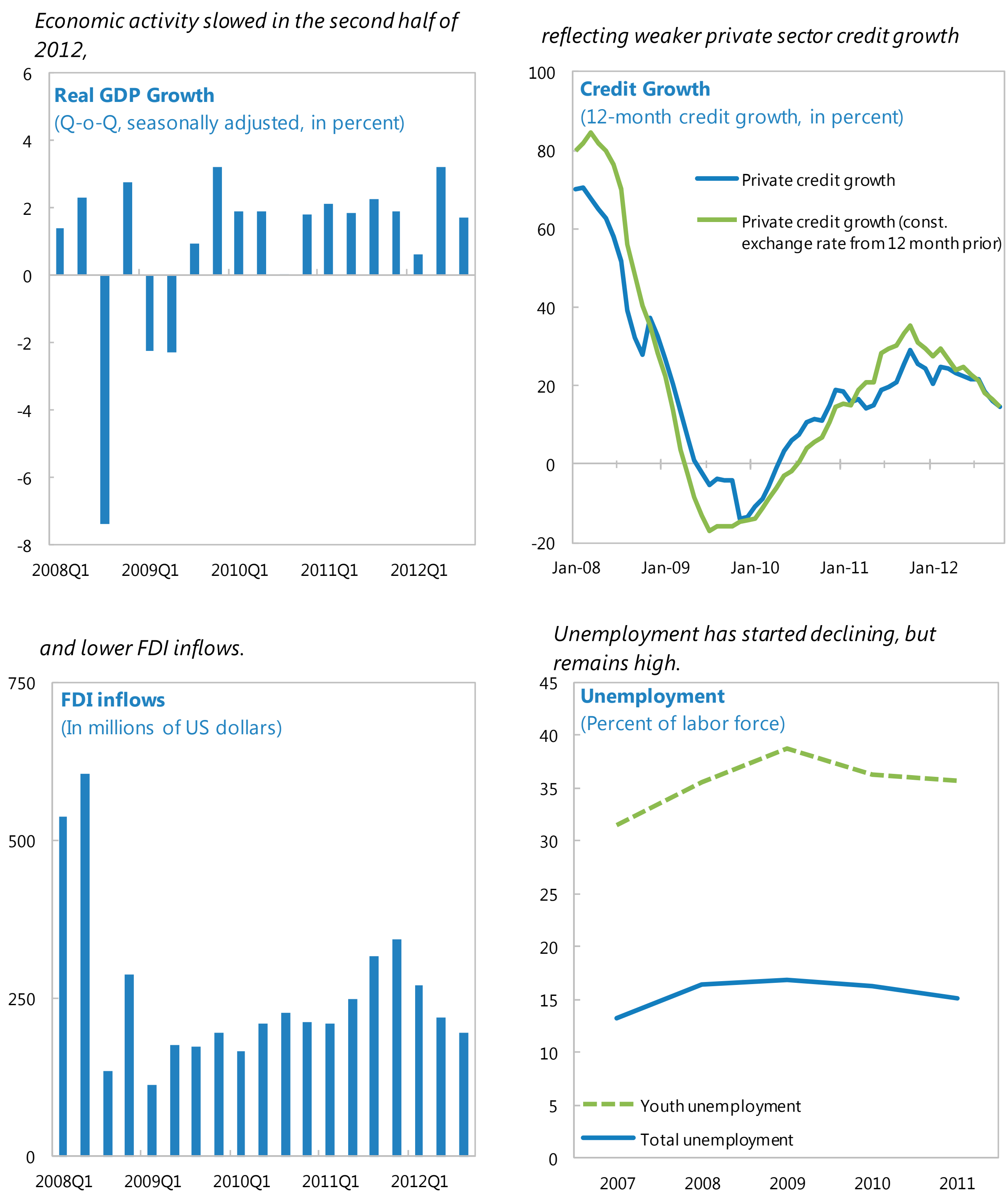
3. **The new authorities are keen to maintain the strong record of cooperation with the Fund, including by continuing with the SBA/SCF-supported program.** While still intending to treat the program as precautionary, they fully subscribe to the program's objectives of promoting external and fiscal adjustment, encouraging inclusive growth, and reducing poverty, and see the program as a useful framework for integrating their economic policies.

RECENT DEVELOPMENTS

4. **Despite an election-related slowdown in the second half of the year, growth is expected to have exceeded 6 percent in 2012** (Table 1). Real GDP grew by 7.5 percent in the first 3 quarters of 2012 driven by construction, manufacturing, and the financial sector. However, growth started to decline ahead of the October 1 election (averaging 6½ percent in August–September) and then declined further (to -0.8 percent in October–December according to the latest flash estimate). This decline appears to reflect a "wait-and-see" attitude among investors, with FDI declining sharply in the third quarter and credit slowing gradually (Figure 1).

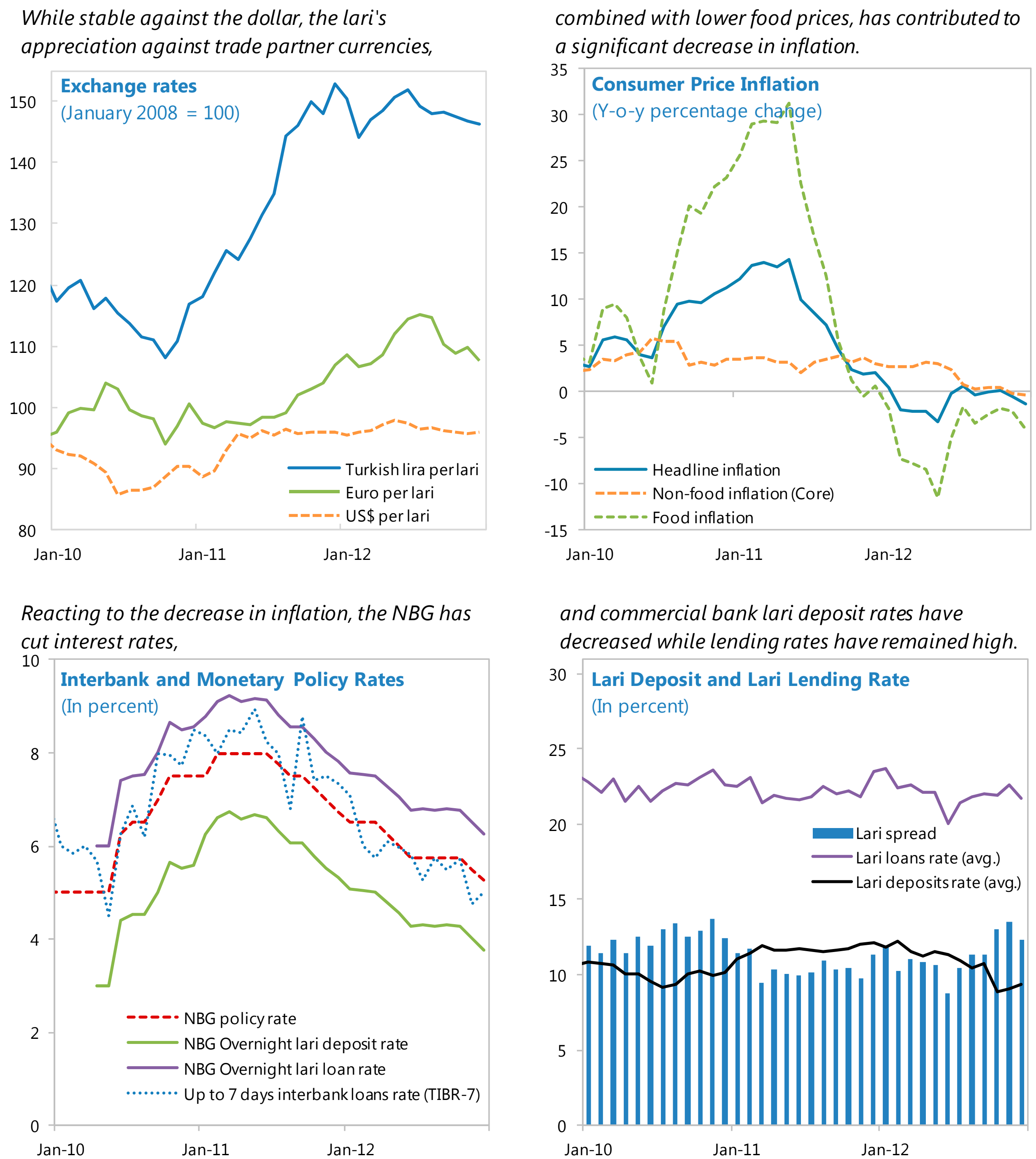
5. **Inflation has dropped well below the National Bank of Georgia's (NBG) 6 percent target, mainly because of lower food prices and the lagged effects of real exchange rate appreciation.** Headline inflation has fallen sharply from almost 15 percent in May 2011 to -1.4 percent at end-2012 (Figure 2). While a large part of this decline reflects falling food prices (27 percent of the basket), exchange rate appreciation has also reduced import prices more generally so that nonfood (or core) inflation has also fallen to around zero.

Figure 1. Georgia: Real Sector Developments, 2008–12



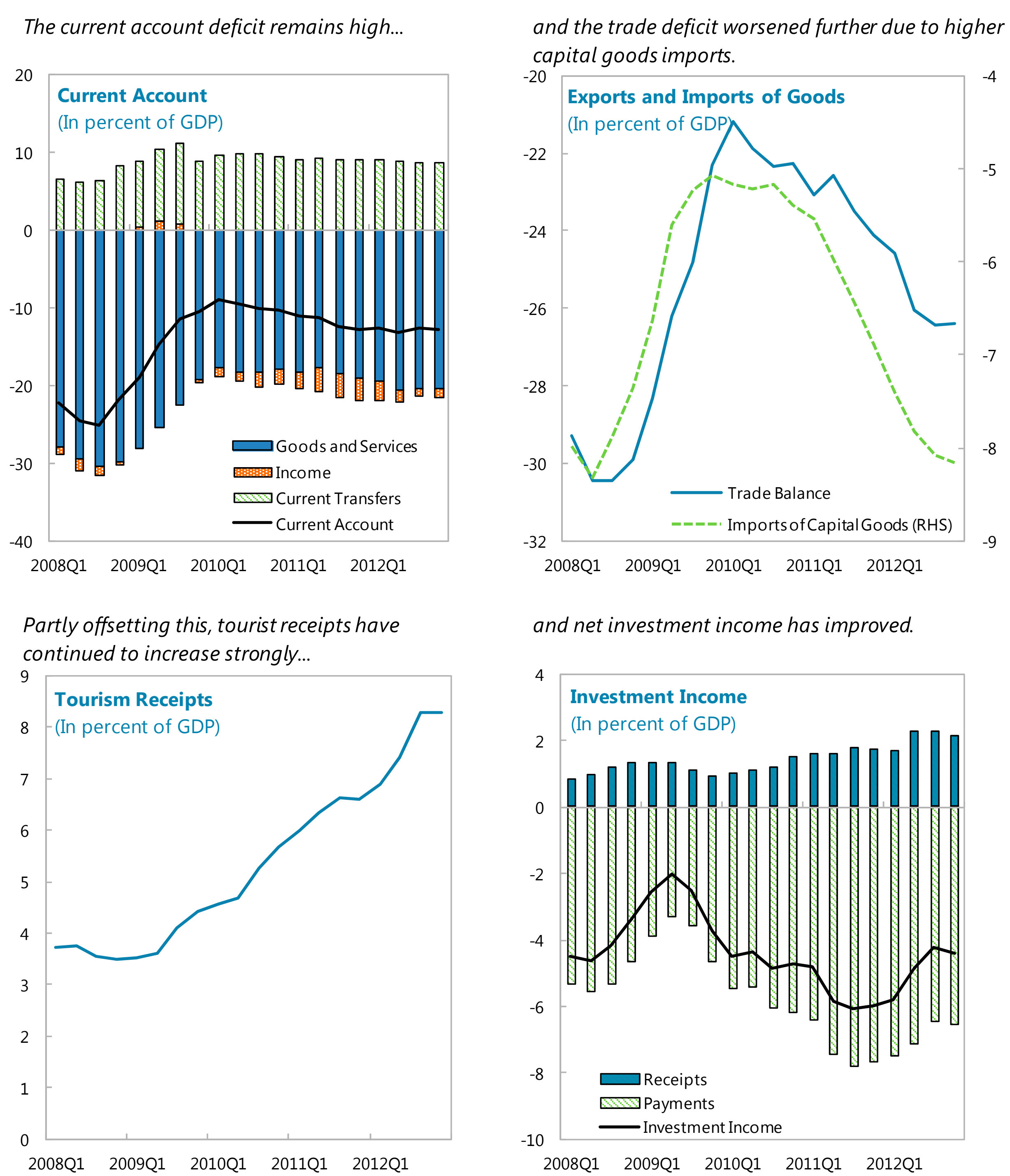
Source: National Bank of Georgia; GeoStat; and Fund staff estimates.

Figure 2. Georgia: Money and Inflation, 2010–12



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

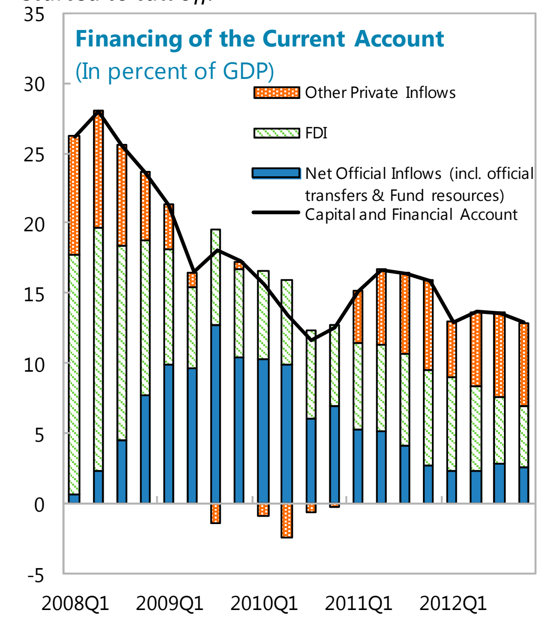
Figure 3. Georgia: Current Account, 2008–12



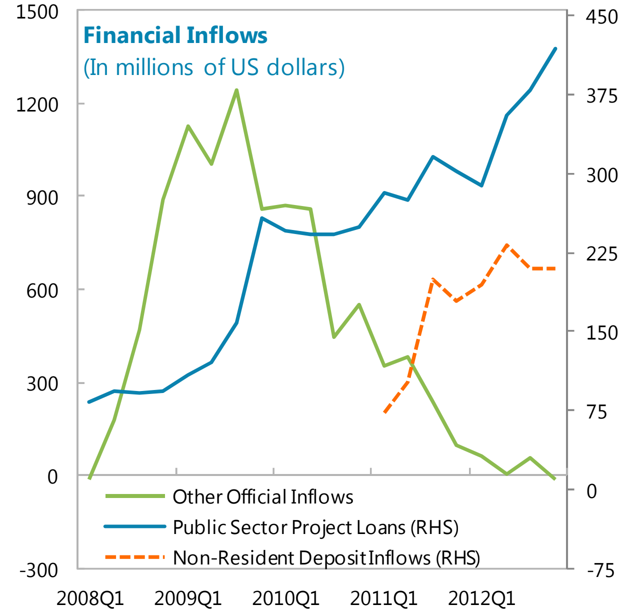
Source: National Bank of Georgia; GeoStat; and Fund staff estimates.

Figure 4. Georgia: Financing of the Current Account Deficit, 2008–12

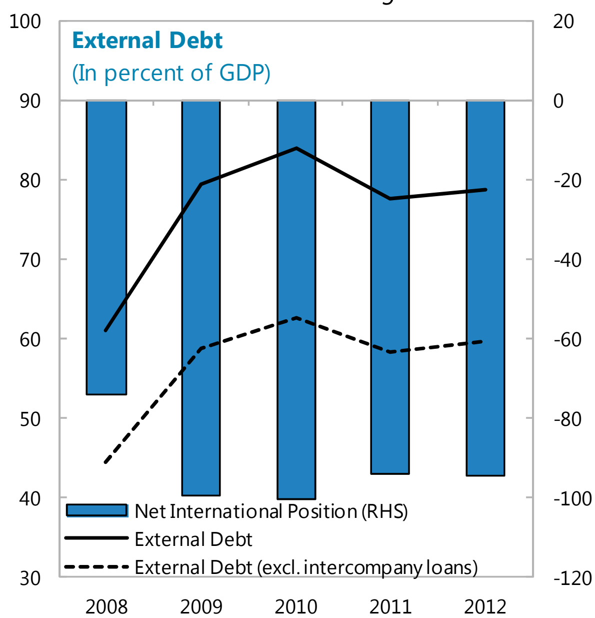
While private inflows remain the main source of financing the current account deficit, FDI has started to tail off.



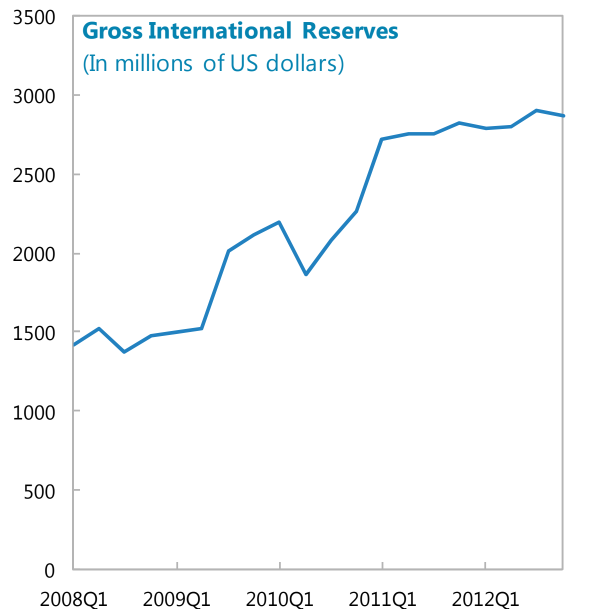
Public sector project loans remained strong even though capital grants and Fund resources were significantly lower, and non-resident deposits surged.



External debt has increased slightly, and net international liabilities remain high.



Gross international reserves continue to increase, but at a slower rate.



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

6. The current account deficit is expected to remain flat at around 12 percent of GDP in 2012—higher than projected under the program (Table 2 and Figure 3). The trade deficit worsened from 24.2 percent of GDP in 2011 to 26.2 percent of GDP in 2012, caused by strong private demand and a one-off surge in capital goods imports driven by large public sector projects before the elections. A 45 percent increase in tourist receipts and higher investment income was unable to offset this worsening in the trade balance.

7. Stronger-than-expected capital inflows financed the widening current account deficit, increasing international reserves above target. A large part of Georgia's external financing remains long term. The state-owned Georgian Railways (GR) and Georgian Oil and Gas Corporation (GOGC) issued Eurobonds totaling US$750 million (almost 5 percent of GDP) to finance their investment programs and hydropower projects. Project loan disbursements to the general government from multilateral and bilateral creditors increased by about 60 percent to about US$450 million. However, short-term inflows are taking an increasing share of external financing. Attracted by dollar interest rates of around 8 percent, inflows of nonresident deposits increased to US$230 million (about 1.5 percent of GDP), while FDI—which in the past has financed around half of the current account deficit—has started to tail off. With overall inflows stronger than expected, reserve accumulation exceeded target.

8. These strong capital inflows meant that the real depreciation envisaged under the program did not materialize. The lari appreciated 1.5 percent against the dollar (3.2 percent in nominal effective terms) during the first half of the year (Figure 4). However, as these flows (especially FDI inflows) subsided in the second half of the year, the NBG cut back its FX purchases (even selling FX around the election), keeping the exchange rate stable. On average, the real effective exchange rate appreciated slightly from 2011 to 2012 before depreciating in the second half of the year. The exchange rate remains somewhat overvalued, contributing to the persistently high current account.

9. The government kept the fiscal deficit to 3 percent of GDP in 2012, much less than the 3.5 percent of GDP that had been expected (Table 3). The lower fiscal deficit primarily reflected the new government's decision to save unexpected one-off revenue. While tax revenues were slightly higher than projected under the program, nontax revenues were significantly higher, reflecting payment of an exceptional dividend by Georgian Railways and collection of overdue fees. These extra revenues, along with higher grants, were used to reduce the deficit, and also to finance disaster relief for the floods in Kakheti.

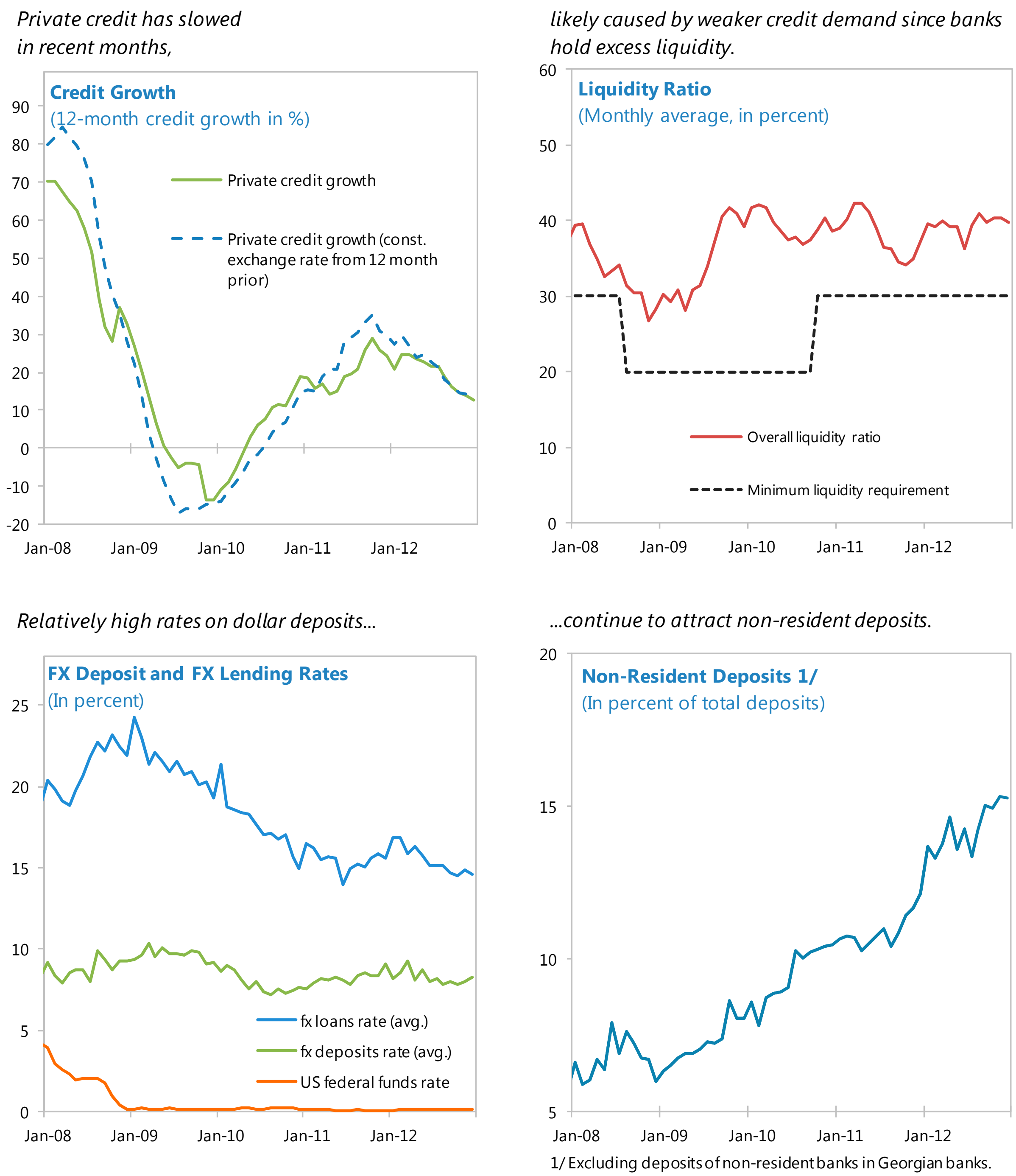
10. However, the Partnership Fund (PF) slightly exceeded its cash deficit target under the program by disbursing US$50 million (0.3 percent of GDP) to finance a thermal power plant project (TPP). The PF also undertook to finance the remaining part of the US$200 million project after the power supplier, who was expected to become the majority shareholder, abandoned plans to finance the project. The breach of the cash deficit target was small, but this disbursement and the commitment to provide future financing contradict the main purpose of the PF: to take minority stakes to catalyze new private investment. While the disbursement took place under the previous government and, following the election, there has been a change in management, the incident points to governance issues in the PF and doubts over whether it truly acts independently and according to private sector principles.

