INTERNATIONAL MONETARY FUND

IMF Country Report No. 14/250

GEORGIA

August 2014

REQUEST FOR A STAND-BY ARRANGEMENT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR GEORGIA

In the context of the Request for a Stand-By Arrangement, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 30, 2014, following discussions that ended on May 6, 2014, with the officials of Georgia on economic developments and policies underpinning the IMF arrangement under the Stand-By Arrangement. Based on information available at the time of these discussions, the staff report was completed on July 15, 2014
- An **Informational Annex** prepared by the staff of the IMF.
- A **Press Release**
- A **Statement by the Executive Director** for Georgia.

The following documents have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Georgia*
Technical Memorandum of Understanding*

*Also included in Staff Report

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: http://www.imf.org
Price: $18.00 per printed copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

GEORGIA

REQUEST FOR A STAND-BY ARRANGEMENT

July 15, 2014

KEY ISSUES

Context. Georgia's previous Fund-supported program, which expired in April 2014, met most of its objectives, in particular by reducing Georgia's external and fiscal imbalances. The program also helped preserve the central bank's independence after the 2012–13 political transition and strengthened its inflation-targeting framework. However, over time it proved increasingly difficult to reconcile the program's fiscal objectives with the new government's policies of increasing social spending, especially after the economy slowed and revenues fell short in 2013. Also, despite the progress achieved under the program, macroeconomic challenges remain. The current account deficit and external debt are high, leaving the economy susceptible to shocks. Strong and inclusive growth is needed to reduce widespread poverty and high unemployment. More recently, the external outlook has worsened, opening up a balance of payments need in 2014.

Program and its objectives. To address these challenges, the authorities request a new three-year SDR 100 million (67 percent of quota) Stand-by Arrangement to address an external financing need in 2014 related in part to the realignment of fiscal policies to more social spending. The program will facilitate Georgia's external adjustment, reduce key macroeconomic vulnerabilities, rebuild policy buffers, and support growth.

Program policies. In 2014, the program balances supporting domestic demand with the need to safeguard external stability. To reduce the output gap, fiscal policy provides a measured stimulus, while monetary policy remains accommodative. However, the authorities will tighten policies and allow the exchange rate to adjust if balance of payments pressures were to intensify. From 2015, the fiscal deficit will be reduced to keep public debt low and to create space for countercyclical policies. This consolidation will rely on raising revenue by broadening the tax base and containing current expenditure, while protecting pro-poor spending and public investment. Monetary policy will aim at price stability through improved inflation targeting. The program will seek to rebuild international reserves while encouraging greater exchange rate flexibility. Strengthening of the financial sector will continue, helped by the recommendations of the recent FSAP mission. The program also aims to contain risks from quasi-fiscal activities and support improvements in tax administration, and will complement the authorities' reforms to strengthen the business environment, improve education and training, create jobs and reduce poverty and inequality.

Approved By
Juha Kähkönen (MCD) and Vivek Arora (SPR)

A staff team comprising Mark Griffiths (head), Gösta Ljungman, Sergio Sola (all MCD), Ruo Chen (SPR), and Christina Kolerus (FAD) visited Tbilisi April 23-May 6, 2014. Azim Sadikov (Resident Representative) and Nia Sharashidze (IMF Office) assisted the mission. The mission met with Deputy Prime Minister Kvirikashvili, Finance Minister Khaduri, National Bank of Georgia Governor Kadagidze, other senior officials, and representatives of the private sector, civil society, and diplomatic community. Willy Kiekens (OED) participated in the discussions.

CONTENTS

BOXES

FIGURES

TABLES

ANNEX

APPENDIX

BACKGROUND AND PERFORMANCE UNDER THE PREVIOUS PROGRAM

1. **Georgia's two-year Fund-supported program which expired in April 2014 managed to meet many of its objectives**. The current account and fiscal deficits fell, exchange rate flexibility increased, and the program helped catalyze official financial support. The program also helped maintain macroeconomic discipline during the difficult 2012–13 political transition and supported central bank independence. However, when the government changed midway through the program, it proved difficult to accommodate the new government's reorientation of economic policies toward higher social spending within the program's existing fiscal framework, particularly when growth slowed and revenues fell short in 2013. For this reason, the program was allowed to expire without completing the last two reviews.

2. **Despite progress achieved under the program, external and fiscal vulnerabilities remain and there is a need to reinvigorate growth while making it more inclusive.** Georgia's high underlying current account deficit and external debt make it dependent on continued capital inflows. The uncertain environment in partner countries has worsened the balance of payments outlook and is creating new risks. Georgia's strong growth performance of recent years has been based on large productivity gains from ambitious reforms launched in the mid-2000s aimed at liberalizing the economy, creating a business-friendly environment, and modernizing public administration. The impact of these reforms faded somewhat in the late 2000s. Productivity gains may prove difficult to sustain without further reforms that create a more competitive and diversified emerging market economy with strong trade links with the region and the EU (which the just signed Deep and Comprehensive Free Trade Area should support), and which encourage the adoption of new technologies and attract foreign investment. Growth also needs to become more inclusive as unemployment and poverty remain high.

3. **The authorities have requested a new three-year Stand-By Arrangement to help them address these challenges.** In the near-term, the program aims to boost confidence by providing a prudent and sustainable macroeconomic framework for the authorities' policies, catalyzing official financial support and investment, and providing modest external financing. The program's medium-term objective is to reduce Georgia's macroeconomic vulnerabilities, and support the government's objective of sustainable and inclusive growth, as outlined in its Georgia 2020 socio-economic development strategy (Box 1).

Box 1. The Georgia 2020 Strategy

The Government of Georgia has developed its medium-term economic strategy, described in its Georgia 2020 document. The main goal of this strategy is a sustainable growth that benefits a majority of the population. This will be achieved by private sector growth, supported by a lean, efficient and transparent government; respect for property rights; openness to trade; and integration with international financial market. The key approach to ensuring that growth benefits the whole population is a reduction of un- and under-employment—with a focus on improving the quality of the education system—complemented by a comprehensive health and social security system.

The Strategy contains a series of measures to be implemented over the coming six years, structured around three pillars:

- **Private sector competitiveness**: including setting up Alternative Dispute Resolution Courts; revising bankruptcy legislation; strengthening intellectual property rights; reducing technical barriers to trade; and developing infrastructure.

- **Human capital development**; including improving labor market matching; updating infrastructure of schools, developing vocational training; streamlining the administration of targeted social assistance; introducing a uniform health procurement mechanism; and strengthening primary health care.

- **Access to finance**; including developing the capital markets, facilitating venture capital and improving access to agricultural investments.

Under each pillar, the Strategy identifies quantitative targets to be achieved by 2017 and 2020, such as the level of FDI, ranking on the Doing Business survey, Travel and Tourism ranking, PISA scores, Gini coefficient, health-care coverage, and Innovation Fund financing.

The Strategy recognizes as preconditions for achieving robust and inclusive growth the need for macroeconomic stability and an effective public administration. To achieve this, Georgia 2020 commits to:

- preserving central bank independence;
- strengthening monetary policy transmission mechanisms;
- reducing the current account deficit;
- ensuring a floating exchange rate;
- maintaining fiscal sustainability;
- preserving financial stability;
- improving policy formulation and budget planning;
- maintaining a qualified civil service; and
- improving the tax system.

The objective of political and economic integration is recognized as a cornerstone for Georgia's medium-term strategy. In line with this, the implementation of the reforms mandated by the EU-Georgia Association Agreement and Deep and Comprehensive Free-Trade Agreement (DCFTA) are seen as an integral part of the policy agenda.

RECENT ECONOMIC DEVELOPMENTS

4. **The economy is recovering from the 2013 slowdown, which was in part caused by uncertainties associated with the political transition (Table 1).** GDP growth fell to 3 percent in 2013 (from 6 percent in 2012), well below potential. Uncertainty after the October 2012 election depressed private investment, while delays in budget execution in the first half of 2013 led to shortfalls in public investment. With consumption also flat, domestic demand declined, though this was partially offset by higher exports, especially to Russia which is gradually re-opening its market to Georgian exports (Figure 1). Domestic activity then accelerated strongly in late 2013 following a rapid fiscal expansion at the end of the year (mainly capital expenditure). As a result, GDP growth jumped and reached 7 percent in the fourth quarter. However, latest indicators point to growth tapering off in the first quarter of 2014, as the fiscal stimulus wears off.

5. **Almost two years of price deflation ended in late 2013.** Inflation had been negative for most of 2012–13 (Figure 1), reflecting the strength of the lari, lower food prices and, later, weak activity, and cuts in utility tariffs engineered by the new government. The National Bank of Georgia (NBG) responded by loosening monetary policy in 2013, cutting its refinancing rate by a total of 150 basis points to 3.75 percent. By end-2013, higher food prices and increased activity had pushed inflation up to 2½ percent. Reacting to projected further increases in inflation that would bring it closer to the NBG's 6 percent target—partly due to the expected pass-through from the lari's depreciation in late 2013 and early 2014—the NBG raised its policy rate in February for the first time since early 2011, by 25 basis points to 4 percent, although monetary policy remains accommodative. However, the nominal effective exchange rate has since strengthened, so future price increases may be less than the NBG had previously anticipated.

6. **Fiscal policy in 2013 became procyclical, which increased macroeconomic volatility.** In recent years fiscal policy has been relatively prudent, with the deficit steadily declining, expenditure falling as a share of GDP, and a stable government debt to GDP ratio (Figure 2). On taking office in late 2012, the new government decided to review existing projects and to strengthen procurement procedures. Public investment was postponed. This resulted in a budget surplus in January-September 2013 even though revenues for the year turned out to be almost 2 percent of GDP less than in the approved budget. But late in the year, spending accelerated strongly and fiscal policy turned expansionary, just when the economy anyway appeared to be recovering. With a fiscal deficit of 3 percent of GDP in the fourth quarter alone, the 2013 deficit increased to 2.6 percent of GDP (Table 2a and Figure 3). However, this was still below the 2.8 percent of GDP program target. In addition though, the composition of spending differed from that in the approved budget, with wages and subsidies 0.4 percent of GDP higher, while all other items were under executed, especially capital spending.[1]

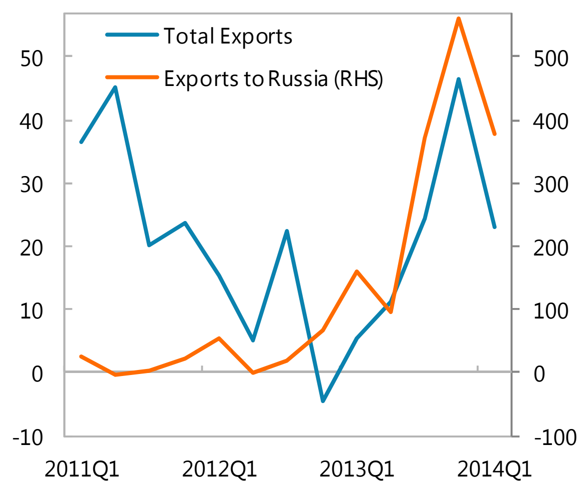
[1] The wage bill increase seems to reflect some easing after a period of de facto nominal wage freezes, increases in wages for soldiers, and local governments hiring workers and raising their salaries closer to the central government

(continued)

7. Loose fiscal policy in the fourth quarter contributed to lari depreciation and foreign reserve losses (Figure 3). The sudden fiscal expansion was largely financed by drawing down government deposits at the central bank, which fell by almost GEL 240 million (0.9 percent of GDP) in December alone. Sterilizing this increase in the money supply would have been difficult and would have resulted in a sharp increase in interest rates, sending confusing signals over monetary policy. The resulting increase in imports led to depreciation pressures on the lari, prompting the NBG to sell more than US$400 million in reserves (15 percent of total), which unwound the reserve accumulation of the first nine months of 2013. Despite this central bank intervention, the lari depreciated by 7 percent against the dollar, breaking through the ±1 percent implicit band that had held for almost two years. Pressures subsided in February and the lari strengthened, though more recently it has been broadly stable against the dollar. Reflecting reserve losses and repayments to the Fund (US$166 million in 2013q4 and 2014q1), the NBG's gross international reserves fell to US$2.6 billion by end-March, about US$480 million less than at end-September.

8. Although the current account deficit narrowed sharply in 2013, the underlying deficit remains high and net external liabilities are around 100 percent of GDP (Figure 4 and Table 3). The current account deficit fell from close to 12 percent of GDP in 2012 to less than 6 percent in 2013—the first single digit-deficit since 2004—due to improvements in the trade balance. Imports were flat due to the slump in investment while exports grew strongly due to the resumption of trade with Russia (exports quadrupled and Russia quickly became Georgia's third largest export market after the trade embargo was lifted) and a solid performance—especially in metals—in traditional CIS and EU markets. The services balance continued to improve, supported by tourism, and remittances grew by ½ percent of GDP. Staff estimates that half of the 6 percent of GDP reduction in the current account deficit in 2013 was due to a cyclical drop in imports, which will likely reverse when public and private investment recover and the fiscal deficit widens in 2014–15. However, the remainder of the reduction is likely to persist, reflecting structural improvements in agricultural exports and continued growth in tourism, so that the current account deficit should remain in single digits. External funding is predominantly FDI and official financing, and only to a small extent more short-term and volatile portfolio investment.

Merchandise Exports
(In Percent Change)



---

pay structure. A law has since been passed to limit local government hiring. Subsidies were higher partly because of the introduction of free pre-school education.

9. Credit growth has recovered to reach 18 percent y/y (exchange rate adjusted) in March, reflecting strong growth in lari-denominated household loans (Figure 5 and Table 4). Weak corporate demand, especially for long-term loans in early 2013, increased bank liquidity. As a result, deposit rates fell to historical lows. Supported by the introduction of lari variable-rate loans in April and the easing of collateral requirements for central bank refinancing, household loans—mortgages and consumer loans—increased by 27 percent year-on-year in March (exchange rate adjusted). This increase was driven by lari-denominated loans (which grew by 40 percent compared to 5 percent for foreign-currency loans). In the last year, the share of household loans has increased from 46 percent to 50 percent. While corporate lending has been much weaker, loans to agriculture, industry, and the hospitality sector have started to increase.

10. Georgia has just signed an Association Agreement with the EU, including an agreement on a Deep and Comprehensive Free Trade Area (DCFTA) (Box 2). These agreements, initialed last November, aim at promoting closer harmonization and integration with the EU. The DCFTA includes the complete elimination of tariff and non-tariff barriers on almost all goods and substantial liberalization of services trade. Regulations on: rules of origin; competition and subsidies; protection of intellectual property; environmental, social and labor policies; food safety, sanitary and phytosanitary standards; technical regulation for industrial goods; public procurement; and customs will also be implemented. The EU estimates that in the long run—assumed to be 5–10 years after the DCFTA is implemented— Georgia's exports to the EU will increase by 12 percent and imports by 7.5 percent, while GDP will be 4 percent higher. A more stable and predictable regulatory environment and free-trade with the EU should also make Georgia more attractive for FDI.

OUTLOOK AND RISKS

11. Growth in 2014 should reach 5 percent, but largely because of the strong base effect from the end of 2013 (Table 1). Accommodative fiscal and monetary policies together with the likelihood of greater political stability after the mid-June local elections should support growth. Medium-term growth is projected to average 5 percent, broadly in line with staff's estimate of potential growth. The authorities believe that potential growth is around 6 percent or even higher, and that there is already a sizeable output gap. Staff is more cautious in its assessment, and believes that part of the slowdown in 2013 may turn out to be permanent. The authorities acknowledge that achieving potential growth of 6 percent or higher will depend on whether or not growth-enhancing reforms outlined in their Georgia 2020 strategy are fully implemented, and on achieving deeper trade integration with the region and the EU. While the impact of most of the late-2013 lari depreciation has already been absorbed, increased economic activity and higher imported food prices should raise inflation towards 5 percent by the end of the year, so that the inflation target should be met over the medium term.

Box 2. EU-Georgia Association Agreement

On 29 November 2013 the EU and Georgia initialed an Association Agreement—including provisions on establishing a Deep and Comprehensive Free Trade Area (DCFTA)—forging a closer political and economic relationship between the two. The Association Agreement was signed on June 27, 2014.

The Association Agreement aims at gradually integrating Georgia into the EU Internal Market, the largest single market in the world. The Agreement includes a comprehensive reform agenda aimed at approximation of Georgia's legislation to EU norms. The Association Agreement is over 1,000 pages witheight Titles: 1) General Principles; 2) Foreign and Security Policy; 3) Justice, Freedom and Security; 4) Economic Cooperation; 5) Other Cooperation Policies; 6) Trade and Trade-related Matters (DCFTA); 7) Financial Assistance and Anti-Fraud; and 8) Institutional, General and Final Provisions. In addition, the Agreement contains 34 Annexes laying down the relevant EU legislation to be adopted by specific dates.

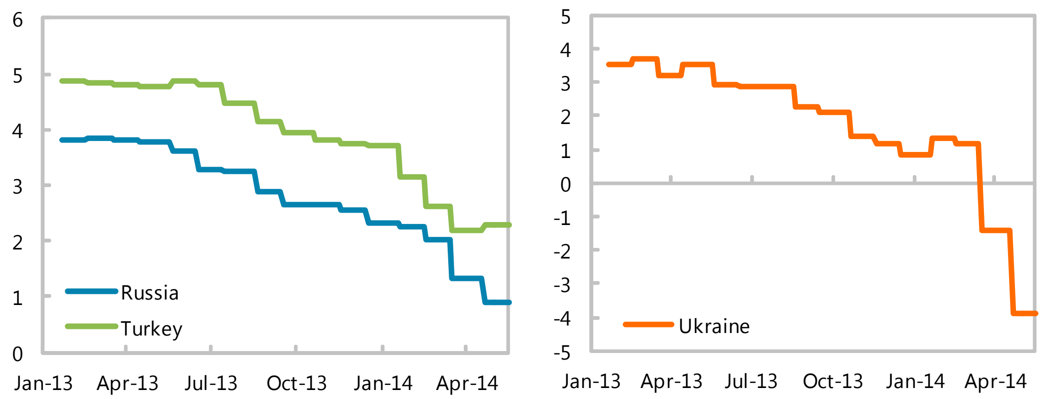
The Association Agreement is built on enhanced cooperation in some 28 key sector policy areas, including: economic dialogue; management of public finances; public financial control; taxation; statistics; transport; energy cooperation; environment; climate action; industrial and enterprise policy; company law, accounting and auditing; financial services; tourism; agriculture and rural development; fisheries; research and, technological development; consumer policy; employment, social policy; public health; education; regional development, and cross-border cooperation. Reforms in these areas will aim at gradual approximation with the EU acquis and also, where relevant, with international norms and standards.

The 6th Title on the DCFTA goes significantly further than earlier forms of economic integration in the context of Association Agreements. It offers not only improved trade and investment opportunities, but also assistance in trade-related reforms with the aim to contribute to economic growth and to better integration of the Georgian economy with world markets. Within the DCFTA, customs duties on all—with some minor exceptions—industrial and agricultural imports and exports will be removed, in line with the World Trade Organization (WTO) GATT Agreement. Georgia also commits to reducing technical barriers to trade (TBT), i.e. technical regulations, standards, conformity assessment procedures and similar requirements applying to industrial goods. To facilitate trade in animals and plants, a common understanding on animal welfare standards that reflects EU norms will be implemented. Georgia will bring its sanitary and phytosanitary legislation in line with the EU's. Within the DCFTA there will be enhanced cooperation in customs and customs-related matters, simplifying customs requirements and formalities while at the same time preventing customs fraud, e.g. through incorrect declarations of product origin. Another important component includes provisions on particular intellectual property rights, such as copyright, designs, patents, trademarks and geographical indications.

EU studies estimate that the DCFTA will boost Georgia's exports to the EU by 12 percent and imports from the EU by 7.5 percent, and to increase GDP by 4.3 percent (€292 million in national income), provided that all reforms are completed.

12. The deterioration in the current account deficit and the need to rebuild foreign reserves have created a balance of payments need in 2014. The recovery in domestic demand, driven largely by investment, is increasing imports. Exports and remittances are being affected by tensions in Ukraine and the slowdown in key trading partners such as Russia and Turkey. Increased capital inflows will likely cover only part of the projected widening of the current account deficit. Together with the foreign exchange intervention of early 2014 and about US$250 million in projected repayments to the Fund this year, these factors imply that, without Fund financing and the donor support that this would catalyze, central bank reserves would fall below US$2.5 billion, or to about 2.7 months of imports. This would be low, especially at a time when rising regional tensions could affect market confidence.

Georgia: 2014 Partner Country Growth Forecasts
(In Percent Change)



Source: Consensus Economics Inc.

13. Near- and medium-term risks are mainly to the downside. Further escalation in the Russia-Ukraine crisis would worsen Georgia's trade balance and inflows of remittances (Box 3). Financial spillovers from these tensions are likely to be small, given limited links, but there could be a contagion impact on FDI. Armenia's accession to the Eurasian Economic Union could reduce Georgia's exports to Armenia (11 percent of total), though the impact could be less if Armenia can negotiate tariff exclusions. The lari could come under pressure if regional tensions or global financial market shocks were to lead to further depreciations among Georgia's trading partners. Medium-term risks include delays to growth-enhancing structural reforms, including DCFTA-related reforms. On the positive side, the domestic political environment (and thus opportunities for economic reform) should improve once June's local elections are over, as there are no national elections until the fall of 2016.

PROGRAM OBJECTIVES AND POLICIES

14. For 2014, the program balances the objective of supporting the domestic economy with the need to safeguard external stability. Fiscal and monetary policies for 2014 should boost growth. So far the impact from the Ukraine-Russia crisis appears contained and, given that the output gap is projected to be only slightly negative, the authorities have agreed to tighten their

Box 3. Potential Spillovers from Developments in Ukraine and Russia

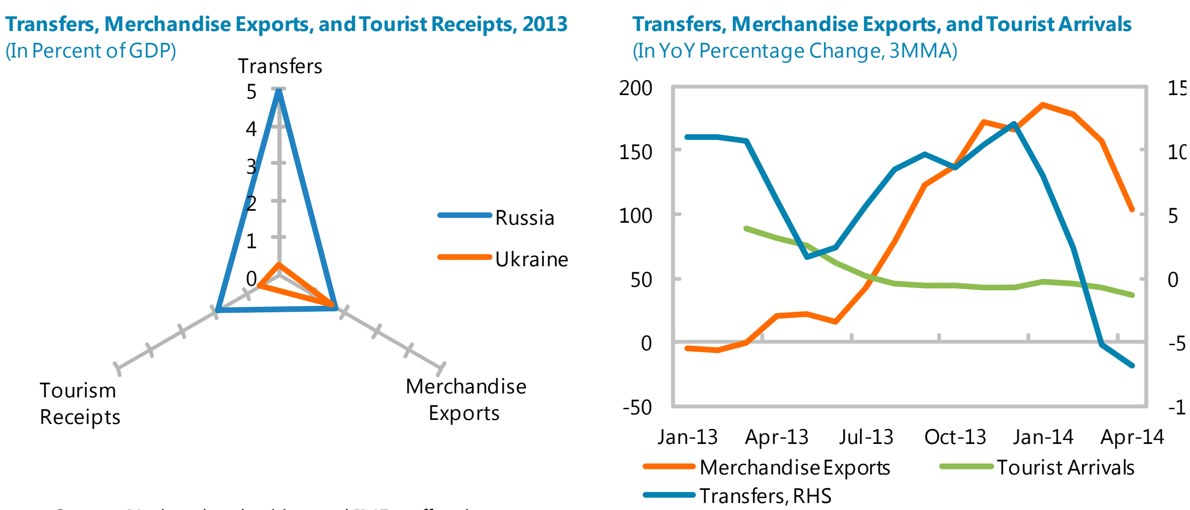
The crisis in Ukraine and economic deterioration in Russia could have serious repercussions on the Georgian economy. Georgia is closely interconnected with both Russia and Ukraine, and economic difficulties there could pose substantial threats to the economy.

The current transfers channel (including remittances) is an important conduit of shocks, especially from Russia. Total current transfers to Georgia account for about 9 percent of GDP, with half of these from Russia. This leaves Georgia exposed to risks even though current transfers have proved resilient in the past. Transfers from Russia and Ukraine have declined 6½ percent yoy in the first four months of this year. For now, this decline has been offset by higher remittances from elsewhere, mainly Southern Europe, but this trend may prove difficult to sustain.

Trade links with Russia and Ukraine are sizeable and growing. The share of Russia in Georgia's exports rose to 7 percent in 2013 (10 percent in the first quarter of 2014) from 2 percent in 2012, after the lifting of the Russian trade embargo in May 2013. Ukraine accounts for 7 percent of Georgia's exports. Together, exports to Russia and Ukraine are equivalent to 3½ percent of Georgia's GDP. Moreover, because food and beverages make up a large part of these exports, exports to Russia and Ukraine probably have relatively high shares of domestic value-added. Economic slowdown or currency depreciations in Russia and Ukraine could dampen Georgia's exports. However, one compensating factor is that Georgian goods have a long way to regain their pre-embargo shares in the Russian market.

Russia and Ukraine account for a large share of tourism inflows to Georgia. The sector makes up 6½ percent of GDP and employs 10 percent of the workforce. The number of Russian tourists has been growing steadily in recent years and now accounts for about 14 percent of total tourist arrivals while those from Ukraine 2½ percent. The effect of the Ukraine crisis could be ambiguous though. The Georgian authorities believe that tensions in other Black Sea resorts could actually divert more tourists, including from Russia and Ukraine, to Georgia.