11. **Reacting to lower inflation and signs that the economy might be slowing, the NBG has continued to ease monetary policy** (Tables 4 and 5). It has gradually cut the policy rate from 8 percent in July 2011 to the current rate of 4.75 percent (although with a pause last summer). Partly explained by the cuts in the policy rate, lari deposit rates fell in 2012 by around 3 percentage points, while lari lending rates remained high at more than 20 percent (Figure 2) so that spreads have increased. In contrast, the spread between FX loan and deposit rates has fallen slightly due to lower lending rates. Despite this, private credit growth has continued to decline, and recently quite rapidly, from close to 30 percent (in FX-adjusted terms) at end-2011 to 13 percent at end-2012 (Figure 5). High dollarization (60 percent for deposits, around two-thirds for loans) remains a substantial impediment to monetary policy transmission.

12. **Although nonperforming loans have increased and profitability has fallen, the banking sector reports comfortable levels of both capital and liquidity** (Table 6 and Figure 5). The capital adequacy ratio, as defined by Basel I, stood at around 25 percent at end-2012, while liquid assets cover 40 percent of liabilities maturing in the next 6 months (Table 6). An increase in NPLs (NBG definition) in late 2012 reflects the NBG's forward-looking (and somewhat conservative) reassessment of borrowers' repayment capacity after the election rather than more tangible developments. According to the standard 90-day-overdue definition, NPLs remained broadly stable at 4 percent. While lower than in 2011, banks' returns on assets and on equity remained positive in 2012, at 1 and 6 percent. Attracted by high FX deposit rates, nonresident deposits continued to increase rapidly and now amount to $700 million, or around 15 percent, of total deposits (up from 12 percent a year earlier). While financial soundness indicators remained strong for the banking sector as a whole, two small banks have been close to the minimum prudential requirements.

13. **While economic performance has been generally positive, the incoming government faces a number of challenges that need to be addressed.** Despite the past record of rapid economic growth, unemployment, poverty and inequality all remain high so that growth in the future needs to be more inclusive. The new government is responding to this by increasing social expenditure, but these spending increases will need to be reconciled with the need for further fiscal consolidation. The current account deficit and external indebtedness also need to be reduced, but without unduly sacrificing growth. The recent economic slowdown creates an additional complication, particularly if it were to prove more protracted than expected.

Figure 5. Georgia: Monetary and Banking Sector, 2008–12

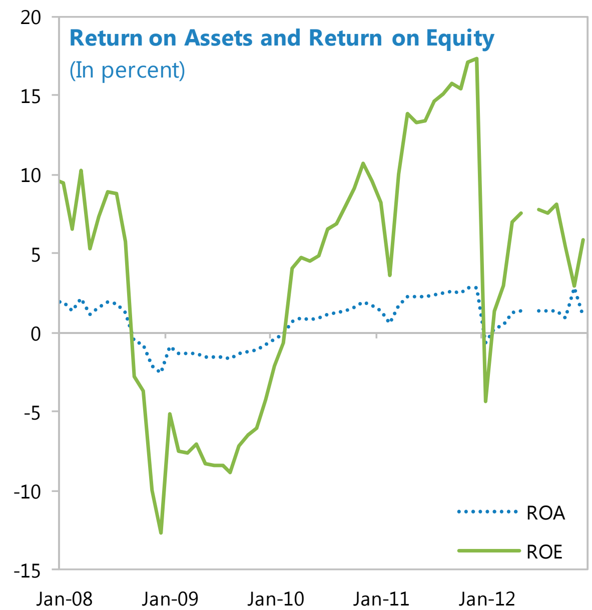


1/ Excluding deposits of non-resident banks in Georgian banks.

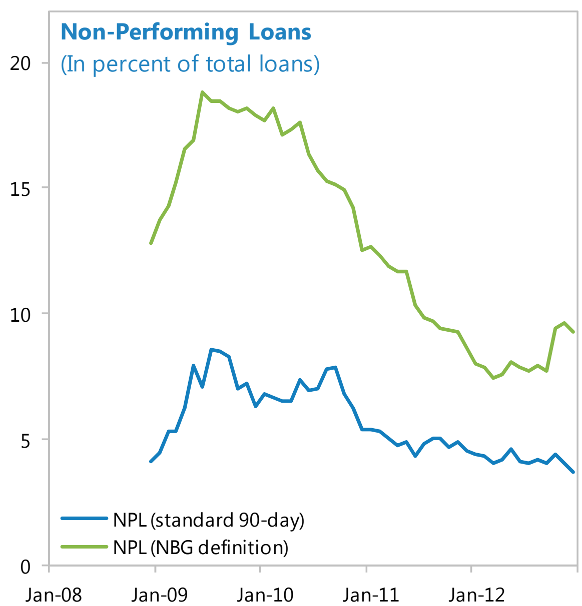
Source: National Bank of Georgia; Board of Governors of the US Federal Reserve System; and Fund staff estimates.

Figure 5. Georgia: Monetary and Banking Sector, 2008–12 (continued)

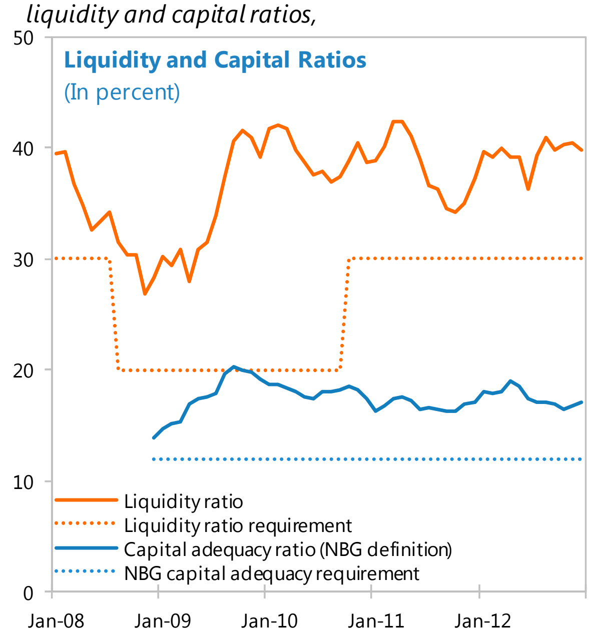
While banking sector profitability fell in 2012,



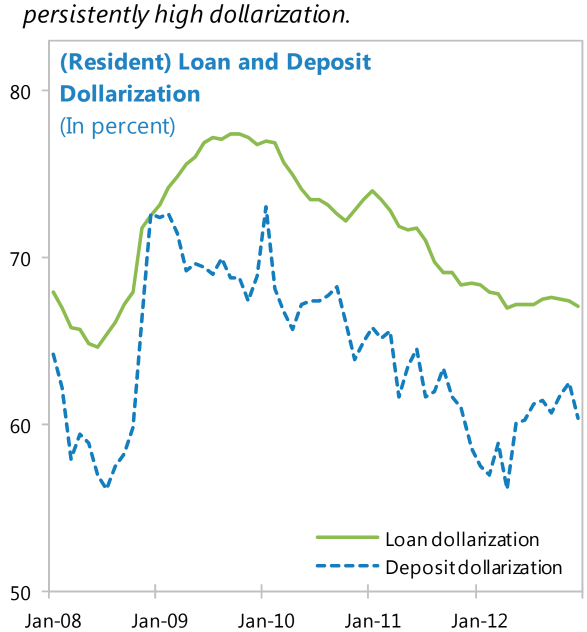
and the NBG's measure of nonperforming loans increased in late 2012...



the banking sector has maintained comfortable liquidity and capital ratios,

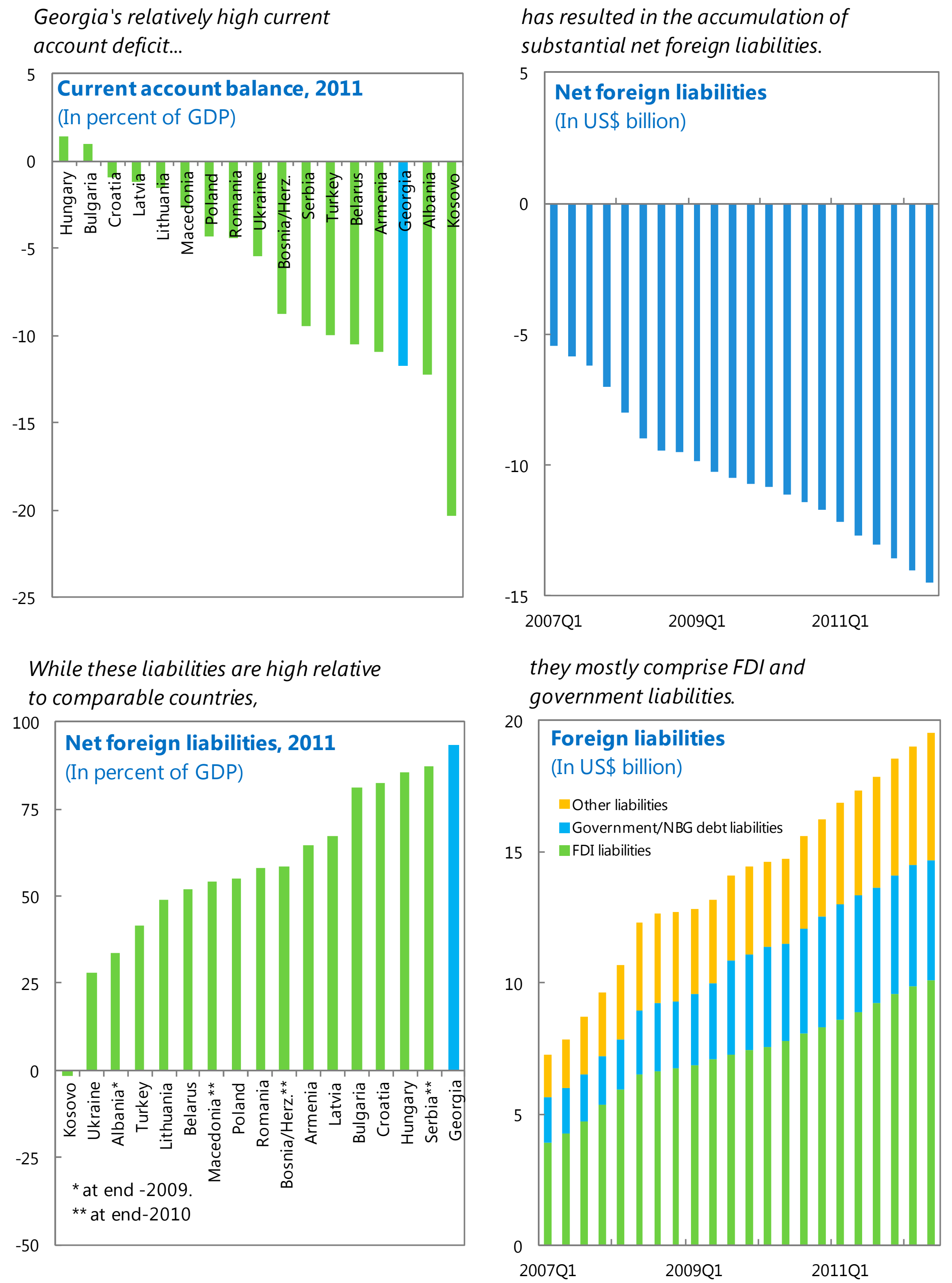


which balances the risks derived from persistently high dollarization.



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

Figure 6. Georgia: Current Account and International Investment Position, 2008–12



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

POLICY DISCUSSIONS

14. Discussions focused on how best to incorporate the new government's economic policy commitments, including their goal of making growth more inclusive, within the program framework. Particular attention was given to policies that would help reduce the current account deficit over the medium term, to ensure external sustainability and facilitate a successful program exit:

- Fiscal discussions addressed the need for further fiscal consolidation as a means of lowering the current account deficit and increasing fiscal space and on measures to contain fiscal risks and increase fiscal transparency.

- Monetary and exchange rate discussions focused on the monetary stance needed for achieving the inflation target and the importance of exchange rate flexibility for external adjustment. The mission emphasized the importance of preserving the NBG's independence as a means to ensuring the effectiveness of these policies.

- Financial sector discussions focused on prudential measures to contain the rise in non-resident dollar deposits, and to discourage other speculative capital inflows.

- Structural reform discussions centered on the authorities' plans to improve the business environment, reform agriculture, and boost competitiveness.

A. Macroeconomic Framework

15. After rebounding strongly over the last 2 years, growth in 2013 is expected to return to trend (LOI, ¶10)**.** The economy had slowed recently reflecting an understandable reaction to the election and the political transition. The government argued that these uncertainties would soon die down, particularly once its commitment to improving the business environment became clear, and that growth would then rebound. The authorities also argued that easing of the Russian embargo on imports from Georgia (which they expect in 2013) would increase external demand, while the establishment of new investment funds (see below) would boost domestic demand in the second half of the year. Against this, the staff noted there was the risk that the current slowdown might prove more protracted than the authorities were anticipating and that the fiscal consolidation, while necessary to reduce the current account deficit and external vulnerabilities, might also dampen growth. The authorities thus agreed with the mission that in view of these many uncertainties, the program (and the budget in particular) needed to be based on cautious assumptions.

16. Inflation is expected to recover gradually toward the NBG's 6-percent target over the next 2 years. The continuing shift towards a more accommodative monetary policy and an expected pickup in domestic demand are expected to raise inflation to around 3 percent by end-2013 and 6 percent by end-2014. Against this, there are downside risks to inflation, including from recent energy tariff reductions (though this should have a one-off effect on the price level) and if the economic slowdown were to continue. The NBG intends to start reducing its inflation target from the current 6 percent to 5 percent in 2015 and then gradually to 3 percent over the medium term.

17. The current account is projected to decline steadily over the medium term, as a result of continued fiscal consolidation, real exchange rate depreciation, and structural reforms to improve competitiveness. Such a decline is warranted by the current high level of the current account deficit and also by Georgia's relatively high external debt (Figure 6), which reached almost 80 percent of GDP at end-2012 (including inter-company loans). The envisaged fiscal consolidation, which relies primarily on streamlining more import-intensive capital expenditures, should help reduce the trade deficit directly. The NBG's commitment to reserve accumulation and exchange rate flexibility, along with prudential measures to contain short-term speculative capital inflows, should help bring the real exchange rate more in line with its equilibrium level. This likely real depreciation, along with structural reforms aimed at improving competitiveness, will contribute to reducing the current account deficit. Over the medium term, projected increases in tourism receipts and exports, once investment projects in tradable goods (agriculture, food processing, and hydropower) are completed, should also improve the current account.

B. Fiscal Policy

18. The 2013 budget aims at more ambitious fiscal consolidation than initially envisaged under the program (LOI, ¶15-18)**.** Reducing the general government deficit to 2.8 percent of GDP in 2013, compared to the 3 percent initially envisaged under the program, should create fiscal space (to later allow automatic stabilizers to operate) and help reduce the current account deficit. While the latter objective might have argued for even more ambitious deficit reduction, the mission and the authorities agreed this risked adding to the recent economic slowdown, as the agreed budget will already impart a negative fiscal impulse of close to 1 percent of GDP in 2013 (though part of this will result in lower imports). In case of upside risks, the authorities also agreed to an expenditure rule so that should government revenue prove higher than projected, then additional revenue beyond a certain threshold would be saved (LOI ¶15). This rule should make fiscal policy countercyclical if growth proves stronger than expected and will ensure that progress is made toward lowering government spending below 30 percent of GDP in 2014, as required by the Economic Liberty Act adopted in July 2011 (see Country Report No. 12/98).

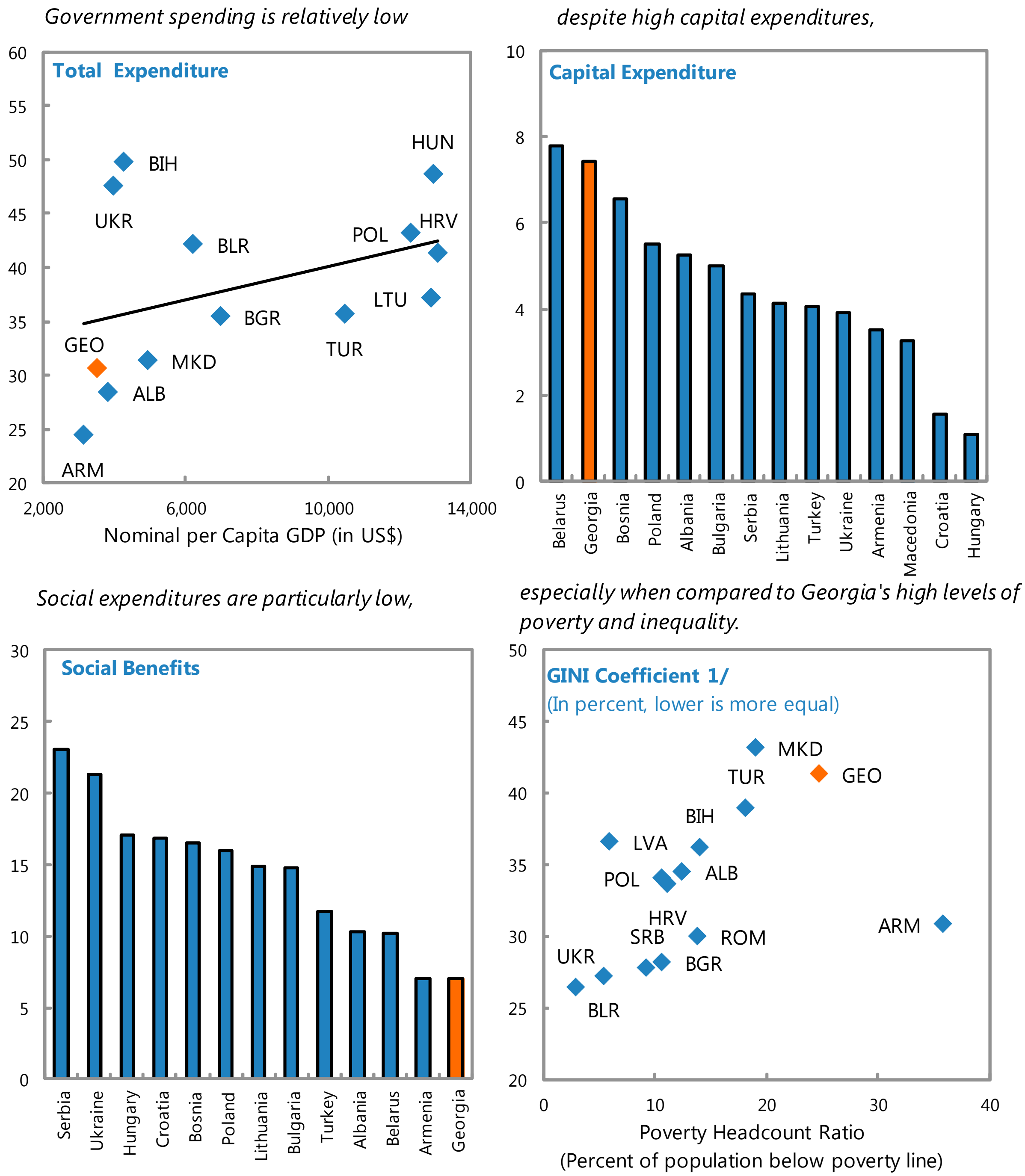
19. To reduce the deficit while delivering on its promises to increase social expenditures, the government focused its fiscal consolidation efforts on streamlining and reprioritizing capital expenditure and on containing other current expenditures. While agreeing on the need to strengthen the social safety net (Figure 7), the mission stressed that any increase in social spending should be targeted to the most vulnerable. The mission welcomed plans towards establishing universal healthcare and expanding social assistance but argued that the planned across-the-board pension increases, while a political commitment, might not be the best targeted way to strengthen the social safety net. The mission welcomed the authorities' intention to review and streamline other current expenditures and capital spending, as well as to implement the most important recommendations of the Fund's technical assistance on tax administration (LOI, ¶24). It also stressed the importance of protecting infrastructure investment but noted that even after the planned cuts, public investment as a share of GDP would remain relatively high. While the authorities argued that recent energy tariff cuts would have only a minimal impact on the budget, the mission encouraged the authorities to work with the World Bank on ensuring transparent energy sector pricing so that investment in this sector is not deterred.

20. The authorities remain committed to gradually reducing the fiscal deficit to 1½ percent of GDP over the medium term (LOI, ¶12). In addition to keeping public debt firmly on a declining path, this reduction will also contribute to lowering the current account deficit and to building a room for automatic stabilizers to operate in case of a shock. The mission emphasized that, in view of Georgia's relatively low current spending (even after the recent increases introduced by the new government) and substantial public investment needs, the authorities should be open to revenue-increasing measures in the future if necessary to achieve the medium-term deficit objectives. There could also be a case for revisiting the 30 percent of GDP limit on government spending that the previous government had established, but this would need to be accompanied by permanent revenue-increasing measures.