Georgia: Links with Russia and Ukraine



Source: National authorities; and IMF staff estimates.

While direct financial links are limited, events in Ukraine could lead to contagion among investors. Official statistics show little FDI from Russia or Ukraine. Russian-owned companies operate in electricity generation/distribution and beverage sectors, but their activities should not be affected by events in Ukraine. Two banks, one a subsidiary of a Russian bank and another a subsidiary of a Ukrainian bank, operate in Georgia, but they are fully ring-fenced and account only for 8 percent of total banking sector assets. The most serious, potentially long-lasting, risk now is that the crisis in Ukraine could make investors averse to investing in Georgia.

policy stance with respect to the approved budget in 2014. However, if balance of payments pressures were to intensify they will tighten policies further and allow the lari to depreciate.

15. In subsequent years, the program seeks to lessen Georgia's macro vulnerabilities by facilitating external adjustment and supporting growth. To do this, the program will: 1) reduce the fiscal deficit to ensure fiscal sustainability and create space for countercyclical policies; 2) aim to lower the current account deficit and build foreign reserves, including by providing Fund financial assistance; 3) strengthen the monetary policy framework through greater exchange rate flexibility and improved inflation targeting; 4) contain fiscal risks from quasi-fiscal activities; 5) support reforms in revenue administration; and 6) bolster financial sector stability. These measures will complement the authorities' structural reforms to strengthen the business environment, improve education and training, encourage private investment, create jobs and reduce poverty. Extensive structural reforms in the context of the EU-Georgia Association Agreement (see Box 2) will help in improving trade competitiveness and reduce the trade deficit.

A. Fiscal Policy

16. The 2014 budget, passed last December, envisaged that the budget deficit would widen to 3.8 percent of GDP from 2.6 percent of GDP in 2013. Although the budget does not include any major new revenue or spending initiatives, the deficit increases because of the full-year effect of spending increases introduced in late 2013 combined with a base effect from lower revenues due to lower than expected growth last year. The spending increase reflects the full year impact of pension increases introduced last April and September (0.5 percent of GDP) and universal healthcare (0.7 percent of GDP). Capital spending is projected to increase by 0.6 percent of GDP, assuming that implementation of infrastructure projects improves. Higher VAT and excise revenues only partially compensate for loss of revenue due to lower grants (mainly due to EU administrative changes) and the introduction of the tax-free personal income threshold for low-income earners (which took effect in 2013, but which is refunded the following year).

17. During the discussions, the authorities agreed to target a slightly lower deficit than in the 2014 budget (LOI ¶13). With unchanged policies, the 2014 deficit would even have increased to 4 percent of GDP, slightly higher than planned in the budget, due to lower-than-projected profits taxes. The government argued that running a higher deficit was reasonable: they believe that the economy is operating somewhat below potential and, with the impact on the balance of payments of the Ukraine crisis and the slow-down in Russia limited so far, fiscal policy should be used to support growth. However, recognizing the increasing uncertainty in the external outlook, the authorities agreed to limit this year's budget deficit to no more than 3.7 percent of GDP. To achieve this, the authorities abolished a preferential scheme that had granted importers a one month grace period to pay import VAT (leading to a one-off revenue gain of around 0.2 percent of GDP) and will contain capital spending. Staff estimates that the resulting 3.7 percent of GDP deficit will still generate a fiscal impulse of close to 1 percent of GDP, following an unintended fiscal contraction of roughly similar magnitude in 2013.

18. While a smaller increase in the deficit would be more desirable, the authorities' plans are consistent with macroeconomic stability and fiscal sustainability. Spending increases in 2014 are predominantly the result of the policy reorientation that was initiated during 2013, and where the full year impact is felt in 2014. Recognizing the importance of fiscal consolidation, the program includes a ceiling on general government expenditure, keeping it to the level in the approved 2014 budget (performance criterion), which ensures that possible revenue overperformance goes to reducing the deficit. The Ministry of Finance also pledged to follow a smoother quarterly spending and deficit path this year (Table 2b), so as to avoid a repeat of last year's procyclical fiscal policy, which also destabilized the balance of payments (LOI ¶13). Were the balance of payments outlook to worsen, staff strongly encouraged the authorities to be ready to hold back spending even if this meant that the deficit might fall short of the revised 3.7 percent target. Likewise if the deficit turns out lower than expected in the first half of the year, staff advised the Ministry of Finance to undershoot the full year target.

19. The program targets a budget deficit of 3 percent of GDP in 2015, backed by pre-announced measures to improve credibility. The authorities' Letter of Intent identifies specific measures to reduce the 2015 deficit while at the same time increasing capital spending (LOI ¶14). On the revenue side, the authorities are preparing an increase in tobacco excises. On the expenditure side, wages, subsidies and spending on goods and services are kept constant in real terms, i.e. only providing inflation compensation. Following the significant increase in social expenditure in 2013 and 2014, benefit levels will be kept constant in 2015. Anticipating a lower-than-projected uptake of the universal health care system, the authorities also project that health expenditure will remain constant in nominal terms between 2014 and 2015.

20. While welcoming the government's commitment to deficit reduction, staff argued for avoiding regressive measures:

- Staff cautioned against taking measures that might put a disproportionate burden on poor households. Staff expressed concern that plans not to increase benefit levels in 2015 might be difficult to sustain, and that there could be a case for replacing this with other more high quality measures.

- In response, the authorities noted the large expansion of the social safety net that had taken place in 2013, and which would remain in place. They argued that planned increases in regional infrastructure spending could also help reduce poverty. However, they also looked forward to drawing on the findings of a recent FAD tax policy technical assistance mission, which had identified a menu of tax measures that would both raise revenue and reduce inequalities.

Fiscal Measures for 2015		
	Fiscal savings	Estimated impact (% GDP)
	Revenue	
a)	Increasing excises on tobacco	0.2
	Expenditure	
b)	Keeping spending on wages and salaries constant in real terms	0.2
c)	Keeping spending on goods and services constant in real terms	0.2
d)	Keeping social benefit levels constant in real or nominal terms	0.7
e)	Keeping subsidies constant in real terms	0.1
f)	Keeping other expenses constant in real terms	0.2
	Use of fiscal savings	
	Expenditure	
a)	Interest expenditure	-0.1
b)	Net Lending	-0.1
c)	Capital expenditure	-0.7
	Net Effect on 2015 Deficit	*0.7*

- Staff raised questions over the authorities' plans for a substantial increase in investment spending in 2015, and how this might be reconciled with earlier commitments to prioritize social spending. The government argued that investment spending was important for growth and stressed that earlier problems with implementation capacity had been overcome.

- While there may be scope for refining the measures proposed by the authorities for the 2015 budget, the measures are adequate and show that next year's deficit target can be met. Staff will continue to discuss ways to improve the quality of measures in the 2015 budget.

21. For the medium term, the program aims to reduce the deficit to no more than 2½ percent of GDP by 2017. This path would keep government debt comfortably below

40 percent of GDP and respect the limits set by the Economic Liberty Act.[2] The lower deficit would facilitate a switch from external to domestic financing (as concessional financing declines), and support external adjustment. A lower structural deficit that is more easily financed from external and domestic sources would also allow room for a countercyclical response to business cycle downturns. Consistent with the legal limits under the Economic Liberty Act on increasing general state taxes, the authorities' adjustment strategy relies on mobilizing revenue by widening the tax base, strengthening revenue administration, and containing current expenditure. In line with this, the authorities are considering various options, including the elimination of the tax-free threshold for the personal income tax; staff cautioned against such a step on the ground that it would disproportionally affect low-income households. The government also places great importance on increasing public investment to strengthen transport and regional infrastructure. However, even if the government succeeds in increasing revenues, the spending limits (as a share of GDP) established in the Economic Liberty Act mean that the government has to make a choice between higher investment and increasing social spending.[3]

22. The authorities recognize the need to manage fiscal risks (LOI ¶27). The authorities will attach a fiscal risk statement to their 2015 budget (December structural benchmark). At the initial stage, this will include a sensitivity analysis, estimating the impact on government revenue and expenditure of various macroeconomic scenarios. The emphasis will be on revenues, as the authorities argue that the absence of unemployment benefits and low level of social welfare schemes make expenditure unresponsive to macroeconomic fluctuations in the short term. Aside from listing public guarantees (so far there is only one guarantee outstanding, which was issued more than a decade ago), the authorities plan to expand the statement to include other public sector fiscal risks, including exposure through state-owned enterprises and off-budget vehicles, in subsequent statements.

23. The program includes tax administration reforms supported by Fund technical assistance (LOI ¶26). To improve the quality of taxpayer information, to provide better taxpayer services, and to improve compliance, the authorities intend to integrate taxpayer registration by the GRS more closely with business registration from the Ministry of Justice. The authorities also agreed to abolish the so-called Alternative Audit program (a scheme where the tax payer hires a private auditor as a substitute for a GRS audit, and where potential penalties are lower) and to strengthen

---

[2] The fiscal rules that came into effect in 2014 under the Economic Liberty Act limit government spending to 30 percent of GDP, government debt to 60 percent of GDP, and the budget deficit to 3 percent of GDP. While the 2014 cash deficit is 3.8 percent of GDP, the government argues that the deficit according to GFSM 2001 (which excludes policy lending and repayment of arrears, and includes privatization proceeds) is 3.0 percent of GDP, and thus the limits are respected.

[3] The 30 percent of GDP expenditure limit in the Economic Liberty Act creates incentives to move spending off-budget (for example through state agencies or extra-budgetary funds (including the new state financial institution that is under consideration)) to circumvent these limits. While there are only a few signs of fiscal fragmentation (resistance to move some quasi-government entities on budget and possible expansion of capital spending through an off-budget state financial institution), these incentives highlight the need for strong public financial management arrangements, including a stronger fiscal policy framework.

the GRS' own audit capacity, by hiring and training new staff. This will reduce risks to the tax system by improving the coverage and quality of GRS-led audit compliance and returning to the GRS its core function of tax collection and enforcement. The GRS plans to introduce single taxpayer accounts by June 2015 to improve the monitoring and accuracy of tax payment data. The authorities also committed to increase their efforts to refund the stock of excess tax credits.

B. Monetary and Exchange Rate Policies

24. The NBG's monetary policy aims at price stability. To achieve this goal, the NBG has set a 6 percent inflation target for 2014, falling to 5 percent for 2015 and 2016. However, in the last two years Georgia has experienced price deflation, due to lower food prices and the strength of the lari, which has prompted significant monetary policy easing. The NBG projects that inflation should come close to the 2014 target by the end of the year, and so believed that the current stance of monetary policy was broadly appropriate. However, while accepting that higher food prices posed a risk, staff expressed some concern that the target might again not be met, given recent strengthening of the lari's nominal effective exchange rate, and that greater exchange rate flexibility might be needed. Continued efforts towards de-dollarization might help overcome the political constraints to this.

25. Respecting the NBG's monetary policy framework, program conditionality includes an inflation consultation clause (LOI Table 1). Staff and the authorities agreed that the NBG's monetary policy framework was sufficiently well developed to introduce an inflation consultation clause, with CPI inflation targets (initially quarterly but from 2015 bi-annual with quarterly guidance targets) consistent with the NBG's annual targets. There will be two bands: an inner band of ±2 percent which would prompt consultations with the staff, and a wider ±3 percent band for consultation with the Executive Board. Although the NBG does not target money, the program retains an indicative target on NDA, as a tripwire to prevent excessive expansion of the central bank balance sheet. However, the NBG expressed concern over including an NDA target, in part because the most volatile component has been movements in government deposits, which typically reflect the path of the government deficit and over which the NBG has little control. The LOI therefore includes commitments to keep government spending close to quarterly projections, and staff stressed to the Ministry of Finance the need to avoid a repeat of 2013 where bunching of the deficit in the last quarter proved too difficult for the NBG to sterilize and where the resulting money supply increase contributed to depreciation pressures and loss of reserves.

26. The program will support further enhancement of the monetary policy framework. The NBG plans to use technical assistance from the Fund to improve its inflation modeling and to refine its communication strategy (LOI ¶19). The NBG will publish its quarterly inflation reports (with press conferences) according to a fixed pre-announced schedule. To strengthen the effectiveness of the monetary policy transmission mechanism, the NBG will continue policies aimed at encouraging further de-dollarization. Finally, the authorities reaffirmed their strong commitment to preserving NBG independence as key to maintaining monetary and financial stability

27. The program targets a modest increase in international reserves, which should safeguard Fund resources and help protect Georgia from external shocks. Meeting this target will depend on a combination of modest foreign exchange purchases by the NBG and the avoidance of large increases in the fiscal deficit. The program aims to increase gross international reserves from around US$2.5 billion at present to US$2.7 billion by the end of the year, which would cover 3 months of 2015 imports and about 100 percent of short-term liabilities. Although reserves now are somewhat lower than at end-2013, this decline reflects foreign exchange sales earlier in the year, plus scheduled repayments to the Fund. With Fund repayments falling sharply in 2015, and with additional fiscal tightening expected to lower the current account deficit, the program will aim to increase gross international reserves to around US$3.0 billion by end-2015 (3.1 months of 2016 imports). The NBG was reluctant to pre-announce its foreign exchange purchase auctions to meet the NIR targets, expressing concern that buying foreign exchange at times of depreciation pressure could cause a self-fulfilling panic. Instead, it would seek to time its purchases in the third and fourth quarters this year, historically times of greater inflows.

28. The authorities reiterated their commitment to the floating exchange rate. The NBG's willingness to allow the exchange rate to depreciate by 7 percent against the dollar (2 percent in nominal effective terms) over December and January signals the authorities' willingness to accept greater exchange rate flexibility. While the NBG believes that overvaluation is less than staff estimates (Box 4), it remains committed to allowing the lari to move freely in line with its fundamentals.

C. Financial Sector Policies

29. The banking sector is liquid and well-capitalized (Figure 6). The sector reports capital adequacy ratios of 17 percent (13 percent for tier 1 capital) and a liquidity ratio of 42 percent, both comfortably above the NBG's minimum requirements of 12 and 30 percent, respectively. Despite the slowdown, NPLs remained largely flat in 2013 as banks had pro-actively written down or restructured bad loans in 2012. After substantial provisioning in 2012, bank profits rose by 16 percent in 2013, also supported by strong interest income. Staff voiced some concern over the rapid growth in floating-rate lari loans (since their introduction in March-2013) and also in consumer lending. The supervisory authorities are monitoring these loans closely and noted that the share of consumer loans in total loans remains relatively low at around 17 percent. While floating rate lari loans have been growing since their introduction in mid 2013, the interest rate risk is contained given that fixed rate loans still dominate. Foreign currency loans (which make up about one-third of total household loans) continue to create risks, emphasizing the need to continue de-dollarization efforts.

30. The NBG is taking steps to strengthen its macroprudential and banking supervision framework:

- **To stem the rapid growth of non-resident deposits (which grew by 50 percent in 2012), last June the NBG introduced a new liquidity requirement**. Banks were required to hold more than the standard level of liquidity (30 percent) if their non-resident deposits exceed 10 percent of total deposits. The NBG believes that this measure has been effective, with year-on-year growth in nonresident deposit slowing to 13 percent in February. After increasing steadily, the share of non-resident deposits has stabilized at around 15 percent of total deposits (excluding deposits from non-resident banks).

- **The NBG will soon introduce the liquidity coverage ratio** (the ratio of high-quality liquid assets to bank's projections of cash outflows) as its core liquidity ratio for banking supervision. Banks will be required to keep this ratio at a minimum of 100 percent. Going beyond Basel recommendations, the liquidity coverage ratio will account for the different characteristics of bank's assets and liabilities. For example, runoff rates on deposits will be allowed to vary based on their type (retail or bank, withdrawable or nonwithdrawable), owner (parent or unrelated party, resident or nonresident), concentration, maturity, and currency.

- **The authorities are moving towards Basel III compliance and risk-based supervision.** In 2013, banks started to comply with the standardized approach of Pillar 1 of Basel III. With assistance from the NBG, banks are developing their own Internal Capital Adequacy Assessment Process that would incorporate both quantitative risks (interest rate, liquidity, concentration, and reputation) as well as key Basel II Pillar 2 qualitative risks, such as the effectiveness of bank management and internal controls. Firm-level stress tests conducted by major banks show that they have sufficient capital to absorb loan deterioration from various macro shocks. The results of these tests will also be used for Pillar 2 capital requirements.

Box 4. Restoring Georgia's External Viability

Georgia's high current account deficit and net external liabilities together with relatively low international reserves are sources of vulnerability. The proposed SBA stresses the need to restore external viability through fiscal consolidation, exchange rate flexibility, reserve accumulation, and structural reforms aimed at improving competitiveness.

Exchange rate assessment

The average of the CGER-based estimates of the lari's overvaluation has declined to 8 percent, compared to 15 percent at the time of the 2013 Article IV.[1] With strong export and tourism growth in 2013, the underlying current account deficit fell to 8.4 percent of GDP from 10.3 percent of GDP. The macroeconomic balance (MB) approach indicates that the real effective exchange rate would need to depreciate by about 7 percent to bring the underlying current account balance to its norm (6.8 percent of GDP). The external sustainability (ES) approach, anchored on reducing Georgia's net foreign liabilities to a more sustainable level of 60 percent of GDP, points to a higher overvaluation of about 17 percent. The equilibrium real exchange rate (ERER) approach suggests that, following the recent depreciation, the lari is broadly in line with its equilibrium value. These estimates are subject to considerable uncertainties and are sensitive to assumptions. Continuing structural reforms to improve competitiveness and raise productivity would reduce the need for exchange rate adjustment.

Georgia: Exchange Rate Assessment

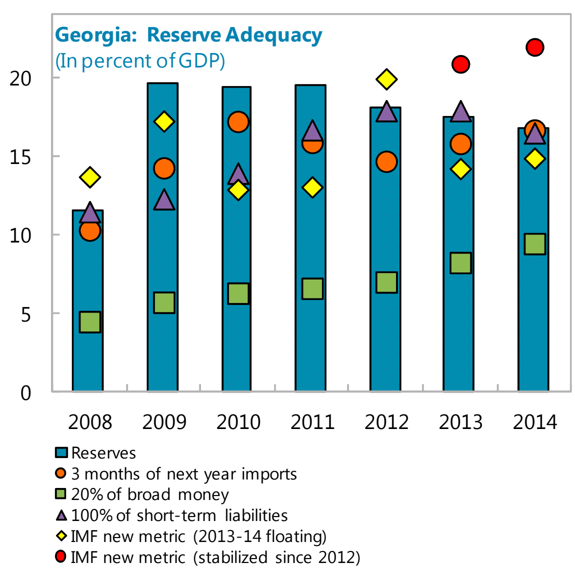
	MB	ERER	ES
Current Account Norm 1/	-6.8		-4.4
Underlying Current Account 2/	-8.4		-8.4
CA gap	1.6		4.0
Elasticity	0.2		0.2
Real Exchange Rate Gap 1/ 3/	7.2	-0.4	17.5

1/ Current account norm and equilibrium real exchange rate are calculated using fundamental values in 2019 without exchange rate adjustment. Calculations use -60 percent of GDP for NFA instead of -101 percent of GDP at end-2013 assuming current level is not sustainable.

2/ Underlying current account is based on actual current account balance in 2013 adjusted by cyclical factors.

3/ Movement in real exchange rate needed to close the CA gap between norm and underlying. Positive values mean overvaluation of real exchange rate.

The lari's recent depreciation against the US$ and the Euro has not led to substantial gains in price competitiveness. Although the lari has depreciated by 5 percent against the US$ and 10 percent against the Euro since end-2012, currency weakness in Turkey, Russia, and Ukraine has meant that Georgia's nominal and real effective exchange rates have changed little. Although the U.S. and the Euro area account for only 30 percent of Georgia's bilateral trade (same as Turkey, Russia, Ukraine combined), the public focuses exclusively on the US$ and Euro exchange rates.



Rebuilding international reserves is one of the key objectives of the proposed SBA. The authorities' commitment to FX purchases under the program and the projected disbursements from the Fund should help gross international reserves increase to about US$2.7 billion by end-2014. With repayments to the

[1] See IMF Country Report No. 13/264.

Box 4. Restoring Georgia's External Viability, concluded

Fund falling sharply in 2015, program policies target an increase of gross reserves to around US$3.0 billion (3.1 months of 2016 imports) by end-2015.

Restore external viability

An appropriate policy mix is needed to address both the short-term risk from low international reserves and the medium-term vulnerability from high current account deficits and net foreign liabilities. While exchange rate flexibility should be the main tool for external adjustment, the reserve accumulation envisaged in the proposed SBA will help build buffers. Continued fiscal consolidation over the medium-term will contain imports. Structural reforms aimed at improving export competitiveness, including those committed to under the EU-Georgia DCFTA are crucial for restoring external viability.

31. The authorities are continuing efforts to reduce financial sector dollarization. High dollarization for both deposits and credit creates depreciation-related balance sheet risks for households and firms as their income is predominantly in lari. This generates resistance to allowing the exchange rate to move freely. High dollarization also limits the NBG's ability to act as lender of last resort. To promote lending in lari, in 2013 the NBG relaxed collateral standards for refinancing lari loans, encouraging banks to introduce lari floating interest rate loans. The government has also recently placed GEL80 million in long-term deposits with commercial banks (in exchange for sale of long-term bonds) to promote long-term lending in lari, and is planning to expand this scheme further. These measures complement regulatory rules to promote the use of the lari, which include additional risk weighting for FX loans, and higher reserve requirements on FX liabilities. These efforts have helped reduce loan dollarization to 60 percent in March from 67 percent a year ago, and from 43 to 36 percent for household loans (all measured in constant exchange rates) (Figure 5). Deposit dollarization fell from 61 percent to 57 percent (constant exchange rates).

32. The government is moving Georgia's Financial Monitoring Service (FMS), a key part of the framework on anti-money laundering and for combating the financing of terrorism (AML/CFT), from the NBG to instead report directly to the Prime Minister's office. While acknowledging that institutional arrangements for financial intelligence units vary across countries, staff questioned the need for such a move. Staff stressed the importance of maintaining the Financial Monitoring Service's independence, and for maintaining the confidentiality and integrity of financial data to which it has privileged access, and for preventing abuses. The Prime Minister responded by giving his personal commitment to protecting confidentiality and FMS independence. The government also agreed to seek comments from the EU Council of MONEYVAL and the Egmont Group. If needed, it would amend the FMS law to address their recommendations (LOI ¶30).

D. Structural Reforms

33. The authorities are keen to take steps to improve access to finance. Staff stressed the importance of removing market imperfections that limit the development of SMEs (e.g. problems assigning collateral, enforcement of property rights). The authorities agreed but believe that these reforms could take time, and so are considering establishing a financial institution (possibly a development bank) that could facilitate private investment and improve access to finance. Staff expressed concern about this proposal. It was not clear that there really was an access to finance problem, especially given relatively rapid credit growth over the last five years (including, very recently, to households). It was also not clear that a state institution would be the best means to improve access to finance, or that the benefits would outweigh the costs. The authorities recognized that these were concerns, and committed to consult with the Fund and other development partners before proceeding. Staff noted that there were already many public funds that had been established with similar goals and urged the authorities to study their effectiveness and to consolidate these before establishing a new state financial institution (LOI ¶31). Staff also recommended transferring state enterprises from the Partnership Fund back to the government, and to finance the Partnership Fund's operations with greater transparency.

PROGRAM MODALITIES

34. Georgia is facing a temporary external financing gap of about US$260 million in 2014. The current account deficit is projected to widen as imports are recovering and exports, while still growing, are being hit by weakening external partner country demand (especially from Russia, Ukraine, and Turkey). In addition, Georgia this year has about US$250 million in scheduled repayments to the Fund. While capital inflows will contribute, to keep international reserves at US$2.7 billion (3 months of imports), Georgia has a financing need of around US$260 million. Planned disbursements from the Fund (about US$120 million) and expected other donor budget support (US$90 million from the World Bank, and US$50 million from the ADB) will cover the projected financing gap. While a further US$60 million in macro-financial assistance would become available from the EU once Georgia makes purchases under the Fund arrangement, the program does not assume any disbursements in 2014 given the uncertainties attached to this assistance.[4] The program will be fully financed through the next 12 months, and there are good prospects for adequate financing for the remainder of the program.

35. The Georgian authorities have requested a Stand-By Arrangement (SBA) with SDR 100 million (about US$155 million, 67 percent of quota) financing for 2014–17. SDR 80 million would be available in 2014 (Table 9), to meet the residual gap after donor support is taken into account. Since the central bank is legally prohibited from providing direct financing to the

[4] Should the macro-financial assistance be brought forward to 2014, the authorities have indicated that they intend to remain with existing domestic borrowing plans and instead build up their deposits and international reserves.

government, the authorities have requested that the first and second purchases under the program (SDR40 million (about US$62 million) each) should be disbursed to the Ministry of Finance to limit a destabilizing draw-down of deposits. The market for government securities is still relatively thin, limiting the scope for domestic financing. While the government could draw down its deposits, this would risk pushing up interest rates and crowding out private credit were the central bank to sterilize, or lead to loss of international reserves. Fund financing will help maintain adequate reserve coverage. From 2015 onwards, there would be only insignificant external financing needs under the baseline scenario, as program policies deliver improvements in the current account deficit and net external debt payments fall, both of which contribute to restoring external viability.

36. The arrangement will last three years and be monitored through six reviews, initially held quarterly and then semi-annually. By lasting through mid-2017, the program should help provide some policy discipline in the run-up to the 2016 Parliamentary elections. There will be staff visits in between reviews as needed to monitor progress and to help ensure the program is on track. The first two program reviews will be based on end-September and end-December test dates respectively with end-June and end-December test dates thereafter with performance criteria on the general government cash deficit, general government expenditure, the cash deficit of the Partnership Fund, net international reserves of the NBG, and external arrears; and indicative targets (ITs) on the net domestic assets of the NBG (Table 2 of the attached Letter of Intent — LOI); and an inflation consultation clause (Table 1 of the LOI). Structural benchmarks are set through December 2015 (Table 3 of the LOI). The front-loaded phasing of access reflects the profile of Georgia's financing needs and the program's signaling nature.

37. A safeguards assessment is in progress and will be completed before the first review. The last safeguards assessment was completed in 2011. The memorandum of understanding between the Ministry of Finance and the NBG on their responsibilities for servicing their respective obligations to the Fund was signed in 2009 and remains in effect. The authorities will update the memorandum as needed (LOI ¶32).

38. Georgia's capacity to repay the Fund remains adequate. It has a strong track record of timely servicing its obligations to the Fund. At 32 percent of GDP, Georgia's public debt is low and is largely owed to multilaterals at favorable terms and with long maturities. Main risks stem from Georgia's relatively high external debt of about 80 percent of GDP. The staff's baseline assumes that the two US$250 million Eurobonds—issued by the state-owned Georgian Oil and Gas Corporation and Bank of Georgia—would be rolled over when they mature in 2017. Still, it is important to prepare a well-designed debt management strategy that takes into account external obligations of both public and private entities, as well as the US$1 billion in sovereign and state enterprise Eurobonds that will mature in 2021–22. The declining exposure of the Fund to Georgia—as disbursements under the proposed arrangement are well below the scheduled repurchases on previous credit—serves as an additional safeguard to Fund resources.

39. The program faces a number of risks, but they should be manageable (Box 5). Implementation risks could arise from difficulties implementing the program's fiscal consolidation in 2015 and delays in structural reforms. While the program will maintain an ambitious policy throughout the program period, the absence of planned disbursements from 2015 and onwards could reduce incentives for adopting policies that, while having a positive impact in the longer run, would be unpopular when implemented. External risks stem from possible further deterioration of the external environment. Staff will continue to monitor balance sheet risks to ensure that the economy is able to withstand possible exchange rate depreciation. Staff and the authorities agreed that a proper response to further widening of Georgia's external financing needs would include policy adjustment—including exchange rate depreciation and fiscal tightening—and likely additional financing. Access may also need to be augmented if higher tensions necessitate the need for higher reserves to restore market confidence. The authorities are ready to make additional policy adjustments should the external environment deteriorate. This provides additional assurances that their capacity to repay the Fund will remain intact.

40. Public debt is projected to remain low at around 30 percent of GDP while external debt, although high, is projected to decrease gradually to less than 60 percent of GDP (Annex 1). The long average maturity of both public debt and external debt, together with the authorities' efforts to reduce the current account deficit, should limit financing and refinancing risks. However, the high share of foreign currency denominated debt (about 84 percent of total public debt in 2013), leaves the country exposed to exchange rate fluctuations. For instance, a 30 percent real depreciation would increase the stock of external debt to about 85 percent of GDP and the total stock of public debt by 8 percent of GDP. The authorities broadly agreed with the DSA results, but noted that a 30 percent depreciation was a very unlikely scenario.

41. Scenario analysis shows that macroeconomic shocks do not substantially jeopardize public debt sustainability. Stress tests show that the profile of public debt is unaffected by a 5 percent real exchange rate shock and only marginally affected by a real interest rate shock. A shock to the primary balance of about 3 percent of GDP increases debt on impact but the debt stock stabilizes at around 32 percent of GDP in 2019. The debt profile is more vulnerable to growth shocks. A one percent reduction in real GDP growth causes the debt to GDP ratio to increase to 40 percent of GDP in 2016 and then gradually decline to about 36 percent of GDP in 2019. When all the macro shocks are considered simultaneously the debt to GDP ratio increases to 45 percent of GDP in 2016 and stabilizes thereafter.

Box 5. Risk Assessment Matrix

Nature/source of risk	Likelihood of realization in the next three years[1]	Expected impact on the economy if risk is realized
Global Shocks		
Side-effects from global financial conditions:	**Staff assessment:**	**Staff assessment: Medium** Market volatility and increases in long-term rates could lead to a reversal in bank flows as a result of advanced countries exiting from UMP. As the current account deficit continues to be high, such a reversal would put pressure on the external account.
• **Surges in global financial market volatility**, triggered by geopolitical tensions or revised market expectations on UMP exit/emerging market fundamentals.	**High**	
• **Distortions from protracted period of low interest rates continue to build:** excess leverage, especially for corporates; delays in fiscal and structural reforms.	**Low**	
Regional geopolitical risks (financial flows, commodity prices, and supply chains)	**Staff assessment:**	**Staff assessment: Medium** So far the reaction of markets has been subdued. However, an increase of political tensions could have adverse effects on international trade and capital flows. The main economic channels of contagion for Georgia would come from trade linkages with Russia and Ukraine and remittances from Russia. Uncertainty over relations with Russia could hurt business confidence and deter investment.
• **A sharp increase in geopolitical tensions surrounding Russia/Ukraine that creates significant disruptions in global financial, trade and commodity markets**.	**Medium**	
• **Heightened geopolitical risks in the Middle East, leading to a sharp rise in oil prices, with negative spillovers to the global economy**.	**Low**	
Protracted period of slower growth in advanced and emerging economies:	**Staff assessment:**	**Staff assessment: High** A long period of slow growth in the world economy (and particularly in Georgia's main trading partners) would hurt exports and GDP growth.
• **Advanced economies:** Lower-than-anticipated potential growth and persistently low inflation due to a failure to fully address legacies of the financial crisis, leading to secular stagnation.	**High**	
• **Emerging markets:** Maturing of the cycle, misallocation of investment, and incomplete structural reforms leading to prolonged slower growth.	**High**	
Country Specific Risks		
Uncertainty over economic policymaking and delays in reform implementation.	**Staff assessment: Medium** Finalization of the government's "Georgia 2020" strategy and the accompanying action plan should give more policy certainty, but their effectiveness and credibility will hinge on timely implementation.	**Staff assessment: High** Questions over economic strategy, lack of clear timetable for policy actions or their slow implementation could continue to deter private investment.

Policy response will depend on the type and the strength of the shock but most likely would involve exchange rate flexibility, acceleration of structural reforms and possibly monetary easing. Scope for additional fiscal stimulus is limited given the proposed increase in the 2014 deficit; the government needs to demonstrate its ability to build sufficient fiscal buffers during tranquil times.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

STAFF APPRAISAL

42. While Georgia has made impressive progress under its Fund-supported programs, it continues to face macroeconomic challenges. Over the last decade Georgia has transformed itself into a high-growth and low-inflation market economy. However, the high current account deficit and foreign indebtedness remain significant vulnerabilities. Reliance on external financing gives rise to high dollarization, which weakens the effectiveness of monetary policy and exposes banks to greater risks. The key challenge for the medium-term is to sustain this rapid growth but to make sure its benefits are shared more widely, while reducing external vulnerabilities.

43. Accommodative monetary and fiscal policy has helped the economy recover from the 2013 slowdown, but has also increased volatility. With inflation well below target, monetary policy has become appropriately stimulatory, both through lower policy rates and measures to encourage new credit in domestic currency. However, fiscal policy in 2013 became inadvertently procyclical: tight early in the year when the economy had slowed, but then loose at the end of the year when the economy was already recovering. The result was a rapid acceleration in growth at the end of 2013, but also exchange rate depreciation pressures and substantial loss of foreign exchange reserves.

44. Near-term risks have risen reflecting the difficult external environment. The crisis in Ukraine, and slower growth in Russia and in Turkey are clouding prospects for the economy, especially for exports. In addition to the direct spillovers from trade and remittances, higher risk premia may deter foreign direct investment.

45. The authorities' program addresses these challenges by reducing macroeconomic vulnerabilities, increasing policy buffers, and supporting growth. For the near term, the program will support macroeconomic stabilization and improve confidence by providing a framework to discipline macroeconomic and fiscal policy, and by providing modest balance of payments financing. Over the program period, policies focus on reducing the fiscal and current account deficit, facilitating exchange rate flexibility, containing fiscal risks, and supporting growth.

46. The authorities are taking some corrective measures to reduce this year's budget deficit, but should be prepared to do more if risks materialize. Following low growth in 2013 and given the uncertain (but so far contained) impact of the Ukraine-Russia crisis, the government is keen to use fiscal policy to help raise output towards potential. A somewhat smaller increase in the deficit might have been more desirable given the large fiscal impulse at the end of 2013, that consumer credit has started to grow rapidly, and that the current account deficit is projected to widen. However, on balance, a deficit of 3.7 percent of GDP in 2014 is acceptable as it should be consistent with macroeconomic stability and fiscal sustainability, particularly given the commitment to deficit reduction in 2015. If balance of payments pressures were to intensify, the authorities need to be ready to tighten fiscal policy further (for example, by underexecuting spending) and to allow the lari to depreciate. The government's pledge to target a much smoother and more predictable fiscal deficit path through the year is welcome, as this should avoid a repeat of last year's volatility, even if this means that the deficit falls below its target.

47. The authorities are demonstrating their commitment to adjustment by pre-announcing measures for 2015 that will lower the budget deficit to 3 percent of GDP. These include increasing excises on tobacco, and moderating the growth of civil service wages and other categories of current spending by keeping them constant in real terms. While recognizing that social spending increased by almost 50 percent from 2012 to 2014, it will be important to ensure that the measures planned for 2015 will not disproportionately affect the poor and vulnerable. To support equitable growth, increasing property taxes (or expanding this tax base), removing tax expenditures benefitting high wealth individuals and reforming the personal income tax could be considered. In preparing the 2015 budget, the authorities will have a further opportunity to reorient policies to further the impact on vulnerable groups.

48. The NBG should continue to improve its inflation-targeting framework. Recognizing the NBG's achievements, monetary policy conditionality introduces an inflation consultation clause. The NBG's efforts to continue developing its monetary policy toolkit are welcome, as are its plans to improve inflation modeling with technical assistance from the Fund and to refine its communications strategy. Respecting the independence of the NBG while enhancing cooperation between the government and the NBG will remain essential to achieving these objectives and to the success of the program.

49. The program aims at strengthening the economy's resilience to external shocks. To lower Georgia's net foreign liabilities to a sustainable level (about 60 percent of GDP) in the medium-term, the current account deficit should be brought down to about 5 percent of GDP, with 60 percent of this latter adjustment having taken place by the program's conclusion. To achieve this, the authorities will need to deliver on greater exchange rate flexibility, fiscal consolidation, and structural reforms to strengthen competitiveness. Given the volatile external environment and risks from dollarization, the NBG should maintain an adequate level of reserves, using timely foreign currency purchases to build reserves in line with the program's NIR path. When conditions normalize, the NBG should consider moving to pre-announced foreign exchange purchase auctions as a way of re-building reserves in a way that is consistent with the floating exchange rate regime. Interventions to defend the lari should respect the program's NIR targets and only aim at preventing disruptive moves in the exchange rate.

50. The NBG should continue to modernize its prudential and supervisory framework. Staff supports the authorities' efforts to move the banking sector toward Basel III compliance and to incorporate Basel II risks in calculating measures of capital adequacy. Policies to encourage de-dollarization—through NBG refinancing, the government's scheme to place long-term lari deposits at banks, and regulatory rules—seem to be working. This should allow greater exchange rate flexibility and make monetary policy more effective. The FSAP that visited Tbilisi in June will give more indications of the strength of the financial sector, and perhaps suggest ways for further improvement. Following the recent decision to move the Financial Monitoring Service from the NBG, the government should strengthen its operational independence and ensure confidentiality.

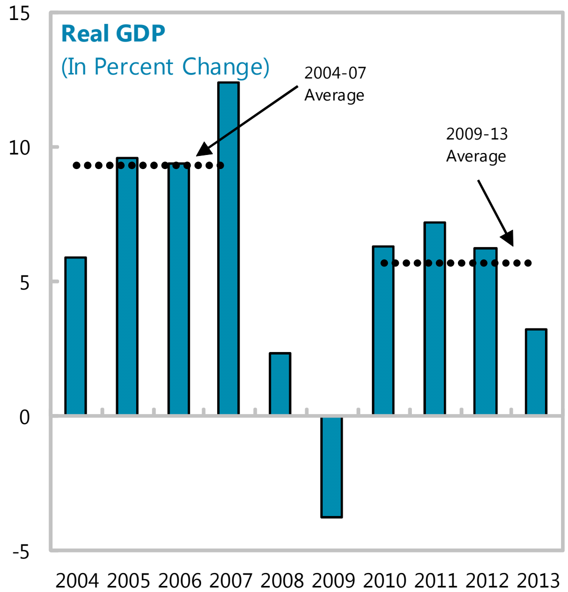
51. The authorities should carefully assess the merits of establishing another state financial institution to facilitate private investment and improve access to finance. The authorities should first make a more detailed analysis of the extent to which "access to finance" is a problem, and then address the underlying market failures. Creating a new financial institution may not be the most appropriate remedy. Without market discipline, it might result in substantial risks that would offset potential benefits. Should there be a decision to set up a financial institution supporting access to finance and development of small- and medium-sized businesses, there need to be clear safeguards against excessive and uncontrolled fiscal risks (for example through implicit or explicit state guarantees), and against creating distortions in the financial sector (for example by taking deposits). There also need to be clearly defined objectives, mandate, governance and oversight rules to avoid politicized lending. Any decision to pursue the establishment of such a state financial institution will require a revision of the draft law previously submitted to parliament. In this regard, the authorities' intention to work closely with the Fund and other development partners (World Bank and KfW) is welcome.

52. Structural reforms and closer trade integration in the region and with the EU are critical for sustaining strong growth. Georgia arguably boasts the best business environment in the region, but needs to enhance competition, strengthen property rights protection, develop commercial dispute resolution mechanisms, streamline bankruptcy procedures, improve workers' skills, and further improve public administration. Signing of the Association Agreement and the DCFTA with the EU will grant Georgian goods free access to the largest market in the world and should make Georgia more attractive for foreign investors, to the extent that Georgia's approximation of EU regulations makes its regulatory environment more predictable.

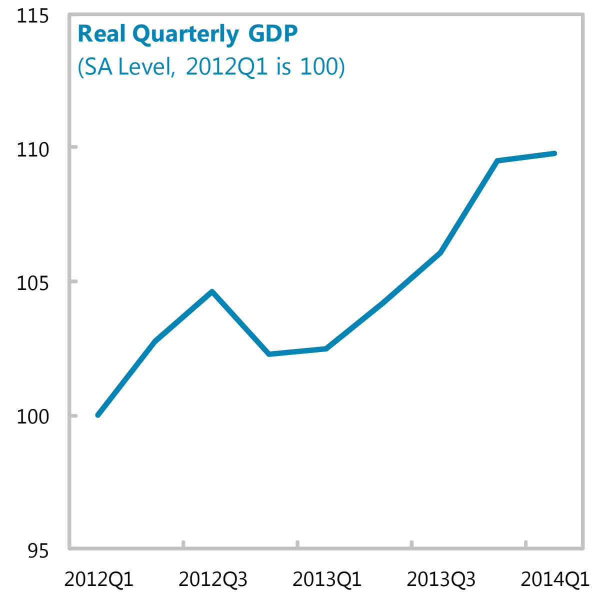
53. The proposed program will facilitate Georgia's external adjustment, reduce key macroeconomic vulnerabilities, and support growth. Fiscal consolidation planned from 2015 will keep public debt low and create space for countercyclical policy. Monetary policy will aim at price stability through improved inflation targeting and exchange rate flexibility. Risks from quasi-fiscal activities will be contained and improvements in tax administration will be supported. These will complement the authorities' reforms to strengthen the business environment, improve education and training, create jobs and reduce poverty and inequality. **Accordingly, staff supports the authorities' request for a 36-month SBA, and the establishment of performance criteria for end-September and end-December 2014, based on the program set out in their Letter of Intent.**

Figure 1. Georgia: Macroeconomic Developments

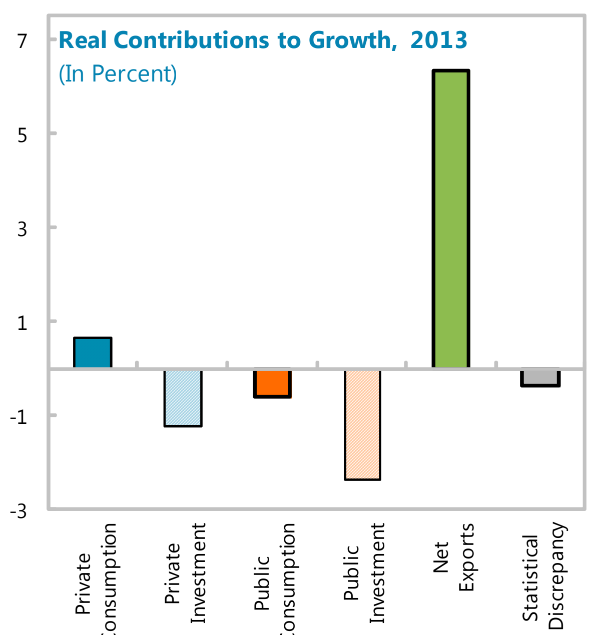
Economic growth in Georgia has moderated in recent years.



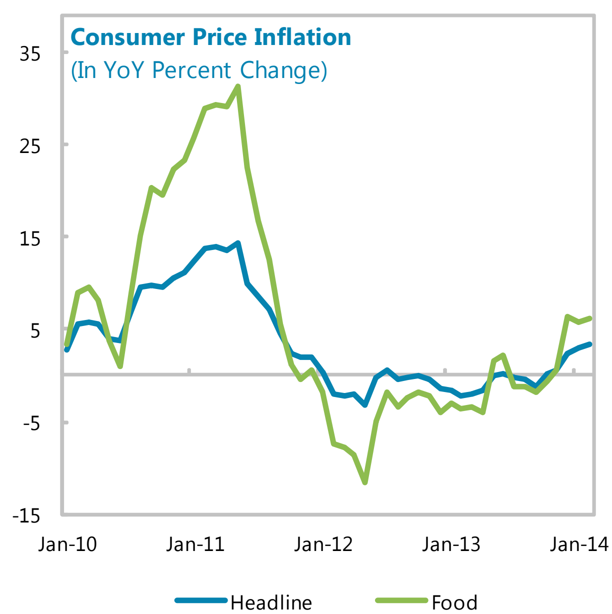
Although slow in the beginning of 2013, the economy accelerated in the second half of the year, …



… led by export growth but constrained by lower investment.

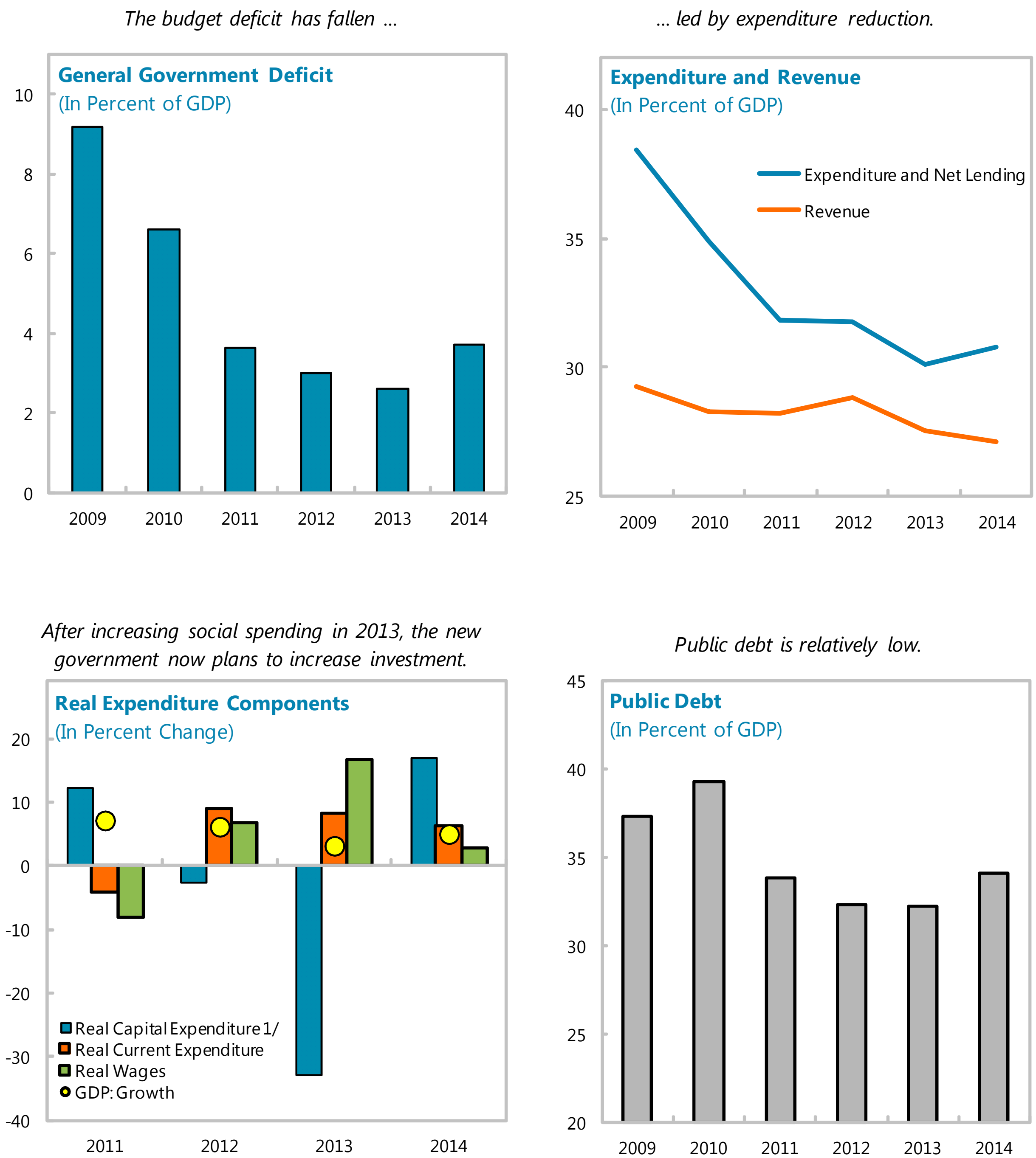


Inflation has fallen sharply, but is on the rise.



Source: National authorities; and IMF staff estimates.

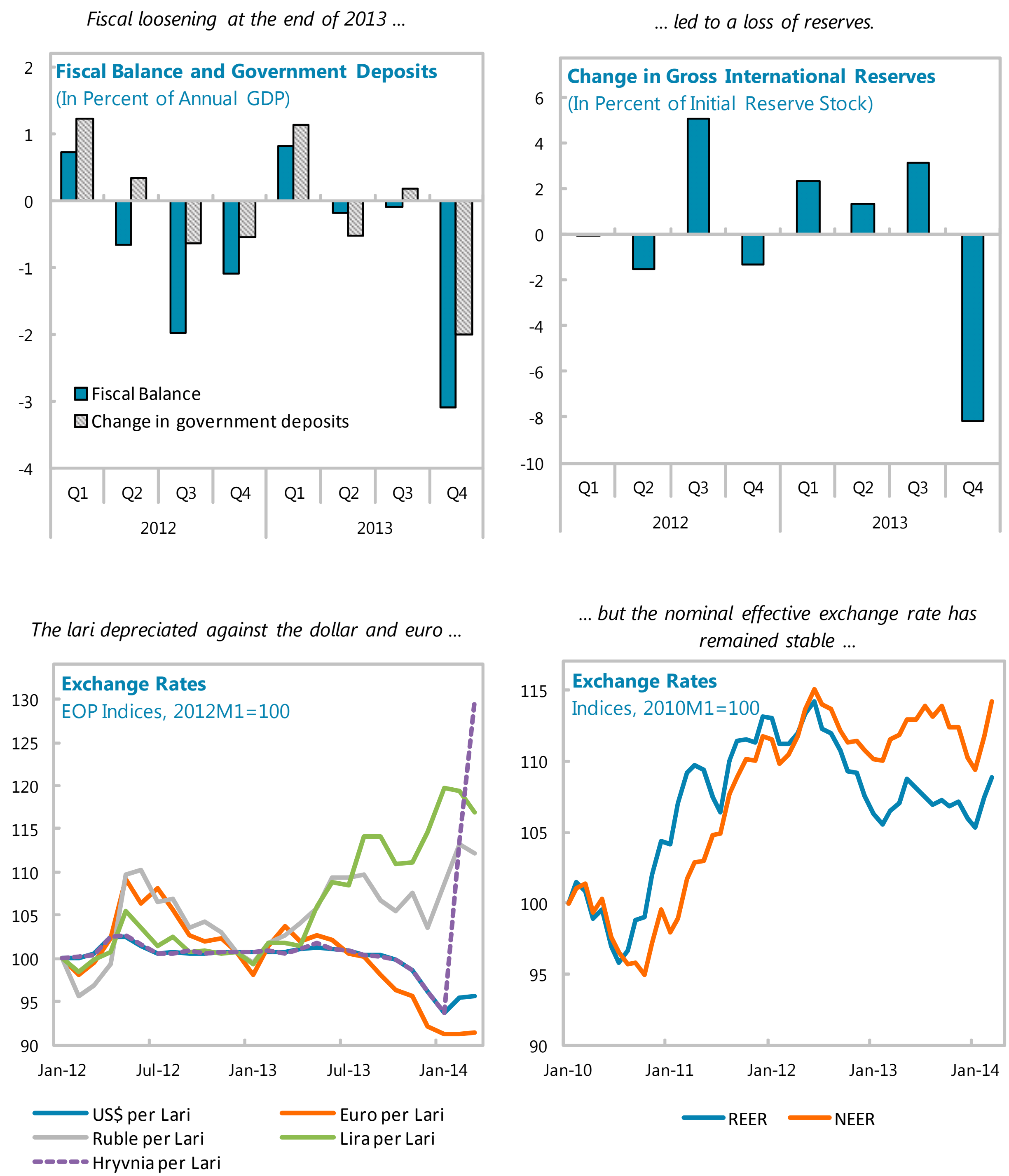
Figure 2. Georgia: Fiscal Developments



1/ Excludes projects financed by grants and loans.