21. While welcoming the introduction of personal income tax thresholds, the mission expressed concern that excluding middle-income earners would distort labor supply and encourage tax evasion. While the new government's introduction of an annual GEL 1,800 (just over US$1000) threshold will make the current flat income tax more progressive, the decision to limit this exemption to those earning less than GEL 6,000 means that those earning slightly above this eligibility threshold will face marginal tax rates well above 100 percent. These workers will face strong incentives not to work or simply to underreport their income. In addition, the decision to implement the scheme through refunds in 2014 rather than direct payroll deduction will complicate the work of the revenue service and would seem to create an unnecessary burden for taxpayers. The authorities considered that, while real, these issues were manageable and agreed to take corrective actions in 2014 (when the first refunds will be transferred to eligible taxpayers) if they prove more severe than they currently estimate. While the mission welcomed these steps towards making the tax system more progressive, given likely future spending needs, the mission would have favored doing this in a revenue-neutral way by combining the new threshold with higher tax rates.

22. The authorities will strengthen the institutional framework of the Partnership Fund and improve fiscal transparency (LOI, ¶20-21). To address the problems that became evident with the PF's majority participation in the power project, and in addition to corrective measures already implemented, the authorities will submit to Parliament an amendment removing non-commercial objectives from the PF Law (structural benchmark for end-April), thereby ensuring that the PF will not finance quasi-fiscal activities in the future. To improve fiscal transparency, the authorities will publish financial accounts of the LEPLs semiannually and indicated that they will start providing more detailed information on government expenditures. In the coming months, and in the context of the creation of new privately financed investment funds, the authorities will review the role of the PF and will consider measures, including its transformation into a Sovereign Wealth Fund, to improve its attractiveness to private partners.

Figure 7. Georgia: General Government Spending, 2012



1/ GINI Coefficient data is from 2007 (BIH and BGR), 2008 (ALB, ARM, BLR, HRV, GEO, LVA, and TUR), and 2009 (MKD, POL, ROU, SRB, and UKR). Poverty data is from 2004 (HRV and LVA), 2006 (MKD), 2007 (BIH and BGR), 2008 (ALB, POL, and UKR), and 2009 (BLR, GEO, and TUR) and 2010 (ARM and SRB).

Sources: WEO; World Development Indicators; and Fund staff estimates.

While staff expressed doubts over the rationale for a Sovereign Wealth Fund, including that there did not seem to be an abundance of assets for it to hold, the authorities agreed to consult with the Fund and other development partners on the best way to do so, if they were to continue in this direction.

C. Monetary and Exchange Rate Policies

23. The central bank stands ready to ease monetary policy if deflationary pressures persist. The authorities agreed that, with the benefit of hindsight, earlier and deeper reductions in the policy rate might have been considered in view of the larger-than-anticipated decline in inflation. However, staff accepted that cutting rates in the second half of 2012 would have been risky given uncertainties stemming from the election and the resulting political transition. Excessive variation in the policy rate might also undermine the NBG's goal of strengthening the monetary transmission mechanism. However, with political conditions stabilizing and inflation continuing to fall, the NBG has started to cut interest rates again.

24. Exchange rate flexibility remains crucial to external sector adjustment and to the success of inflation targeting. Over the last two years the lari/US$ exchange rate has been kept broadly stable, which resulted in an appreciation of the real exchange rate of around 9 percent between end-2010 and mid-2012 before a recent partial reversal. The mission questioned the consistency of this apparent "fear of floating" with the authorities' commitment to inflation targeting, which would normally require some degree of exchange rate flexibility. The resulting appreciation of the real effective exchange rate (because of the strength of the US dollar) also did not seem helpful given Georgia's wide current account deficit. Delayed adjustment of the exchange rate could create additional risks and higher costs in the future. Against this, the authorities noted the difficulties of resisting exchange rate appreciation given the challenges posed by large capital inflows. Looking ahead, while the authorities agreed on the need to improve Georgia's competitiveness, they emphasized the role that structural reforms could play and raised questions about the need for exchange rate depreciation particularly in the short term. Given the extent of financial dollarization and the importance to the public of the lari/USD rate, the authorities argued that maintaining social and financial stability during the current political transition meant that exchange rate fluctuations would be costly, at least until these uncertainties subside. Reflecting these discussions, the mission and the authorities agreed on an NIR path consistent with the program's reserve adequacy and current account reduction objectives while leaving some room for the NBG to intervene on the FX market to smooth short-term exchange rate fluctuations.

25. Protecting the NBG's independence and strengthening its accountability will help ensure monetary policy's effectiveness (LOI, ¶25). The new government agreed to continue to protect the NBG's independence and to cooperate with the NBG on the formulation of economic policy. The NBG intends to improve the transparency and accountability of monetary policy, including by: (i) making its quarterly inflation reports more forward looking, focusing on macroeconomic forecasts built with the new structural model and providing detailed explanations if the target is missed (LOI, ¶27-28); (ii) making its inflation reports more timely (by publishing these only two months after the quarter ends, compared with three months at present); and (iii) enhancing its communication strategy by meeting quarterly with analysts and media to explain Monetary Policy Committee decisions and forecasts. The NBG is also introducing new credit conditions survey and assisting with creation of a new inflation expectations survey to enhance its monetary policy decision making.

26. The NBG is taking steps to encourage de-dollarization. To encourage lending in lari, the NBG has recently relaxed collateral standards for refinancing lari loans and is encouraging commercial banks to issue long-term standardized lari CDs. The authorities are also considering a scheme to encourage lari lending by placing long-term lari government bonds at commercial banks (LOI, ¶29). Supervisory policies already discourage FX funding and FX lending (including through additional risk weighting for FX loans and higher reserve requirements for FX liabilities), but these extra charges have so far proved insufficient to offset the large risk premium that lari depositors require. Looking ahead, bank stress tests in 2013 that will require capital add-ons for FX lending risks, together with introduction of a Liquidity Coverage Ratio (LCR) that will include higher outflow rates for FX deposits in 2013, should further discourage use of foreign currency in the banking system (LOI, ¶29).

D. Financial Sector Policies

27. The NBG is taking measures to contain non-core funding by banks. While the NBG views noncore funding, including nonresident deposits, as a potentially useful source of financing diversification for banks, the steady increase in this funding, combined with its potentially volatile nature, increases financial stability risks. The mission welcomed the NBG's new initiatives to contain nonresident deposits by increasing their regulatory costs. In particular, the NBG has decided to adopt sooner (end-2013 versus 2015) the LCR framework, which assigns a higher outflow rate to nonresident deposits. Moreover, starting in June 2013, banks whose nonresident deposits represent more than 10 percent of total deposits will face a higher liquidity requirement on nonresident deposits—this requirement will increase by one percentage point for each additional percentage point over the 10 percent threshold (LOI, ¶34).

28. The NBG has further strengthened its supervisory framework and is continuing preparing its transition towards Basel III and risk-based supervision. The NBG completed its self-assessment of its supervisory framework against Basel Core Principles in December 2012 and agreed to submit it to staff for review, along with a document describing the NBG's updated approach to supervision, by March 2013. They are requesting an FSAP to start by the end of 2013 (LOI, ¶35). From March 2013, banks will be expected to comply with the standardized approach of Pillar 1 of Basel III. The NBG has been assisting banks with their risk models and, in line with Pillar 2, banks are expected to submit their first Internal Capital Adequacy Assessment Process (ICAAP) forms in May 2013. The development of risk models for ICAAP, in addition to allowing the NBG to better monitor different risks, will strengthen bank risk analysis and should contribute to refining banks' risk taking behavior. To comply with Pillar 2 capital requirements, banks will perform firm-level stress tests under macro scenarios (LOI, ¶31). Following Basel recommendations, the NBG has developed a monitoring framework for domestic systemically important banks, which will be used, together with micro-level stress tests, to determine countercyclical supervisory measures (LOI, ¶32).

E. Structural Reforms to Boost Growth and Reduce Poverty

29. The authorities intend to implement a far-reaching set of structural reforms to improve the business environment and boost competitiveness (LOI, ¶37-38):

- **Free Trade Agreement (FTA) with EU.** Georgia hopes to fulfill EU requirements and complete negotiations (started at the end of 2011) in 2013. If successful, the FTA should increase Georgia's trade integration with EU and encourage foreign direct investment.

- **Competition Agency.** As part of the FTA negotiations between Georgia and the EU, the government has established an independent Competition Agency. This agency will work on a new framework law to ensure free trade and competition in Georgia.

- **Strengthening the judicial system.** To enhance the business environment, the government is working with development partners to strengthen the judicial system. The government plans to increase professional training of judges on financial issues so as to allow for a more timely and effective resolution of corporate disputes.

- **Promoting agricultural development.** The government will finalize and implement its comprehensive strategy for agriculture, focused on increasing irrigation, supporting private service centers, and assisting small farmers in establishing cooperatives. The newly established Rural and Agricultural Fund will support this strategy.

- **Tackling skill mismatches.** The government will pursue previous efforts to upgrade skills in the labor force, including through the development of vocational training.

- **In addition, the government will start working on pension reform, labor market reforms, and the strengthening of property rights.**

30. To accompany these reforms and to channel foreign financing to key sectors of the economy, the government is helping establish new privately financed investment funds. A Rural and Agricultural Fund will support the government's agricultural reforms, and an Investment Fund will have the broader mandate of stimulating private investment in general. The mission stressed that, at this early stage, the rationale for these funds, and the market imperfections they are supposed to address, are not quite clear and will need to be articulated more forcefully. The exact mandate, financing, and institutional framework of these funds, and their relationship to the PF, will also need to be defined more precisely over the next few months. In view of their potential significant macroeconomic implications, and the governance issues they raise, over the coming months the authorities will discuss with their development partners, including with the Fund as part of the Article IV review discussions, the best way to set up these funds to ensure that they pursue their objectives in a transparent, fiscally responsible, and sustainable manner.

PROGRAM ISSUES

31. **Program performance has been for the most part strong (LOI Table 1). All end-June and end-December performance criteria and all structural benchmarks were met except for the end-December performance criterion (zero-ceiling) on the cash deficit of the PF.** The PF registered a deficit as a result of the aforementioned US$50 million disbursement to finance construction of a thermal power plant. As corrective actions, the new government has changed the management of the PF and is limiting the PF's participation in projects to minority stakes (first by changing its charter, later by submitting amendments to the PF Law). In staff's view, these corrective actions would justify a waiver of the relevant performance criterion. The PF's management is actively seeking to reduce the PF's participation in the TPP to a minority stake through the sale of a majority stake to a private investor. Staff will continue to monitor PF activities closely to make sure that it sticks to its original goal of catalyzing private investment.

32. **Conditionality under the program will be strengthened through adoption of a ceiling on general government expenditures (new performance criterion) and a number of new structural benchmarks** (LOI Tables 2 and 3). The expenditure ceiling will help ensure progress toward meeting the spending limits established by the Economic Liberty Act, which, unless revised, will become effective with next year's budget. The structural benchmarks will help strengthen further the PF's institutional framework, monitor progress in improving fiscal transparency, and contain risks related to banks' noncore funding.

33. **Capacity to repay the Fund.** Georgia has established a record of timely servicing its obligations to the Fund, and its capacity to repay the Fund is expected to remain strong.

RISKS

34. **Macroeconomic prospects are more uncertain than usual with risks skewed to the downside.** The mission emphasized that growth could be lower than expected if the post-election slowdown persists, notably if investors remain cautious until the government defines more clearly its economic strategy. Concerning external risks, a slowdown in Euro Area growth could hurt Georgian exports, while a shortfall in private capital inflows, especially FDI, could also adversely affect external and financial stability. Nonresident deposits, and the potential for crisis if they are rapidly withdrawn, remain another source of vulnerability. On the upside, the authorities emphasized that the opening of the Russian market to Georgian products could boost exports substantially, as would the free trade agreement with the EU if negotiations are successful. Also, if established early in 2013, the Rural and Agricultural Fund could boost domestic demand in the second half of the year (but might worsen the current account deficit in the short term).

35. **Political risks are also a factor.** Tensions between the government and the president, if protracted, could dent investor confidence in the new government's ability to implement its policies. Conversely, greater moves towards promoting the rule of law, economic freedom, and transparency could promote growth in the long term.

36. The policies supported by the program should help mitigate these risks. The acceleration of fiscal consolidation efforts will help lower the current account deficit and rebuild fiscal buffers, leaving more room for countercyclical policies in the event of an economic slowdown. Though not expected to be drawn, the financing made available under the program and acceptance of the need for greater exchange rate flexibility should help in case there were a sudden drop in net external inflows, or if external shocks were to materialize. Structural reforms in the financial sector should also increase the capacity of the NBG to respond to shocks.

STAFF APPRAISAL

37. Macroeconomic policies and outcomes have been generally positive. Growth has remained strong and inflation subdued. Despite spending pressures ahead of the election, the government met the program's fiscal deficit target comfortably. While the current account deficit proved substantially higher than envisaged, reserve accumulation has been in line with program objectives thanks to strong capital inflows.

38. The new government's commitment to prudent macroeconomic policies and to further enhancing Georgia's business-friendly environment is welcome. This commitment has been instrumental in ensuring that the program has remained on track and in developing a set of economic policies consistent with the main goals of the Fund-supported program.

39. While the authorities' more pro-active approach should help reduce the current account deficit, they should stand ready to take further steps if needed. Georgia's large external liabilities plus its high current account deficit remain the main sources of vulnerability, and reducing these in an orderly manner without too much sacrifice to growth remains the key macroeconomic challenge. The authorities' plans for fiscal consolidation, a more flexible exchange rate, and structural reforms to improve Georgia's competitiveness, should go some way towards meeting this challenge. However, the authorities might be more ambitious in unwinding the real exchange rate appreciation that they have allowed in recent years. They should thus be ready to increase their reserve accumulation above plan if, as was the case in 2012, financial flows prove higher than projected.

40. The government's 2013 budget balances the need to reduce the external current account against the risk that a larger adjustment might deepen the current slowdown. The budget includes a welcome increase in social spending to protect the most vulnerable while continuing with fiscal consolidation. This should facilitate external adjustment and create room for countercyclical fiscal policy. While the introduction of thresholds will improve the progressivity of the personal income tax system, using rebates seems unnecessarily cumbersome and may weaken the impact of this reform. The elimination of the tax free exemption for higher income earners will lead to marginal tax rates of more than 100 percent, which creates unnecessary labor supply distortions and could encourage income tax evasion. For the medium term, the government should be ready to consider revenue-increasing measures given likely pressures to increase social spending.

41. The authorities' commitment to greater exchange rate flexibility should help the NBG align its monetary policy and exchange rate decisions more closely with its inflation targeting objective. After gradually cutting interest rates since mid-2011, the NBG kept its policy rate fixed for much of the second half of 2012. However, given that inflation was low and turned into deflation, with the benefit of hindsight there would seem to have been a case for continuing with rate cuts, though this needed to be weighed against the risks stemming from election and political uncertainties. While understandable in view of Georgia's extensive dollarization, there is a tension between the stability of the lari-dollar exchange rate and the NBG's commitment to inflation targeting. Though capital inflows would have made this difficult to resist, the resulting appreciation of the real and nominal effective exchange rate (given the strength of the dollar) almost certainly contributed to the considerable inflation undershoot. Looking ahead, greater exchange rate flexibility should strengthen the inflation targeting regime and might help with current account adjustment.

42. The government's commitment to maintaining central bank independence and the NBG's commitment to increasing monetary policy transparency are both welcome. The independence of the NBG, together with continued cooperation between the government and the NBG, are essential to the implementation and success of the program. The measures announced by the NBG, including the organization of quarterly meetings with analysts and the media and the publication of additional information on the macroeconomic forecasts underlying its monetary policy decisions, will help increase the central bank's accountability and contribute to strengthening monetary policy's effectiveness.

43. Georgia's financial sector appears healthy, and the authorities' efforts to continue to monitor and minimize risks are welcome. The NBG has continued to strengthen its supervisory framework and its efforts to transition towards risk-based supervision are welcome. However, high financial dollarization is a source of significant vulnerability, and reducing it will prove challenging. The NBG's attempts to limit the growth in banks' noncore funding are welcome, and it will be important to continue to monitor the isolated signs of possible risk that may be present in one or two relatively small banks.

44. The Partnership Fund's governance needs to be strengthened to ensure that it focuses on supporting private investment and avoids undertaking quasi-fiscal activities. The PF's decision to fully finance a TPP is inconsistent with its mandate of supporting private investment through minority participations and instead represents a quasi-fiscal activity. Changing the PF's charter and the PF Law to limit participation in future projects to minority stakes and to make sure it follows commercial objectives should ensure this does not happen again. The role of the PF may need to be revisited in view of the government's intention to establish two new private funds. In this regard, the size of the new funds, their mandate, financing model, institutional framework, and relationship to the PF should be clarified. The authorities should work with their development partners to ensure that the envisaged new private funds contribute to increasing growth and employment and reducing poverty in a transparent, fiscally responsible, and sustainable manner, and that potential governance issues are addressed. These issues will be discussed further at the time of the Article IV review.

45. The government's impressive structural agenda aims at improving the business environment and boosting competitiveness. This broad agenda, which includes reforms to boost trade, strengthen competition, and strengthen business and property rights, is welcome. Progress in strengthening the rule of law will be critical to its success. The proposed increases in government social spending and measures to support agricultural development should help promote more inclusive growth. While the recent cut in energy tariffs has helped fulfill an election commitment, the government needs to ensure that the price cuts are consistent with the independence of the energy regulator and with prospects for future investment in this sector.

46. In light of Georgia's strong performance under the program, staff supports the authorities' requests for completing the first and second reviews and for waiver of nonobservance of the performance criterion on the cash deficit of the Partnership Fund (given the corrective actions taken by the authorities to strengthen the PF's governance, which will strengthen its financial controls).

Table 1. Georgia: Selected Macroeconomic Indicators, 2010–14

	2010	2011	2012		2013	2014
	Act.	Act.	SR	Proj.	Proj.	Proj.
National accounts	(annual percentage change; unless otherwise indicated)					
Real GDP	6.3	7.2	6.0	6.5	6.0	6.0
Nominal GDP (in billion of laris)	20.7	24.3	26.7	26.3	28.9	32.2
Nominal GDP (in billion of U.S. dollars)	11.6	14.4	15.9	15.9	17.0	17.9
GDP per capita (in thousand of U.S. dollars)	2.6	3.2	3.6	3.5	3.8	3.9
GDP deflator, period average	8.5	9.5	4.5	1.4	3.5	5.2
Population (in million) 1/	4.4	4.5	4.4	4.5	4.5	4.5
Unemployment rate (in percent)	16.3	15.1	...	...	...	...
Investment and saving	(in percent of GDP)					
Gross national saving	11.3	12.9	13.3	14.4	16.1	17.3
Investment	21.6	25.7	23.0	26.4	26.1	25.6
Private	14.4	19.6	15.5	20.0	20.3	20.5
Inflation	(in percent)					
Period average	7.1	8.5	1.7	-0.9	1.0	4.6
End-of-period	11.2	2.0	5.0	-1.4	3.2	6.0
Consolidated government operations	(in percent of GDP)					
Revenue 2/	28.3	28.2	27.4	28.7	27.5	27.1
o.w. Tax revenue	23.5	25.2	24.7	25.3	25.3	25.0
Expenditures	34.9	31.8	30.9	31.6	30.4	29.3
Current expenditures	26.0	23.1	22.5	23.0	23.7	23.3
Capital spending and net lending	8.8	8.8	8.4	8.6	6.6	6.0
Overall balance	-6.6	-3.6	-3.5	-3.0	-2.8	-2.2
Public debt	39.2	33.8	32.9	32.7	31.2	31.1
Of which: foreign-currency denominated	33.6	28.8	27.8	28.1	26.6	26.0
Money and credit	(annual percentage change; unless otherwise indicated)					
Credit to the private sector	18.8	24.3	24.4	12.8	25.4	23.6
Credit to the private sector (constant exchange rate from 12 month prior)	14.5	29.5	...	13.4	21.7	17.6
Broad money (incl. fx deposits) 3/	23.9	20.3	22.0	11.4	20.5	20.5
Broad money (incl. fx deposits, constant exchange rate from 12 month prior) 3/	20.9	23.7	...	11.8	17.9	16.3
Deposit dollarization (in percent)	68.6	63.3	...	66.0	64.8	61.6
Policy rate (in percent, end-of-period)	7.5	6.8	...	5.3	...	...
Deposit interest rate (in percent, annual average)	7.9	9.4	...	8.6	...	...
Lending interest rate (in percent, annual average)	19.5	18.7	...	19.0	...	...
External sector	(in percent of GDP; unless otherwise indicated)					
Gross international reserves (in billions of US$)	2.3	2.8	2.7	2.9	2.6	2.6
In months of next year's imports of goods and services	3.4	3.7	3.9	3.6	3.2	3.0
In percent of broad money and non-resident deposits	62.0	59.3	...	52.0	41.6	38.0
Current account balance (in billions of US$)	-1.2	-1.8	-1.6	-1.9	-1.7	-1.5
In percent of GDP	-10.2	-12.8	-9.7	-12.0	-10.0	-8.4
Trade balance	-22.3	-24.2	-22.3	-26.2	-24.7	-23.5
Foreign direct investment (inflows)	7.0	7.7	6.1	5.5	5.7	7.0
Gross external debt	83.9	77.5	...	79.5	77.8	77.0
Gross external debt, excl. intercompany loans	62.7	58.2	54.5	60.5	59.0	57.9
Exchange rates						
Laris per U.S. dollar (period average)	1.78	1.69	...	1.65	...	...
Laris per euro (period average)	2.36	2.35	...	2.12	...	...
REER (period average; CPI based, 2005=100)	118.5	129.6	...	131.8	...	...

Sources: Georgian authorities; and Fund staff estimates.

1/ Excludes Abkhazia residents.

2/ Includes grants.

3/ Not including the proceeds of the Georgian Railway eurobond issuance of July 2010, deposited in Georgian commercial banks which placed the corresponding funds abroad.