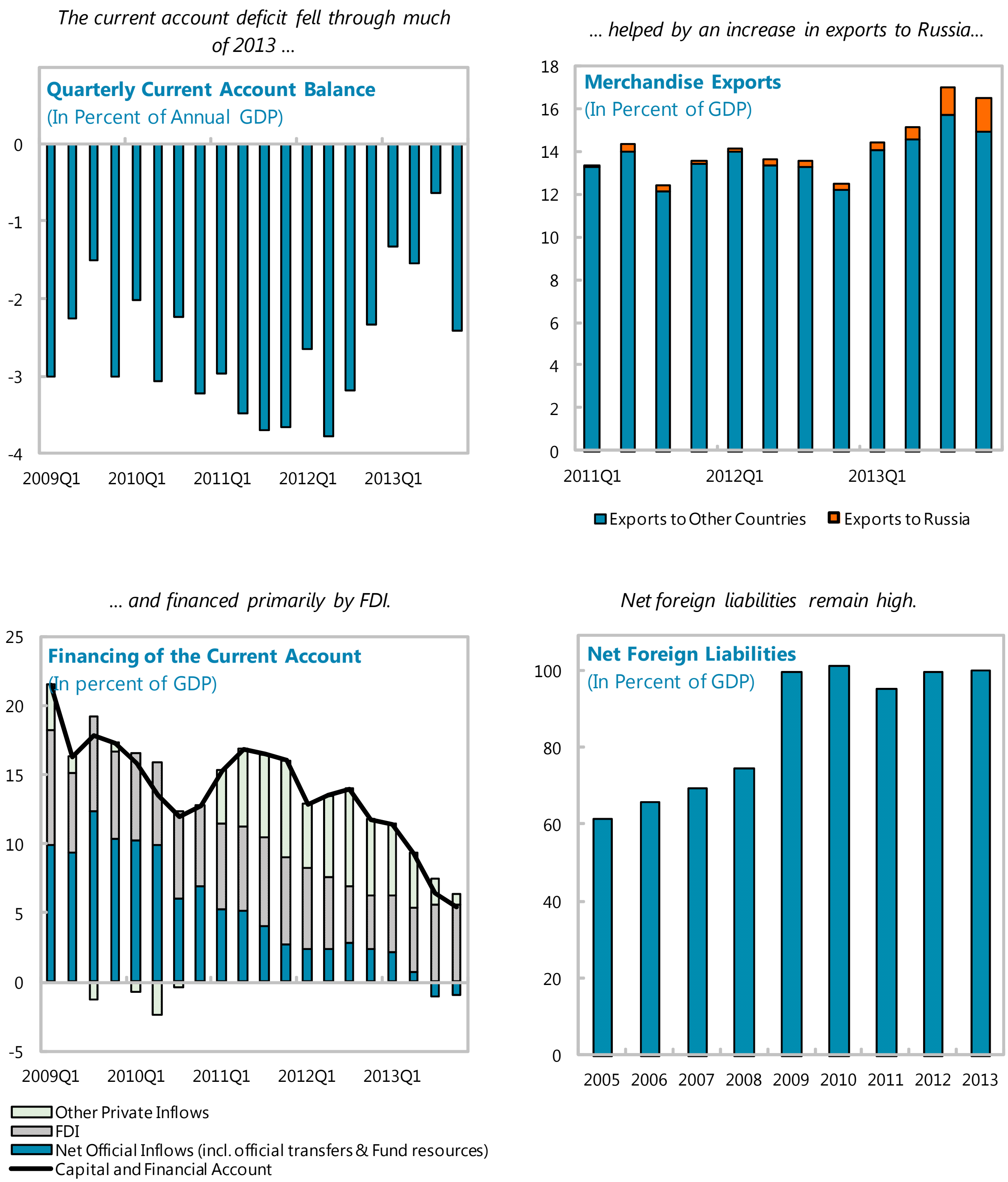
Sources: National authorities; and IMF staff estimates.

Figure 3. Georgia: Reserves and Exchange Rates



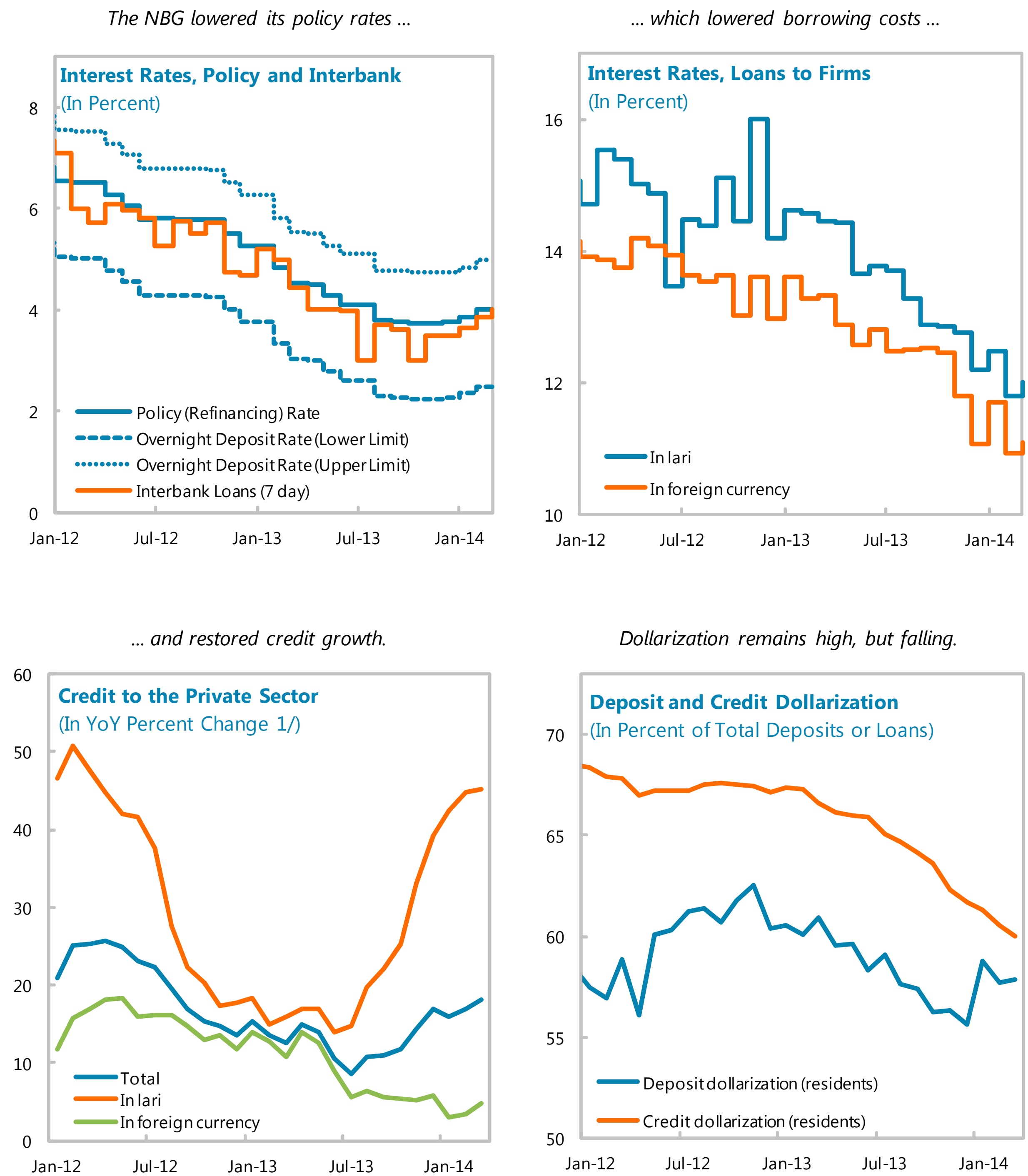
Source: National authorities; and IMF staff calculations.

Figure 4. Georgia: External Sector



Source: National authorities; and IMF staff estimates.

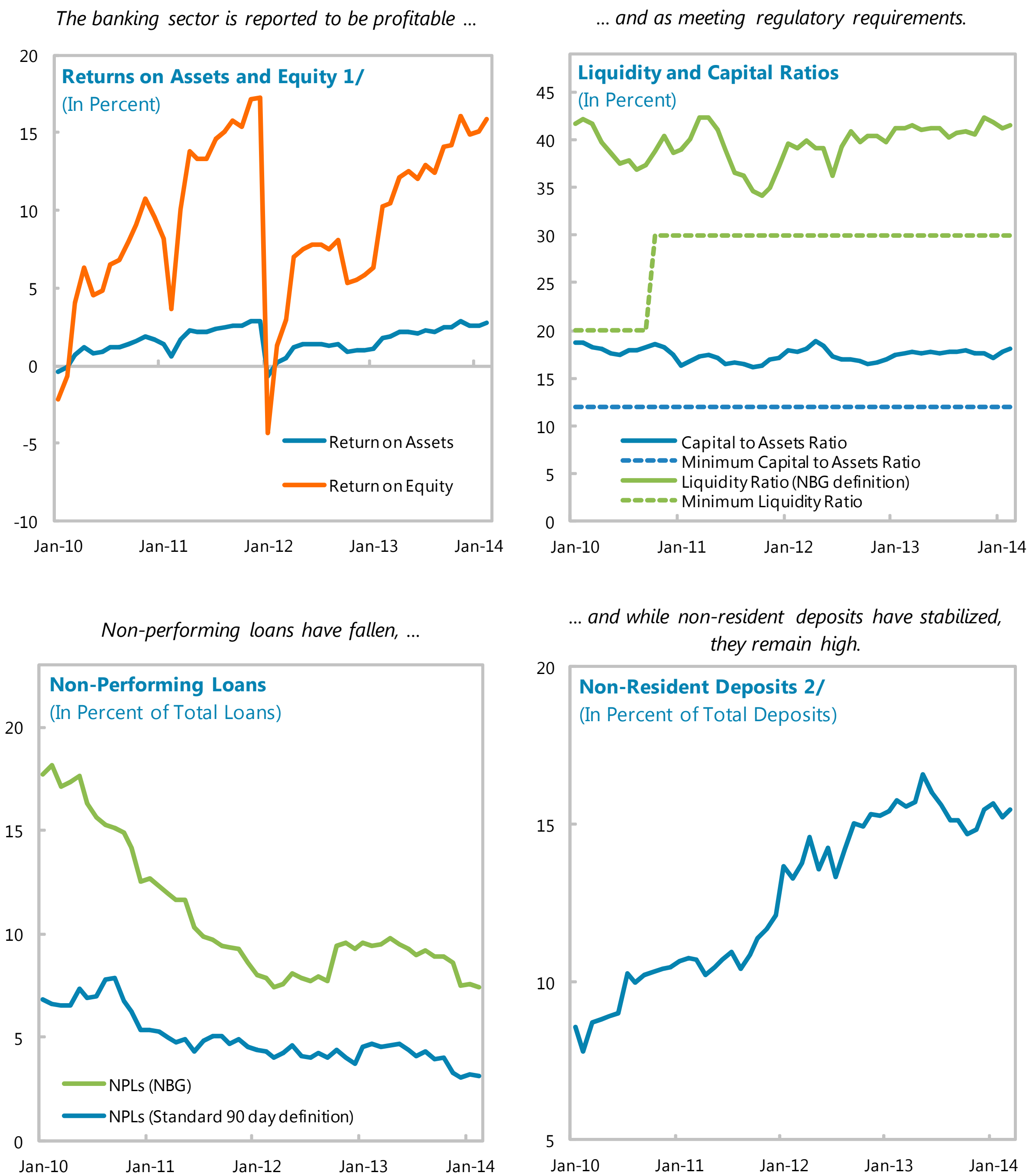
Figure 5. Georgia: Monetary Indicators



Source: National authorities; and IMF staff estimates.

1/ At constant exchange rates.

Figure 6. Georgia: Financial Sector Developments



Source: National authorities; and IMF staff calculations

1/ Cumulative starting from January each year.
2/ Excludes deposits of non-resident banks in Georgian banks.

Table 1. Georgia: Macroeconomic Framework, 2012–19

	Actual		Projections					
	2012	2013	2014	2015	2016	2017	2018	2019
National accounts	(annual percentage change; unless otherwise indicated)							
Real GDP	6.2	3.2	5.0	5.0	5.0	5.0	5.0	5.0
Nominal GDP (in billion of laris)	26.2	26.8	29.2	32.2	35.5	39.1	43.1	47.5
Nominal GDP (in billion of U.S. dollars)	15.8	16.1	16.1	17.5	18.9	20.4	22.1	23.8
GDP per capita (in thousand of U.S. dollars)	3.5	3.6	3.6	3.9	4.2	4.6	4.9	5.3
GDP deflator, period average	1.2	-0.7	3.5	5.0	5.0	5.0	5.0	5.0
Investment and saving	(in percent of GDP)							
Gross national saving	17.3	18.9	17.2	18.3	19.8	20.9	21.6	22.1
Investment	28.9	24.8	25.5	26.2	26.7	27.2	27.2	27.1
Public	7.5	5.1	5.7	6.4	6.4	6.4	6.3	6.3
Private	21.4	19.7	19.8	19.8	20.3	20.8	20.8	20.8
Inflation	(in percent)							
Period average	-0.9	-0.5	4.6	4.9	5.0	5.0	5.0	5.0
End-of-period	-1.4	2.4	5.0	5.0	5.0	5.0	5.0	5.0
Consolidated government operations	(in percent of GDP)							
Revenue 1/	28.8	27.5	27.1	27.1	27.1	27.0	27.0	26.8
o.w. Tax revenue	25.4	24.8	24.7	24.8	24.9	24.9	24.8	24.7
Expenditures	31.8	30.1	30.8	30.1	29.8	29.5	29.5	29.3
Current expenditures	23.1	24.3	24.8	23.3	23.1	22.9	22.8	22.8
Capital spending and net lending	8.7	5.9	6.0	6.8	6.7	6.7	6.6	6.6
Overall balance	-3.0	-2.6	-3.7	-3.0	-2.7	-2.5	-2.5	-2.5
Public debt	30.0	32.2	33.9	33.6	33.1	32.3	31.7	31.1
Of which: foreign-currency denominated	27.6	27.2	27.6	27.5	27.4	26.8	25.9	24.7
Money and credit	(annual percentage change; unless otherwise indicated)							
Credit to the private sector	12.8	19.5	21.6	17.7	15.1	15.1	15.1	15.1
Credit to the private sector (constant exchange rate from 12 month prior)	13.4	16.1	18.7	16.4	13.8	13.8	13.8	13.8
Broad money, incl. fx deposits	11.4	24.4	21.5	18.5	16.0	15.0	15.0	15.0
Broad money, incl. fx deposits (constant exchange rate from 12 month prior)	11.8	21.8	19.2	17.5	15.0	14.0	14.0	14.1
Deposit dollarization (in percent)	66.0	62.1	63.6	61.2	60.0	58.8	56.8	55.2
External sector	(in percent of GDP; unless otherwise indicated)							
Gross international reserves (in billions of US$)	2.9	2.8	2.7	3.0	3.4	3.8	4.3	4.8
In months of next year's imports of goods and services	3.7	3.3	3.0	3.1	3.4	3.5	3.7	3.9
In percent of broad money and non-resident deposits	51.9	42.5	35.5	34.0	34.8	34.0	34.5	34.6
Current account balance (in billions of US$)	-1.9	-1.0	-1.3	-1.4	-1.3	-1.3	-1.2	-1.2
In percent of GDP	-11.7	-5.9	-8.4	-7.9	-6.9	-6.3	-5.6	-5.0
Trade balance	-26.6	-21.7	-25.1	-24.7	-23.9	-23.4	-22.8	-22.2
Foreign direct investment (inflows)	5.8	6.3	6.4	6.5	6.5	6.0	6.0	6.0
Gross external debt	82.2	81.5	84.2	83.1	82.4	80.0	77.6	74.7
Gross external debt, excl. intercompany loans	63.7	62.3	64.0	63.5	63.5	61.8	59.4	56.5
Exchange rates								
Laris per U.S. dollar (period average) 2/	1.65	1.66	1.75	...	...	...	...	...
Laris per euro (period average) 2/	2.12	2.21	2.40	...	...	...	...	...
REER (period average; CPI based, 2005=100)	131.7	125.8	...	...	...	...	...	...

Sources: Georgian authorities; and IMF staff estimates.

1/ Includes grants.

2/ The 2014 value of the Lari/Dollar and the Lari/Euro exchange rate for 2014 is based on the value as of June 30th 2014.

Table 2a. Georgia: General Government Operations, 2012–19

	Act.	Act.	Proj.					
	2012	2013	2014	2015	2016	2017	2018	2019
	(In millions of lari)							
Revenues	7,539	7,386	7,909	8,714	9,639	10,583	11,632	12,753
Taxes	6,644	6,642	7,224	7,967	8,847	9,729	10,711	11,758
Direct taxes	2,880	3,000	3,046	3,404	3,777	4,148	4,557	5,000
Taxes on income	1,765	1,934	1,994	2,236	2,480	2,733	3,012	3,320
Taxes on profits	851	807	795	910	1,014	1,123	1,244	1,371
Other Taxes (incl. property)	264	259	257	258	284	292	301	310
Indirect taxes	3,764	3,642	4,178	4,563	5,070	5,581	6,154	6,757
VAT	3,015	2,831	3,308	3,586	4,022	4,455	4,935	5,439
Excises	660	722	767	855	919	989	1,072	1,161
Custom duties	90	89	103	122	129	137	147	158
Other revenues	618	536	510	500	557	614	677	746
Grants	277	208	175	247	235	240	245	249
Expenditures	8,318	8,087	8,989	9,693	10,599	11,562	12,710	13,941
Current expenditures	6,054	6,515	7,237	7,511	8,209	8,946	9,846	10,826
Compensation of employees	1,203	1,395	1,498	1,570	1,697	1,831	2,018	2,205
Use of goods and services	1,298	1,011	1,079	1,130	1,236	1,358	1,497	1,650
Subsidies and grants	526	562	558	581	630	675	740	811
Social expenses	1,858	2,295	2,811	2,840	3,134	3,446	3,794	4,172
Other expenses	917	1,014	981	1,020	1,116	1,198	1,299	1,408
Interest	254	238	310	370	396	438	498	581
Capital spending and net lending	2,265	1,572	1,753	2,182	2,390	2,615	2,864	3,114
Capital	1,971	1,361	1,657	2,052	2,260	2,485	2,734	2,984
Net lending	293	211	96	130	130	130	130	130
Overall balance	-779	-700	-1,080	-979	-959	-978	-1,078	-1,189
Financing	779	700	1,080	979	959	978	1,078	1,189
Domestic	-95	419	455	207	191	379	656	864
Net T-bill issuance	58	150	600	300	250	400	700	900
Amortization 1/	-44	-50	-48	-48	-55	-58	-60	-62
Use of deposits	-109	320	-97	-45	-4	36	16	27
External	595	155	525	702	718	570	412	324
Borrowing	690	586	1,078	1,057	944	889	846	821
Amortization	-95	-430	-554	-355	-225	-319	-434	-497
Privatization receipts	280	126	100	70	50	30	10	0
Memorandum items:								
Public debt	8,448	8,640	9,953	11,007	12,071	13,194	14,516	15,930
End-year government deposits 2/	846	526	623	668	671	635	619	592
Cyclically adjusted primary balance	-620	-443	-774	-619	-583	-560	-599	-625
Structural primary balance 3/	-982	-376	-817	-734	-676	-655	-697	-725
Fiscal deficit excluding grants	1,056	909	1,256	1,226	1,194	1,218	1,323	1,438

Sources: Ministry of Finance; and IMF staff estimates.

1/ Excluding arrears clearance, provisions and T-bill repayment.

2/ Includes Treasury single account, Revenue reserve account, Local government deposit, and long-term deposits at commercial banks.

3/ Excludes grants and one-offs.

Table 2a. Georgia: General Government Operations, 2012–19, concluded

	Act.	Act.	Proj.					
	2012	2013	2014	2015	2016	2017	2018	2019
Revenues	28.8	27.5	27.1	27.1	27.1	27.0	27.0	26.8
Taxes	25.4	24.8	24.7	24.8	24.9	24.9	24.8	24.7
Direct taxes	11.0	11.2	10.4	10.6	10.6	10.6	10.6	10.5
Taxes on income	6.7	7.2	6.8	6.9	7.0	7.0	7.0	7.0
Taxes on profits	3.3	3.0	2.7	2.8	2.9	2.9	2.9	2.9
Other Taxes (incl. property)	1.0	1.0	0.9	0.8	0.8	0.7	0.7	0.7
Indirect taxes	14.4	13.6	14.3	14.2	14.3	14.3	14.3	14.2
VAT	11.5	10.6	11.3	11.1	11.3	11.4	11.4	11.4
Excises	2.5	2.7	2.6	2.7	2.6	2.5	2.5	2.4
Custom duties	0.3	0.3	0.4	0.4	0.4	0.4	0.3	0.3
Other revenues	2.4	2.0	1.7	1.6	1.6	1.6	1.6	1.6
Grants	1.1	0.8	0.6	0.8	0.7	0.6	0.6	0.5
Expenditures	31.8	30.1	30.8	30.1	29.8	29.5	29.5	29.3
Current expenditures	23.1	24.3	24.8	23.3	23.1	22.9	22.8	22.8
Compensation of employees	4.6	5.2	5.1	4.9	4.8	4.7	4.7	4.6
Use of goods and services	5.0	3.8	3.7	3.5	3.5	3.5	3.5	3.5
Subsidies and grants	2.0	2.1	1.9	1.8	1.8	1.7	1.7	1.7
Social expenses	7.1	8.6	9.6	8.8	8.8	8.8	8.8	8.8
Other expenses	3.5	3.8	3.4	3.2	3.1	3.1	3.0	3.0
Interest	1.0	0.9	1.1	1.2	1.1	1.1	1.2	1.2
Capital spending and net lending	8.7	5.9	6.0	6.8	6.7	6.7	6.6	6.6
Capital	7.5	5.1	5.7	6.4	6.4	6.4	6.3	6.3
Net lending	1.1	0.8	0.3	0.4	0.4	0.3	0.3	0.3
Overall balance	-3.0	-2.6	-3.7	-3.0	-2.7	-2.5	-2.5	-2.5
Financing	3.0	2.6	3.7	3.0	2.7	2.5	2.5	2.5
Domestic	-0.4	1.6	1.6	0.6	0.5	1.0	1.5	1.8
Net T-bill issuance	0.2	0.6	2.1	0.9	0.7	1.0	1.6	1.9
Amortization 1/	-0.2	-0.2	-0.2	-0.1	-0.2	-0.1	-0.1	-0.1
Use of deposits at the NBG and banks	-0.4	1.2	-0.3	-0.1	0.0	0.1	0.0	0.1
External	2.3	0.6	1.8	2.2	2.0	1.5	1.0	0.7
Borrowing	2.6	2.2	3.7	3.3	2.7	2.3	2.0	1.7
Amortization	-0.4	-1.6	-1.9	-1.1	-0.6	-0.8	-1.0	-1.0
Privatization receipts	1.1	0.5	0.3	0.2	0.1	0.1	0.0	0.0
Memorandum items:								
Public debt	30.0	32.2	33.9	33.6	33.1	32.3	31.7	31.1
End-year government deposits 2/	3.2	2.0	2.1	2.1	1.9	1.6	1.4	1.2
Cyclically adjusted primary balance 3/	-2.4	-1.6	-2.7	-1.9	-1.6	-1.4	-1.4	-1.3
Structural primary balance 4/	-3.8	-1.4	-2.8	-2.3	-1.9	-1.7	-1.6	-1.5

Sources: Ministry of Finance; and IMF staff estimates.

1/ Excluding arrears clearance, provisions and T-bill repayment.
2/ Includes Treasury single account, revenue reserve account, Local government deposits, and long-term deposits at commercial banks.
3/ In percent of potential GDP.
4/ In percent of potential GDP, excludes grants and one-offs.