Table 2. Georgia: Summary Balance of Payments, 2010–17

(In millions of U.S. dollars)

	2010	2011	2012		2013	2014	2015	2016	2017
	Act.	Act.	SR	Est.	Proj.	Proj.	Proj.	Proj.	Proj.
Current account balance	-1,192	-1,844	-1,551	-1,914	-1,694	-1,495	-1,578	-1,591	-1,665
Trade balance	-2,590	-3,494	-3,551	-4,182	-4,193	-4,200	-4,345	-4,494	-4,718
Exports	2,462	3,254	3,251	3,523	3,790	4,078	4,405	4,762	5,178
Imports	-5,052	-6,748	-6,802	-7,705	-7,983	-8,278	-8,750	-9,257	-9,896
Services	513	748	881	1,055	1,266	1,461	1,557	1,714	1,909
Services: credit	1,599	2,008	2,190	2,544	2,738	2,957	3,125	3,354	3,613
Services: debit	-1,085	-1,261	-1,309	-1,488	-1,472	-1,495	-1,568	-1,640	-1,704
Income (net)	-214	-427	-324	-180	-173	-191	-288	-381	-502
Of which : interest payments	-252	-309	-316	-399	-391	-410	-446	-478	-522
Transfers (net)	1,098	1,329	1,443	1,392	1,407	1,435	1,497	1,570	1,646
Of which : remittances	415	617	711	703	746	782	820	860	903
Capital account	206	153	113	106	85	69	70	70	70
General government	189	136	100	99	77	62	62	62	62
Financial account	972	2,214	1,599	2,074	1,757	1,640	1,837	1,789	1,658
Direct investment (net)	679	971	964	698	794	1,065	1,122	1,212	1,291
Monetary authorities, net 1/	0	2	0	0	0	0	0	0	0
General government	336	319	452	550	355	321	259	145	118
Portfolio investment (net)	0	44	0	105	-15	10	10	10	10
Long-term loans received	335	274	442	446	369	310	248	134	107
Other, net	1	1	10	-1	1	1	1	1	1
Private Sector, excl. FDI	-43	922	183	826	609	254	456	432	249
Banks	-213	834	102	56	448	63	252	188	4
Portfolio investment, net	-10	89	-27	-10	5	20	25	30	-115
Of which: equity liabilities	-22	-7	8	75	15	20	25	30	35
Loans received (net)	18	212	73	2	207	213	198	141	111
Long-term loans	7	-1	47	1	200	206	190	132	102
Short-term loans	11	213	26	1	7	7	8	9	9
Other, net (currency and deposits)	-220	533	57	64	236	-170	29	17	8
Assets	-299	339	-7	-195	170	-12	-13	-15	-16
Liabilities (including NRDs)	79	194	63	260	66	-158	43	32	24
of which: NRDs	84	179	…	264	66	-158	43	32	24
Other sectors	170	88	80	770	161	190	203	243	245
Portfolio investment, net	261	0	0	510	0	0	-11	0	0
Long-term loans received (net)	31	256	130	214	197	209	224	248	247
Other, net	-122	-168	-50	46	-37	-18	-9	-5	-2
Errors and omissions	-17	29	0	14	0	0	0	0	0
Overall balance	-31	551	161	280	148	215	328	268	63
Financing	31	-551	-161	-280	-148	-215	-328	-268	-63
Gross International Reserves (-increase)	-208	-572	84	-52	238	41	-249	-253	-57
Use of Fund Resources	276	-59	-245	-246	-385	-256	-80	-15	-6
Purchases (SBA)	297	0	0	0	0	0	0	0	0
Repayments (SBA and ECF)	-22	-59	-245	-246	-385	-256	-80	-15	-6
Exceptional financing	-37	80	0	18	0	0	0	0	0

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

1/ SDR allocation included under monetary authorities' long-term liabilities.

Table 2. Georgia: Summary Balance of Payments, 2010–17 (continued)
(In millions of U.S. dollars)

	2010	2011	2012		2013	2014	2015	2016	2017
	Act.	Act.	SR	Est.	Proj.	Proj.	Proj.	Proj.	Proj.
				(in percent of GDP)					
Current account balance	-10.2	-12.8	-9.7	-12.0	-10.0	-8.4	-8.3	-7.7	-7.4
excluding official transfers	-11.7	-13.8	-10.4	-12.7	-10.3	-8.4	-8.3	-7.7	-7.4
Trade balance	-22.3	-24.2	-22.3	-26.2	-24.7	-23.5	-22.9	-21.8	-21.0
Net capital inflows to private sector	5.5	13.1	7.2	9.6	8.2	7.4	8.3	8.0	6.9
				(growth rates, in percent)					
Exports of GNFS									
value growth	26.6	29.6	3.9	15.3	7.6	7.8	7.1	7.8	8.3
volume growth	7.8	12.0	5.5	15.2	8.8	9.5	7.6	7.0	7.0
price change	17.5	15.7	-1.5	0.1	-1.1	-1.6	-0.5	0.7	1.2
Imports of GNFS									
value growth	16.5	30.5	2.5	14.8	2.8	3.4	5.6	5.6	6.5
volume growth	0.6	9.5	7.1	18.6	4.3	4.5	6.4	6.4	6.1
price change	15.8	19.2	-4.4	-3.2	-1.4	-1.1	-0.8	-0.8	0.3
				(in billions of U.S. dollars, unless otherwise indicated)					
Gross international reserves (end of period)	2.3	2.8	2.7	2.9	2.6	2.6	2.8	3.1	3.2
in months of next year GNFS imports	3.4	3.7	3.9	3.6	3.2	3.0	3.1	3.2	3.1
in percent of short-term debt at remaining maturity	140	123	107	109	103	114	120	123	117
in percent of broad money and non-resident deposit	62	59	...	52	42	38	36	35	31
Reserve cover 1/	73	64	60	54	48	51	56	60	59
External debt	9.8	11.2	11.4	12.7	13.2	13.8	14.6	15.4	15.9
External debt, excluding intercompany loans	7.3	8.4	8.7	9.6	10.0	10.3	11.0	11.5	11.9
Public	3.9	4.2	4.4	4.4	4.4	4.5	4.7	4.8	4.9
Private	3.4	4.2	4.3	5.2	5.6	5.9	6.3	6.7	6.9
Long-term	2.3	2.6	2.8	3.3	3.7	4.1	4.5	4.9	5.1
Short-term	1.0	1.6	1.5	1.9	1.9	1.7	1.8	1.8	1.8
Intercompany loans	2.5	2.8	2.8	3.0	3.2	3.4	3.6	3.8	4.0
				(in percent of GDP)					
External debt	83.9	77.5	...	79.5	77.8	77.0	76.9	74.5	70.8
External debt, excluding intercompany loans	62.7	58.2	54.5	60.5	59.0	57.9	57.8	55.8	52.8
Public	33.8	29.1	27.7	27.9	26.0	25.1	24.6	23.3	21.8
Private	28.9	29.1	26.9	32.5	33.0	32.7	33.2	32.6	30.9
Long-term	20.0	18.3	17.3	20.9	21.8	23.1	23.9	23.8	22.7
Short-term	8.8	10.8	9.6	11.7	11.1	9.7	9.3	8.7	8.2
Intercompany loans	21.2	19.3	17.3	19.0	18.8	19.1	19.2	18.7	18.0
Memorandum items:									
Nominal GDP (billions of U.S. dollars)	11.6	14.4	15.9	15.9	17.0	17.9	19.0	20.6	22.5

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

1/ Gross international reserve in percent of total short-term liabilities plus the current account deficit.

Table 3. Georgia: General Government Operations, 2010–14 1/

	2010	2011	2012		2013	2014
	Act.	Act.	SR	Act.	Proj.	Proj.
	(In millions of lari)					
Revenues	5,866	6,870	7,314	7,539	7,942	8,727
Taxes	4,867	6,135	6,615	6,644	7,289	8,043
Direct taxes	2,033	2,642	2,872	2,880	3,160	3,390
Taxes on income	1,202	1,551	1,701	1,765	1,955	2,033
Taxes on profits	576	832	931	851	923	1,041
Other Taxes (incl. property)	255	259	240	264	281	317
Indirect taxes	2,834	3,493	3,743	3,764	4,129	4,653
VAT	2,203	2,784	2,977	3,015	3,349	3,773
Excises	561	615	663	660	686	773
Custom duties	70	93	103	90	95	106
Other revenues	526	516	454	618	450	502
Grants	473	220	245	277	203	182
Expenditures	7,232	7,750	8,257	8,318	8,760	9,436
Current expenditures	5,399	5,613	6,008	6,054	6,847	7,498
Compensation of employees	1,138	1,136	1,218	1,203	1,296	1,384
Use of goods and services	1,086	1,211	1,189	1,298	1,225	1,308
Subsidies and grants	385	437	447	526	468	500
Social expenses	1,612	1,656	1,821	1,858	2,500	2,869
Other expenses	972	886	985	917	1,045	1,118
Interest	206	288	348	254	314	318
Capital spending and net lending	1,834	2,137	2,249	2,265	1,913	1,938
Capital	1,706	1,869	2,011	1,971	1,810	1,858
Net lending	128	268	239	293	103	80
Overall balance	-1,366	-880	-943	-779	-819	-708
Statistical discrepancy	0	0	0	0	0	0
Identified financing	1,366	880	943	779	819	708
Domestic	-6	-47	-19	-95	422	415
Net T-bill issuance	172	91	200	58	150	350
Amortization 2/	-42	-43	-42	-44	-50	-52
Use of deposits at the NBG and banks	-136	-96	-177	-109	323	117
External	1,152	548	822	595	247	224
Borrowing	1,275	1,375	919	690	718	709
Of which : IMF	523	0	0	0	0	0
Amortization	-123	-827	-98	-95	-471	-485
Of which : IMF	0	0	0	-20	-250	-335
Privatization receipts	220	379	140	280	150	70
Memorandum items:						
Public debt	8,124	8,216	8,785	8,614	8,995	10,009
Of which: foreign-currency denominated	6,979	7,016	7,435	7,390	7,672	8,388
End-year government deposits 3/	665	761	834	870	547	431
Primary balance	-1,160	-592	-595	-526	-505	-391
Operating/Current balance	467	1,257	1,307	1,485	1,094	1,230
Fiscal deficit excluding grants	1,839	1,100	1,188	1,056	1,021	891

Sources: Ministry of Finance; and Fund staff estimates.

1/ General government includes central and local governments.
2/ Excluding arrears clearance, provisions and T-bill repayment.
3/ Include Treasury single account, Revenue reserve account, and local government deposits.

Table 3. Georgia: General Government Operations, 2010–14 1/ (continued)

	2010	2011	2012		2013	2014
	Act.	Act.	SR	Act.	Proj.	Proj.
	(In percent of GDP)					
Revenues	28.3	28.2	27.4	28.7	27.5	27.1
Taxes	23.5	25.2	24.7	25.3	25.3	25.0
Direct taxes	9.8	10.9	10.7	10.9	10.9	10.5
Taxes on income	5.8	6.4	6.4	6.7	6.8	6.3
Taxes on profits	2.8	3.4	3.5	3.2	3.2	3.2
Other Taxes (incl. property)	1.2	1.1	0.9	1.0	1.0	1.0
Indirect taxes	13.7	14.3	14.0	14.3	14.3	14.4
VAT	10.6	11.4	11.1	11.5	11.6	11.7
Excises	2.7	2.5	2.5	2.5	2.4	2.4
Custom duties	0.3	0.4	0.4	0.3	0.3	0.3
Other revenues	2.5	2.1	1.7	2.3	1.6	1.6
Grants	2.3	0.9	0.9	1.1	0.7	0.6
Expenditures	34.9	31.8	30.9	31.6	30.4	29.3
Current expenditures	26.0	23.1	22.5	23.0	23.7	23.3
Compensation of employees	5.5	4.7	4.6	4.6	4.5	4.3
Use of goods and services	5.2	5.0	4.4	4.9	4.2	4.1
Subsidies and grants	1.9	1.8	1.7	2.0	1.6	1.6
Social expenses	7.8	6.8	6.8	7.1	8.7	8.9
Other expenses	4.7	3.6	3.7	3.5	3.6	3.5
Interest	1.0	1.2	1.3	1.0	1.1	1.0
Capital spending and net lending	8.8	8.8	8.4	8.6	6.6	6.0
Capital	8.2	7.7	7.5	7.5	6.3	5.8
Net lending	0.6	1.1	0.9	1.1	0.4	0.2
Overall balance	-6.6	-3.6	-3.5	-3.0	-2.8	-2.2
Statistical discrepancy	0.0	0.0	0.0	0.0	0.0	0.0
Identified financing	6.6	3.6	3.5	3.0	2.8	2.2
Domestic	0.0	-0.2	-0.1	-0.4	1.5	1.3
Net T-bill issuance	0.8	0.4	0.7	0.2	0.5	1.1
Amortization 2/	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Use of deposits at the NBG and banks	-0.7	-0.4	-0.7	-0.4	1.1	0.4
External	5.6	2.3	3.1	2.3	0.9	0.7
Borrowing	6.1	5.6	3.4	2.6	2.5	2.2
Of which : IMF	2.5	0.0	0.0	0.0	0.0	0.0
Amortization	-0.6	-3.4	-0.4	-0.4	-1.6	-1.5
Of which : IMF	0.0	0.0	0.0	-0.1	-0.9	-1.0
Privatization receipts	1.1	1.6	0.5	1.1	0.5	0.2
Memorandum items:						
Public debt	39.2	33.8	32.9	32.7	31.2	31.1
Of which: foreign-currency denominated	33.6	28.8	27.8	28.1	26.6	26.0
End-year government deposits 3/	3.2	3.1	3.1	3.3	1.9	1.3
Primary balance	-5.6	-2.4	-2.2	-2.0	-1.7	-1.2
Operating/Current balance	2.3	5.2	4.9	5.6	3.8	3.8
Fiscal deficit excluding grants	8.9	4.5	4.4	4.0	3.5	2.8

Sources: Ministry of Finance; and Fund staff estimates.

1/ General government includes central and local governments.
2/ Excluding arrears clearance, provisions and T-bill repayment.
3/ Include Treasury single account, Revenue reserve account, and local government deposits.

Table 4. Georgia: Monetary Survey, 2010–13

	2010	2011	2012	2013	
				Jun.	Dec.
	Act.	Act.	Act.	Proj.	Proj.
	(In billions of lari)				
Broad money (M3)	5.9	7.1	7.9	8.4	9.5
Lari Broad money (M2)	3.0	3.8	4.1	4.3	4.8
Currency held by the public	1.4	1.4	1.6	1.5	1.6
Lari resident deposits	1.6	2.3	2.5	2.8	3.2
Resident foreign exchange deposits	2.9	3.3	3.8	4.2	4.7
Net foreign assets	0.9	0.7	0.8	0.4	0.0
NBG	2.5	3.3	3.7	3.7	3.9
Commercial banks	-1.6	-2.6	-2.9	-3.3	-3.9
Of which : liabilities	-2.8	-3.5	-4.2	-4.6	-5.2
Net domestic assets	5.0	6.4	7.1	8.0	9.5
Domestic credit	6.4	7.8	8.6	9.6	11.2
Net claims on general government	0.2	0.1	-0.1	0.0	0.3
Of which : government deposits at NBG	-0.8	-0.8	-1.0	-0.9	-0.7
Of which : T-bills at commercial banks	0.4	0.5	0.6	0.7	0.8
Private credit	6.2	7.7	8.7	9.6	10.9
Other items, net	-1.3	-1.4	-1.5	-1.6	-1.7
Sources of funds of commercial banks	7.4	9.2	10.5	11.5	13.1
Resident deposits	4.5	5.7	6.4	7.0	7.9
Non-resident deposits	0.6	0.8	1.3	1.3	1.4
Other foreign liabilities	2.2	2.7	2.9	3.2	3.8
Uses of funds of commercial banks	7.4	9.2	10.5	11.5	13.1
Reserves	2.1	2.3	2.8	2.9	3.1
Lari domestic credit	1.9	2.6	3.2	3.6	4.1
Fx domestic credit	4.6	5.3	5.8	6.4	7.3
Other foreign assets	0.1	0.1	0.1	0.1	0.1
Other items, net	-1.3	-1.0	-1.4	-1.5	-1.5
	(Percentage change, year on year)				
Broad money (M3)	23.9	20.3	11.4	16.5	20.5
Broad money (M3, constant exchange rate from 12 month prior)	20.9	23.7	11.8	14.4	17.9
Private credit	18.8	24.3	12.8	15.2	25.4
Private credit (constant exchange rate from 12 month prior)	14.5	29.5	13.4	12.4	21.7
	(Percent of GDP, unless otherwise indicated)				
Memorandum items:					
Broad money (M3)	28.5	29.2	30.0	30.8	33.0
Non-resident deposits (percent of total deposits)	10.5	12.1	15.3	14.7	14.1
Private credit	29.9	31.7	33.0	35.1	37.8
Nominal GDP (billions of lari)	20.7	24.3	26.3	27.4	28.9

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

Table 5. Georgia: Accounts of the National Bank of Georgia, 2010–13

	2010	2011	2012	2013	
				Jun.	Dec.
	Act.	Act.	Act.	Proj.	Proj.
	(In millions of lari)				
Net foreign exchange position	2,218	2,596	2,858	2,765	2,844
Gross International Reserves	4,013	4,707	4,760	4,540	4,568
Other foreign assets	8	1	1	1	1
Foreign currency liabilities	1,803	2,113	1,902	1,776	1,725
Of which : use of Fund resources	1,150	981	590	378	206
Of which : compulsory reserves in USD	245	752	874	947	1,061
Net domestic assets	-396	-457	-548	-507	-396
Net claims on general government	-95	-74	-425	-348	-161
Claims on general government (incl. T-bills)	714	685	529	508	494
Nontradable govt. debt	601	561	521	481	481
Securitized debt (marketable)	113	124	8	27	13
Deposits	809	759	954	856	655
Claims on rest of economy	2	2	1	1	1
Claims on banks	-165	-429	-172	-121	-153
Bank refinancing	190	14	391	300	300
Certificates of deposits and bonds	355	442	563	421	453
Other items, net	-138	43	48	-40	-82
Reserve money	1,822	2,139	2,310	2,258	2,449
Currency in circulation	1,618	1,754	1,918	1,847	1,998
Bank lari reserves	144	155	200	279	321
Banks overnight deposits	60	230	192	131	130
	(Percentage change, year on year)				
Reserve money	4.5	17.4	8.0	16.5	6.0
Currency in circulation	11.0	8.4	9.4	15.0	4.2
Bank lari reserves	-49.7	7.8	28.9	8.7	60.5
Memorandum items:					
Net international reserves					
(in millions of USD, at prog. exchange rates) 1/	882	1,152	1,326	1,296	1,416
Net domestic assets (in millions of lari) 1/	349	216	95	94	84

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

1/ Based on 2012 program definition as defined in the TMU.

Table 6. Georgia: Selected Monetary and Financial Soundness Indicators, 2007–12

	2007	2008	2009	2010	2011	2012
	Dec.	Dec.	Dec.	Dec.	Dec.	Dec.
Deposit dollarization (residents and non-residents, in percent)	66.1	74.8	71.8	68.6	63.3	66.0
Deposit dollarization (residents, in percent)	62.3	72.6	68.8	65.0	58.6	60.4
Loan-to-deposit ratio (in percent)	130.7	155.9	124.2	107.6	105.3	106.7
Credit-to-GDP ratio (in percent)	27.4	31.7	29.0	29.9	31.7	33.0
Capital adequacy ratio (in percent) 1/	16.0	13.9	19.1	17.4	17.1	17.0
Capital adequacy ratio (in percent) 2/	30.0	24.0	25.6	23.6	25.6	25.3
Liquidity ratio (in percent) 3/	37.2	28.3	39.1	38.7	37.3	39.8
Nonperforming loans (in percent of total loans) 4/	2.6	12.8	17.9	12.5	8.6	9.3
Nonperforming loans (in percent of total loans) 5/	0.8	4.1	6.3	5.4	4.6	3.7
Loans collateralized by real estate (in percent of total loans)	43.8	43.6	55.5	47.5	53.4	50.6
Loans in foreign exchange (in percent of total loans)	68.6	72.8	76.9	74.0	68.8	67.5
Specific provisions (in percent of total loans)	1.7	6.0	9.7	6.5	4.6	4.6
Net foreign assets (in percent of total assets)	-17.7	-19.6	-14.9	-8.2	-13.7	-19.7
Net open foreign exchange position (in percent of regulatory capital)	5.0	1.7	1.8	8.1	5.9	3.3
Return on equity (cumulative through the year, annualized) 6/	9.6	-12.4	-4.3	9.6	17.3	5.8
Borrowed funds from abroad-to-GDP ratio 7/	9.5	12.7	11.6	12.2	9.4	11.4

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

1/ National definition. Risk weight to forex loans was reduced from 200 to 175 percent in September 2008, and to 150 percent in August 2009, and raised to 175 percent in January 2011.
2/ Basel I definition.
3/ Ratio of liquid assets to 6-month and shorter maturity liabilities.
4/ National definition: NPLs are defined as loans in substandard, doubtful, and loss loan categories.
5/ Standard 90-day overdue definition.
6/ Pre tax.
7/ Borrowed funds include Subordinated Debt.

Table 7. Georgia: External Vulnerability Indicators, 2010–17

	2010 Act.	2011 Act.	2012 Est.	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.	2017 Proj.
Value of exports of goods and services, percent change	26.6	29.6	15.3	7.6	7.8	7.1	7.8	8.3
Value of imports of goods and services, percent change	16.5	30.5	14.8	2.8	3.4	5.6	5.6	6.5
Terms of trade (deterioration -)	1.5	-2.9	3.4	0.2	-0.5	0.3	1.5	0.9
Current account balance (percent of GDP)	-10.2	-12.8	-12.0	-10.0	-8.4	-8.3	-7.7	-7.4
Capital and financial account (percent of GDP)	10.1	16.4	13.7	10.8	9.6	10.0	9.0	7.7
External public debt (percent of GDP)	33.8	29.1	27.9	26.0	25.1	24.6	23.3	21.8
(in percent of exports of goods and services)	96.9	79.8	73.4	67.8	63.8	62.0	59.1	55.8
Debt service on external public debt								
(in percent of exports of goods and services)	4.1	4.1	6.2	9.6	6.3	3.9	3.2	3.2
External debt (percent of GDP) 1/	62.7	58.2	60.5	59.0	57.9	57.8	55.8	52.8
(in percent of exports of goods and services)	179.6	159.6	158.8	153.7	147.1	145.6	141.9	134.8
Debt service on MLT external debt								
(in percent of exports of goods and services)	17.3	16.7	18.3	17.6	14.9	12.9	12.9	13.7
Gross international reserves								
in millions of USD	2,265	2,818	2,873	2,635	2,594	2,843	3,095	3,152
in months of next year's imports of goods and services	3.4	3.7	3.6	3.2	3.0	3.1	3.2	3.1
in percent of external debt	31.1	33.6	29.8	26.3	25.1	25.9	26.9	26.6
in percent of short-term external debt (remaining maturity)	140	123	109	103	114	120	123	117

Source: Fund staff estimates and projections.

1/ Excluding intercompany loans.

Table 8. Georgia: Indicators of Fund Credit, 2010–17
(In millions of SDR)

	2010 Act.	2011 Act.	2012 Est.	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.	2017 Proj.
Existing Fund credit								
Stock 1/	682.1	644.0	484.1	233.0	66.3	14.0	4.2	0.0
ECF 2/	105.0	87.1	67.2	47.6	29.4	14.0	4.2	0.0
SBA	577.1	556.9	416.9	185.4	36.8	0.0	0.0	0.0
Obligations	21.7	48.9	167.7	248.3	166.8	52.2	9.8	4.2
ECF 2/	14.1	17.9	19.9	16.8	18.2	15.4	9.8	4.2
SBA	7.6	31.0	147.8	231.5	148.6	36.8	0.0	0.0
Prospective purchases under the SBA/SCF Blend								
Disbursements	...	...	...	190.0	60.0	0.0	0.0	0.0
SCF	...	...	...	95.0	30.0	0.0	0.0	0.0
SBA	...	...	...	95.0	30.0	0.0	0.0	0.0
Stock 1/	...	...	...	190.0	250.0	250.0	225.6	149.1
Obligations 3/	...	...	...	0.9	1.4	2.0	26.3	78.0
Principal (repurchases)	...	...	...	0.0	0.0	0.0	24.4	76.5
Interest charges	...	...	...	0.9	1.4	2.0	2.0	1.5
Stock of existing and prospective Fund credit 1/	682.1	644.0	484.1	423.0	316.3	264.0	229.8	149.1
In percent of quota	453.8	428.5	322.1	281.4	210.4	175.6	152.9	99.2
In percent of GDP	8.9	7.0	4.7	3.8	2.7	2.1	1.7	1.0
In percent of exports of goods and nonfactor services	25.6	19.3	12.2	10.0	6.9	5.4	4.3	2.6
In percent of gross reserves	45.9	36.1	25.8	24.7	18.7	14.2	11.3	7.2
In percent of public external debt	26.4	24.2	16.7	14.7	10.8	8.6	7.3	4.6
Obligations to the Fund from existing and prospective Fund credit	21.7	48.9	167.7	249.3	168.2	54.2	36.1	82.2
In percent of quota	14.4	32.5	111.6	165.8	111.9	36.1	24.0	54.7
In percent of GDP	0.3	0.5	1.6	2.3	1.4	0.4	0.3	0.6
In percent of exports of goods and nonfactor services	0.8	1.5	4.2	5.9	3.7	1.1	0.7	1.4
In percent of gross reserves	1.5	2.7	8.9	14.5	9.9	2.9	1.8	4.0
In percent of public external debt service	19.6	36.1	68.1	60.9	58.5	27.9	21.0	43.9

Source: Fund staff estimates and projections.

1/ End of period.

2/ Following the Low Income Countries (LIC) reforms, effective January 7 2010, the PRGF arrangements were renamed Extended Credit Facility (ECF) Arrangements.ECF interest is based on 0 percent through end December 2014 and 0.25 percent thereafter.

3/ Repayment schedule based on repurchase obligations and GRA charges. Includes service charges and surcharges.

Table 9. Georgia: Schedule of Prospective Reviews and Available Purchases and Loans

Availability Date	Condition	Available Purchases under the SBA		Available Loans under the SCF		Total Available Purchases and Loans	
		(SDR millions)	(Percent of quota)	(SDR millions)	(Percent of quota)	(SDR millions)	(Percent of quota)
15-Mar-12	Approve the 24-month arrangement	12.5	8.3	12.5	8.3	25.0	16.6
15-Aug-12	Complete the first review based on end-June 2012 performance criteria and other relevant performance criteria	22.5	15.0	22.5	15.0	45.0	29.9
15-Feb-13	Complete the second review based on end-December 2012 performance criteria and other relevant performance criteria	30.0	20.0	30.0	20.0	60.0	39.9
15-Aug-13	Complete the third review based on end-June 2013 performance criteria and other relevant performance criteria	30.0	20.0	30.0	20.0	60.0	39.9
15-Feb-14	Complete the fourth review based on end-December 2013 performance criteria and other relevant performance criteria	30.0	20.0	30.0	20.0	60.0	39.9
Total available		125.0	83.2	125.0	83.2	250.0	166.3

Table 10. Georgia: External Financing Requirements and Sources, 2010–17

(In millions of U.S. dollars)

	2010	2011	2012	2013	2014	2015	2016	2017
Total requirements	-1,644	-2,434	-2,655	-2,483	-2,166	-2,136	-2,198	-2,382
Current account deficit	-1,192	-1,844	-1,914	-1,694	-1,495	-1,578	-1,591	-1,665
Capital outflows: Repayments of MLT loans	-452	-590	-741	-789	-671	-558	-607	-717
Total sources	1,644	2,434	2,655	2,483	2,166	2,136	2,198	2,382
Capital flows	1,592	2,927	2,689	2,245	2,126	2,385	2,450	2,439
Public sector	593	523	689	562	467	431	341	341
Project grants	189	136	99	77	62	62	62	62
Long-term loan disbursements to public sector	403	340	485	434	394	358	269	268
Other	1	47	104	51	11	11	11	11
Private sector	999	2,404	2,001	1,683	1,659	1,954	2,109	2,098
Foreign direct investment in Georgia	814	1,117	880	978	1,252	1,310	1,402	1,483
Long-term loan disbursements to private sector	401	720	672	670	747	782	837	899
Other net inflows 1/	-216	566	449	35	-339	-138	-130	-284
Financing	260	80	18	0	0	0	0	0
IMF 2/	297	0	0	0	0	0	0	0
Change in arrears, net (- decrease)	12	44	12	0	0	0	0	0
Debt rescheduling, pre-payment (net)	11	36	6	0	0	0	0	0
Advance Repayments	-60	0	0	0	0	0	0	0
Change in reserves (- increase)	-208	-572	-52	238	41	-249	-253	-57
Financing gap	0	0	0	0	0	0	0	0
Memorandum items				(In percent of GDP)				
Total financing requirements	-14.1	-16.9	-16.7	-14.6	-12.1	-11.3	-10.7	-10.6
Total sources	14.1	16.9	16.7	14.6	12.1	11.3	10.7	10.6
Capital inflows	13.7	20.3	16.9	13.2	11.9	12.6	11.9	10.9
Exceptional financing	2.2	0.6	0.1	0.0	0.0	0.0	0.0	0.0
Change in reserves (- increase)	-1.8	-4.0	-0.3	1.4	0.2	-1.3	-1.2	-0.3

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

1/ Including errors and omissions.

2/ SBA, including augmentation in 2010.

Table 11. Georgia: External Debt Sustainability Framework, 2007–17

(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	**Debt-stabilizing non-interest current account 7/**
1	**Baseline: External debt 1/**	38.8	44.5	58.7	62.7	58.2	**60.5**	**59.0**	**57.9**	**57.8**	**55.8**	**52.8**	**-9.3**
2	Change in external debt	0.8	5.7	14.2	4.0	-4.5	2.3	-1.5	-1.1	-0.1	-1.9	-3.1	
3	Identified external debt-creating flows (4+8+9)	-6.3	7.8	7.1	-0.6	-6.3	4.0	1.8	-1.1	-1.0	-1.5	-1.6	
4	Current account deficit, excluding interest payments	18.2	19.8	7.6	7.5	10.2	9.0	7.0	5.5	5.5	4.9	4.6	
5	Deficit in balance of goods and services	26.9	29.8	19.1	17.8	19.0	19.6	17.2	15.3	14.7	13.5	12.5	
6	Exports	31.3	28.8	29.8	34.9	36.5	38.1	38.4	39.3	39.7	39.4	39.1	
7	Imports	58.2	58.6	48.9	52.7	55.5	57.7	55.6	54.7	54.4	52.9	51.6	
8	Net non-debt creating capital inflows (negative)	-16.7	-12.0	-6.4	-5.6	-6.7	-4.6	-4.8	-6.1	-6.0	-6.0	-5.9	
9	Automatic debt dynamics 2/	-7.8	0.0	5.8	-2.5	-9.8	-0.4	-0.5	-0.5	-0.4	-0.4	-0.3	
10	Contribution from nominal interest rate	1.5	2.6	2.6	2.7	2.6	3.1	3.0	2.9	2.8	2.8	2.8	
11	Contribution from real GDP growth	-3.5	-0.8	1.8	-3.3	-3.6	-3.5	-3.4	-3.4	-3.2	-3.2	-3.1	
12	Contribution from price and exchange rate changes 3/	-5.8	-1.8	1.4	-1.8	-8.7	...	...	...	...	...	...	
13	Residual, incl. change in gross foreign assets (2-3) 4/	7.2	-2.1	7.1	4.6	1.8	-1.7	-3.3	-0.1	0.9	-0.4	-1.5	
	External debt-to-exports ratio (in percent)	123.9	154.4	197.0	179.6	159.6	158.8	153.7	147.1	145.6	141.9	134.8	
	Gross external financing need (in billions of US dollars) 5/	2.7	3.8	2.6	2.5	3.5	4.2	4.3	4.1	3.9	4.0	4.2	
	in percent of GDP	26.7	29.7	24.2	21.6	24.0	26.8	26.3	23.8	20.9	19.7	19.1	
	Scenario with key variables at their historical averages 6/						**60.5**	**51.7**	**46.2**	**44.0**	**41.3**	**38.0**	**-13.5**
	Key Macroeconomic Assumptions Underlying Baseline												
	Real GDP growth (in percent)	12.3	2.3	-3.8	6.3	7.2	6.5	6.0	6.0	6.0	6.0	6.0	
	GDP deflator in US dollars (change in percent)	18.1	4.7	-3.1	3.2	16.2	2.0	-0.8	-2.3	2.1	2.8	2.9	
	Nominal external interest rate (in percent)	5.2	7.2	5.5	5.0	5.1	5.8	5.2	5.2	5.2	5.2	5.4	
	Growth of exports (US dollar terms, in percent)	24.7	15.9	-13.0	26.6	29.6	15.3	7.6	7.8	7.1	7.8	8.3	
	Growth of imports (US dollar terms, in percent)	34.1	26.8	-29.8	16.5	30.5	14.8	2.8	3.4	5.6	5.6	6.5	
	Current account balance, excluding interest payments	-18.2	-19.8	-7.6	-7.5	-10.2	-9.0	-7.0	-5.5	-5.5	-4.9	-4.6	
	Net non-debt creating capital inflows	16.7	12.0	6.4	5.6	6.7	4.6	4.8	6.1	6.0	6.0	5.9	

1/ Excludes intercompany loans

2/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

3/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on

4/ For projection, line includes the impact of price and exchange rate changes.

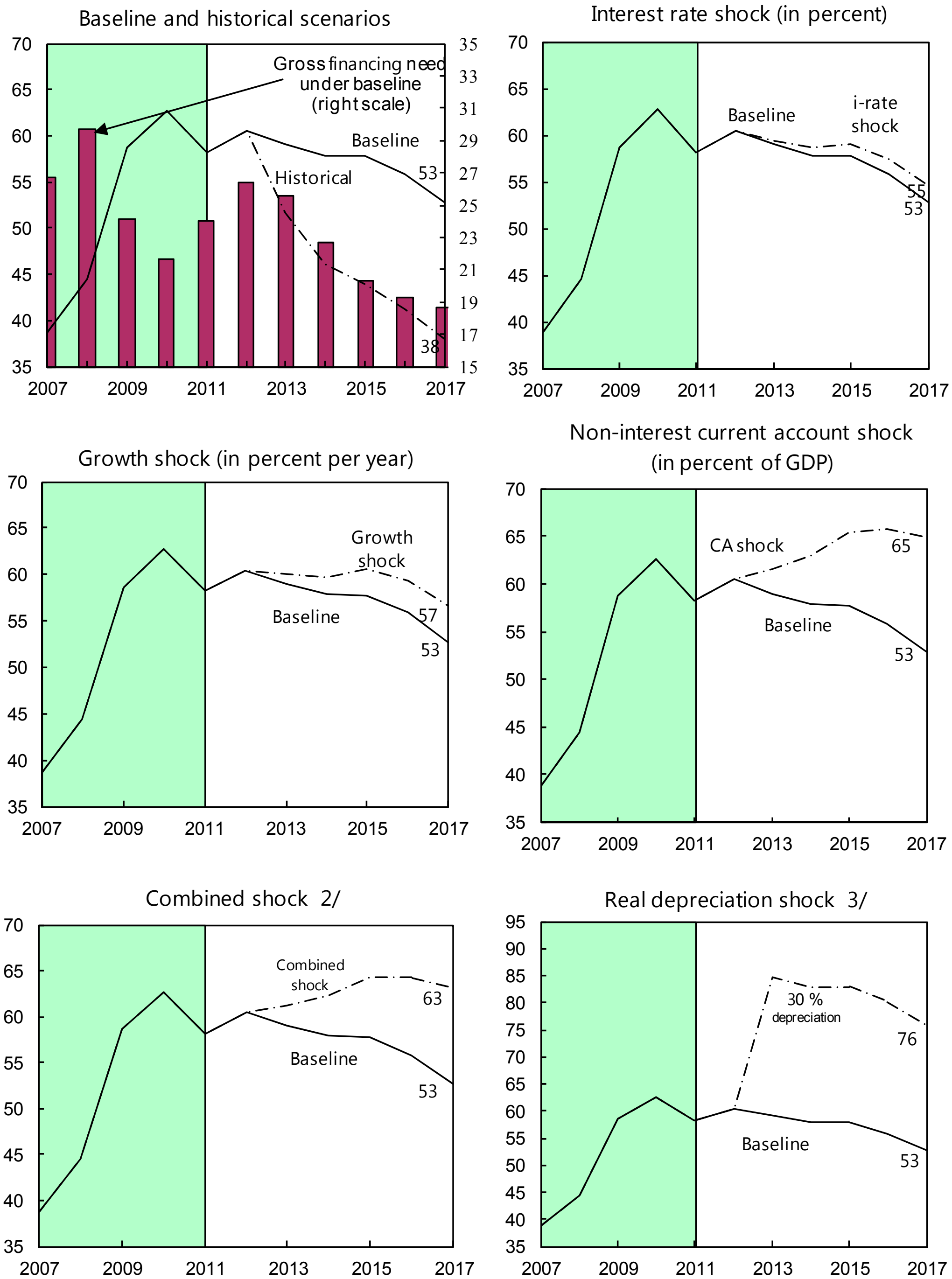
5/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

6/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

7/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure 8. Georgia: External Debt Sustainability: Bound Tests 1/

(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

3/ One-time real depreciation of 30 percent occurs in 2013.

Table 12. Georgia: Public Sector Debt Sustainability Framework, 2007–17

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2007	2008	2009	2010	2011			2012	2013	2014	2015	2016	2017	Debt-stabilizing primary balance 9/
1 **Baseline: Public sector debt 1/**	21.5	27.6	37.3	39.2	33.8			**32.7**	**31.2**	**31.1**	**30.3**	**29.2**	**27.9**	**-1.6**
o/w foreign-currency denominated	16.8	23.5	31.7	33.6	28.8			28.1	26.6	26.0	25.0	23.6	22.1	
2 Change in public sector debt	-5.6	6.1	9.7	1.9	-5.4			-1.0	-1.6	-0.1	-0.7	-1.1	-1.3	
3 Identified debt-creating flows (4+7+12)	-6.8	1.0	9.1	2.0	-5.4			-0.6	-0.6	-1.2	-1.7	-1.9	-1.7	
4 Primary deficit	4.2	5.7	8.2	5.6	2.4			2.0	1.7	1.2	0.8	0.5	0.5	
5 Revenue and grants	29.3	30.7	29.3	28.3	28.2			28.7	27.5	27.1	27.3	27.5	27.6	
6 Primary (noninterest) expenditure	33.4	36.4	37.5	33.9	30.7			30.7	29.3	28.3	28.1	28.0	28.0	
7 Automatic debt dynamics 2/	-5.8	-1.0	2.9	-2.5	-6.3			-1.6	-1.8	-2.2	-2.3	-2.3	-2.1	
8 Contribution from interest rate/growth differential 3/	-4.5	-1.7	2.6	-4.0	-4.6			-1.6	-1.8	-2.2	-2.3	-2.3	-2.1	
9 Of which contribution from real interest rate	-1.8	-1.3	1.5	-1.9	-2.2			0.5	0.0	-0.6	-0.7	-0.6	-0.6	
10 Of which contribution from real GDP growth	-2.7	-0.4	1.1	-2.0	-2.4			-2.0	-1.8	-1.7	-1.7	-1.6	-1.6	
11 Contribution from exchange rate depreciation 4/	-1.2	0.7	0.3	1.5	-1.7			...	...	...	...	...	...	
12 Other identified debt-creating flows	-5.2	-3.7	-2.0	-1.1	-1.6			-1.1	-0.5	-0.2	-0.2	-0.1	-0.1	
13 Privatization receipts (negative)	-5.2	-3.7	-2.0	-1.1	-1.6			-1.1	-0.5	-0.2	-0.2	-0.1	-0.1	
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3) 5/	1.3	5.1	0.5	-0.2	0.0			-0.4	-1.0	1.2	1.0	0.8	0.4	
Public sector debt-to-revenue ratio 1/	73.6	90.0	127.4	138.5	119.6			114.3	113.3	114.7	111.0	106.0	101.2	
Gross financing need 6/	5.7	6.9	10.1	8.6	9.0			5.5	6.7	6.1	5.8	5.8	6.4	
In billions of U.S. dollars	0.6	0.9	1.1	1.0	1.3			0.9	1.1	1.1	1.1	1.2	1.4	
Scenario with key variables at their historical averages 7/								**32.7**	**30.6**	**31.1**	**31.6**	**31.8**	**31.7**	**-2.6**
Scenario with no policy change (constant primary balance) in 2012-2017								**32.7**	**30.7**	**31.0**	**32.0**	**32.3**	**32.4**	**-1.8**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline						10-Year Historical Average	10-Year Standard Deviation							
Real GDP growth (in percent)	12.3	2.3	-3.8	6.3	7.2	6.6	4.7	6.5	6.0	6.0	6.0	6.0	6.0	
Average nominal interest rate on public debt (in percent) 8/	2.6	3.3	3.2	3.1	3.5	3.0	0.4	3.1	3.6	3.5	3.6	3.7	3.8	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-7.1	-6.4	5.3	-5.5	-6.0	-4.4	4.3	1.6	0.1	-1.7	-2.1	-2.0	-1.9	
Inflation rate (GDP deflator, in percent)	9.7	9.7	-2.0	8.5	9.5	7.0	3.7	1.4	3.5	5.2	5.8	5.7	5.7	
Growth of real primary spending (deflated by GDP deflator, in percent)	29.6	11.4	-0.9	-4.0	-3.0	16.7	18.1	6.5	1.2	2.6	5.2	5.7	6.1	
Primary deficit	4.2	5.7	8.2	5.6	2.4	2.8	3.6	2.0	1.7	1.2	0.8	0.5	0.5	

1/ Public sector debt includes general government debt and liabilities of NBG to IMF, and it does not include SOE's debt. It is reported on a gross basis.

2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

5/ For projections, this line includes exchange rate changes.

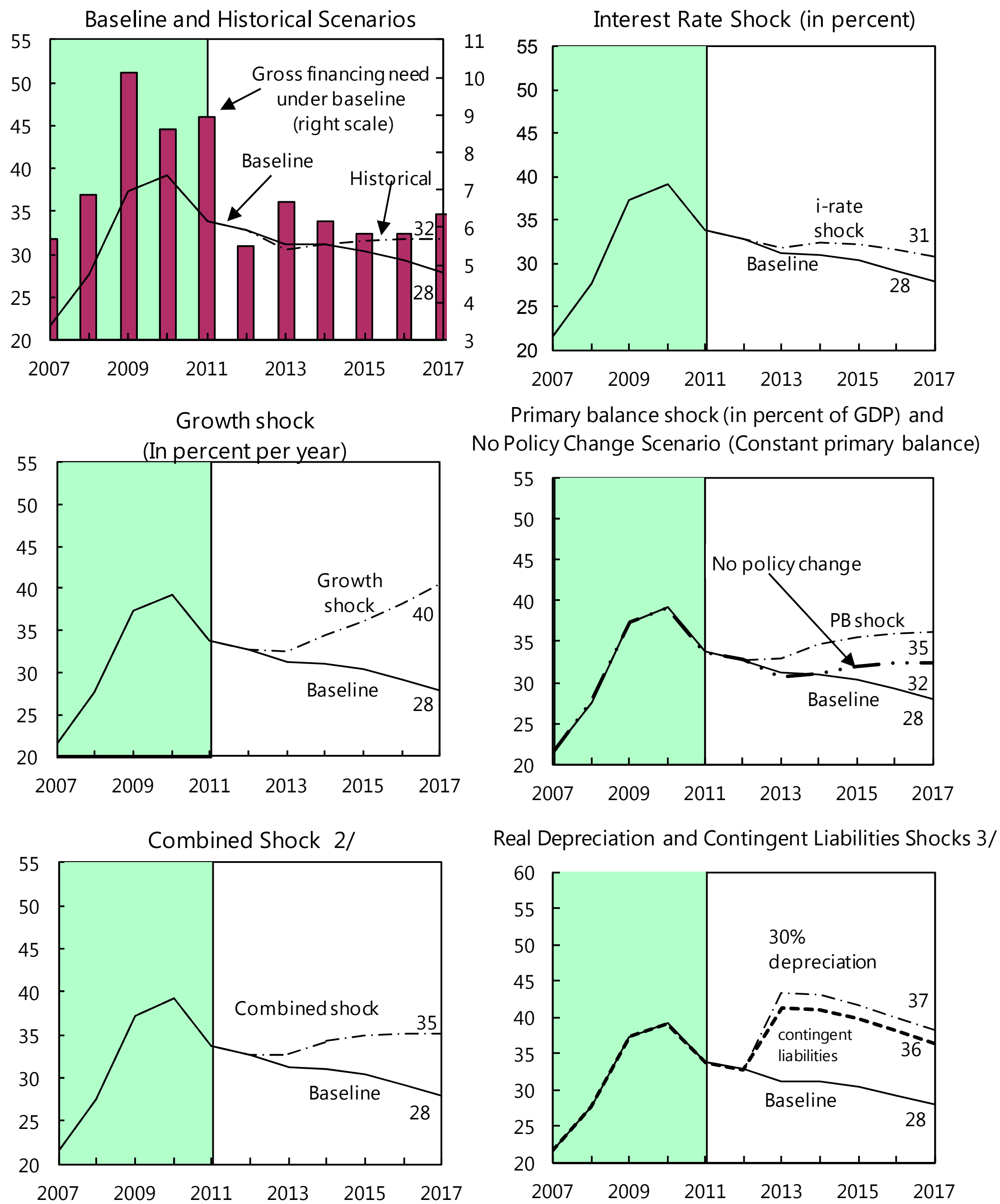
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 9. Georgia: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data; and Fund staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2013, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

APPENDIX I. LETTER OF INTENT

Tbilisi, March 1, 2013

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

Dear Ms. Lagarde:

1. **The convincing victory of our Georgian Dream coalition in the October 2012 parliamentary election has given our new government impetus to further advance Georgia's political and economic transformation based on transparency, accountability, and the rule of law.** Free and fair conduct of the election and the peaceful handover of power demonstrate Georgia's progress toward a vibrant democracy. The newly elected parliament has approved a new government, a new prime minister, and 19 other cabinet members. Throughout this momentous transition macroeconomic stability has been maintained.

2. **Although Georgia's economic performance has been solid in the recent past, our country continues to face sizeable economic and social challenges.** The economy recovered quickly after the armed conflict with Russia in August 2008 and the global financial crisis of 2008–09. However, although we have achieved strong growth, serious social challenges remain, including high unemployment and widespread poverty, especially in rural areas. Our foreign trade and current account deficits remain large but are financed mainly by long-term capital inflows, which has allowed us to increase international reserves. High external indebtedness is a burden for future generations, and we are keen to address this issue and to ensure that external debt is on a sustainable downward path.