Table 2b. Georgia: Quarterly General Government Expenditures and Balance

	2014				
	Q1 Act.	Q2 Proj.	Q3 Proj.	Q4 Proj.	Year
	(in millions of Lari)				
Total expenditure and net lending	1,800	2,035	2,299	2,856	8,990
Current expenditure	1,658	1,764	1,808	2,007	7,237
Employee compensation	355	380	370	393	1,498
Use of goods and services	222	240	270	347	1,079
Subsidies and grants	136	138	140	144	558
Social expenses	659	690	710	752	2,811
Other expenses	231	235	240	275	981
Interest	53	81	78	98	310
Capital expenditure and net lending	142	271	491	849	1,753
Capital	129	250	450	828	1,657
Net lending	13	21	41	21	96
Overall balance	31	-233	-273	-604	-1,080
Memorandum items:					
Nominal GDP	6,250	7,118	7,490	8,333	29,191

Sources: Ministry of Finance; and Fund staff estimates.

Table 3. Georgia: Summary Balance of Payments, 2012–19

	Act.	Est.	Proj.					
	2012	2013	2014	2015	2016	2017	2018	2019
Current account balance	-1,854	-951	-1,347	-1,380	-1,306	-1,276	-1,240	-1,199
Trade balance	-4,216	-3,492	-4,041	-4,309	-4,512	-4,783	-5,027	-5,295
Exports	3,502	4,246	4,456	4,683	5,050	5,483	5,937	6,420
Imports	-7,718	-7,738	-8,497	-8,992	-9,562	-10,266	-10,965	-11,715
Services	1,101	1,410	1,466	1,647	1,843	2,076	2,240	2,414
Services: credit	2,544	2,970	3,163	3,400	3,648	3,935	4,199	4,479
Services: debit	-1,443	-1,560	-1,697	-1,753	-1,804	-1,859	-1,958	-2,065
Income (net)	-147	-337	-300	-345	-349	-379	-319	-303
Of which: interest payments	-395	-371	-394	-415	-446	-460	-409	-434
Transfers (net)	1,408	1,469	1,528	1,627	1,711	1,810	1,866	1,985
Of which: remittances	712	786	863	922	980	1,045	1,112	1,183
Capital account	134	134	109	107	105	103	101	99
General government	124	129	106	104	102	100	98	96
Financial account	1,979	1,126	1,249	1,619	1,659	1,518	1,714	1,692
Direct investment (net)	614	897	916	1,009	1,099	1,093	1,189	1,294
Monetary authorities, net 1/	1	0	0	0	0	0	0	0
General government	503	108	343	425	383	314	244	180
Portfolio investment (net)	106	-172	-12	0	0	0	0	0
Long-term loans received	396	280	354	423	382	313	243	179
Other, net	1	0	1	1	1	1	1	1
Private Sector, excl. FDI	860	121	-10	186	178	111	281	218
Banks	200	-43	118	177	165	118	122	92
Portfolio investment, net	232	133	6	11	16	11	22	23
Of which: equity liabilities	73	0	6	11	16	21	22	23
Loans received (net)	-88	-131	110	96	54	31	24	-8
Long-term loans	3	-48	109	96	54	31	24	-8
Short-term loans	-91	-83	1	0	0	0	0	0
Other, net (currency and deposits)	56	-45	3	71	95	75	76	77
Assets	-194	-182	-30	1	25	5	6	7
Liabilities (including NRDs)	250	137	33	70	70	70	70	70
of which: NRDs	264	206	33	70	70	70	70	70
Other sectors	659	164	-128	9	13	-7	158	126
Portfolio investment, net	510	2	3	-28	1	-2	0	0
Long-term loans received (net)	205	85	13	7	-3	-12	155	124
Other, net	-56	77	-144	30	15	8	4	2
Errors and omissions	-23	-24	0	0	0	0	0	0
Overall balance	235	285	11	346	458	345	575	592
Financing	-235	-285	-11	-346	-458	-345	-575	-592
Gross International Reserves (-increase)	-38	45	122	-277	-455	-329	-509	-536
Use of Fund Resources	-245	-382	-134	-69	-3	-16	-65	-56
Purchases (SBA)	0	0	123	12	13	6	0	0
Repayments (SBA/SCF)	-245	-382	-257	-81	-15	-22	-65	-56
Exceptional financing	49	52	0	0	0	0	0	0

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

The tables assume Fund disbursements and so reflect a program scenario.
1/ SDR allocation included under monetary authorities' long-term liabilities.

Table 3. Georgia: Summary Balance of Payments, 2012–19, concluded

	Act. 2012	Est. 2013	Proj. 2014	2015	2016	2017	2018	2019
			(in percent of GDP)					
Current account balance	-11.7	-5.9	-8.4	-7.9	-6.9	-6.3	-5.6	-5.0
Trade balance	-26.6	-21.7	-25.1	-24.7	-23.9	-23.4	-22.8	-22.2
Net capital inflows to private sector	9.3	6.3	5.6	6.8	6.8	5.9	6.7	6.3
			(growth rates, in percent)					
Exports of GNFS								
value growth	14.9	19.3	5.6	6.1	7.6	8.3	7.6	7.5
volume growth	15.5	25.0	8.6	7.5	6.6	7.1	6.5	6.3
price change	-0.5	-4.5	-2.8	-1.4	0.9	1.2	1.1	1.1
Imports of GNFS								
value growth	14.4	1.5	9.6	5.4	5.8	6.7	6.6	6.6
volume growth	18.9	3.5	11.1	6.6	6.4	6.4	6.2	6.2
price change	-3.8	-1.9	-1.3	-1.2	-0.6	0.3	0.4	0.4
			(in billions of U.S. dollars, unless otherwise indicated)					
Gross international reserves (end of period)	2.9	2.8	2.7	3.0	3.4	3.8	4.3	4.8
in months of next year GNFS imports	3.7	3.3	3.0	3.1	3.4	3.5	3.7	3.9
in percent of short-term debt at remaining maturity	101	98	102	106	113	122	130	140
in percent of broad money and non-resident deposits	52	43	36	34	35	34	34	35
Reserve cover 1/	55	59	52	56	62	66	73	80
External debt	13.0	13.1	13.6	14.5	15.6	16.3	17.1	17.8
External debt, excluding intercompany loans	10.1	10.0	10.3	11.1	12.0	12.6	13.1	13.5
Public	4.4	4.2	4.5	4.8	5.2	5.5	5.7	5.9
Private	5.7	5.8	5.9	6.3	6.8	7.1	7.4	7.6
Long-term	3.9	3.9	4.0	4.2	4.6	4.8	5.0	5.1
Short-term	1.9	2.0	1.9	2.0	2.2	2.3	2.4	2.4
Intercompany loans	2.9	3.1	3.3	3.4	3.6	3.7	4.0	4.3
			(in percent of GDP)					
External debt	82.2	81.5	84.2	83.1	82.4	80.0	77.6	74.7
External debt, excluding intercompany loans	63.7	62.3	64.0	63.5	63.5	61.8	59.4	56.5
Public	27.5	26.1	27.6	27.5	27.4	26.8	25.9	24.7
Private	36.2	36.2	36.4	36.0	36.1	35.0	33.5	31.8
Long-term	24.5	24.1	24.7	24.3	24.6	23.8	22.8	21.6
Short-term	11.7	12.1	11.8	11.7	11.5	11.2	10.7	10.2
Intercompany loans	18.5	19.2	20.2	19.6	18.9	18.2	18.2	18.2
Memorandum items:								
Nominal GDP (billions of U.S. dollars)	15.8	16.1	16.1	17.5	18.9	20.4	22.1	23.8

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

The tables assume Fund disbursements and so reflect a program scenario.

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

Table 4. Georgia: Monetary Survey, 2012–14

	2012	2013		2014			
	Act.	Jun. Act.	Dec. Act.	Mar. Act.	Jun. Proj.	Sep. Proj.	Dec. Proj.
	(In billions of lari)						
Broad money (M3)	7.9	8.3	9.8	9.5	10.1	10.8	11.9
Lari Broad money (M2)	4.1	4.3	5.4	5.0	5.3	5.8	6.3
Currency held by the public	1.6	1.5	1.9	1.7	1.9	2.1	2.2
Lari resident deposits	2.5	2.9	3.5	3.3	3.4	3.7	4.1
Resident foreign exchange deposits	3.8	4.0	4.4	4.5	4.7	5.1	5.6
Net foreign assets	0.8	0.9	1.0	0.7	0.7	0.8	0.7
NBG	3.7	4.1	4.2	3.9	4.0	4.1	4.2
Commercial banks	-2.9	-3.1	-3.2	-3.2	-3.3	-3.4	-3.6
Of which: liabilities	-4.2	-4.3	-4.8	-4.7	-4.9	-5.0	-5.1
Net domestic assets	7.1	7.4	8.8	8.8	9.4	10.1	11.3
Domestic credit	8.6	9.0	11.0	11.1	11.9	12.6	13.7
Net claims on general government	-0.1	-0.2	0.6	0.5	0.8	0.6	1.1
Of which: government deposits at NBG	-1.0	-1.0	-0.5	-0.6	-0.4	-0.7	-0.3
Of which: T-bills at commercial banks	0.6	0.7	0.8	1.0	1.1	1.2	1.4
Private credit	8.7	9.1	10.4	10.6	11.1	11.9	12.6
Other items, net	-1.5	-1.6	-2.1	-2.3	-2.5	-2.5	-2.5
Sources of funds of commercial banks	10.5	11.1	12.7	12.5	13.0	13.7	14.8
Resident deposits	6.4	6.9	7.9	7.8	8.2	8.7	9.7
Non-resident deposits	1.3	1.5	1.7	1.7	1.6	1.7	1.8
Other foreign liabilities	2.9	2.8	3.1	2.9	3.2	3.3	3.3
Uses of funds of commercial banks	10.5	10.7	12.7	12.6	13.0	13.7	14.8
Reserves	2.8	2.7	3.5	3.3	3.2	2.9	3.2
Lari domestic credit	3.2	3.4	4.5	4.9	5.2	5.7	6.1
Fx domestic credit	5.8	6.0	6.4	6.4	6.6	7.1	7.4
Other foreign assets	0.1	0.2	0.2	0.2	0.2	0.2	0.2
Other items, net	-1.4	-1.5	-1.9	-2.1	-2.1	-2.1	-2.1
	(Percentage change, year on year)						
Broad money (M3)	11.4	15.2	24.4	20.0	20.5	21.3	21.5
Broad money (M3, constant exchange rate from 12 month prior)	11.8	15.0	21.8	17.1	14.7	15.8	19.2
Private credit	12.8	9.6	19.5	21.2	20.8	26.1	21.6
Private credit (constant exchange rate from 12 month prior)	13.4	9.3	16.1	17.5	13.4	19.0	18.7
	(Percent of GDP, unless otherwise indicated)						
Memorandum items:							
Broad money (M3)	30.2	31.7	36.6	35.0	36.1	38.0	40.9
Non-resident deposits (percent of total deposits)	15.3	16.0	15.5	15.5	14.7	14.4	14.0
Private credit	33.2	34.8	38.7	38.9	39.6	41.8	43.3
Nominal GDP (billions of lari)	26.2	26.3	26.8	27.3	27.9	28.5	29.2

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

Table 5. Georgia: Accounts of the National Bank of Georgia, 2012–14

	2012	2013		2014			
	Act.	Jun. Act.	Dec. Act.	Mar. Act.	Jun. Proj.	Sep. Proj.	Dec. Proj.
	(In millions of lari)						
Net foreign exchange position	2,858	3,171	3,183	2,879	2,940	3,060	3,068
Gross International Reserves	4,760	4,922	4,902	4,541	4,657	4,807	4,890
Other foreign assets	1	6	1	1	1	1	1
Foreign currency liabilities	1,902	1,758	1,720	1,664	1,718	1,748	1,823
Of which: use of Fund resources	590	352	199	133	118	91	82
Of which: compulsory reserves in USD	874	887	993	992	1,035	1,090	1,181
Net domestic assets	-548	-1,034	-329	-361	-252	30	188
Net claims on general government	-425	-449	35	-93	81	-181	191
Claims on general government (incl. T-bills)	529	521	523	519	519	519	519
Nontradable govt. debt	521	481	481	441	441	441	441
Securitized debt (marketable)	8	40	43	78	78	78	78
Deposits	954	970	488	612	438	700	328
Claims on rest of economy	1	1	1	1	1	1	1
Claims on banks	-172	-689	-285	-156	-71	473	209
Bank refinancing	391	150	400	420	500	500	500
Certificates of deposits and bonds	-563	-839	-685	-576	-571	-27	-291
Other items, net	48	103	-81	-113	-263	-263	-213
Reserve money	2,310	2,137	2,854	2,518	2,688	3,090	3,256
Currency in circulation	1,918	1,822	2,352	2,115	2,296	2,499	2,657
Bank lari reserves	200	149	206	291	343	367	406
Banks overnight deposits	192	165	297	111	49	224	192
	(Percentage change, year on year)						
Reserve money	8.0	10.3	23.6	25.5	25.8	18.7	14.1
Currency in circulation	9.4	13.5	22.6	21.2	26.0	21.0	13.0
Bank lari reserves	28.9	-41.9	3.1	15.0	129.4	-11.6	97.2
Memorandum items:	(In millions of lari)						
Net international reserves							
(in millions of USD, at prog. exchange rates)[1]			1,555	1,452	1,395	1,510	1,520
Net domestic assets (in millions of lari)[1]			154	-21	250	450	600

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

[1] Program definition

Table 6. Georgia: External Vulnerability Indicators, 2012–19

	Act. 2012	Est. 2013	Proj. 2014	2015	2016	2017	2018	2019
Value of exports of goods and services, percent change	14.9	19.3	5.6	6.1	7.6	8.3	7.6	7.5
Value of imports of goods and services, percent change	14.4	1.5	9.6	5.4	5.8	6.7	6.6	6.6
Terms of trade (deterioration -)	3.4	-2.6	-1.5	-0.2	1.5	0.9	0.7	0.8
Current account balance (percent of GDP)	-11.7	-5.9	-8.4	-7.9	-6.9	-6.3	-5.6	-5.0
Capital and financial account (percent of GDP)	13.3	7.8	8.4	9.9	9.3	7.9	8.3	7.6
External public debt (percent of GDP)	27.5	26.1	27.6	27.5	27.4	26.8	25.9	24.7
(in percent of exports of goods and services)	72.1	58.2	58.4	59.4	59.5	58.2	56.4	54.1
Debt service on external public debt								
(in percent of exports of goods and services)	6.4	7.3	6.0	3.3	2.5	2.8	3.8	3.9
External debt (percent of GDP) 1/	63.7	62.3	64.0	63.5	63.4	61.7	59.3	56.4
(in percent of exports of goods and services)	167.0	139.2	135.5	137.2	137.7	133.6	129.0	123.3
Debt service on MLT external debt								
(in percent of exports of goods and services)	20.2	18.4	17.1	14.3	13.8	13.8	11.8	12.4
Gross international reserves								
in millions of USD	2,873	2,823	2,701	2,979	3,434	3,763	4,272	4,807
in months of next year's imports of goods and services	3.7	3.3	3.0	3.1	3.4	3.5	3.7	3.9
in percent of external debt	28.5	28.1	26.2	26.9	28.7	29.9	32.7	35.8
in percent of short-term external debt (remaining maturity)	101	98	102	106	113	122	130	140

Source: Fund staff estimates and projections.
1/ Excluding intercompany loans.

Table 7. Georgia: Indicators of Fund Credit, 2012–19

	Act. 2012	Act. 2013	Proj. 2014	2015	2016	2017	2018	2019
Existing Fund credit								
Stock 1/	484.1	233.0	66.2	14.0	4.2	0.0	0.0	0.0
ECF 2/	67.2	47.6	29.4	14.0	4.2	0.0	0.0	0.0
SBA	416.9	185.4	36.8	0.0	0.0	0.0	0.0	0.0
Obligations	167.5	255.1	94.3	52.2	9.8	14.2	42.0	36.0
ECF 2/	19.9	19.6	9.8	15.4	9.8	4.2	0.0	0.0
SBA	147.6	235.5	84.5	36.8	0.0	10.0	42.0	36.0
Prospective purchases under the SBA								
Disbursements	...	...	80.0	8.0	8.0	4.0	0.0	0.0
Stock 1/	...	...	80.0	88.0	96.0	90.0	49.0	14.0
Obligations 3/	...	...	1.1	1.1	1.1	11.1	41.8	35.3
Principal (repurchases)	...	...	0.0	0.0	0.0	10.0	41.0	35.0
Interest charges	...	...	1.1	1.1	1.1	1.1	0.8	0.3
Stock of existing and prospective Fund credit 1/	484.1	233.0	146.2	102.0	100.2	90.0	49.0	14.0
In percent of quota	322.1	155.0	97.3	67.9	66.7	59.9	32.6	9.3
In percent of GDP	4.7	2.2	1.4	0.9	0.8	0.7	0.4	0.1
In percent of exports of goods and nonfactor services	12.3	4.9	3.0	2.0	1.8	1.5	0.8	0.2
In percent of gross reserves	25.8	12.5	8.3	5.3	4.6	3.8	1.8	0.5
In percent of public external debt	17.0	8.4	5.1	3.3	3.0	2.6	1.4	0.4
Obligations to the Fund from existing and prospective Fund credit	167.5	255.1	95.4	53.4	10.9	25.3	83.8	71.3
In percent of quota	111.5	169.7	63.5	35.5	7.2	16.8	55.8	47.5
In percent of GDP	1.6	2.4	0.9	0.5	0.1	0.2	0.6	0.5
In percent of exports of goods and nonfactor services	4.2	5.4	1.9	1.0	0.2	0.4	1.3	1.1
In percent of gross reserves	8.9	13.7	5.4	2.8	0.5	1.1	3.1	2.4
In percent of public external debt service	66.7	74.0	32.2	31.5	7.7	15.3	34.7	26.9

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 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.

Table 8. Georgia: External Financing Requirements and Sources, 2012–19

	2012	2013	2014	2015	2016	2017	2018	2019
	(in millions of U.S. dollars)							
Total requirements	-2,706	-1,930	-2,275	-2,140	-2,070	-2,124	-2,066	-2,161
Current account deficit	-1,854	-951	-1,347	-1,380	-1,306	-1,276	-1,240	-1,199
Capital outflows: Repayments of MLT loans	-852	-979	-928	-760	-764	-847	-826	-962
Total sources	2,706	1,930	2,275	2,140	2,070	2,124	2,066	2,161
Capital flows	2,696	1,833	2,030	2,404	2,512	2,446	2,575	2,697
Public sector	674	289	568	627	605	565	532	509
Project grants	124	129	106	104	102	100	98	96
Long-term loan disbursements to public sector	441	333	472	522	502	464	433	412
Other	109	-172	-11	1	1	1	1	1
Private sector	2,022	1,543	1,462	1,777	1,908	1,882	2,043	2,188
Foreign direct investment in Georgia	911	1,010	1,040	1,135	1,227	1,224	1,323	1,430
Long-term loan disbursements to private secto	770	581	675	681	692	707	726	761
Other net inflows 1/	341	-48	-252	-39	-12	-50	-6	-3
Financing	49	52	123	12	13	6	0	0
IMF	0	0	123	12	13	6	0	0
Change in arrears, net (- decrease)	22	0	0	0	0	0	0	0
Debt rescheduling, pre-payment (net)	27	53	0	0	0	0	0	0
Advance Repayments	0	-2	0	0	0	0	0	0
Change in reserves (- increase)	-38	45	122	-277	-455	-329	-509	-536
Financing gap	0	0	0	0	0	0	0	0
Memorandum items	(In percent of GDP)							
Total financing requirements	-17.1	-12.0	-14.1	-12.3	-11.0	-10.4	-9.4	-9.1
Total sources	17.1	12.0	14.1	12.3	11.0	10.4	9.4	9.1
Capital inflows	17.0	11.4	12.6	13.8	13.3	12.0	11.7	11.3
Exceptional financing	0.3	0.3	0.8	0.1	0.1	0.0	0.0	0.0
Change in reserves (- increase)	-0.2	0.3	0.8	-1.6	-2.4	-1.6	-2.3	-2.2

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

1/ Including errors and omissions. The 2014 value includes a projected outflow of non-resident deposits due to the additional liquidity measures introduced by the authorities.

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

Availability Date	Condition	Amount of Purchase (SDR millions)	Amount of Purchase (Percent of quota)
30-Jul-14	Approve the 36-month SBA	40	26.7
15-Nov-14	Complete the first review based on end-September 2014 performance criteria and other relevant performance criteria	40	26.7
15-Feb-15	Complete the second review based on end-Dec 2014 performance criteria and other relevant performance criteria	4	2.7
15-Aug-15	Complete the third review based on end-June 2015 performance criteria and other relevant performance criteria	4	2.7
15-Feb-16	Complete the fourth review based on end-December 2015 performance criteria and other relevant performance criteria	4	2.7
15-Aug-16	Complete the fifth review based on end-June 2016 performance criteria and other relevant performance criteria	4	2.7
15-Feb-17	Complete the sixth review based on end-December 2016 performance criteria and other relevant performance criteria	4	2.7
Total available		100	67

Annex I. Debt Sustainability Analysis

Georgia Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

(in percent of GDP unless otherwise indicated)

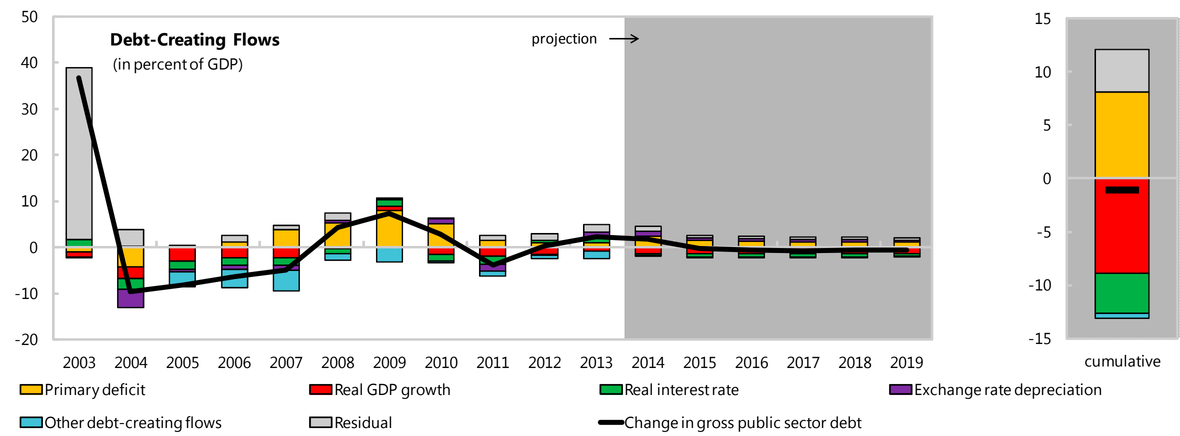
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2003-2011 [2/]	2012	2013	2014	2015	2016	2017	2018	2019
Nominal gross public debt	31.0	30.0	32.2	33.9	33.6	33.1	32.3	31.7	31.1
Public gross financing needs	4.9	2.4	3.8	6.4	5.8	5.5	5.2	5.4	6.2
Real GDP growth (in percent)	6.7	6.2	3.2	5.0	5.0	5.0	5.0	5.0	5.0
Inflation (GDP deflator, in percent)	7.1	1.2	-0.7	3.5	5.0	5.0	5.0	5.0	5.0
Nominal GDP growth (in percent)	14.3	7.5	2.5	8.8	10.3	10.3	10.2	10.2	10.2
Effective interest rate (in percent) [4/]	5.3	3.5	3.0	2.8	3.0	3.0	2.9	2.9	3.0

As of March 21, 2014		
Sovereign Spreads		
EMBIG (bp) 3/		403
5Y CDS (bp)		566
Ratings	Foreign	Local
Moody's	Ba3	Ba3
S&Ps	BB-	BB-
Fitch	BB-	BB-

Contribution to Changes in Public Debt

	Actual			Projections							
	2003-2011	2012	2013	2014	2015	2016	2017	2018	2019	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	2.0	0.2	2.2	1.7	-0.3	-0.6	-0.7	-0.6	-0.6	-1.1	
Identified debt-creating flows	-3.1	-1.1	0.6	0.6	-0.8	-1.1	-1.3	-1.2	-1.1	-5.0	
Primary deficit	2.1	0.9	0.9	2.3	1.5	1.2	1.0	1.0	1.0	8.1	-2.1
Primary (noninterest) revenue and grants	26.2	28.8	27.5	27.1	27.1	27.1	27.0	27.0	26.8	162.1	
Primary (noninterest) expenditure	28.3	29.7	28.5	29.4	28.6	28.4	28.1	28.0	27.8	170.3	
Automatic debt dynamics [5/]	-3.2	-1.3	1.4	-1.7	-2.2	-2.2	-2.2	-2.1	-2.1	-12.6	
Interest rate/growth differential [6/]	-2.6	-1.1	0.1	-1.7	-2.2	-2.2	-2.2	-2.1	-2.1	-12.6	
Of which: real interest rate	-0.9	0.6	1.1	-0.3	-0.7	-0.7	-0.7	-0.7	-0.6	-3.7	
Of which: real GDP growth	-1.6	-1.7	-0.9	-1.5	-1.5	-1.5	-1.5	-1.5	-1.4	-8.9	
Exchange rate depreciation [7/]	-0.7	-0.2	1.2	…	…	…	…	…	…	…	
Other identified debt-creating flows	-2.0	-0.7	-1.7	0.0	-0.1	-0.1	-0.2	-0.1	-0.1	-0.5	
GG: Privatization and Drawdown of deposits (negative)	-2.0	-0.7	-1.7	0.0	-0.1	-0.1	-0.2	-0.1	-0.1	-0.5	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euroarea loans)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	5.1	1.3	1.6	1.2	0.5	0.6	0.6	0.6	0.5	3.9	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = 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).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi (1+g)$ and the real growth contribution as $-g$.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