3. **Our new government's economic program seeks sustained and inclusive growth while ensuring macroeconomic stability.** Our priorities are to:

- Maintain a sound macroeconomic environment, backed by prudent fiscal, monetary and financial policies, to deliver sustained economic growth and higher employment.

- Preserve the strength and respect the independence of the National Bank of Georgia (NBG), as we believe there is a strong correlation between central bank independence, price stability, and economic performance. The National Bank of Georgia remains committed to price stability and to meeting its inflation target (6 percent in 2013 and 2014; 5 percent in 2015). We believe that maintaining macroeconomic stability is the surest way to sustained growth.

- Facilitate external adjustment by taking measures now to reduce the current account deficit over the medium term through reasonable fiscal consolidation, greater exchange rate flexibility, and structural reforms that will improve Georgia's competitiveness and export capacity. We will implement measures to limit noncore funding to reduce external vulnerability and protect the financial system.

- Support growth that is private sector-led, geographically diverse and which is inclusive and job-creating. We will ensure an enabling business environment by providing a level playing field for all businesses. We will remove barriers to free and fair competition, and strengthen the role of the Competition Authority. We will protect workers' rights and improve working conditions.

- Reprioritize government expenditure toward social spending; improve the quality of capital spending, while maintaining key infrastructure projects; and increase budget transparency and accountability.

4. We also intend to implement structural reforms to improve governance, encourage employment, and reduce poverty:

- In terms of governance, we will increase the transparency and accountability of the budget process. We will also strengthen the institutional framework of the Partnership Fund (PF), and publish accounts of the LEPLs every six months.

- To boost growth and employment, we will accelerate reforms aimed at improving the business environment, including strengthening competition policy and protection of property rights. We have established a Rural and Agricultural Development Fund and are facilitating creation of new investment funds to support key sectors of the economy.

- We will enhance dialogue with business and will make the tax code and tax administration more fair and comfortable for business operation, but without lowering tax rates.

- We will strengthen the social safety net to help the poorest and most vulnerable. The 2013 budget provides for an increase in basic pensions and social allowances, for the introduction of universal emergency health insurance starting from February and universal health insurance starting from July 2013, and for reducing the income tax burden on low-income workers.

5. To support this strategy, we will continue to cooperate strongly with the IMF under the 24-month Stand-By Arrangement (SBA) and Standby Credit Facility (SCF) adopted last April. We fully share the goals set under these arrangements, namely to keep the budget deficit on a reasonable downward path so as to create room for countercyclical fiscal policy, promote external adjustment, strengthen market confidence, catalyze continued official financial support, and encourage employment and reduce poverty, while maintaining the output gap close to zero. As was the case in April 2012, we project our program to be fully financed and intend to keep treating the SBA and SCF as precautionary.

6. We are current on our program obligations and have met all but one of our end-December 2012 program targets (Tables 1, 2 and 3). We met all the end-June 2012 quantitative performance criteria (PCs) and indicative targets. The fiscal deficit target was met comfortably, owing to lower-than-expected public investment. The NIR and NDA targets were also met comfortably as the NBG stepped up, and sterilized, its foreign currency purchases. We also met the structural benchmarks related to the reporting of SOEs' and LEPLs' financial flows and to the audited financial accounts of the Partnership Fund. Reflecting our commitment to stable macroeconomic policies, we met all but one of the end-December 2012 quantitative PCs and indicative targets.

7. We request a waiver for the end-December 2012 performance criterion on the deficit ceiling for the Partnership Fund, in light of the corrective measures we have implemented to ensure that this does not happen again. The PC was not met because the PF took full responsibility for the financing of the Gardabani thermal power plant (TPP) investment project (US$200 million total), after the power supplier, who negotiated a draft MoU to finance the project, decided not to participate. The PF had already advanced US$50 million to the contractor so it would have been too costly to abandon the project. This action was contrary to the PF's goal of taking minority stakes and bringing in outside private investment. We are firmly committed to taking all necessary measures to avoid this kind of issue recurring in the future. As a first step, in line with IMF technical assistance recommendations, we have amended the PF charter to limit PF participation in projects to a minority equity stake. Specifically, PF financing (debt plus equity plus guarantees) will not be allowed to exceed 100 percent of the equity of the private partner in the project. We will submit to parliament an amendment to the PF Law removing all noncommercial objectives from the PF by end-April 2013 (structural benchmark). We have also changed the management of the PF and have initiated work on a new organizational structure that will ensure more prudent decision making (see below).

8. In light of Georgia's strong economic performance and the policies outlined in this letter, we request completion of the first and second Reviews under the SBA and SCF. Given our strong financial position, we do not intend to draw the funds available once the review is completed. As envisaged when the program was approved last April, the third review will be based on end-June 2013 performance criteria and is scheduled for completion by end-October 2013, and the fourth review will be based on end-December 2013 performance criteria and is scheduled for completion by April 10, 2014.

9. We authorize the IMF to publish this Letter of Intent and its attachments (including the Technical Memorandum of Understanding).

I. MACROECONOMIC FRAMEWORK

10. The economy continued to expand at a healthy rate in 2012 and growth is expected to remain strong in 2013. While slowing somewhat in the fourth quarter, growth is expected to have exceeded 6 percent in 2012 and to have been broad based, with strong growth in construction, manufacturing, and the financial sector. We expect growth to remain strong in 2013, reaching at least 6 percent, as the impact of renewed fiscal consolidation efforts will be offset by increases in foreign direct investment. On the plus side, growth could be significantly higher if, as we expect, Russia reopens its market to Georgian products, and the Rural and Agricultural Fund starts operations. However, on the negative side, there is the risk of continued weakness in the world economy and the Eurozone, and there are also indications of some pause in growth towards the end of 2012, which we are monitoring closely. Thus, while we are confident that growth in 2013 will reach 7 percent, we will base our policies on a more prudent assumption of 6 percent growth, and we will revisit our growth assumption during the Article IV discussions. These continued strong growth rates should be sufficient to reduce the unemployment rate further.

11. **While inflation in 2012 has been much lower than expected, we expect it to gradually increase to 3 percent by end-2013 and to reach the NBG's inflation target of 6 percent sometime in 2014.** Exchange rate appreciation against our main trading partners through early 2012, the decline in food prices, and slower bank credit growth have contributed to the low inflation observed in 2012, which fell below the NBG's inflation target. In 2013, we expect that domestic demand will pick up, and that bank credit will grow more rapidly again once uncertainties die out. Combined with increased social expenditures, accommodative monetary policy, and greater exchange rate flexibility, inflation should pick up during the year and approach the NBG's target. We will base our policies on the assumption of a GDP deflator of 3.5 percent in 2013 but stand ready to revisit this assumption during the Article IV discussions.

Georgia: Main Economic Indicators, 2012–13

	2012	2013 projections
	(In percent)	
Growth	6.5	6.0
Inflation, end of period	-1.4	3.2
Inflation, average	-0.9	1.0
GDP deflator, period average	1.4	3.5
Current Account deficit (in percent of GDP)	12.0	10.0

12. **Starting in 2013, we will put in place measures that will support reduction of the current account deficit through the medium term**. For 2012, we project that the current account deficit will remain constant at around 12 percent of GDP, rather than falling to 9.7 percent of GDP as had been projected in the program. We are committed to reducing the current account deficit to a sustainable level through a combination of policy measures. We will reduce the fiscal deficit from 3 percent of GDP in 2012 to 2.8 percent of GDP in 2013 and then gradually to 1½ percent of GDP over the medium term. We will implement this fiscal consolidation largely by streamlining import-intensive capital expenditures, which should improve the trade deficit directly and increase public savings. We will support this effort through monetary and exchange rate policies as well as

macroprudential measures to limit noncore funding and to protect the financial system. Structural reforms would further enhance our competitiveness and increase exports in general, including of agriculture products, tourism, and hydropower energy. We are working closely with the EU on the Deep and Comprehensive Free Trade Agreement, which we aim to sign by fall 2013 and which we expect will take effect from 2014. We are also taking steps to reopen trade with Russia, where we anticipate significant increases in exports.

13. We plan to implement policies to improve the business and investment environment, to boost Georgia's growth, competitiveness, and employment over the medium term:

- We will enhance the capacity of the court and judicial system to more effectively handle business cases. We will improve the efficiency, effectiveness, and integrity of the tax appeal process with TA from donors and in collaboration with business representatives.
- We are committed to a stable regulatory environment, and we will reinforce the protection of property rights by lifting political pressure from the judiciary system.
- We will introduce new antitrust regulation so that a strengthened competition agency will be in place by the end of June 2013. Relevant legislative changes are already initiated.

14. We are keen to promote agricultural development and private investment. We have established a new Rural and Agricultural Fund to support agricultural development through investment in infrastructure, irrigation, and technology; access to credit; and export promotion. This fund will not be financed from the budget; it will not receive government guarantees and will not create any contingent liabilities to the government. We will also address some of the issues impeding employment creation starting with the need to upgrade skills in the labor force. We are also encouraging creation of a new private Investment Fund that will provide long-term financing for development projects. This fund will be fully private and will not receive financing or guarantees from the government. Its audited financial statements will be published regularly.

II. FISCAL POLICY

15. In view of the persistence of high current account deficits, and to create room for countercyclical fiscal policy, we are accelerating our fiscal consolidation efforts. While our medium-term fiscal objective remains to reduce the deficit to about 1.5 percent of GDP by 2016, we have reduced our fiscal deficit target to 2.8 percent of GDP in 2013 compared to the 3 percent of GDP envisaged last April. In view of the need to strengthen our social safety net while meeting our constitutional requirement to bring overall spending under 30 percent of GDP from 2014 onward, our efforts will focus primarily on increasing the efficiency of other current and capital expenditures. Consistent with our commitment to using fiscal policy in a countercyclical manner, the program includes an expenditure rule so that if revenue exceeds projection by around 0.5 percent of GDP, then the excess will be saved (performance criterion).

16. Consistent with our commitment in the March 2012 LOI and MEFP, we reduced our fiscal deficit to no more than 3.0 percent of GDP in 2012. Revenue turned out slightly higher than projected, reflecting primarily higher grants and an exceptional dividend by Georgian Railways. In addition to reducing the deficit, these higher revenues were used to finance emergency assistance in Kakheti, accelerate investment spending, and to finance the agricultural sector (by allocating an additional 81 million GEL (0.3 percent of GDP) to the Ministry of Agriculture in amendments to the 2012 budget last December).

17. Our 2013 budget aims at reducing the fiscal deficit to 2.8 percent of GDP while increasing social spending to protect the most vulnerable:

- We will increase pensions to GEL 150 (subsistence minimum) for all pensioners. Pensions will be increased in two stages. First, from April 1, pensions for pensioners below age 67 will be increased from GEL 110 to GEL 125; thus all pensioners (women from 60 and men from 65) will have equal pensions. Second, from September 1, pensions will be increased to GEL 150. Including the full year effect of the September 2012 pension increase, these will cost about 0.6 percent of GDP in 2013. The full year effect of the 2013 increases in pensions is GEL 237.3 million (0.8 percent of GDP).

- We will increase other types of pensions starting from September. Disability Pension (I group) will be increased from GEL 100 to GEL 150; Disability Pension (II group) will be increased from GEL 70 to GEL 100; Survivors' Benefits and Benefits for Victims of Political Repression will be increased from GEL 55 to GEL 100. These increases will cost GEL 26 million in 2013 (0.1 percent of GDP), with a full year effect of GEL 68.3 million (0.24 percent of GDP).

- We will double our spending on social allowances by increasing benefits and broadening their coverage starting from July 2013. This will cost an additional GEL 71.5 million in 2013 (full year cost GEL 143 million (0.5 percent of GDP)).

- We will provide universal healthcare insurance. Three different packages will be introduced for different categories of beneficiaries. Adding the cost of packages introduced in 2012, health insurance spending in 2013 will rise by GEL 350 million compared to 2012 to reach a total of GEL 505 million (1.75 percent of GDP). The annual impact of the insurance packages introduced in 2013 will be GEL 302 million (about 1 percent of GDP). We are consulting closely on this reform with the World Bank.

- We are reducing the tax burden for low-income earners by making the first GEL 150 each month of wages free from personal income tax. Tax rebates will be given in early 2014. Making the personal income tax more progressive in this way will cost 0.6 percent of GDP in 2014. We are also increasing spending on education (0.2 percent of GDP). Funding of the Ministry of Education will increase by GEL 44.2 million in 2013 to GEL 670 million. The increase is mainly directed to voucher financing of the public schools, rehabilitation of the public schools, and grants for Higher Education.

- We are also increasing spending on agriculture. Financing of the Ministry of Agriculture will be increased to 241 million GEL in 2013, mainly directed to the programs of purchasing agricultural machinery, melioration activities, and developing the agricultural sector.

- As a result of these measures, government spending on pensions, social allowances, healthcare, education, and agriculture will increase from 9.4 percent of GDP in 2012 to 11.1 percent of GDP in 2013.

18. We are taking the following measures to pay for these new socially oriented policies, and to offset the projected decline in nontax revenue and grants (by 1.2 percent of GDP). These will reduce the budget deficit to 2.8 percent of GDP:

- We are reorienting capital spending away from new government buildings and will instead prioritize infrastructure. This, along with a decline in net lending, will generate savings of around 2 percent of GDP. Government investment will still be around 6.5 percent of GDP, which is high compared to neighboring countries.

- We will introduce a nominal freeze on all other categories of spending. This will save 1.5 percent of GDP in 2013.

19. Consistent with our election mandate and our vision for Georgia, we will adopt a number of reforms to contain fiscal risks and increase fiscal transparency.

20. First, we will define the Partnership Fund's role more clearly and strengthen its governance:

- The PF's overarching goal is to catalyze private investment in key sectors through providing cofinancing (in the form of minority equity or debt financing) in situations where the private sector cannot mobilize sufficient funding from the market without some form of state participation.

- We are reviewing the PF's existing investment portfolio and will halt projects that are not commercially viable. We are currently involved in negotiations with several investors who would potentially acquire majority equity in the Gardabani TPP project so that it can become private. If these negotiations are not successful, we will work on alternative options to reduce the PF equity in this project to a minority.

- In the coming months we will review the PF's role, bearing in mind its relation to the new Rural and Agricultural Fund and also that the PF owns state assets of considerable value. We will consult with the Fund and the World Bank before concluding this review.

- In the meantime, we will continue to strengthen the PF's governance in line with IMF technical assistance recommendations. In addition to restricting the PF's participation in projects to a minority stake, we will submit to parliament an amendment to the PF law to remove noncommercial objectives from the PF (structural benchmark, end-April 2013). In the meantime, the PF will not engage in any activities with noncommercial objectives.

21. Second, we will increase budget transparency and accountability by providing the public with more information on government spending. Starting from end-July 2013, we will publish semiannual public sector accounts that cover the general government and the LEPLs (structural benchmark, end-July 2013). The government will review its policy with regard to the issuance of guarantees. In the meantime, it will not issue guarantees.

22. Third, we will be considering public sector involvement in large hydropower projects in accordance with our strategy for the further development of the energy sector, provided that all related fiscal risks are assessed. The government will abstain from outright guarantees; however, the issuance of PPA guarantees for domestic supply may be necessary for power plant investment projects. In line with World Bank recommendations, we will consider further liberalization of the energy market and modifications to the rules governing the energy market. Any subsequent public sector involvement, if warranted, will take place based on (i) the financial viability of the projects; (ii) the associated fiscal risks (including in the form of contingent liabilities); and (iii) economic benefits to Georgia. We are also working with the regulator to review applicable methodologies for energy tariffs and will consult with the World Bank on this.

23. Electricity tariffs were reduced by 3.54 tetri (about 22-28 percent of the tariff) as of January 2013 for consumers who consume less than 300 kWH per month. The reduction was achieved through a renegotiation of tariffs with the operating companies. In the Kakheti region, this reduction will be financed from the state budget, but with a small estimated cost of 875,000 GEL for the first three months of the year.

24. We are receiving TA from the IMF and intend to strengthen revenue administration:

- We will strengthen taxpayer registration, the management of tax return filing compliance, and debt management.
- We will increase the number and qualification of auditors and continue the US Treasury Office of Technical Assistance modern audit training program.
- In line with international practice, we are working on legislation that will allow auditors controlled access to bank account information for the purpose of carrying out audits.
- In concert with scaling up GRS audit capacity, we plan to review by end-2013 the private sector-led alternative audit program introduced in recent years.
- We will review the GRS’ excessive reliance on fees and charges, with the goal of ensuring that all core tax administration operational activities are provided free of charge. This will encourage higher levels of voluntary compliance by taxpayers.

- We propose to further develop taxpayer service and compliance programs with an emphasis on tailoring these to the needs of different taxpayer segments. We have already introduced special services for micro and small enterprises through both service centers and electronically.

III. MONETARY AND EXCHANGE RATE POLICIES

25. We remain committed to price stability and exchange rate flexibility. Maintaining monetary and financial stability requires credible policymaking independence. As such, as stated in the NBG's organic law and in the Constitution of Georgia, we reaffirm the existing strong institutional and financial independence of the NBG and also the importance of strong cooperation between the government and the NBG. In 2012, inflation fell well below our 6 percent target because of the base effect from one-off price increases in 2011 and was driven mainly by the decline in food prices and the decline in prices of other imported goods. The NBG will gradually decrease its inflation target towards its medium-term objective of 3 percent. For 2013 and 2014, we are committed to our monetary policy objective of keeping inflation to 6 percent, declining to 5 percent in 2015. The NBG is committed to explaining in public any deviations from these targets and for regularly making public its revised inflation and macroeconomic projections. Changes in the monetary policy rate will be guided by developments in credit and monetary aggregates complemented by our inflation forecast model but with the primary goal of achieving our inflation target.

26. We will continue our policy of purchasing foreign exchange to boost our net international reserves. During 2012, we purchased a (net) total of US$155 million, so that our gross international reserves increased to US$ 2.873 billion. In 2013, gross reserves are expected to decline moderately to US$ 2.635 billion, but will stay comfortably above 3 months of 2014 imports of goods and nonfinancial services.

27. We will refine our inflation targeting framework by further customizing our modeling to Georgia's conditions and by assisting with the implementation of a credit conditions survey. The NBG will continue to invest in human capital to further strengthen modeling and forecasting skills to refine the new FPAS framework for forecasting inflation. In the first half of 2013, the International School of Economics in Tbilisi, assisted by the NBG, will launch a business confidence survey that will measure inflation expectations. Moreover, the NBG will launch a new credit conditions survey to assess present and expected credit conditions, which will further assist the forecasting analysis.

28. To strengthen external communication, a new Inflation Report will be introduced in 2013. The revised document will be more forward looking and will provide to the public the NBG's views on the outlook for inflation, economic growth, and the broad macro environment. The report will give medium-run inflation and output projections in fan charts. In case actual inflation deviates from the targeted level, the NBG will continue to explain in detail the main reasons why the target was missed, showing the revised future inflation path, and will explain how and when inflation will be back on track. The new Inflation Report will be part of the communication strategy that the

NBG plans to implement starting from February-March 2013. We believe that a broader communication strategy, comprising regular meetings with analysts, journalists and other experts, could significantly improve the public's understanding of monetary policy, improve credibility, and increase accountability of the NBG.

29. To accelerate de-dollarization and to strengthen the monetary transmission mechanism, we will implement policies to encourage the use of the lari in the financial system. The NBG has relaxed collateral standards for refinancing loans and will encourage commercial banks to issue long-term standardized lari CDs. We are also considering placing long-term government deposits with commercial banks (in exchange for sale of treasury bills to commercial banks) to promote long-term lari lending.

IV. FINANCIAL SECTOR

30. We are taking steps to further strengthen the financial sector and to enhancing the regulatory environment:

- Competition in the banking industry has intensified. However, our financial sector maintains comfortable buffers of capital and liquidity. The capital adequacy ratio as defined by the BIS is around 24.6 percent (NBG definition: 16.5 percent); the BIS Tier I ratio is 18.8 percent (NBG definition: 13.2 percent). Liquid assets (excluding short-term loans) cover 53 percent of client deposits and 33.7 percent of total liabilities, while the liquidity ratio (NBG definition) stands at 40 percent. These high capital and liquidity ratios mean that our banks have very low levels of leverage, with a net loans-to-capital ratio of only 3.5.

- Given that there is very little difference at present between the cost of funds and the cost of equity, we believe that our conservative capital requirements do not impede efficiency; on the contrary, they contribute to a lower cost of funds due to lower bank credit risk. We are committed to ensuring that banks will continue to improve their efficiency without compromising their financial soundness.

- We will encourage banks to develop enhanced pricing models for their products. We have developed common guidelines for the development of those models and have intensified profitability analysis of the banks to identify profit and loss generating sources.

31. We will continue the transition towards Basel III compliance and risk-based supervision. In 2013, banks should start to comply with the standardized approach of Pillar 1 of Basel III. In line with the transition to Pillar 2, banks are expected to submit their first Internal Capital Adequacy Assessment Process (ICAAP) forms in 2013. Banks will also perform firm-level stress tests under macro scenarios. These results will be used for Pillar 2 capital requirements. We have initiated programs to help financial sector firms make this transition, especially regarding ICAAP, while some banks are receiving assistance from external consultants to smooth the process.

32. In line with Basel III, we are monitoring the need for additional countercyclical measures, vis-à-vis our old, more rigid methodology of changing the risk weighting for FX assets in the capital adequacy ratio; which, given the high dollarization of the banking system, has been quite an effective regulatory tool. We have developed the framework for monitoring domestic systemically important banks (D-SIBs), in line with recent Basel recommendations. This framework, together with the development of micro-level stress tests, will gradually replace the current, less fine-tuned approach.

33. Starting from 2012, the NBG has made efforts to make the liquidity coverage ratio (LCR) the core liquidity ratio for banking supervision. We are currently calibrating our use of the LCR. Currently we use the LCR as a monitoring tool; after some further fine-tuning, we aim to adopt it by end-2013, well ahead of Basel III's 2015 deadline. Within our LCR, we already include higher liquidity requirements for nonresident deposits compared with resident deposits. Going beyond Basel recommendations, our LCR also accounts for such characteristics as: withdrawable vs. non-withdrawable deposits, parent financing vs. private financing, concentration, and loan quality.

34. While in the past we have relied mainly on moral suasion, we are now taking a more formal approach to discouraging nonresident deposits. By June 2013, we will introduce a transitory liquidity ratio for nonresident deposits, which will take effect until the full LCR comes into force. Provided nonresident deposits are no more than 10 percent of total deposits (in which case we believe they can be a useful source of diversified funding), they will face the standard 30 percent liquidity requirement. For each percentage point above the 10 percent threshold, the liquidity requirement for nonresident deposits will increase by the same amount. Thus if nonresident deposits make up 15 percent of total deposits, then total nonresident deposits will face a liquidity requirement of 35 percent. At the same time, the NBG will continue to work on distinguishing nonresident depositors with no interest in the country from non-residents who have close economic links to Georgia (employees of international organizations and embassies, diaspora, foreign companies with business relations in Georgia, etc.). While hard to calculate precisely, our current estimates suggest the share of NRDs of people with no other interests in the country is less than half of total reported NRDs. This will help us refine our supervisory measures.

35. After upgrading the NBG's supervisory structure and approach, we completed a self-assessment of our regulatory framework against Basel Core Principles. To complement our self-assessment we have developed General Risk Assessment Program (GRAPE), a document which describes our approach to supervision. We aim to send GRAPE and our self-assessment documents to the IMF for review by March 2013. These would be important inputs for an FSAP, which we request from the Fund and which we hope will be launched by the end of 2013.

36. We are continuing our attempts to further de-dollarize the banking system. Our existing policies, including additional risk weighting for FX loans, higher reserve requirements for FX liabilities, and overall higher negative liquidity carry for FX liabilities already discourage FX funding and FX lending. Our micro-level stress testing framework (to be performed by banks in 2013) will also take into account currency-induced credit risk. Furthermore, to address the macro-level implications of dollarization, in our new framework we will impose a capital add-on for FX lending on top of the amounts indicated by the micro stress tests. We will do this gradually in 2013–14. The use of higher-than-required run-off rates for FX deposits, once our LCR framework takes effect, should also help discourage the use of foreign currency.

V. EMPLOYMENT AND POVERTY REDUCTION

37. We are implementing a set of policies to encourage employment and reduce poverty:

- We have established a Rural and Agricultural Fund to provide necessary support for infrastructure development and modernization in the agricultural sector. This will alleviate rural poverty and unemployment and increase agricultural exports.

- To address the shortage of skilled workers, we will create vocational and technical training programs. We intend to improve the effectiveness and efficiency of the professional education system in Georgia through enhancing social partnership, reviewing occupational standards and educational programs, linking educational programs to labor market demands, and upgrading the qualifications of those engaged in professional education. We will work to develop the professional education infrastructure and to provide quality assurances. Intense cooperation between the line ministries, donor community, and industry representatives has been launched to facilitate the creation of professional and technical training programs for ensuring the provision of a skilled workforce.

- We will strengthen workers' rights through amendments to the Labor Code. One amendment regarding social partnership—improving the dialogue and working relations between the employer (union of employers), the employee (union of employees) and state agency representatives—was approved by parliament on December 27, 2012. This will bring Georgia in line with ILO standards while keeping Georgia attractive as a place for doing business.

- To promote additional assistance for the most vulnerable, we will improve the targeting of existing social programs.

38. We are launching extensive reforms to raise living standards in agriculture, which employs almost half of our population. These reforms include improvement of irrigation and drainage systems (already started and to be implemented throughout 2013), which will result in expansion of irrigated areas and improvement of land productivity; establishment of district level information and extension centers for providing advice, and extension services to farmers hence improving their efficiency (recruitment has already started and these centers will function from March 2013); enhancement of cooperation and provision of support to smallholder farmers to improve food security and decrease rural poverty (new legislation on agricultural cooperatives should be in place by late Spring 2013); and improvement of food safety regulations and administration to approximate Georgian standards and legislation with those of the European Union. Moreover, the introduction of modern technologies and development of credit schemes together with commercial banks and microfinance organizations will provide affordable agricultural loans to farmers through the private sector.

VI. OTHER ISSUES

39. We have made good progress improving our Balance of Payment Statistics. In June 2012, we started to report our external sector statistics in BPM6 format. To further improve compliance with BPM6, we will launch two new survey forms for collecting data on manufacturing and insurance services early in 2013. With Fund technical assistance, we are updating the methods applied for adjusting trade statistics. We strengthened the data sharing agreement between the NBG and the National Statistics Office of Georgia (GeoStat), which will help improve data quality. To make further progress, we will initiate an amendment to the Law on Official Statistics to strengthen GeoStat's legal right to collect necessary statistical data by obliging private entities to provide the information to GeoStat upon request (with penalties for noncompliance). The Law requires that such information is treated in strict confidence and disseminated only in aggregated form. We will ensure that GeoStat has adequate resources (including additional staff and funding) to perform current and upcoming tasks, including the population census in 2014, and to produce higher frequency indicators of the real economy.

Sincerely yours,

/s/
Bidzina Ivanishvili
Prime Minister of Georgia

/s/
Nodar Khaduri
Minister of Finance of Georgia

/s/
Giorgi Kadagidze
Governor of the National Bank of Georgia

Table 1. Georgia: Quantitative Performance Criteria and Indicative Targets, 2012

	June-12	June-12	June-12	Dec-12	Dec-12	Dec-12
	PC	Adjusted PC	Actual	PC	Adjusted PC	Actual
	(Cumulative change since the beginning of the year, in mill lari)					
Ceiling on the cash deficit of the general government	190	195	29	943	952	779
Ceiling on the cash deficit of the PF	0	…	-33	0	…	10
	(End-period stock, in mill lari)					
Ceiling on NDA of NBG 1/	99	127	-28	238	254	95
	(End-period stock, in mill USD)					
Floor on NIR of NBG 1/	1,116	1,099	1,177	1,196	1,186	1,326
	(Cumulative change since the beginning of the year, in mill USD)					
Ceiling on the accumulation of external arrears	0	…	0	0	…	0
	Indicative Target		Actual	Indicative Target		Actual
Ceiling on contracting or guaranteeing of external debt by the public sector	800	…	554	1,100	…	724

Sources: Georgian authorities and Fund staff estimates.

1/ Actual figures and quantitative targets are based on program exchange rates.

Table 2. Georgia: Quantitative Performance Criteria, 2013

	June-13	Dec-13
	PC	PC
	(Cumulative change since the beginning of the year, in mill lari)	
Ceiling on the cash deficit of the general government	150	819
Ceiling on the cash deficit of the PF	0	0
Ceiling on the expenditures of the general government	3,900	8,890
	(End-period stock, in mill lari)	
Ceiling on NDA of NBG 1/	94	84
	(End-period stock, in mill USD)	
Floor on NIR of NBG 1/	1,296	1,416
	(Cumulative change since the beginning of the year, in mill USD)	
Ceiling on the accumulation of external arrears	0	0
	Indicative Target	Indicative Target
Ceiling on contracting or guaranteeing of external debt by the public sector	500	1200

Sources: Georgian authorities and Fund staff estimates.

1/ Actual figures and quantitative targets are based on program exchange rates.

Table 3. Georgia: Structural Benchmarks

Structural Benchmarks and proposed Structural Benchmarks	Date	Status
The Ministry of Finance will provide to the IMF an annual report of the financial flows for each of the 5 largest SOEs as well as an annual report consolidating the financial flows of the 5 largest LEPLs	End-June 2012	Met
The PF will publish and transmit to its Supervisory Board its audited IFRS compliant financial statements for 2011	End-Sept 2012	Met
Submit to parliament an amendment to the PF law to remove non-commercial objectives from the PF	End-April 2013	
Implement prudential measures in line with paragraph 34 of the letter of intent	End-June 2013	
Develop and publish public sector accounts that cover the general government and the LEPLs	End-July 2013	

Sources: Georgian authorities and Fund staff estimates.

ATTACHMENT I. TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)

March 1, 2013

1. This memorandum sets out the understandings between the Georgian authorities and the IMF staff regarding the definitions of quantitative performance criteria and indicative targets, as well as respective reporting requirements for the Stand-By Arrangement and Standby Credit Facility.

2. These performance criteria and indicative targets are reported in Tables 1 and 2 attached to the letter of intent dated March 1, 2013. The exchange rate for the purposes of the program of the Georgian lari to the U.S. dollar is set at GEL1.67 = $1. The corresponding cross exchange rates are provided in Table 1.

I. GENERAL GOVERNMENT AND THE PUBLIC SECTOR

3. **Definition:** The general government is defined as the central government and local governments. It does not include Legal Entities of Public Law, State-Owned Enterprises, or the Partnership Fund (PF). The public sector consists of the general government and the National Bank of Georgia (NBG).

4. **Supporting material:** The Treasury Department of the Ministry of Finance (MOF) will provide to the IMF detailed information on monthly revenues of the general government within two weeks of the end of each month and monthly expenditures and arrears of the central government within four weeks of the end of each month. In addition, the treasury will provide, on a daily basis, the cash balances in all the accounts of the general government as of the previous business day.

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

A. Quantitative Performance Criteria and Indicative Targets

5. The quantitative performance criteria and indicative targets specified in Tables 1 and 2 attached to the letter of intent are:

- a performance criterion (ceiling) on the cash deficit of the general government;
- a performance criterion (ceiling) on the expenditures of the general government;
- a performance criterion (ceiling) on the cash deficit of the Partnership Fund;
- a performance criterion (ceiling) on the net domestic assets (NDA) of the NBG;

- a performance criterion (floor) on the net international reserves (NIR) of the NBG;
- a continuous performance criterion (zero ceiling) on the accumulation of external arrears; and
- an indicative target (ceiling) on the contracting and guaranteeing of new total external debt by the public sector.

6. The performance criteria and indicative targets have been set for end-June and end-December 2013, and are monitored on a cumulative basis from the beginning of the calendar year (with the exception of the NIR and NDA targets, which are monitored in terms of stock levels), while the continuous performance criterion is monitored on a continuous basis.

B. Ceiling on the Cash Deficit of the General Government

7. **Definition:** The cash deficit of the general government will be measured from the financing side at current exchange rates and will be defined as equal to total financing. Total financing will be defined as the sum of (i) net domestic financing from banks and nonbanks, (ii) net external financing, and (iii) privatization receipts.

- Net domestic financing consists of bank and nonbank net financing to the general government, which will be defined as follows:

  (i) Net lending (borrowing net of repayments) provided by commercial banks to the general government plus the use of deposits held by the general government at commercial banks. Monitoring of net lending and government accounts will be based on the NBG's monetary survey and treasury data. The change in cash balances of the local government at commercial banks for budget financing purposes will be monitored based on the "budget of territorial unit" account data provided by the treasury department. Any securities issued by the general government and purchased by commercial banks (for example, T-Bills) are also included in domestic financing.

  (ii) Net lending (borrowing net of repayments) provided by the NBG to the general government plus the use of deposits of the general government held at the NBG. Monitoring of net lending and government accounts will be based on the central bank survey and treasury data. The change in cash balances of the central government at the NBG for budget financing purposes will be monitored based on the "State budget's Treasury single account (TSA)" and "Revenue reserve account" data provided by the treasury department. Any securities issued by the general government and purchased by the NBG (for example, T-Bills) are also included in domestic financing.

  (iii) Any securities issued by the general government and purchased by nonbanks (for example, T-Bills or securitized claims on the government sold by the NBG) are also included in domestic financing.

- Net external financing is defined as the total of loans disbursed to the general government for budget support (including the financing from the IMF whose domestic counterpart is used to finance the budget), and project financing (capital expenditure and net lending), net change in external arrears, change in the accounts of the general government abroad, minus amortization and net deposit accumulation in the state budget's foreign currency account. Amortization includes all external debt-related payments of principal by the general government.

- Privatization receipts consist of all transfers of monies received by the central and local governments in connection with the sale of central or local government assets. This includes receipts from the sale of shares, the sale of nonfinancial assets as well as leases and the sale of licenses with duration of 10 years and longer.

8. Supporting Material:

- Data on domestic bank and nonbank financing will be provided to the IMF by the NBG and the treasury department of the MOF within four weeks after the end of the month.

- Data on external project financing as well as other external borrowing will be provided to the IMF monthly by the debt unit at the MOF (specifying projects by creditor) within two weeks of the end of each month.

- Data will be provided at the actual exchange rates.

- Data on privatization receipts of the general government will be provided by the treasury department of the MOF to the IMF on a monthly basis within two weeks of the end of each month.

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

C. Ceiling on the Expenditures of the General Government

9. Definition: Expenditures of the general government comprise all current and capital expenditures as well as net lending: (i) current expenditures comprise compensation of employees, use of goods and services, subsidies, grants, social expenses, other expenses, other account payables, and domestic and external interest payments; (ii) capital expenditures include projects financed by foreign loans and grants; and (iii) net lending is defined as lending by, minus repayments to, the general government.

10. Supporting material: Data for monitoring expenditures will be derived from the accounts of the general government covered under the ceiling (based on state, local authority, and autonomous republics budgets). The Ministry of Finance is responsible for such reporting according to the above definition. Data on expenditures of the general government should be reported within four weeks after the end of the quarter.

D. Ceiling on the Cash Deficit of the Partnership Fund

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

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

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

14. Supporting Material: The MoF will provide to the IMF detailed information on the PF's quarterly revenue, expenditures, and financial operations within four weeks of the end of each quarter.

E. Floor on the Net International Reserves of the NBG

15. Definition: Net international reserves (NIR) of the NBG in U.S. dollars are defined as foreign assets of the NBG minus the sum of foreign liabilities of the NBG. Foreign assets of the NBG include gold, gross foreign exchange reserves, Georgia's SDR holdings, and the reserve position in the IMF. Gross foreign exchange reserves of the NBG are defined as liquid, convertible currency claims of the NBG on nonresidents, including cash holdings of foreign exchange that are readily available. Pledged or otherwise encumbered assets, including (but not limited to) assets used as collateral (or guarantee for third party external liabilities) are excluded from foreign assets. Foreign liabilities of the NBG shall be defined as the sum of Georgia's outstanding liabilities to the IMF (at face value), Georgia's SDR allocation, and any other liabilities of the NBG (including foreign currency deposits of financial institutions at the NBG and currency swaps and foreign exchange forward contracts with financial institutions), excluding the foreign exchange balances in the government's account with the NBG. For program monitoring purposes, the stock of foreign assets and foreign liabilities of the NBG shall be valued at program exchange rates as described in paragraph 2 above. The stock of NIR amounted to $1,152 million as of December 31, 2011 (at the program exchange rate).

16. Adjustors: The floor on the NIR of the NBG will be adjusted:

- Upward/downward by 50 percent for any excess/shortfall in the balance of payments support loans and balance of payments support grants relative to the projected amounts presented in Table 2.

- Upward/downward by 50 percent for any excess/shortfall in the disbursements of the project loans and project grants to the treasury single account at the NBG relative to the projected amounts presented in Table 2.

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

F. Ceiling on Net Domestic Assets of the NBG

18. Definition: Net domestic assets of the NBG are defined as the difference between reserve money and NIR as defined above in paragraph 15. Therefore, the ceiling on NDA is defined as projected reserve money (as defined in Table 3) minus the target NIR.

19. Adjustors: The ceiling on the NDA of the NBG will be adjusted:

- Upward/downward by 50 percent for any shortfall/excess in the balance of payments support loans and balance of payments support grants relative to the projected amounts presented in Table 2.

- Upward/downward by 50 percent for any shortfall/excess in the disbursements of the project loans and project grants to the treasury single account at the NBG relative to the projected amounts presented in Table 2.

20. Supporting Material: The NBG will provide to the IMF its balance sheet, which includes data on reserve money and net domestic assets on a weekly basis within three working days following the end of the week. Data will be provided using both actual and program exchange rates.

G. Ceiling on Contracting or Guaranteeing of New External Debt by the Public Sector

21. Definition: External debt is defined as set forth in point No. 9 of the Executive Board Decision No. 6230-(79/140), as revised on August 31, 2009 (Decision No. 14416-(09/91)).[1] External debt is defined as debt contracted by the public sector with nonresidents other than the IMF. Previously disbursed external debt that has been rescheduled will be excluded from the definition of "new debt" for the purposes of this performance criterion.

22. Supporting Material: Details of all new contracted debt and government guarantees for external borrowing, with detailed explanations, will be provided by the MOF to the IMF on a quarterly basis within thirty days of the end of each quarter. Data will be provided using actual exchange rates.

H. Continuous Performance Criterion on Accumulation of External Arrears

23. Definition: External arrears are defined as unpaid debt service by the public sector to official and private creditors beyond 30 days after the due date.

24. Supporting Material: Details of official arrears accumulated on interest and principal payments to creditors will be reported to the IMF within one week from the date of the missed payment. Data will be provided using actual exchange rates.

[1] Point No. 9 of the IMF's guidelines reads as follows: "(a) For the purpose of this guideline, the term "debt" will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows: (i) loans, i.e., advances of money to obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans and buyers' credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements); (ii) suppliers' credits, i.e., contracts where the supplier permits the obligor to defer payments until sometime after the date on which the goods are delivered or services are provided; and (iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the leaser retains the title to the property. For the purpose of the Guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair, or maintenance of the property. (b) Under the definition of debt set out in point 9(a) above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt."

Table 1. Program Exchange Rates		
	Currency Name	**Currency/US$**
SDR	Special Drawing Rights	0.65
GEL	Georgian lari	1.67
EUR	Euro	0.77

Table 2. Projected Balance of Payments Support Financing 1/ (In millions of U.S. dollars)		
	Balance of payments support loans and balance of payments support grants	Project loans and project grants
June 30, 2013	22.5	83.8
December 31, 2013	86.5	215.5

1/ Cumulative from the beginning of the calendar year.

Table 3. Projected Reserve Money (End-of-period stock, in millions of lari)	
June 30, 2013	2,258
December 31, 2013	2,449

INTERNATIONAL MONETARY FUND

GEORGIA

March 1, 2013

FIRST AND SECOND REVIEWS UNDER THE STAND-BY ARRANGEMENT AND UNDER THE STANDBY CREDIT FACILITY ARRANGEMENT, AND REQUEST FOR WAIVER OF NONOBSERVANCE OF PERFORMANCE CRITERION—INFORMATIONAL ANNEX

Prepared By

Middle East and Central Asia Department
(In Consultation with Other Departments)

CONTENTS

RELATIONS WITH THE FUND

(As of January 31, 2013)

Membership Status

Date of membership: May 5, 1992.

General Resources Account

	SDR Million	Percent of Quota
Quota	150.30	100.00
Fund Holdings of Currency	567.19	377.37
Reserve Tranche Position	0.01	0.01

SDR Department

	SDR Million	Percent Allocation
Net Cumulative Allocation	143.96	100.00
Holdings	142.58	99.04

Outstanding Purchases and Loans

	SDR Million	Percent of Quota
Stand-By Arrangements	416.89	277.37
ECF Arrangements	65.80	43.78

Latest Financial Arrangements

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	Apr. 11, 2012	Apr. 10, 2014	125.00	0.00
SCF	Apr. 11, 2012	Apr. 10, 2014	125.00	0.00
Stand-By	Sept. 15, 2008	June 14, 2011	747.10	577.10

Projected Payments to the Fund

(SDR million; based on existing use of resources and present holdings of SDRs)

			Forthcoming		
	2013	2014	2015	2016	2017
Principal	249.71	166.75	52.23	9.80	4.20
Charges/Interest	3.98	1.49	0.23	0.02	0.01
Total	**253.69**	**168.24**	**52.46**	**9.82**	**4.21**

Safeguard Assessments

An update of the January 2010 safeguards assessment of the National Bank of Georgia (NBG) was completed in September 2011. The NBG continues to publish financial statements that comply with International Financial Reporting Standards, and are externally audited by an international firm in accordance with International Standards on Auditing. In response to the safeguards assessment of 2010, the authorities implemented recommendations including the appointment of an external audit firm for a multi year term beginning with financial year 2010.

Implementation of Multilateral Debt Relief Initiative (MDRI)

Not applicable.

Implementation of HIPC Initiative

Not applicable.

Exchange Arrangements

From 1993 to 2009, the NBG conducted foreign exchange market interventions through daily fixing sessions at the Tbilisi Interbank Currency Exchange (TICEX). A temporary de facto exchange rate peg to the U.S. dollar was introduced in the wake of the early August 2008 armed conflict. During the second week of November 2008, the authorities allowed a 17 percent depreciation of the lari. In March 2009, the authorities introduced an auction-based system for the foreign exchange market. This mechanism was intended to allow more flexibility and give market forces a greater role in setting the price, with a view to reaching faster and smoother convergence toward equilibrium in the foreign exchange market and giving the market greater clarity about the authorities' policies. At end-May 2009, the authorities officially ended foreign exchange market interventions on TICEX. The exchange rate arrangement of Georgia is classified as floating.

The government uses the official exchange rate for budget and tax accounting purposes as well as for all payments between the government and enterprises and other legal entities and for foreign exchange transactions with the NBG. The official rate is defined as the average of the previous day's market transaction rates, and may thus differ by more than two percent from the freely determined market rate, which gives rise to a multiple currency practice. In practice, the official and market rates have never differed by more than 2 percent since the introduction of foreign exchange auctions in March 2009. The NBG and the Ministry of Finance have been considering moving to a system whereby the government would conduct a single foreign exchange transaction with the NBG at the end the day, at that days' market price, calculated as the average rate of that day's market transactions. This system would eliminate the multiple currency practice. The implementation of this system has, however, been delayed by some technical issues. Over the coming months the authorities will try to address these issues.

Article IV Consultation

The 2011 Article IV consultation was concluded on March 23, 2011.

FSAP Participation

Two FSAP missions visited Tbilisi in May 1–15, and in July 24–August 7, 2001. An FSAP update mission visited Tbilisi in February 15–28, 2006.

Technical Assistance

See Table 1 of this Annex.

Resident Representative

The seventh resident representative, Mr. Azim Sadikov, took up his post on July 9, 2012.

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 served from September 2004 to October 2007 as a resident advisor on banking supervision issues.

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. Between 2001 and 2003, Mr. Welling was an FAD peripatetic advisor to assist the State Customs Department in preparing and introducing measures for the custom reform and modernization program. In March 2005, Mr. Zohrab started advising the authorities on treasury-related reforms, and his term ended in November 2006.