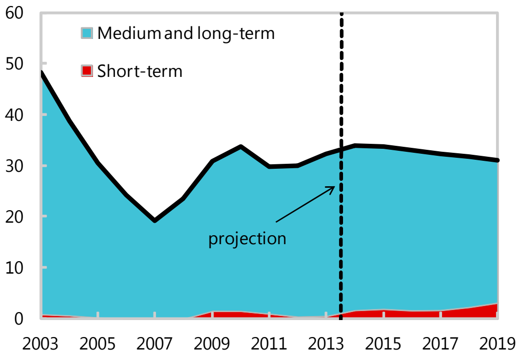
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Georgia Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

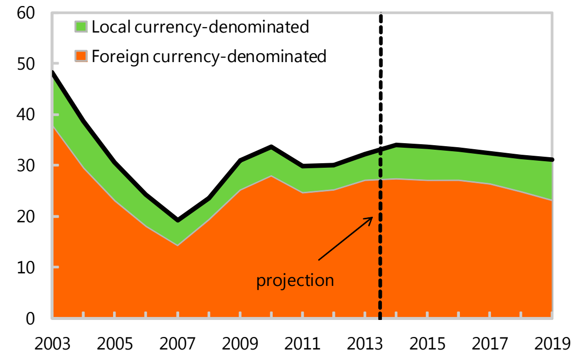
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

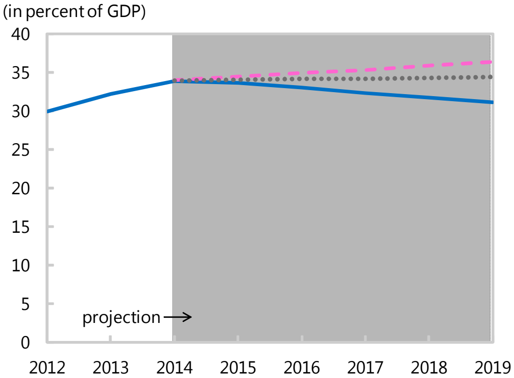


Alternative Scenarios

Baseline   Historical   Constant Primary Balance

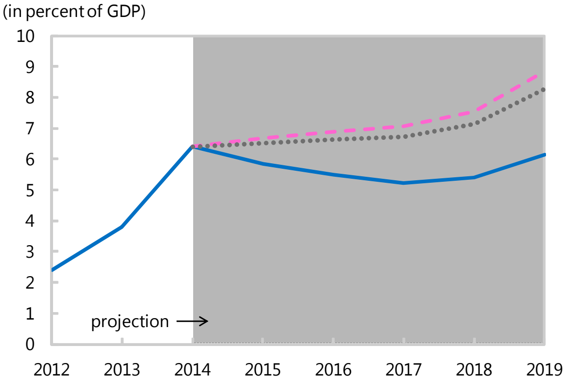
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	5.0	5.0	5.0	5.0	5.0	5.0
Inflation	3.5	5.0	5.0	5.0	5.0	5.0
Primary Balance	-2.3	-1.5	-1.2	-1.0	-1.0	-1.0
Effective interest rate	2.8	3.0	3.0	2.9	2.9	3.0
Constant Primary Balance Scenario						
Real GDP growth	5.0	5.0	5.0	5.0	5.0	5.0
Inflation	3.5	5.0	5.0	5.0	5.0	5.0
Primary Balance	-2.3	-2.3	-2.3	-2.3	-2.3	-2.3
Effective interest rate	2.8	3.0	3.0	2.9	3.0	3.1

Historical Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	5.0	5.9	5.9	5.9	5.9	5.9
Inflation	3.5	5.0	5.0	5.0	5.0	5.0
Primary Balance	-2.3	-2.2	-2.2	-2.2	-2.2	-2.2
Effective interest rate	2.8	3.0	2.9	2.7	2.7	2.8

Source: IMF staff.

Georgia: External Debt Sustainability Framework, 2009-2019
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2009	2010	2011	2012	2013	10-Year Historical Average	10-Year Standard Deviation	2014	2015	2016	2017	2018	2019	Debt-stabilizing non-interest current account 6/
Baseline: External debt	58.8	63.2	59.1	63.7	62.3			**64.0**	**63.5**	**63.5**	**61.8**	**59.4**	**56.5**	**-7.3**
Change in external debt	14.3	4.3	-4.0	4.6	-1.5			1.8	-0.5	-0.1	-1.7	-2.4	-2.9	
Identified external debt-creating flows (4+8+9)	12.6	0.0	-5.7	2.7	-0.8			-0.5	-0.8	-1.9	-2.0	-2.6	-3.1	
Current account deficit, excluding interest payments	7.6	7.5	10.2	8.7	2.9			5.1	4.8	3.8	3.3	3.1	2.5	
Deficit in balance of goods and services	19.1	17.8	19.0	19.7	12.9			16.0	15.2	14.1	13.3	12.6	12.1	
Exports	29.8	34.9	36.5	38.2	44.7			47.3	46.3	46.1	46.2	46.0	45.7	
Imports	48.9	52.7	55.5	57.8	57.7			63.2	61.5	60.2	59.4	58.6	57.8	
Net non-debt creating capital inflows (negative)	-6.3	-5.8	-6.2	-3.7	-5.6			-5.7	-5.8	-5.8	-5.4	-5.4	-5.4	
Automatic debt dynamics 1/	11.3	-1.7	-9.7	-2.2	1.9			0.1	0.1	0.1	0.0	-0.3	-0.2	
Contribution from nominal interest rate	2.9	2.7	2.6	3.0	3.0			3.2	3.1	3.1	3.0	2.6	2.5	
Contribution from real GDP growth	2.0	-3.4	-3.7	-3.3	-2.0			-3.1	-3.0	-3.0	-2.9	-2.8	-2.7	
Contribution from price and exchange rate changes 2/	6.4	-1.0	-8.6	-1.9	0.9			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	1.6	4.3	1.7	1.8	-0.6			2.2	0.3	1.8	0.4	0.2	0.2	
External debt-to-exports ratio (in percent)	197.5	181.1	162.2	167.0	139.2			135.5	137.2	137.8	133.9	129.3	123.6	
Gross external financing need (in billions of US dollars) 4/	2.6	2.5	3.5	4.3	3.8			4.2	4.0	4.1	4.3	4.3	4.5	
in percent of GDP	24.2	21.6	24.0	26.9	23.5			26.2	23.1	21.8	21.1	19.6	18.8	
Scenario with key variables at their historical averages 5/								**64.0**	**61.8**	**60.8**	**58.5**	**56.2**	**54.0**	**-13.9**
Key Macroeconomic Assumptions Underlying Baseline														
Real GDP growth (in percent)	-3.8	6.3	7.2	6.2	3.2	5.9	4.5	5.0	5.0	5.0	5.0	5.0	5.0	
GDP deflator in US dollars (change in percent)	-12.5	1.7	15.7	3.4	-1.4	9.3	11.2	-4.8	3.1	3.0	3.0	3.0	3.0	
Nominal external interest rate (in percent)	5.4	5.0	5.1	5.6	4.8	4.8	1.3	5.2	5.2	5.2	5.0	4.5	4.5	
Growth of exports (US dollar terms, in percent)	-13.0	26.6	29.6	14.9	19.3	19.5	13.0	5.6	6.1	7.6	8.3	7.6	7.5	
Growth of imports (US dollar terms, in percent)	-29.8	16.5	30.5	14.4	1.5	19.4	20.4	9.6	5.4	5.8	6.7	6.6	6.6	
Current account balance, excluding interest payments	-7.6	-7.5	-10.2	-8.7	-2.9	-10.5	5.4	-5.1	-4.8	-3.8	-3.3	-3.1	-2.5	
Net non-debt creating capital inflows	6.3	5.8	6.2	3.7	5.6	8.8	4.3	5.7	5.8	5.8	5.4	5.4	5.4	

1/ 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.

2/ 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 GDP deflator).

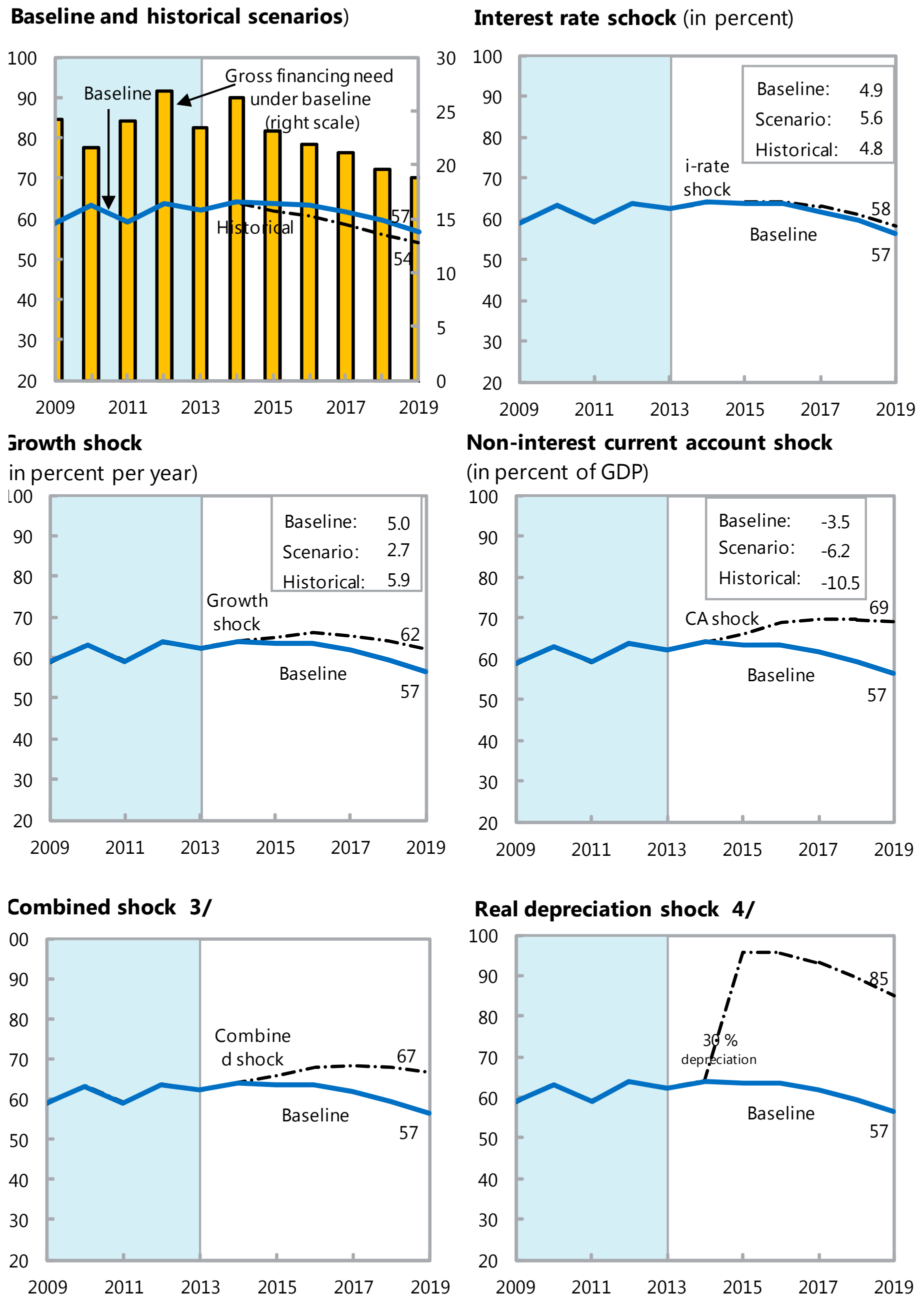
3/ For projection, line includes the impact of price and exchange rate changes.

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

5/ 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.

6/ 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.

Georgia External Debt Sustainability: Bound Tests 1/ 2/
(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/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

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

Appendix I. Letter of Intent

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

Tbilisi, July 15, 2014

Dear Madam Lagarde:

1. **We, the Georgian government and the National Bank of Georgia, are committed to promoting sustainable and inclusive growth, reducing macroeconomic imbalances and strengthening the resilience of our economy**. Our goal is to build a dynamic and efficient economy that supports improvements in the standard of living for the whole population. We have developed our own Socio-Economic Strategy—Georgia 2020—which has detailed policies to promote macroeconomic stability, generate a more effective public administration, strengthen private sector competitiveness, improve access to finance, and strengthen human capital. We are committed to implementing Georgia 2020 so as to achieve our goals.

2. **We are strengthening our economy and building more robust institutions for economic policy making, and are counting on IMF support to help us achieve these goals.** Our government was elected with a mandate to strengthen the protection of the poor and to expand our social safety net. In our first year of office, we kept this promise, while containing the overall level of expenditure and maintaining moderate levels of government debt. External imbalances have been reduced, albeit from a high starting point. We have remained committed to central bank independence and we have established an Economic Council, chaired by the Prime Minister, to improve the coordination of economic policy. The National Bank remains committed to low and stable inflation and to exchange rate flexibility.

3. **Despite these achievements, we are beginning to face new and difficult challenges.** In some of our main trading partners—most prominently Ukraine and Russia—uncertainty is increasing and the economic outlook is deteriorating. Although there are few signs of a domestic slowdown as of now, the outlook for exports, inward investment, and growth has become less predictable, and downside risks have increased due to the external environment. This has put us in a situation where we have to make a trade-off between stabilizing demand in the short run and reducing structural imbalances in the medium-run. While we are forced to accept that there are limits to what we can do in the very near term, we remain firmly committed to low fiscal deficits, a moderate level of public debt and a healthy external account.

4. **Our approach to these challenges will be to take a multi-year perspective, clarify our policies and make public our commitments for the coming years**. In line with this, we will:

- keep the fiscal deficit to 3.7 percent of GDP in 2014, and initiate a medium-term fiscal consolidation with substantial part of the deficit reduction in 2015, primarily based on containing current spending, supported by specific revenue measures;
- control and monitor fiscal risks, including by limiting public guarantees and other contingent liabilities, and improving the disclosure of fiscal risks in the budget;
- continue to modernize our revenue administration, including by phasing out the system of alternative audit, and introducing tax payers' accounts;
- widen the coverage of the Treasury Single Account to include all budget entities and large LEPLs;
- in response to increasing external uncertainties we will further build up fiscal and foreign reserve buffers. The IMF program will be instrumental in providing an efficient response to external shocks;
- remain committed to a floating exchange rate and pursue policies that reduce dollarization;
- strengthen our inflation targeting regime, including by improving inflation modeling and enhancing the NBG's communication strategy;
- improve national accounts statistics by introducing quarterly real national accounts from the demand side, and making business reporting to GEOSTAT compulsory; and
- introduce structural reforms to promote growth and competitiveness.

5. On the basis of these polices, and to signal our continued commitment to macroeconomic stability, we request that the IMF supports this multi-year program under a Stand-By Arrangement (SBA) for a period of 36 months in the amount of SDR 100 million (67 percent of quota). Faced with a deterioration in the external environment, we request that the IMF provides support for our balance of payments need in the amount of SDR 80 million in 2014, to allow us to maintain reserves above 3 months of imports. Of this amount, we request that SDR 40 million is made available upon the approval of the program, another SDR 40 million upon completion of the first review, and that these are provided to the budget to help avoid a draw-down of government deposits that would otherwise put additional pressures on international reserves.

6. While we do not project a significant balance of payments need as of the start of 2015, we recognize that uncertainties remain large and also see intrinsic value in remaining engaged through a Fund-supported program. We expect that the external environment will stabilize, and that we will be able to maintain adequate reserves with only minimal disbursements under the program from 2015 onwards. However, we will continue to monitor the situation carefully, and will discuss with the IMF the appropriate policy response should the external environment worsen and our balance of payments need persist. We also believe that remaining engaged with the IMF strengthens our policies and provides valuable assurances to investors and financial markets in these uncertain times, and so has value in its own right.

7. We believe that the policies set forth in this Letter will achieve the objectives of our economic program. We will monitor progress continuously in consultation with the IMF, and we stand ready to take further measures if needed to reach our objectives. We will continue to consult with the IMF on the adoption of measures, and in advance of any revisions to policies included in this Letter of Intent in accordance with the Fund's policies on such consultation. We will also provide the IMF with information it requests for monitoring program implementation. We authorize the IMF to publish this Letter of Intent and its attachments (including the Technical Memorandum of Understanding (TMU)), as well as the related Staff Report.

A. Macroeconomic Framework

8. The economy has started to recover, and the benefits of this recovery are being shared more widely. Since mid-2013, there have been many encouraging signs of economic recovery: GDP has been growing consistently, inflation has moved more closely in line with the NBG's target, and private sector credit has been growing. In 2013, we increased spending on targeted social assistance from 1 to 1.8 percent of GDP, raised pensions from GEL 110 to 150 per month, and introduced universal health insurance, to make sure that the benefits of economic growth are shared more widely.

9. However, the more difficult external environment poses challenges to our economy. The combination of the slow-down in Russia and the crisis in Ukraine poses risks for the Georgian economy. While it is too early to assess to what extent the economic downturn in these countries will spill over to Georgia, we will continue to monitor developments closely. Should the external environment worsen, we stand ready to respond by revising our policies to preserve our balance of payments, including tightening monetary and fiscal policy, and allowing depreciation to maintain trade competitiveness. We estimate that the potential growth rate of our economy is above 6 percent, but given uncertainties we base policies conservatively by assuming a 5 percent growth rate for 2015.

10. We remain committed to reducing our foreign debt through lowering the current account deficit, but recent developments have made this goal more challenging. Following the sharp recession-induced contraction of the current account deficit in 2013, we projected that it would widen moderately in 2014. Faced by lower export demand and reduced remittances from Russia, we now project that the current account deficit will reach 8.5 percent of GDP in 2014. It will then fall in response to fiscal consolidation, exchange rate flexibility and reforms to improve export competitiveness, which we have committed to as part of the EU-Georgia Association Agreement (including the Deep and Comprehensive Free Trade Area (DCFTA) agreement). Our objective is to stabilize net foreign liabilities at prudent levels. In line with this, we aim for a current account deficit of 6–7 percent of GDP during the program period, and around 5 percent of GDP in the longer term, taking into account the need to maintain rapid growth.

11. The main challenge we face is to mitigate the impact of this worsening external environment while sticking to our medium-term policy objectives. Faced by the threat of lower growth in exports and remittances, and weaker FDI, in the short-term our policies will focus on maintaining trade competitiveness and avoiding a sharp drop in domestic demand. This calls for exchange rate flexibility and allowing the automatic stabilizers to work. However, we will balance these objectives with our aim of strengthening macroeconomic fundamentals by reducing fiscal and external vulnerabilities, and to reduce the underlying budget deficit so as to give more room for countercyclical fiscal policy. The remaining sections of this Letter describe the policies we will implement to overcome this challenge and to achieve our goals.

B. Fiscal Policy

12. For the medium-term, we remain committed to reducing the general government fiscal deficit to a prudent level of no more than 2.5 percent of GDP. This is consistent with our goal of keeping public debt comfortably below 40 percent of GDP, to build room for countercyclical policies, and to increase savings and so reduce our trade deficit. While we are setting ambitious goals for ourselves for improving the welfare of the Georgian people, we also understand the need to preserve fiscal sustainability.

13. In 2014, we will ensure that the general government deficit does not exceed an equivalent of 3.7 percent of GDP. Since approving the budget, uncertainties have increased. To maintain sufficient buffers, we will keep the budget deficit to no more than GEL 1,080 million, which is equivalent to 3.7 percent of GDP (performance criteria December 2014). We will do this by:

- introducing VAT payments on imports at the border, as opposed to granting a one month grace period (GEL 60 million, 0.2 percent of GDP); and

- lowering capital spending (GEL 25 million, 0.1 percent of GDP).

To avoid procyclical policies in the case the recovery should be stronger than our projection, total general government expenditure will not exceed Lari 9,012 million (performance criteria December 2014), consistent with the level set in the initial 2014 budget. While remaining committed to our annual fiscal targets, we recognize the importance of keeping a smooth deficit profile throughout the year as not to put destabilizing pressures on the economy. Our aim is to keep actual quarterly spending close to the schedule agreed with the IMF to avoid a large part of the annual deficit occurring in the final quarter.

14. We will reduce the 2015 general government deficit to no more than 3.0 percent of GDP. To do this, we will take the following measures:

- We will increase the excise on cigarettes to generate GEL 65 million (0.2 percent of GDP) in 2015. We will submit a draft law to parliament in October, and the increase will take effect from January 2015.

- While we remain committed to our agenda of supporting vulnerable groups—evidenced by the overall growth of social expenditure in 2014 of well over 20 percent—in 2015 we will keep social benefits constant in nominal or real terms, depending on the category of benefit. This measure will contain social expenditure at GEL 2,840 million, improving the balance in 2015 by 0.7 percent of GDP compared to 2014.

- We will keep spending on goods and services to no more than 1,130 million, which is consistent with keeping it constant in real terms between 2014 and 2015. This will improve the balance by 0.2 percent of GDP.

- We will keep spending on wages and salaries constant in real terms between 2014 and 2015 at no more than 1,570 million, which will improve the balance by 0.2 percent of GDP.

- We will grant only moderate increases in subsidies and other expenditure categories, which together will improve the balance by close to 0.3 percent of GDP.

- In line with our policy to improve public infrastructure, we are also planning an increase of capital expenditure in 2015 of around GEL 400 (0.7 percent of GDP compared to 2014). There is also a need to allow for a slight increase in interest expenditure of around GEL 60 million (0.2 percent of GDP) and of net lending of around GEL 30 million (0.1 percent of GDP).

Together these measures will reduce the general government deficit to no more than 3.0 percent of GDP in 2015. We will discuss the draft 2015 budget closely with the Fund. Agreement with the Fund on a budget that includes these measures and that targets a 3.0 percent deficit for 2015 will be a structural benchmark for end-December 2014.

We will request follow-up technical assistance from the Fiscal Affairs Department (FAD) on tax policy. A recent FAD mission report has identified several potential measures (e.g. in the areas of mining, thin capitalization, taxation of immovable property and personal income tax) that could mobilize revenue while at the same time enhance equality. In consultation with the IMF, we will explore these areas for their fiscal, economic and social effects, taking into account tax administration challenges. Our objective is to raise more revenue, while improving the efficiency of the tax system and making it more equitable.

15. To keep government debt sustainable, we will seek a more balanced composition between external and domestic debt, and we do not plan to issue any public guarantees. While much of the government's external debt is long-term and concessional from IFIs, we aim to gradually lower the share of foreign currency denominated debt as the share of market-based debt increases. We recognize that public guarantees create contingent liabilities, and currently we do not have any plans to issue guarantees. However, if we were to reconsider these plans, we will consult with the IMF and WB, and we will include such guarantees in our fiscal risk statement attached to the annual budget.

16. We are considering ways to ease the access to finance problem which is an impediment to Georgia's development. Business surveys identify a lack of access to finance and equity, especially among SMEs and start-ups, among the top problems facing businesses. While we are strongly committed to removing market imperfections that impede access to finance (e.g., lack of collateral, enforcement of property rights) and to developing domestic capital markets, these reforms will take time. For that reason, we are considering establishing a financial vehicle that could facilitate private investment and improve access to finance. We are fully aware of the potential risks, and therefore we will ensure that this institution does not distort the markets, does not compete with commercial banks, does not pose undue fiscal risks, operates in line with good transparency and governance practices, and that its objectives have a sound economic foundation. We will conduct an assessment of the access to finance (structural benchmark, September 2014) and will consult with the IMF and other development partners regarding the mandate, policy instruments, structure, as well as operational and financial setting of the institution before introducing legislation for its operations.

17. The Partnership Fund will continue to operate according to its mandate of using minority co-financing to catalyze commercially viable projects with developmental objectives. As under the previous program, Partnership Fund financing (debt plus equity plus guarantees) will not be allowed to exceed 100 percent of the equity of the private partner in the project. The PF will continue to pursue only commercial objectives. In line with the earlier commitments the Partnership Fund will not run a cash deficit (performance criterion, December 2014).

C. Monetary and Financial Sector Policies

18. We remain committed to price stability and exchange rate flexibility. Maintaining monetary and financial stability requires independence of monetary policy-making. Consistent with the NBG's organic law and the Constitution of Georgia, we reaffirm the existing strong institutional and financial independence of the NBG, and also continue to recognize the importance of consistency of policies between the NBG and the government.

19. We will refine our inflation targeting framework by further customizing our modeling to Georgia's conditions and by strengthening our communication strategy. Starting in 2015, the inflation target is reduced from 6 to 5 percent. Monetary policy in 2014 will take into account the transitioning to the new inflation target. We expect inflation to reach 5 percent by the year's end, close to our target. We are keen to further enhance our monetary tools to strengthen the transmission channel. We have requested technical assistance from the IMF to improve inflation modeling and to refine our communication strategy. We are committed to regular publication each quarter of our inflation report, with associated press conferences, on a fixed pre-announced schedule. To signal our commitment to the inflation targeting regime, we are including an inflation consultation clause in the SBA, with central (bi-annual) targets consistent with inflation targets of 5 percent. There will be dual consultation bands around these targets. Should actual inflation be higher or lower than the inner consultation band of +/- 2 percent, the NBG will consult with IMF staff on the reasons for the deviation and the policies to return to target. Should actual inflation be higher or lower than the outer consultation band of +/- 3 percent, a consultation with the IMF Board will be triggered. However, in the transition period to firmly establishing the inflation consultation clause, we will continue to monitor NDA (indicative target).

20. Provided that market conditions allow, we will continue to purchase foreign exchange to boost our net international reserves. Our objective is to maintain reserves comfortably above 3 months of imports. Under the Fund-supported program, we project reserves to remain at around US$2.7 billion at the end of 2014. We will achieve this goal, despite making US$257 million in repayments this year from earlier programs to the IMF. With these repayments rapidly diminishing, and with the current account declining and FDI increasing, we expect to increase reserves to US$3.0 billion in 2015—equivalent to 3.1 months of 2016 imports. To achieve this objective, while remaining consistent with our floating exchange rate regime, the NBG is planning to purchase foreign currency during 2014. However, purchases will only be made to the extent that they do not add to already existing depreciation pressures.

21. We will continue our efforts to reduce dollarization, and will implement policies that encourage the use of the Lari in the financial system. While both loan and deposit dollarization is gradually being reduced, at around 60 percent it is still too high, and there is still scope to increase the use of Lari in the financial system. Our existing policies include additional risk weighting for FX loans to unhedged borrowers, higher reserve requirements for FX liabilities and overall higher negative liquidity carry for FX liabilities. To promote long-term Lari lending, we are placing long-term government deposits with commercial banks.

22. We will continue our policies to strengthen the banking system. We believe that the banking system is relatively robust, with a capital adequacy ratio (NBG definition) for banks at 18 percent (26 percent under Basel I definition). The NPL ratio calculated according to NBG methodology has decreased to 7 percent (3 percent according to the standard 90-day overdue definition). Last year we introduced an additional liquidity requirement for large non-resident deposits and their share has stabilized at 15 percent of total deposits.

23. We appreciate the IMF-World Bank FSAP mission that visited Tbilisi in May 2014. We are discussing how to take into account the mission's assessment and recommendations into the SBA, and will likely include some of the recommendations in future program conditionality.

D. Structural Reforms

24. To achieve our goal of sustainable and inclusive growth, we are planning wide-ranging structural reforms over the coming seven years; we describe many of these in our Georgia 2020 socio-economic development strategy. Our reforms aim at addressing existing impediments to equitable growth in Georgia by promoting private sector competitiveness, strengthening human capital and improving access to finance. We are counting on the support of our development partners in implementing our structural reform agenda, including from the World Bank in the context of the Country Partnership Strategy 2014–17, the Asian Development Bank under the Country Operations Business Plan 2014–16, and the European Commission in the context of the EU-Georgia Association Agreement. We also want to continue working with the IMF to implement reforms in the areas of tax administration, public financial management and national accounts statistics.

25. As part of our Georgia 2020 strategy, we are taking the following steps to reduce poverty and inequality.

- We will improve access to education, update the infrastructure of schools and develop professional education (VET) with the objective of diminishing job mismatch. We will develop vocational education according to labor market needs, aiming at increasing the competitiveness of our workforce; strengthening public private partnership in order to improve the quality of VET system and deliver vocational education training tailored to needs.

- We will continue targeted assistance of municipalities according to their priorities and needs for upgrading infrastructure, including local roads, water supply, and irrigation.

- We will streamline the administration of targeted social assistance and also ensure that the basic package of the current universal health coverage is sustained.

26. As outlined in Georgia 2020, we will strengthen tax administration to improve the quality of taxpayer services and to secure full compliance by taxpayers with their obligations. We intend to enhance our co-operation with the IMF's Fiscal Affairs Department (FAD), and aim to modernize tax administration through the following main steps:

- **We will strengthen our tax audit capacity and increase attention to core filing and payment obligations.** Improving the level and quality of tax audit will lead to increased revenue from current non-compliers, increasing confidence and compliance by honest taxpayers and lowering overall risk in the tax system. Significantly increasing audit resources inside the GRS and phasing out the privatized component of audit (alternative audit)—while still allowing the GRS to procure specialized audit competence in specific cases—will lower risks to the tax system. We plan to increase the GRS audit staffing level significantly (from 230 today to 350 during 2015), paying attention to staff training, and will eliminate alternative audit by April 2015 (structural benchmark).

- **In 2015, we will introduce single tax payers' accounts to better manage the distribution of tax payments between different tax categories and improve the accuracy of tax payment data.** We are working towards reforming the basis for tax payments monitoring, shifting from payments data to the information in tax returns. This development will improve accuracy and facilitate a more rapid and accurate distribution of taxes, including between central and local government taxes. In line with this, we will introduce single tax payers' accounts in the first half of 2015 (structural benchmark June 2015).

- **Finally, we are also committed to reducing the stock of excess tax credits and avoiding the build-up of overdue refunds.** We continue to view timely tax refunds as an important aspect of a good business environment, and we aim at eliminating any overdue refunds. Auditing the firms with overpaid taxes will be performed based on streamlined risk based methodology. We will introduce pre-release, risk-based auditing of refund requests.

27. We believe that comprehensive, accurate and transparent management of public finances is crucial for fiscal stability, and we will continue public financial management reforms. We are committed to developing our framework for assessing and disclosing fiscal risks under various macroeconomic scenarios by including in the 2015 budget a fiscal risk statement, supported by FAD (structural benchmark (December 2014)). We will also continue to broaden the coverage of our fiscal accounts, consolidating LEPLs in the 2014 government financial statements (structural benchmark, June 2015). The fiscal rules limiting the deficit to 3 percent of GDP, gross public debt to 60 percent of GDP and expenditure to 30 percent of GDP is a cornerstone of our fiscal policy framework. We intend to make it more transparent and to increase accountability. We will consult with the IMF on the best practices of fiscal rules.

28. We will improve fiscal transparency and cash management by including more government entities in the treasury system. Starting in 2015, all central and local budget units will be executed by the Treasury, and all their cash inflows and outflows will be integrated into the Treasury Single Account.

29. We are committed to strengthening our statistics, in part because these are a precondition for strong economic policy-making, and we will increase resources to GEOSTAT to do this. To improve the quality and coverage of statistics, we will revise the Law on Statistics by December 2014 to make it mandatory for businesses to report to GEOSTAT, and ensure appropriate application of sanctions for nonreporting, in line with IMF and United Nations recommendations. So as to improve our understanding of the labor market and the condition of workers, and to make this more timely, we will provide new resources so that GEOSTAT will be able to publish quarterly labor force statistics (including rural-urban and regional unemployment rates). This will bring us into line with international standards. Building on technical assistance from the IMF's Statistics Department (STA), we aim to publish GDP by expenditure in constant prices (structural benchmark, December 2015).

30. Parliament recently passed a law placing Georgia's Financial Monitoring Service (FMS) under the Prime Minister. We remain committed to preserving the strong operational independence of the FMS and protecting the confidentiality and integrity of banking data to which the FMS has privileged access, including not sharing records with other government entities. The Government will request a consultation with MONEYVAL and the Egmont Group. If need be, we will submit an amended law to Parliament to reflect the recommendations of MONEYVAL and the Egmont Groups together with the IMF's comments. The FMS will continue to honor its bilateral obligations with financial monitoring units in other countries. The Government will continue to strictly enforce AML/CFT regulations and will widen AML/CFT oversight of new activities, such as gambling and leasing.

31. To support sustainable growth and to improve the trade balance, we are launching a wide range of structural reforms:

- Our government will take a unified approach to the support it provides underdeveloped sectors of the economy. To this end, we will work with the World Bank to review the performance of the largest funds and to prepare an action plan for their future operation, including possible consolidation, by September 2014.

- We are taking steps to further streamline the business environment, with a focus on small and medium-sized enterprises (SMEs). With this objective, we have recently established the Entrepreneurship Development Agency (EDA), which will start full-scale operations in the second half of 2014. EDA will, among other things, provide training to entrepreneurs and start-ups, and support export promotion and SMEs' adaptation to DCFTA requirements. By the end of 2015, we will elaborate an SME development strategy.

- In line with our commitments under the EU-Georgia DCFTA, we are strengthening the legislative and institutional framework in the food safety area. We amended the Code on Food/Feed Safety, Veterinary and Plant Protection, and we are continuing to strengthen the National Food Agency. Also, by the end of 2015, we will elaborate a list of EU sanitary and phytosanitary, animal welfare and other legislative measures to be approximated by Georgia under the EU-Georgia DCFTA.

- According to the EU-Georgia DCFTA, we will continue the development of a national system of quality infrastructure. In order to bring the Georgian national market surveillance system in line with best practice in the EU, we will elaborate a market surveillance action plan in accordance to relevant gap analysis and needs assessment by the end of 2015. The gap analysis and needs assessment will be carried out during 2015.

- In order to improve labor market matching we will streamline communication systems between employers and jobseekers through online web-portals, where the registration of jobseekers is free. By the end of 2014, the module of the employer's registration will be added to the web-portal. In addition, in 2014 a System of Labour Mediation will be formed, which will support the effective resolution of labor disputes.

E. Program Monitoring and Safeguards

32. We recognize the importance of completing an updated safeguards assessment of the NBG by the first review under the SBA arrangement. We are approving a memorandum of understanding between the Ministry of Finance and the NBG to clarify responsibilities related to the financial obligations associated with IMF resources for budget support.

33. Our program will be monitored through quantitative performance criteria (PC), indicative targets (IT), structural benchmarks (SB), and an inflation consultation clause set out in Tables 1 and 2 and described in the attached Technical Memorandum of

Understanding (TMU). We ask that reviews are conducted based on end-September and end-December 2014 test dates and semi-annually thereafter based on end-June and end-December test dates. The first and second reviews will be expected to take place after November 15, 2014 and February 15, 2015, respectively.

Very truly yours,

/s/
Irakli Garibashvili
Prime Minister of Georgia

/s/
Giorgi Kvirikashvili
Deputy 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: Inflation Consultation Targets and Bands for 2014

	End September	End December
Inflation Consultation Bands for CPI (in percent)		
Central point	5	5
Inner band, upper limit/lower limit	7/3	7/3
Outer band, upper limit/lower limit	8/2	8/2

Table 2. Georgia: Quantitative Performance Criteria and Indicative Targets for 2014

	End September	End December
Performance Criteria		
Ceiling on the General Government cash deficit (in mn lari)	810	1,080
In Percent of GDP	*2.8*	*3.7*
Ceiling on Expenditures of the General Government	-	9,012
Floor on NIR of NBG (End-period stock, in mn USD)	1,510	1,520
Ceiling on the accumulation of external arrears of the General Government (continuous criterion) (in mn USD)	0	0
Ceiling on the cash deficit of the Partnership Fund (in mn lari)	0	0
Indicative Targets		
Ceiling on NDA of NBG (End-period stock, in mnl lari)	450	600

Table 3. Georgia: Proposed Structural Benchmarks

Measure	Date
Financial Sector	
With the support of the World Bank, conduct a thorough assessment of the presence, nature and remedies for credit market imperfections	End-Sep 2014
Fiscal	
Include in the 2015 state budget a statement of fiscal risks	End-Dec 2014
Approve the budget for 2015 with 3 percent of GDP deficit	End-Dec 2014
Abolish the alternative tax audit program	End-April 2015
Introduce a single taxpayer account system in the General Revenue Service	End-June 2015
Consolidate LEPLs[1] in the 2014 government financial statements	End-June 2015
Statistics	
Publish GDP by expenditure in constant prices	End-Dec 2015

[1]LEPL: Legal Entities of Public Law. They are semi-autonomous government agencies receiving partial financing from the budget.

Attachment I. Technical Memorandum of Understanding (TMU)

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 used to monitor developments under the Stand-By Arrangement. To this effect, the authorities will provide the necessary data to the IMF as soon as it becomes available.

2. Inflation consultation targets and bands, performance criteria and indicative targets are listed in Tables 1 and 2 attached to the Letter of Intent dated July 15, 2014. The Georgian Lari to U.S. Dollar exchange rate is assumed to be GEL 1.75 = $1 for the purpose of the program. Table 1 below includes the corresponding cross exchange rates.

Table 1. Program Exchange Rates

	Currency Name	**Currency/US$**
SDR	Special Drawing Rights	0.65
GEL	Georgian Lari	1.75
EUR	Euro	0.73

A. General government and the public sector

3. **Definition:** The general government is defined as the central government and local governments, excluding Legal Entities of Public Law. The definition of the general government includes any new funds, or other special budgetary or extra-budgetary entities that may be created during the program period to carry out operations of a fiscal nature as defined in the IMF's Manual on Government Finance Statistics 2001. The authorities will inform IMF staff on the creation of any such entities without delay. The general government does not include State-Owned Enterprises and the Partnership Fund. The public sector consists of the general government, Legal Entities of Public Law and public financial and non-financial corporations, including the National Bank of Georgia.

4. **Supporting material:** The Treasury Department of the Ministry of Finance will provide to the IMF detailed information on monthly revenues of the general government within two weeks of the end of each month and monthly expenditures and arrears of the central government within four weeks of the end of each month. The Ministry of Finance will provide the stock of general government debt, broken down by currency and original maturity within one month from the end of each quarter. The Treasury will provide, on a daily basis, the cash balances in all the accounts of the general government as of the end of the previous business day.

B. Quantitative performance criteria, indicative targets and continuous performance criteria: definitions and reporting standards

Quantitative Performance Criteria and Indicative Targets

5. The quantitative performance criteria and indicative targets specified in Tables 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 (floor) on the net international reserves (NIR) of the NBG;
- a continuous performance criterion (zero ceiling) on the accumulation of external arrears;
- a performance criterion (ceiling) on the cash deficit of the Partnership Fund; and
- an indicative target (ceiling) on the net domestic assets (NDA) of the NBG; and

6. Performance criteria and indicative targets have been set for end-September and end-December 2014 (the next two test dates). They 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.

Inflation Consultation Mechanism

7. Inflation consultation bands around a central target are set for each test date under the program, and for quarterly dates in between to help assess program performance, see table 1 attached to the Letter of Intent. Inflation is identified as the 12-month percentage change of the consumer price index (CPI) as measured and published by the National Statistics Office of Georgia (Geostat). Should the observed year-on-year rate of CPI inflation fall outside the outer bands specified in Table 2 below on any one of the program's test dates, the authorities will consult with the IMF's Executive Board on the reasons for the deviation and the proposed policy response before further purchases can be requested under the SBA. The NBG will discuss with IMF staff should the observed year-on-year rate of CPI inflation fall outside of the inner bands specified for each test date in Table 2.

Table 2. Inflation Consultation Target and Bands		
	September 30, 2014	December 31, 2014
Inflation target	5.0	5.0
Inner band	±2.0	±2.0
Outer band	±3.0	±3.0

Ceiling on the Cash Deficit of the General Government

8. Definition: The cash deficit of the general government will be measured from the financing side at current exchange rates. Accordingly, the cash deficit is defined as the sum of: i) net domestic financing from banks and nonbanks; ii) net external financing; and iii) privatization receipts.

9. Net domestic bank and nonbank financing is defined as:

a. Net lending (borrowing net of repayments) provided by commercial banks to the general government, including securities (for example T-Bills), plus the use of deposits held by the general government in commercial banks. Monitoring of net lending and the use of government deposits will be based on the NBG's monetary survey and Treasury data. The change in local governments' cash balances in commercial banks for budget financing purposes will be monitored based on the 'budget of territorial unit' account data provided by the Treasury Department.

b. Net lending (borrowing net of repayments) provided by the NBG to the general government, including securities (for example T-Bills), plus the use of deposits of the general government held at the NBG. Monitoring of net lending and use of government deposits will be based on the central bank survey and treasury data. The change in cash balances of the general government at the NBG for budget financing purposes will be monitored based on the 'State Budget's Treasury Single Account (TSA)', 'Revenue Reserve Account' data provided by the Treasury Department and 'Accounts of Territorial Units' provided by the Treasury Department. From 2015, the balance of local government accounts will be monitored using the NBG's monetary survey.

c. 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.

10. 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.

11. Privatization receipts consist of all proceeds to 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 or longer.

12. Supporting Material:

a. Data on domestic bank and nonbank financing will be provided to the IMF by the NBG and the Treasury Department of the Ministry of Finance within four weeks after the end of each month.

b. Data on external project financing as well as other external borrowing will be provided to the IMF monthly by the Ministry of Finance (specifying projects by creditor) within two weeks of the end of each month.

c. Data will be provided at actual exchange rates.

d. Data on privatization receipts of the general government will be provided by the Treasury Department of the Ministry of Finance to the IMF on a monthly basis within two weeks of the end of each month.

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

Ceiling on the Expenditures of the General Government

13. Definition: Expenditures of the general government comprise all current and capital expenditures as well as net lending according to GFSM 1986: i) current expenditures comprise compensation of employees, purchase of goods and services, subsidies, grants, social expenditures, other expenditures, other accounts payables, and domestic and external interest payments; ii) capital expenditure includes projects financed by foreign loans and grants as well as domestically financed capital expenditure; and iii) net lending is defined as lending minus repayments to the general government.

14. 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 expenditure of the general government should be reported to the IMF within four weeks after the end of the quarter.

Ceiling on the Cash Deficit of the Partnership Fund

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

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

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

18. Supporting Material: The Ministry of Finance will provide to the IMF detailed information on the Partnership Fund's quarterly revenue, expenditure and financial operations within four weeks of the end of each quarter.

Floor on the Net International Reserves of the NBG

19. Definition: Net international reserves (NIR) of the NBG in U.S. dollars are defined as foreign assets of the NBG minus the sum of foreign liabilities of the NBG, including all of Georgia's liabilities to the IMF. Foreign assets of the NBG include gold, gross foreign exchange reserves, Georgia's SDR holdings, and the reserve position in the IMF. Gross foreign exchange reserves of the NBG are defined as liquid, convertible currency claims of the NBG on nonresidents, including cash holdings of foreign exchange that are readily available. Pledged or otherwise encumbered assets, including (but not limited to) assets used as collateral (or guarantee for third party external liabilities) are excluded from foreign assets. Foreign liabilities of the NBG shall be defined as the sum of Georgia's outstanding liabilities to the IMF (at face value), Georgia's SDR allocation, and any other liabilities of the NBG (including foreign currency deposits of financial institutions at the NBG and currency swaps and foreign exchange forward contracts with financial institutions), excluding the foreign exchange balances in the government's account with the NBG. For program monitoring purposes, the stock of foreign assets and foreign liabilities of the NBG shall be valued at program exchange rates as described in paragraph 2 above. The stock of NIR amounted to US$1,452 million as of March 31, 2014 (at program exchange rates).

20. Adjustors: The floor of 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 payment support grants relative to the projected amounts presented in Table 3.

- 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 3.

Table 3. Projected Balance of Payment Support Financing[1]

(in millions of U.S. dollars)

	Balance of payments support loans and grants	Project loans and grants
September 30, 2014	106.6	119.5
December 31, 2014	164.3	180.5

[1] Cumulative from the beginning of the calendar year.

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

Ceiling on Net Domestic Assets of the NBG

22. Definition: Net domestic assets (NDA) of the NBG are defined as the difference between reserve money and NIR as defined above in paragraph 19. Therefore, the ceiling on NDA is defined as projected reserve money minus the target NIR. Thus defined, the stock of NDA amounted to GEL -21 million on March 31, 2014.

23. 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 3.

- Upward/downward by 50 percent for any shortfall/excess in the disbursement of the project loans and project grants to the treasury single account at the NBG relative to the projected amounts presented in Table 3.

24. Supporting material: The NBG will provide to the IMF its balance sheet, which includes data on reserve money and net domestic assets on a daily basis. Data will be provided using both actual and program exchange rates.

Continuous Performance Criterion on Accumulation of General Government External Arrears

25. Definition: External debt is defined as set forth in point No. 9 of the Executive Board Decision No. 6230-(97/140), as revised on August 31, 2009 (Decision No. 14416-(09/91).[1] External debt is defined as debt contracted by the general government with nonresidents other than the IMF.

26. Definition: External arrears are defined as unpaid external debt service by the general government to official and private creditors beyond 30 days after the due date.

27. Supporting Material. Details of external 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 agreement 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. Debt 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 payments under a contractual obligation that constitutes the debt are debt. Failure to make payments on an obligation that is not considered debt under this definition (e.g. payment on delivery) will not give rise to debt."

Appendix to the TMU: The Partnership Fund

Organization and operational structure

A. Legal Structure

The Partnership Fund (PF) is incorporated as a Joint Stock Company (JSC). Under civil law, JSCs are profit maximizing entities, organized with value creation as their main objective.

B. Corporate Governance

The PF is organized as a commercial financial institution. Its governance structure includes:

- An investment board, currently composed of internal members (CEO, CIO, portfolio officers) and can add external members (like experts and private sector representatives), which approves business cases and initiates projects;
- A risk management committee, composed of internal members (CFO, Chief Legal Officer, and Chief Accountant), which advises on project risks to be reflected in project implementation agreements;
- A supervisory board (i.e. board of directors), which approves projects (based on the feasibility studies, risk assessments, and business cases presented by the investment board and risk committee) and approves budget for project development needs. The supervisory board includes members of the government and is chaired by the Prime Minister; and
- In cases of equity participation in projects, the PF needs government approval.

Corporate mandate and portfolio management

C. Corporate Mandate

The corporate mandate of the PF is approved by the supervisory board and the government. The PF will provide project financing through equity participations, senior loan, quasi-equity through subordinated convertible debt, and performance bonds/guarantees. Investments will focus on the following sectors: energy, agriculture, manufacturing, and real estate. Under its corporate mandate, the PF is not allowed to provide financing to the service industry. The PF will charge market rates for services provided.

D. Portfolio Management Strategy

The PF's portfolio management strategy has been developed. It sets portfolio limits, performance management objectives, and project evaluation guidelines, and will be based on the following principles:

- The PF will participate only in commercially viable projects; and
- The PF's performance will be monitored on the basis of the following evaluation criteria: IRR, APV, sharp ratio, and risk adjusted return.

E. Project Development Methodology

The PF will only participate in projects in which a corporate investor, with sufficient experience in industry, expresses its willingness to take an equity participation that represents at least 51 percent of the project's total equity. PF financing (debt plus equity plus guarantees) will not be allowed to exceed 100 percent of the equity of the private partner in the project. The PF will pursue only commercial objectives.

Reporting and Auditing

The PF will engage an internationally recognized auditing company to conduct semi-annual IFRS audits of its financial statements.

The PF will hire on a permanent basis the services of rating agencies, which will prepare regular ratings reports—there will no minimum rating requirement for the PF.

The PF's audited financial statements, as well as the ratings reports will be available on permanent basis to a broad audience.

Fiscal risks associated with the PF will be limited since:

- The PF projects don't create any kind of contingent liability for the sovereign balance sheet, as the government as no legal obligation to bail out the PF, should it become illiquid or insolvent;
- All liabilities of the PF are limited to its own balance sheet;
- The PF has its own revenue sources, namely: the dividends from its investments, the interest earnings from the loans its provides, the fees it charges on the guarantees it provides, and the proceeds of asset sales; and
- The PF may decide to borrow from credible financial institution with recourse to its balance sheet facility and without state guarantee.

INTERNATIONAL MONETARY FUND

GEORGIA

July 15, 2014

REQUEST FOR A STAND-BY ARRANGEMENT—INFORMATIONAL ANNEX

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

CONTENTS

RELATIONS WITH THE FUND

(As of May 13, 2014)

Membership Status

Date of membership: May 5, 1992, Article VIII.

General Resources Account

	SDR Million	Percent of Quota
Quota	150.30	100.00
Fund Holdings of Currency	271.59	180.70
Reserve Tranche Position	0.01	0.01

SDR Department

	SDR Million	Percent Allocation
Net Cumulative Allocation	143.96	100.00
Holdings	144.09	100.09

Outstanding Purchases and Loans

	SDR Million	Percent of Quota
Stand-By Arrangements	121.29	80.70
ECF Arrangements	39.20	26.08

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				
	2014	2015	2016	2017	2018
Principal	94.26	52.23	9.80	4.20	
Charges/Interest	0.51	0.23	0.02	0.00	0.00
Total	**94.78**	**52.46**	**9.82**	**4.20**	**0.00**

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. A new safeguards assessment will be completed before the first review of the program.

Implementation of Multilateral Debt Relief Initiative (MDRI)

Not applicable.

Implementation of HIPC Initiative

Not applicable.

Exchange Arrangements

The de jure exchange rate arrangement of Georgia is floating. In line with the official policy, the NBG has remained committed to improving the functioning of the foreign exchange market and enhancing exchange rate flexibility since the introduction in March 2009 of multiple-price foreign exchange auctions. While the NBG intervenes in the foreign exchange market through the FX auctions, the NBG does not make any explicit or implicit commitment with respect to an exchange rate target or path. In the first half of 2012, the FX purchase auctions were moderate, with a cumulative volume of US$75 million. However, since July 2012, the NBG has intensified the FX auctions both in volume and frequency and has been active on both sides of the market, with total purchases of US$740 million and total sales of US$505 million through February 2014.

FX purchase auctions have been directed toward rebuilding foreign exchange reserves; an objective of the authorities' economic program that is supported by the IMF SBA/SCF arrangement. The large sales of reserves which took place towards the end of 2013 instead had the goal of limiting the depreciation of the lari. With respect to intervention data, the volume sold at the NBG's FX auctions and the average exchange rates are posted on the NBG website immediately after each auction. Although FX interventions account for a small portion of annual foreign exchange market turnover, the size of these interventions on any given day is substantial. Between July 2012 and mid October 2013, the lari remained stable against the U.S. dollar in a 2 percent band. During that period market supply and demand played a role in determining the exchange rate, as does official action based on the observed path of the exchange rate and the discretionary nature of the FX auctions. Therefore, as of end-April 2013, the de facto exchange rate arrangement was reclassified to a stabilized arrangement against the U.S. dollar from floating, effective July 1, 2012. However, since October 2013 the lari has shown greater volatility against the U.S. dollar, depreciating by almost 7 percent.