Georgia: Technical Assistance Missions, 2008–13			
Subject	Type of Mission	Timing	Counterpart
Fiscal Affairs Department (FAD)			
Tax Administration	Expert assistance (Woodley)	Jan/Feb and Apr/May 2008	Ministry of Finance
Public Financial Management	Expert assistance	Apr. 6-19, 2010	Ministry of Finance
Pension Reform	Expert assistance	Apr. 21-27, 2011	Ministry of Finance
Public Financial Management	Advisory	May 14-24, 2012	Ministry of Finance, Partnership Fund
Tax Administration	Advisory	Aug. 15-28, 2012	Ministry of Finance, Revenue Service
Monetary and Capital Markets Department (MCM)			
Lender of Last Resort Framework	Advisory	Dec. 11-17, 2008	National Bank of Georgia
Stress Testing and Foreign Exchange Market	Advisory	Apr. 21-30, 2009	Financial Supervisory Agency; National Bank of Georgia
Macroeconomic Modeling for Monetary Policy Formulation	Advisory	June 2-10, 2010	National Bank of Georgia
Macroeconomic Modeling for Monetary Policy Formulation	Advisory	October 4-13, 2010	National Bank of Georgia
Payment Systems Oversight	Advisory	May 3–12, 2011	National Bank of Georgia
Statistics Department (STA)			
Monetary and Financial Statistics	Advisory	Mar. 18-31, 2009	National Bank of Georgia
Evaluation of Technical Assistance	Follow-up assistance	Jul. 14–16, 2010	National Statistics Office, National Bank of Georgia, Ministry of Finance
External Sector Statistics	Follow-up assistance	Oct. 4–15, 2010	National Bank of Georgia
ROSC Data Module	ROSC	Oct. 4–17, 2011	National Statistics Office, National Bank of Georgia, Ministry of Finance
External Sector Statistics	Follow-up assistance	Oct. 17-26, 2012	National Bank of Georgia
National Accounts Statistics	Follow-up assistance	Jan. 14-25, 2013	National Statistics Office
Legal Department (LEG)			
Payment Systems	Advisory	May 25–Jun. 5, 2010	National Bank of Georgia
Payment Systems	Follow-up assistance	Nov. 8–14, 2010	National Bank of Georgia
Legislative Drafting	Advisory	Feb. 28–Mar. 7, 2011	National Bank of Georgia
International tax policy	Advisory	June 6-7, 2012	Ministry of Finance

RELATIONS WITH THE WORLD BANK

(As of January 18, 2013)

Title	Product	Tentative Timing of Mission	Expected Delivery of Report
Bank	*Operations*		
	DPO-2 to support reforms to sustain growth, promote job creation, strengthen social safety nets, and deepen public financial management reforms.	February–June 2013	Second half of 2013
	Statistics Capacity Building Trust Fund grant to support preparation work for national population census.	Periodic 2012–13	Ongoing, closing in 2013
	Institutional Development Fund grant for strengthening capital budgeting in Tbilisi municipality	Periodic 2012–13	Ongoing, closing in 2013
	Analytical Work		
	Sources of Growth Study	Quarterly	March 2013
	Programmatic PER; PER-1 follow-up and PER-2	Quarterly	December 2012 December 2013
	Programmatic Poverty Assessment	Periodic	Periodic
	PEFA 2012 Repeat Assessment	Periodic	May, 2013
Fund	*Missions and Technical Assistance*		
	TA: Strengthening the Partnership Fund's institutional framework	Apr. 25–May 2, 2012	June 2012
	Staff visit on 2013 budget and macroeconomic framework update	Sept. 11–18, 2012	Sept. 24, 2012
	1st and 2nd reviews under the SBA/SCF blend	Nov. 28– Dec. 12, 2012	February 27, 2013
	3rd reviews under the SBA/SCF blend	FY 2014	FY 2014
	TA: Improving national account and external sector statistics	FY 2014	FY 2014
	TA: Strengthening tax administration	FY 2014	FY 2014
Joint Bank-Fund	Joint Debt Sustainability Analysis	Ongoing collaboration	June 2013

RELATIONS WITH THE EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT (EBRD)

(As of January 2013)

Since 1994, the EBRD has been active in supporting Georgia's transformation toward a market economy. The bank's current country strategy for Georgia, approved in February 2010, outlines the following main strategic directions:

- Supporting stabilization and restructuring of the financial sector, strengthening risk and portfolio management practices and increasing the share of local currency operations;

- Helping rehabilitate and modernize the country's road, energy and municipal infrastructure to strengthen energy security and promote energy efficiency, help Georgia benefit from its potential as a transit country, and improve efficiency and long-term financial sustainability of its municipal services;

- Provide financing to the enterprise sector with the view of supporting innovation, competition and export potential, in particular in manufacturing and agribusiness.

As of end-December 2012, the bank signed 152 investments in Georgia with the cumulative commitment totaling €1.72 billion. Its outstanding portfolio stood at €638 million. One-half of the portfolio is in the financial sector, one-third—in the energy sector, with the corporate sector and infrastructure accounting for 17 and 15 percent, respectively. The ratio of private sector projects in the portfolio currently stands at 82 percent. The bank gives preference to non-sovereign operations. Where sovereign guarantees are required, donor co-funding on a grant basis is sought.

Banks overall investment in 2012 reached €97 million. It was active in supporting the agribusiness sector directly and through provision of credit lines to local partner banks. The Georgian Agriculture Financing Facility (GAFF), a €40 million framework launched in 2011, made credit lines available to local commercial banks, non-bank microfinance institutions and leasing companies for on-lending to farmers and other agricultural entities. Additional credit lines were extended to Bank of Georgia, VTB Bank Georgia, Bank Republic and TBC Bank, most of them were provided in lari. The bank has also supported the enterprise sector by investing €18.2 million across various industries.

Georgia is part of the EBRD's 'Early Transition Countries' (ETC) initiative. Launched in April 2004, the initiative aims to increase investments in the bank's then seven poorest countries. The initiative builds on international efforts to address poverty in these countries. Through this initiative, the EBRD focuses its efforts on private sector business development and selected public sector interventions. It aims to stimulate market activity by using a streamlined approach to financing, focusing on smaller projects, mobilizing more investment, and encouraging ongoing economic reform. The bank accepts higher risk in the projects it finances in the ETCs, while respecting the principles of sound banking. Since the launch of the ETC initiative, the bank's annual business volume in Georgia has increased five-fold.

The bank's country strategy for the period of 2013–15 is currently under preparation and expected to be approved by mid-2013. It is expected to focus the bank on fostering private investments, completing the restructuring and modernization of the energy sector, supporting Georgia's transformation into a regional economic hub, and promoting broad-based growth.

Going forward, the EBRD will also:

- Continue to support the authorities' goal of developing local capital market and reducing dollarization by providing synthetic local currency loans and offering technical cooperation and policy advice, particularly in the legal and regulatory area and on debt and equity capital market infrastructure. The bank is actively engaged in promoting local currency lending and de-dollarization of the Georgian banking system in cooperation with other IFIs. Georgia was one of the first countries to undergo a joint EBRD-IMF-World Bank assessment of the economic policy, regulatory and legal frameworks for development of the local currency capital markets, and sign a framework agreement with the authorities on policy reforms required to support de-dollarization.

- Actively pursue viable renewable energy projects, while promoting energy efficiency across the country and leading policy dialogue on improving the regulatory framework for energy efficiency and renewable energy.

- Invest in the development of the agribusiness sector and modernization of the food distribution sector supported by intensive policy dialogue.

- Support policy and regulatory developments in Georgia by providing further legal transition assistance, including improvements to the laws on secured transactions and insolvency, reform of concession laws, improved corporate governance, and judiciary reforms.

- Maintain dialogue with the government to ensure fair and transparent implementation of tax policies and audits as well as the independence of the judiciary in dealings with businesses.

STATISTICAL ISSUES

Data provision has some shortcomings but is broadly adequate for surveillance. There is some room for improving the compilation and dissemination of price, national accounts, and external sector statistics. Insufficient price and economic activity indicators to assess underlying inflation and output trends partly hamper the development of an effective inflation targeting framework. To support the authorities' effort to improve the compilation of macroeconomic statistics, the Fund has provided a significant amount of technical assistance (TA). (Annex I, Table1.) The data module of the Report on the Observance of Standards and Codes (ROSC), prepared in October 2011, indicated that since the previous 2002 ROSC, the authorities have made significant institutional and methodological improvements in macroeconomic statistics. Georgia graduated to the IMF's Special Data Dissemination Standard (SDDS) on May 17, 2010, after participating in GDDS since 2006.

A. Real Sector Statistics

National accounts statistics follow the concepts and definitions of the *System of National Accounts 1993*. Annual and quarterly GDP estimates are compiled by both the production and expenditure approaches. Preliminary national accounts estimates are available after 85 days and final estimates after 13 months. The 2011 data ROSC mission found serious source data deficiencies owing to: absence of an economic census; under-reporting in the business survey and household budget survey; shortcomings in the business register; and incomplete coverage of some activities (trade, other community, social and personal activities). Also, a better method could be used to benchmark quarterly national accounts (QNA) data to annual estimates. Volume measures of GDP by the expenditure approach are not compiled. During the national accounts TA mission in January 2013, actions on several issues were either initiated or partly implemented (benchmarking of QNA in current and constant prices, new methodology for estimating volume of taxes on products, compilation of unit values for imports). Although the authorities have made good progress in addressing some of these issues, there was scope for improving the constant price estimates and advancing the development of the system of supply and use tables.

On price statistics, the scope of the consumer price index (CPI) is limited to only urban areas while the treatment of owner-occupied housing is conceptually imprecise. The structure of producer price index (PPI) relies on turnover rather than output concept while product based PPIs are not compiled. The export and import price indices are not compiled. Despite important progress achieved in the development of agricultural price indices, inadequate funding was causing delays in implementation. The accuracy of the CPI and PPI weights, with respect to actual household consumption and market turnover, suffers from the same HBS and business register shortcomings as the national accounts. The imputation methods for both CPI and PPI, while recently improved, need to be enhanced to ensure coherent long-term treatment of seasonal goods.

B. Monetary and Financial Statistics

The NBG compiles monetary data broadly in line with the recommendations of the *Monetary and Financial Statistics Manual 2000*. Data are compiled based on STA's Standardized Report Forms and reported to STA on a regular and timely basis for publication in the *International Financial Statistics (IFS)*.

C. Government Finance Statistics

The Ministry of Finance is well advanced on a program of reform to their central and local government budget and accounting systems to fully adopt the *Government Finance Statistics Manual 2001 (GFSM 2001*) methodology and the International Public Sector Accounting Standards (IPSASs), including the staged introduction of accrual recording into transactions data, and an expansion in the range of items recorded in the balance sheet. The reform includes the implementation of accrual accounting by 2020. The authorities' commitment to the accounting reform strategy is set out in Decree 101 issued by the Minister of Finance on February 10, 2006. This decree approves the general strategy, but implementation of some of the individual steps in the transition plan will require amendments to the law of Georgia on the budget system (Budget System Law). Since 2008, the budget classification follows the *GFSM 2001*. However, there are deficiencies in the sectorization of Legal Entities of Public Law (LEPLs) and securities are not recorded at market value. The authorities report annual and monthly government finance statistics (GFS) compiled on a cash basis in the *GFSM 2001* framework for publication in the *GFS Yearbook* and *IFS*, respectively.

D. External Sector Statistics

The NBG began to take the responsibility in the compilation of balance of payments statistics in January 2007. It received extensive technical assistance from STA, including the STA Resident Statistics Advisor who, stationed in Baku, undertook six peripatetic TA missions to Georgia during April 2007–October 2008.

Balance of payments data are compiled broadly in accordance with the definitions set out in the fifth edition of the *Balance of Payments Manual* (*BPM5*) and elements of the sixth edition (*BPM6*). The scope of the balance of payments statistics includes transactions of institutional units resident in Georgia with the rest of the world. However, data do not cover the territories of Abkhazian Autonomous Republic and Tskhinvali Region, a part of Georgian territory not controlled by the central authorities. Source data used for compiling the balance of payments are generally adequate and timely. However, the accuracy of the data received from the enterprises survey should be improved. Moreover, foreign direct investment (FDI) data are subject to significant revisions and the classification of some inflows as FDI (rather than other capital flows) has been the subject of prolonged debates between the statistical office and the NBG. Some data sources for balance of payments need strengthening, notably the International Transactions Reporting System (ITRS) and the private nonfinancial external debt compilation program. For the balance of payments, statistical techniques are adequate, except for the estimation of import and export of cars which should be further improved.

Georgia: Table of Common Indicators Required for Surveillance

(As of January 29, 2013)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items: Data Quality—Methodological soundness[8]	Memo Items: Data Quality—Accuracy and reliability[9]
Exchange Rates	Dec. 2012	1/8/13	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Dec. 2012	1/9/13	D	D	M		
Reserve/Base Money	Dec. 2012	1/8/13	D	D	M	O, O, LO, O	LO,O,O,O,O
Broad Money	Dec. 2012	1/17/13	D	D	M		
Central Bank Balance Sheet	Dec. 2012	1/17/13	D	D	M		
Consolidated Balance Sheet of the Banking System	Dec. 2012	1/17/13	M	M	M		
Interest Rates[2]	Dec. 2012	1/17/13	D	D	D		
Consumer Price Index	Nov. 2012	1/18/13	M	M	M	O,LO,O,O	LO,O,LO,O,O
Revenue, Expenditure, Balance and Composition of Financing[3]—General Government[4]	Nov. 2012	12/28/12	M	M	M	O,O,LO,LO	O,O,O,O,O
Revenue, Expenditure, Balance and Composition of Financing[3]—Central Government	Nov. 2012	12/28/12	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Dec. 2011	02/15/12	Q	Q	Q		
External Current Account Balance	Q1 2012	7/12/12	Q	Q	Q	O,O,O,O	LO, O, LO ,O, LO
Exports and Imports of Goods and Services	Q1 2012	7/12/12	Q	Q	Q		
GDP/GNP	Q4 2011	4/19/12	Q	Q	Q	O,LO,LO,LO	LNO, O, LO, O, LO
Gross External Debt	Dec. 2011	02/15/12	Q	Q	Q		
International Investment Position[6]	Q1 2012	8/10/12	A	A	A		

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).
[8] Reflects the assessment provided in the data ROSC (published on March 19, 2012, and based on the findings of the mission that took place from October 4–17, 2011) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[9] Same as footnote 8, except referring to international standards concerning (respectively) source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

Press Release No. 13/75
FOR IMMEDIATE RELEASE
March 13, 2013

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes First and Second Reviews under Stand-By Arrangement and StandBy Credit Facility Arrangement for Georgia

On March 13, 2013, the Executive Board of the International Monetary Fund (IMF) completed the first and second reviews under the Stand-By Arrangement (SBA) and the Stand-by Credit Facility (SCF) arrangement for Georgia. The Executive Board approved the 24-month SBA and SCF arrangements for Georgia on April 11, 2012 (see Press Release No. 12/131). The total access under the blend of SBA and SCF arrangements is up to SDR 250 million (about US$375.7 million), evenly divided between the two arrangements. The authorities intend to continue to treat the arrangements as precautionary.

In completing the reviews, the Executive Board approved the authorities' request for the waiver of nonobservance of the end-December 2012 performance criterion on the cash deficit of the Partnership Fund.

Following the Executive Board discussion on Georgia, Mr. Min Zhu, Deputy Managing Director and Acting Chair, said:

"Macroeconomic developments have been generally positive, with growth remaining strong and inflation subdued. The fiscal deficit target was met comfortably and reserve accumulation was in line with program objectives. Georgia's financial sector appears healthy. Reducing the persistently high current account deficit in an orderly manner remains the key macroeconomic challenge. The authorities' plans for fiscal consolidation, greater exchange rate flexibility, and structural reforms to improve competitiveness will help meet this challenge.

"The budget includes a welcome increase in social spending to protect the most vulnerable while continuing with fiscal consolidation. The proposed measures to support social spending and agricultural development should help promote more inclusive growth. In light of large investment and social spending needs, revenue-enhancing measures may be necessary in the medium term.

“The authorities’ plans to prudently allow greater exchange rate flexibility should help the National Bank of Georgia (NBG) align its monetary policy decisions more closely with its inflation targeting objective. The government’s commitment to maintaining central bank independence and the NBG’s intention to increase monetary policy transparency will contribute to strengthen the policy framework.

“The Partnership Fund’s decision to fully finance a power plant project has highlighted the need to strengthen the Fund’s governance and the recent steps taken by the authorities in this regard are welcome. The authorities should work with their development partners to ensure that the new private investment funds contribute to inclusive growth in a transparent, fiscally responsible, and sustainable manner.

“The government is working on an ambitious structural reform agenda, aimed at improving the business environment and boosting competitiveness. Progress in strengthening the rule of law will be critical to the success of the program.”

Statement by Yuriy G. Yakusha, Alternate Executive Director for Georgia
March 13, 2013

Georgia has accomplished quite a lot in its market transformation and modernization so far, and this transformation is expected to be further advanced by the new authorities who received a substantial mandate from the electorate. IFIs, including the Fund, will continue to play an important role in ensuring stability and growth.

The Georgian authorities appreciate the dialogue with the IMF and thank staff for their advice and guidance. The transition accomplished after the October 2012 parliamentary elections has allowed the new government to embark on its agenda of preserving financial stability while supporting economic growth. From now on the growth is expected to be led to a larger extent by the private sector and will be more inclusive socially, and more diverse geographically as well as sector-wise.

Program and Outlook

Georgia's macroeconomic performance under the current program has been rather good since the time of the program approval as well as under the previous program. Staff, however, emphasized in the report that, while Georgia has been one of the highest public capital spenders among peers, its spending on social benefits was one of the lowest, and Gini coefficients are among the highest. It is now widely acknowledged in Georgia that unemployment, poverty and inequality remain unacceptably high.

The reform agenda implied reorientation of some fiscal spending from heavily import-dependent public investment projects towards social and health-related spending, a strengthened competition policy as well as increased budgetary transparency and greater accountability. The latter would correct the unfortunate episode with one missed performance criteria under the program. All other PCs have been met with comfortable margins, helped by robust economic growth and financial as well as price stability. The new Georgian government confirms its intention to treat the SBA/SCF as a precautionary arrangement.

The authorities expect growth to be high next year as well, but they agreed to base policies on more prudent assumptions, especially in the wake of the regional and European slowdown. The modest economic slowdown linked to election-related uncertainties is expected to be short-lived.

Fiscal and External Stability and Sustainability

The authorities want to ensure that the sovereign balance sheet remains solid, with fiscal buffers to protect against negative exogenous and/or cyclical factors, while maintaining the significantly higher emphasis on social spending and agricultural development. They will continue to seek advice from staff on the challenges of containing fiscal risks while rebalancing their fiscal priorities. Further impetus to the Georgian economy will be provided by streamlining the tax administration and tax appeal system to further improve service delivery to the taxpayers. The authorities received TA from the Fund on strengthening revenue administration. They also cooperate with the European Commission on the design of the tax appeal system.

Compared with the original program the authorities will accelerate the path of fiscal consolidation in 2013. Consolidation will continue in the medium term, inter alia by streamlining import-intensive spending. Reforms supported by the IMF program will help to further increase the attractiveness of the country as an investment destination and to reduce external vulnerabilities. The new government recognizes the persistently high current account deficit as a potential future vulnerability, even if financing has been largely long-term. It also took note that interest rate differentials have started to attract short-term inflows as well.

The authorities are also negotiating a Free Trade Agreement with the EU and are working on reopening of the Russian market for the export of Georgian products. They have also made good progress in improving the balance of payments statistics, and are preparing legislative changes to the Law on Official Statistics which will improve GeoStat's ability to collect data, also by introducing penalties for noncompliance with data provision requirements while protecting the privacy of proprietary information.

The authorities remain committed to addressing the challenge of the current account deficit without unduly sacrificing growth, by adjusting their economic model that used to be centered to a substantial degree on public investment projects. Better selectivity in capital infrastructure spending means that there will be fewer new government buildings and more focus on investment projects with pronounced developmental benefits and export or import substitution potential.

The stronger-than-expected capital inflows financed the widening current account deficit so far. The National Bank of Georgia (NBG) increased interventions above the projected amount to accumulate more reserves, with corresponding sterilization to meet NDA targets. In December 2012 the NBG outperformed the NIR target set under the program by $140 million, and the NDA targets by 160 million GELs. The mission and the authorities also agreed on a new NIR path consistent with reserve adequacy and current account reduction objective. The authorities confirm their commitment to exchange rate flexibility.

Monetary Policy and Financial Stability

Measured easing of monetary policy in response to persistent deflationary pressures and in the context of a refined inflation targeting framework should help to achieve the inflation objectives and reduce the attractiveness of nonresident deposits. Reacting to lower inflation and signs that the economy might be slowing, the NBG has continued to ease monetary policy. It has gradually cut the policy rate from 8 percent in July 2011 to the current rate of

4.75 percent. The NBG has temporarily paused policy easing due to the increased uncertainty and risks to inflation before the election in November last year.

The NBG strengthened its communications regarding monetary policy and will be introducing its new Inflation Report that will better explain deviations from the established inflation targets. Cooperation between the NBG and the government has also been improved, while institutional and financial independence of the NBG has been reaffirmed.

A high dollarization of the Georgian economy remains a substantial impediment to monetary policy transmission. The NBG traditionally implements differentiated reserve requirements to discourage dollarization, and persistently improves access to longer term lending in the domestic currency. To encourage lending in domestic currency (Lari) and to strengthen the monetary policy transmission channel, the NBG has recently relaxed collateral standards for refinancing Lari loans and is encouraging commercial banks to issue long-term standardized Lari CDs. The NBG together with the MOF is also considering a scheme to encourage Lari lending by offering long-term Lari-denominated government bonds to commercial banks in support of de-dollarization. The authorities appreciate the harmony with the staff in this approach. By mid 2013, the NBG will be taking more formal steps to discourage nonresident deposits by introducing a transitory liquidity ratio for such deposits above certain thresholds.

Interventions on the FX market are in line with the program objectives and staff advice, aimed at limiting exchange rate appreciation. However, the interventions have a stabilizing effect on the nominal exchange rate. The Georgian authorities are committed to a flexible exchange rate and regret possible classification of exchange rate policies as “stabilized arrangements” in the upcoming publication of AREAER.

The financial sector has demonstrated a relatively solid and stable performance in the course of last year, although competition in the banking industry intensified. Capital adequacy ratios remained rather high (over 24 percent as defined by the BIS, 16.5 percent in Georgia’s definition) providing comfortable buffers together with high liquidity ratios. The authorities will continue transition towards Basel III compliance. In this context banks will submit their first Internal Capital Adequacy Assessment (ICAAP) forms this year. A framework for monitoring systemically important domestic banks has been developed. To complement self-assessment of the regulatory framework against Basel Core Principles, the NBG has developed its own General Risk Assessment Program and has asked the Fund for an FSAP.

Structural reforms

Certain sectors of the real economy, like agriculture and food processing, have not benefited from the economic boom in other sectors, thus also increasing demand for imports. The authorities envisage the creation of a new Rural Development and Agricultural Fund that would facilitate private sector involvement. At the same time the operations of the Partnership Fund will undergo a comprehensive review. The authorities will consult IFIs before concluding such review.

Workers' rights will from now on be better protected and working conditions are going to be gradually improved through modernization of the Labor Code -- the first such amendment was approved in late December. There will be more attention to education and training, while training will be better linked to the demands of the labor market. The list of reform priorities of the government of Georgia also includes strengthening the rule of law; improving protection of property rights and increasing transparency and openness of public institutions to boost public confidence; ensuring a level playing field for doing business in Georgia by fostering free and fair competition and by strengthening the capacity and mandate of the newly established Competition Agency; promoting agricultural development through an array of structural and investment measures aimed at supporting income and employment generation in the rural areas across the country; establishing investment vehicles to encourage foreign and domestic private investments into the economy; expanding the social safety net and healthcare to protect the socially vulnerable. The authorities are in close consultations with the World Bank on the latter reform.