Moreover, the NBG has not been intervening on the FX market since February 2014. For this reason the exchange rate arrangement has been reclassified to "floating" effective November 6 2013.

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 had caused a multiple currency practice in the past. However, in March 2013, an amendment was introduced to the 2010 agreement between the NBG and the Treasury Service of the Ministry of Finance on the Participation in the Real Time Gross Settlement (RTGS) System that eliminates Georgia's multiple currency practice. The 2013 amendment ensures that foreign exchange transactions between the government and the NBG are priced with the market exchange rate of the day when the foreign exchange order is submitted to NBG.

Article IV Consultation

The 2013 Article IV consultation was concluded on June 24, 2013.

FSAP Participation

An FSAP mission visited Tbilisi between May 20 and June 3, 2014.

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.

Georgia: Technical Assistance Missions, 2008–13			
Subject	**Type of Mission**	**Timing**	**Counterpart**
	Fiscal Affairs Department (FAD)		
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
International Tax Policy	Advisory	June 6-7, 2012	Ministry of Finance
Tax Administration	Expert Assistance	Oct. 2-17, 2012	Ministry of Finance, Revenue Service
Public Financial Management	Expert Assistance	Sept. 11-24, 2013	Ministry of Finance
VAT Refund Arrears			
Tax Administration	Follow-up assistance	Sept. 25-Oct. 8 2013	Ministry of Finance, Revenue Service
Tax Administration	Advisory	May 28–June 10, 2014	Ministry of Finance, Revenue Service
	Monetary and Capital Markets Department (MCM)		
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)		
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			
National Accounts Statistics	Follow-up assistance	Sept. 23-Oct. 4 2013	National Statistics Office
	Legal Department (LEG)		
AML/CFT	Advisory	May 13–20 2010	Financial Monitoring Service
Payment Systems	Advisory	May 25–Jun. 5, 2010	National Bank of Georgia
AML/CFT	Advisory	Sep 20–23 2010	Financial Monitoring Service
Payment Systems	Follow-up assistance	Nov. 8–14, 2010	National Bank of Georgia
AML/CFT	Advisory	Feb 28–Mar 7 2011	Financial Monitoring Service
AML/CFT	Advisory	June 6–11 2011	Financial Monitoring Service

RELATIONS WITH THE WORLD BANK

(As of May 22, 2014)

Title	Product	Tentative Timing of Mission	Expected Delivery of Report
Bank	*Operations*		
	DPO-3 to support reforms to sustain growth, promote job creation and competitiveness, strengthen health care and social safety nets, and deepen public financial management reforms.	February–June 2014	Second half of 2014
	Statistics Capacity Building Trust Fund grant to support preparation work for national population census.	Periodic 2012–14	Ongoing, closing in 2014
	Institutional Development Fund grant for strengthening capital budgeting in Tbilisi municipality	Periodic 2012–14	Ongoing, closing in July 2014
	Analytical Work		
	Programmatic CEM: inclusive growth	Periodic	July 2014
	Public Expenditure Review: Strategic issues and reform agenda	Periodic	June 2014
	South Caucasus Programmatic Poverty Assessment	Periodic	June 2014
	South Caucasus Programmatic Gender Assessment	Periodic	June 2014
	Country environmental analysis	Periodic	February 2015
	Georgia FSAP update	June 2014	October 2014
	Georgia Debt management reform plan	Periodic	December 2014
		Periodic	December 2014

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

(As of May 22, 2014)

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 September 2013, outlines the following main strategic directions:

- Supporting the development of private sector companies, mainly via or jointly with local commercial banks but also on a selective basis directly. All sectors of the economy are eligible, but some represent better opportunities: tourism and hospitality in general, agriculture and food processing and light manufacturing;
- Support the efforts of Georgia to ensure energy security focusing on generation of electricity via renewable, and transmission lines;
- Support projects that enhance Georgia's regional integration.

As of end-April 2014, the bank has signed 167 investments in Georgia with a cumulative commitment of €1.9 billion. Its outstanding portfolio stood at €515 million. Almost one half of the portfolio is in the financial sector, followed by energy with over one third, the corporate sector at 15 percent and infrastructure accounting for 3 percent. The ratio of private sector projects in the portfolio currently stands at around 80 percent. The bank gives preference to non-sovereign operations. Where sovereign guarantees are required, donor co-funding on a grant basis is sought.

The Bank's overall investment in 2013 reached €116 million with 14 projects. 2013 was a disappointing year with very few projects. Again a large proportion of new activity was concentrated in the banking sector, mainly in trade facilitation lines. EBRD also financed a few private sector companies and a transmission line guaranteed by the sovereign.

With the Bank's assistance, Georgia has become an electricity exporting country. The Bank played a critical role in strengthening access to the international market through financing of the Black Sea Transmission line, which is expected to be operational by end-2014. The Bank has been actively pursuing viable small, medium and large renewable energy projects. The Bank has financed Paravani, the first Independent Power Producer (IPP) in the hydroelectric sector. 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 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.

Going forward, the EBRD will also:

- Continue to support the authorities' goal of developing local capital markets 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. In this respect, the Bank issued in early 2014 the first ever IFI Bond in Georgian Lari in order to diversify its sources of funding and to develop the range of products available in local capital markets. 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 local currency capital markets, and to 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 the policy dialogue on improving the regulatory framework for energy efficiency and renewable energy.
- Invest in 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. The Bank has also provided advice to the government with regards the switch from analog transmission to digital, bankruptcy laws, competition and public procurement.
- 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 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 an 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 June 6, 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	May. 2014	5/19/14	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Apr. 2014	5/7/14	D	D	M		
Reserve/Base Money	Mar. 2014	4/25/14	D	D	M	O, O, LO, O	LO,O,O,O,O
Broad Money	Mar. 2014	4/25/14	D	D	M		
Central Bank Balance Sheet	Apr. 2014	5/7/14	D	D	M		
Consolidated Balance Sheet of the Banking System	Mar. 2014	4/17/14	M	M	M		
Interest Rates[2]	May. 2014	5/19/14	D	D	D		
Consumer Price Index	Apr. 2014	5/02/14	M	M	M	O,LO,O,O	LO,O,LO,O,O
Revenue, Expenditure, Balance and Composition of Financing[3]—General Government[4]	Mar. 2014	5/9/2014	M	M	M	O,O,LO,LO	O,O,O,O,O
Revenue, Expenditure, Balance and Composition of Financing[3]—Central Government	Mar. 2014	5/9/2013	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Mar. 2014	4/23/14	Q	Q	Q		
External Current Account Balance	Q4 2013	3/31/14	Q	Q	Q	O,O,O,O	LO, O, LO ,O, LO
Exports and Imports of Goods and Services	Q4 2013	3/31/14	Q	Q	Q		
GDP/GNP	Q4 2013	3/20/14	Q	Q	Q	O,LO,LO,LO	LNO, O, LO, O, LO
Gross External Debt	Dec. 2013	03/31/14	Q	Q	Q		
International Investment Position[6]	Q4 2013	3/31/14	Q	Q	Q		

[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.14/377
FOR IMMEDIATE RELEASE
July 31, 2014

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Approves US$154 million Stand-by Arrangement for Georgia

The Executive Board of the International Monetary Fund (IMF) yesterday approved a 36-month SDR100 million (about US$154 million, or 67 percent of Georgia's quota) Stand-by arrangement (SBA) with Georgia to support the authorities' economic program. The Executive Board's decision enables the immediate disbursement of SDR 40 million (about US$62 million), while the remaining amount will be phased over the duration of the program, subject to reviews.

The authorities' economic reform program that will be supported by the SBA aims to reduce macroeconomic vulnerabilities, increase policy buffers and support growth, while making the economy more resilient to external shocks.

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

"Georgia's macroeconomic performance under the previous Fund-supported program demonstrated a strong commitment to economic and structural reforms, contributing to a recovery in growth and improved price stability. Sustained delivery of policy and structural reforms designed to rebuild policy buffers and promote higher, and more inclusive, diversified growth will help alleviate significant downside risks and reduce high poverty and unemployment rates. In this regard, Georgia's new 36-month Stand-By Arrangement will help lower the fiscal and current account deficits, strengthen inflation targeting, maintain a flexible exchange rate regime, and support more equitable growth.

"While fiscal policy is set to support economic recovery in the short run, the program aims at reducing the deficit over the medium term to create the space for fiscal policy to help stabilize the economy. The modernization of the tax system, including with support from the Fund will improve revenue collection while reducing distortions. Under the program, output and exchange rate volatility will be reduced by promoting a more even execution of the budget through the year.

"Monetary policy will continue to be anchored by inflation targeting, supported by an inflation consultation clause with the Fund and an enhanced regime of exchange rate flexibility. In addition, monetary policy effectiveness will be strengthened by ongoing efforts to reduce high levels of dollarization, while the modernization of the prudential and supervisory frameworks continues at a brisk pace.

"Structural reforms will be essential for achieving the program objectives of enhanced competitiveness and an improved business climate. In this context, the signing of the Deep and Comprehensive Free Trade Area (DCFTA) and EU Association Agreements are welcome developments that signal Georgia's deeper integration with the EU, which should enhance export competitiveness and help boost Foreign Direct Investments."

Recent Developments:

Georgia's performance under the Fund-supported program in 2012-2013 was strong. Nonetheless, the country continues to face macroeconomic challenges. The current account deficit and foreign indebtedness remain high and make the Georgian economy vulnerable. While gradually being reduced, high dollarization weakens the effectiveness of monetary policy and exposes banks to risks. Regional geopolitical tensions and potential spillovers from neighboring countries may affect the prospects for the economy, especially for trade, remittances and potentially foreign direct investment. Fiscal policy in early 2013 turned out to be procyclical: tight early in the year when the economy had slowed, but loose at the end of the year when the economy was recovering. The fiscal expansion helped growth to accelerate at the end of 2013, while causing the exchange rate to depreciate and foreign exchange reserves to decline.

Program Summary:

The program will support macroeconomic stabilization and improve confidence by providing a framework to discipline macroeconomic and fiscal policy and by providing modest balance of payments financing.

Strengthening the economy's resilience to external shocks requires reducing Georgia's net foreign liabilities to a sustainable level (about 60 percent of GDP) in the medium-term. To achieve this, the current account deficit should be brought down to about 5 percent of GDP, with 60 percent of this latter adjustment to take place by the program's conclusion.

Fiscal and monetary policies will focus on reducing the fiscal deficit, containing fiscal risks, maintaining low and stable inflation, facilitating exchange rate flexibility, and supporting growth. The program will support strengthened fiscal risk disclosure and improvements in tax administration.

To achieve a budget deficit reduction to 3 percent of GDP in 2015, the authorities will adopt measures that include increasing excises on tobacco and moderating the growth of the public wage bill, as well as other categories of current spending by keeping them constant in real terms. A key principle for deficit reduction will be to avoid measures that disproportionately affect the poor and vulnerable.

Structural reforms will focus on improving the business environment, developing education and training, creating jobs, and reducing poverty and inequality. The reform agenda includes enhancing competition, strengthening property rights, developing a commercial dispute resolution mechanism, streamlining bankruptcy procedures, improving workers' skills, and further improving the public administration.

The National Bank of Georgia (NBG) will continue to develop its monetary policy toolkit and improve its inflation modeling with technical assistance from the Fund. The NBG will also refine its communications strategy. To ensure the success of the program, the fiscal policy of the government and the monetary policy of the central bank will need to be conducted in a coherent manner while preserving the independence of the central bank.

Georgia: Macroeconomic Framework, 2012–15

	2012	2013	2014	2015
			Proj.	
	Percentage change unless otherwise indicated)			
National accounts				
Real GDP	6.2	3.2	5.0	5.0
Nominal GDP (in billion of laris)	26.2	26.8	29.2	32.2
Nominal GDP (in billion of U.S. dollars)	15.8	16.1	16.1	17.5
GDP per capita (in thousand of U.S. dollars)	3.5	3.6	3.6	3.9
GDP deflator, period average	1.2	-0.7	3.5	5.0
Investment and saving	(in percent of GDP)			
Gross national saving	17.3	18.9	17.2	18.3
Investment	28.9	24.8	25.5	26.2
Public	7.5	5.1	5.7	6.4
Private	21.4	19.7	19.8	19.8
Inflation	(in percent)			
Period average	-0.9	-0.5	4.6	4.9
End-of-period	-1.4	2.4	5.0	5.0
Consolidated government operations				
Revenue [1]	28.8	27.5	27.1	27.1
o.w. Tax revenue	25.4	24.8	24.7	24.8
Expenditures	31.8	30.1	30.8	30.1
Current expenditures	23.1	24.3	24.8	23.3
Capital spending and net lending	8.7	5.9	6.0	6.8
Overall balance	-3.0	-2.6	-3.7	-3.0
Public debt	30.0	32.2	33.9	33.6
Of which: foreign-currency denominated	27.6	27.2	27.6	27.5
Money and Credit	(annual percentage change; unless otherwise indicated)			
Credit to the private sector	12.8	19.5	21.6	17.7
Credit to the private sector (constant exchange rate from 12 month prior)	13.4	16.1	18.7	16.4
Broad money, incl. fx deposits	11.4	24.4	21.5	18.5
Broid money, incl. fx deposits (constant exchange rate from 12 months prior)	11.8	21.8	19.2	17.5
Deposit dollarization (in percent)	66.0	62.1	63.6	61.2
External sector	(in percent of GDP; unless otherwise indicated)			
Gross international reserves (in billions of US$)	2.9	2.8	2.7	3.0
In months of next year's imports of good and services	3.7	3.3	3.0	3.1
In percent of broad money and non-resident deposits	51.9	42.5	35.5	34.0

Georgia: Macroeconomic Framework, 2012–15 (continued)				
	2012	**2013**	**2014**	**2015**
			Proj	
Current account balance (in billions of US$)	-1.9	-1.0	-1.3	-1.4
In percent of GDP	-11.7	-5.9	-8.4	-7.9
Trade balance	-26.6	-21.7	-25.1	-24.7
Foreign direct investment (inflows)	5.8	6.3	6.4	6.5
Gross external debt	82.2	81.5	84.2	83.1
Gross external debt, excl. intercompany loans	63.7	62.3	64.0	63.5
Exchange rates				
Laris per U.S. dollar (period average)[2]	1.65	1.66	1.75	...
Laris per euro (period average)[2]	2.12	2.21	2.40	...
REER (period average; CPI based, 2005=100)	131.7	125.8	...	...

Sources: Georgian authorities; and IMF staff estimates

[1] A negative value indicates a level of actual GDP that is below potential output.

[2] Fiscal projections include measures as specified in the Government Program.

Statement by Willy Kiekens, Executive Director for Georgia
July 30, 2014

1. The Stand-By Arrangements is part of a comprehensive socio-economic strategy in close cooperation with the EU and international financial institutions.

In its document "Georgia 2020", the government of Georgia has formulated its medium-term economic and social objectives. It is implementing a comprehensive and coherent economic policy strategy to achieve its ambitious socio-economic goals. Political and economic integration with the EU is a cornerstone of Georgia's strategy. Close cooperation and financial support from the World Bank, the EBRD and the Asian Development Bank are integral parts of the strategy. So is the Stand-By Arrangement with the Fund. It will enhance credibility of the government's macroeconomic policies and strengthen the country's balance-of-payments position.

The goal is robust sustainable inclusive economic growth of 6 percent annually that benefits all layers of the population. Specific measures are identified to improve the environment for private sector development, human capital and the financing of enterprises.

On June 27 2014, Georgia has signed an association agreement with the EU. It also provides for a Deep and Comprehensive Free Trade Area (DCFTA). This agreement is of prime strategic importance for Georgia. It will deepen political and economic relations with the EU. It will enable Georgia to gradually integrate its economy in the EU's internal market, the largest single market in the world. This agreement requires that Georgia implements, with the support of the EU, core structural reforms in areas such as public governance, justice, law enforcement, consumer protection, and sectors such as energy, transport, environmental protection, industrial development, social protection and education. Under the DCFTA Georgia will modernize its trade relations and develop its economy through the progressive removal of custom duties, tariffs and quotas, and harmonizing laws, norms and regulations in various trade related sectors. The agreement will also facilitate investment. This is particularly important for Georgia which needs further foreign investment to boost its economic growth. All this will allow the Georgian economy to catch up with the EU and the rest of the world in terms of competitiveness. The most sensitive sectors of the Georgian economy will benefit from sufficiently long transition periods to ensure the smooth adaptation of Georgia's economy.

Georgia will receive macrofinancial assistance from the EU once it makes purchases under the Fund arrangement. The negotiations on the MOU with the EU for this financial support are well advanced. Depending on the speed of subsequent internal EU procedures, a first tranche of euro 23 million may become available by mid-October 2014.

On May 8, 2014, the World Bank adopted its country partnership strategy for Georgia for the next three years. This strategy aims at supporting (a) social sector programs in a fiscally sustainable way, in particular improving the effectiveness and efficiency of public services that reduce extreme poverty and boost shared prosperity; (b) enabling private sector-led job creation through improved competitiveness. In the current fiscal year, the remaining IDA allocation of US$ 71 million will be fully used. It may be complemented by US$ 325 million IBRD lending. For next years the indicative IBRD lending envelope for Georgia is almost US$ 300 million per year. In addition, subject to market demand and available viable investments, IFC is planning investments between US$ 250 million and US$ 350 million with the goal of mobilizing additional financing from the private sector and other IFIs.

The EBRD's latest lending and investment strategy for Georgia has been adopted in September 2013. It supports the government's structural reform policies by fostering private investment, reforming the energy sector and supporting Georgia's regional and economic integration. With a cumulative investment commitment of euro 1.9 billion, and an outstanding portfolio of euro 550 million, the EBRD remains committed to further support the Georgian economy with significant amounts of financing which are for about 80 percent supporting private sector projects.

With a loan portfolio of US$ 1.35 billion, mainly in the transportation and ICT sectors, the ADB is an important development partner of Georgia. The SBA with the Fund will facilitate additional ADB lending to Georgia.

Obviously, a Stand-By arrangement with the Fund will provide for a stable macroeconomic framework on which the success of the financing and investments by other IFIs and private investors depends.

2. The program's macroeconomic framework.

The Georgian authorities have formulated their macroeconomic objectives and policies in their Letter of Intent.

The authorities estimate that, thanks to the structural reforms which are now being implemented, the potential growth rate is above 6 percent. However, because of uncertainties, they conservatively assume a growth rate of 5 percent for this and the next year.

The public debt ratio which might reach almost 34 percent of GDP this year should steadily decline over the medium-term towards 31 percent after 5 years. This requires that the budget deficit estimated at 3.7 percent of GDP this year, declines steadily to 2.5 percent of GDP over the course of the 3-year program period.

With improved external competitiveness, the current account deficit, projected to reach 8.4 percent of GDP for this year, would gradually decline to 5 percent of GDP over the next five years.

With inward foreign direct investment conservatively estimated at 6 percent of GDP, the country's relatively high level of external debt is scheduled to drop by 10 percent of GDP over the next 5 years, to reach about 56 percent of GDP, excluding inter-company loans. At the same time, under a flexible exchange rate regime, gross international reserves should steadily rise from a low level of US$ 2.7 billion this year to US$ 4.8 billion over the next 5 years thereby increasing the import coverage from 3 months now to 4 months.

Lastly, the central bank will target a stable, moderately low inflation rate of 5 percent over the next 3 years horizon.

We will now succinctly review in some more detail macroeconomic policies on the basis of which the authorities request the Fund's financial support.

3. Fiscal policy.

Keeping public debt comfortably below 40 percent of GDP is the overarching objective of fiscal policy. In fact, under the program's baseline scenario, the public debt to GDP ratio is projected to decline to about 31 percent by 2019. This will build room for countercyclical policies and allow for reducing the trade deficit.

To reach this ambitious goal the government has taken measures to reduce this year's budget deficit from 3.9 percent to 3.7 percent of GDP. The government has already specified all needed fiscal measures to reduce the 2015 fiscal deficit to no more than 3 percent of GDP.

The fiscal expansion of the current fiscal year mainly reflects increased spending on targeted social assistance from 1 percent to 1.8 percent of GDP as part of the government's commitment to make sure that the benefits of economic growth are shared more widely.

In the face of a more difficult environment created by the slowdown in Russia and the crisis in Ukraine, two important trading partners of Georgia, and, as far as Russia is concerned, the main source of remittances, the government considered it necessary and the staff agreed, to avoid a sharp drop in domestic demand which would be caused by an aggressive reversal of the fiscal expansion.

However, in order to secure a prudent fiscal stance and positive public debt dynamics, the program outlines all necessary measures to secure a 0.7 percent of GDP fiscal consolidation in 2015. These measures are primarily based on containing current spending, supported by specific revenue measures.

After an overall growth of social expenditures of well over 20 percent in 2014, in 2015 social benefits will be kept constant in nominal or real terms, depending on the category of the benefit.

Spending on goods and services, wages and salaries will also be kept constant in real terms. As a revenue measure, increased excises on cigarettes should generate revenues equal to 0.2 percent of GDP.

These planned measures generate sufficient savings to secure the needed fiscal consolidation in 2015 while also creating room for additional public spending to enhance the economic potential.

Reaching agreement on the government's draft 2015 budget that includes all necessary measures to secure a deficit of no more than 3 percent of GDP in 2015 will be an important topic of the first review scheduled for October/December 2014.

To keep the decline of public debt ratio on the intended trajectory, the government will handle the assumption of contingent liability with great care. The government currently has no plans to issue guarantees. If issuing guarantees would be considered, the government will consult with the IMF and the World Bank. Such guarantees will be included in the fiscal risk statement attached to the annual budget. In the same vein, the structure and modalities of operation of a possible public financial vehicle to facilitate private investment and improve access to finance will be such, as outlined in paragraph 16 of the LoI, that they minimize, if not exclude, risks for the budget. Here again, the government will consult with the IMF and other development partners before introducing legislation for such a public financial vehicle.

4. Monetary and Financial Sector Policies.

The National Bank of Georgia's independence is enshrined in the constitution and its organic law. The government reaffirms in the LoI the existing strong institutional and financial independence of the NBG. At the same time, both the government and the NBG recognize the importance of consistency of their respective policies.

The NBG expects inflation to reach 5 percent by year's end which is the new, reduced inflation target for 2015, under an enhanced inflation targeting regime and a flexible exchange rate regime.

The central bank will improve its inflation modeling and refine its communication strategy, including quarterly publication of an inflation report and press conference on a fixed schedule.

Consistent with Fund policy, the NBG will consult with the IMF staff if actual inflation deviates more than 2 percent from the target. If the deviation exceeds 3 percent, the Board will be involved in the consultation.

The NBG is planning to purchase foreign currency in the remainder of this year to boost gross reserves to US$ 2.7 billion by the end of 2014, assuming that there are no depreciation pressures by the time of purchases.

At about 60 percent, both loan and deposit dollarization is still high, even if it is gradually being reduced. The program of placing long-term government deposits with commercial banks is helping to promote long-term Lari-lending. Additional risk-weighting on FX loans and higher reserve requirements on FX liabilities will help reduce dollarization.

A World Bank-Fund mission is updating the FSAP for Georgia. Its finalization is expected by October. The authorities and the staff will assess to what extent implementing FSAP recommendations could be included in program conditionality.

5. Structural Reform.

Georgia will implement a comprehensive set of structural reforms following the recently signed association agreement with the EU, and as part of the recently adopted Country Partnership Strategy with the World Bank. Under the requested Stand-By Arrangement, Georgia has outlined a set of macro-critical structural reforms in the areas of tax administration, public financial management and national statistics, as described in more detail in paragraphs 26 to 30 of the LoI. In each of these domains, the authorities have asked for technical assistance from the Fund. They are committed to make use of Fund TA as effectively as possible.

The other area of structural reforms as part of the Fund supported program are streamlining the business environment, with particular focus on SMEs, improving labor market matching services through a system of labor market mediation and easing access to finance for businesses, in particular SMEs.

In this connection, the authorities will conduct an assessment of access to finance for enterprises (structural benchmark for September 2014), take measures to remove market imperfections and promote domestic capital markets. Establishing a public financial vehicle to facilitate private investment to overcome market imperfections will be carefully considered in consultation with the IMF and other development partners in order to ensure its sound operation and avoiding undue fiscal risks.

6. The balance-of-Payments Outlook and Access

Georgia's relatively large current account deficit and maturing external debt obligations result in external financing requirements exceeding US$ 2 billion annually. With continued sound economic policies, as outlined under the program, and with financing programs adopted by other IFIs and macrofinancial assistance from the EU, access under the Stand-By Arrangement can be of a catalytic nature and can be limited to SDR 100 million for the entire 3-year period. Yet, in light of the uncertainties created by Russia and Ukraine, the observed drop in exports and remittances, the rather low level of external reserves and US$ 257 million repayments to the Fund in 2014, disbursing SDR 40 million on the occasion of the approval of the program and again after the first review, would provide useful support for the balance-of-payments in 2014. In tandem with program implementation, these drawings will help bolster creditor and investor confidence.

*

*   *

The authorities firmly own their policies and are strongly committed to make their cooperation with the Fund and other international partners highly successful.