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Georgia and the IMF

Press Release:
IMF Executive Board Completes Fourth Review of Georgia's PRGF Arrangement and Approves US$20.7 Million Disbursement
September 29, 2006

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Georgia: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

September 13, 2006

The following item is a Letter of Intent of the government of Georgia, which describes the policies that Georgia intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Georgia, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

LETTER OF INTENT

September 13, 2006
Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
700 19th Street N.W.
Washington, D.C. 20431

Dear Mr. de Rato:

The attached Memorandum of Economic and Financial Policies (MEFP) describes the policies for 2006 and 2007 that we ask to be supported by the International Monetary Fund as Trustee under a three-year Poverty Reduction and Growth Facility (PRGF) arrangement. The memorandum proposes revised performance criteria for end-September 2006 and end-March 2007. These policies are consistent with the Economic Development and Poverty Reduction Program (EDPRP) presented to the IMF and World Bank in October 2003 and with the Annual Progress Report of our EDPRP, which was submitted in August 2006.

The Government of Georgia believes that the policies set forth in the attached memorandum will achieve the objectives of the program, but it will take any additional measures that may become appropriate for this purpose. The government will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultation.

We request hereby the completion of the fourth review under the PRGF arrangement and we request a waiver for nonobservance of a structural performance criterion for end-March 2006. The performance criterion required establishing and populating a database of all central government Legal Entities of Public Law (LEPLs). Unfortunately, misunderstandings led to the omission of several LEPLs from the database, but we have since corrected this omission.

Georgia will conduct discussions with the Fund for the fifth review of its program under the PRGF arrangement before end-December 2006.

Sincerely yours,

/s/
Zurab Nogaideli
Prime Minister of Georgia

/s/	/s/
Aleksi Aleksishvili	Roman Gotsiridze
Minister of Finance	President of the National Bank

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

SEPTEMBER 13, 2006

Introduction

1. The government's economic program for 2006 and 2007, which is supported by a PRGF arrangement, aims to achieve poverty reduction through sustained, rapid, and equitable economic growth in an environment of low inflation. This supplemental Memorandum of Economic and Financial Policies reviews our progress with implementation of our program and describes our economic policies and strategy through the remainder of 2006 and early 2007.

Current Economic Developments and Performance

2. The favorable economic results for 2005 have continued in the first half of 2006 and we estimate that real GDP increased by more than eight percent compared with the same period in 2005. This growth is broad based and robust despite several external shocks. The cost of energy imports from Russia increased significantly this year. In 2005, we were able to import gas from Russia at $65 per thousand cubic meters, but this year the cost has risen to $110. Additionally, Russia has banned the importation of numerous Georgian commodities . While these actions have hindered economic growth this year, the momentum of our reform program has allowed the economy to continue its strong performance.

3. Price pressures intensified in the second quarter this year because of structural factors and excess liquidity, with 12-month inflation reaching double digits. Structural factors included higher world prices of energy and some other major commodities, increases in administrative prices on natural gas and electricity and greater-than-expected growth in the money multiplier causing 12-month growth in broad money to exceed 36 percent as of end-July.

4. Reforms in the tax and customs departments have yielded continued benefits. Revenue collection in the first half of 2006 again exceeded our projections in all tax categories. Nontax revenues were also higher than expected because of improved administration. Given the strong revenue performance, we requested approval of two supplemental budgets. The first was approved in May and the second in July. The supplemental budgets allow increased spending in the priority areas, including social issues, infrastructure rehabilitation, upgrading the defense capacity to NATO standards, and other local expenditures, e.g., election administration.

5. While we had committed, under the PRGF arrangement to resolve all GEL 149 million in arrears claims outstanding at end-2005, this has proven to be impossible as the task of verifying the claims has been more difficult than expected. We have continued the process of verifying these arrears. In the first six months of this year, we verified and

cleared GEL 23 million in arrears. An additional GEL 36 million in claims have been verified and we are committed to clearing all verified arrears during 2006. We are also committed to resolving the status of all remaining arrears claims as quickly as possible.

6. The government has continued to improve the budget process by enhancing our medium-term expenditure framework (MTEF). Our MTEF consists of two parts, the Basic Data and Directions (BDD) and the detailed expenditure plans of government contained in the annual budget law. The BDD and our macroeconomic projections for 2007-10 were submitted to parliament in April for comment. The detailed spending plans of government for 2007 will be included in the draft budget for 2007 that will be submitted to parliament before 1st of October 2006.

7. We are continuing to develop tools for monitoring and assessing the performance of Legal Entities of Public Law (LEPLs). In the first quarter of 2006 we prepared a database that we thought covered all central government LEPLs (structural performance criterion for end-March 2006). However, subsequent examination revealed a small number of LEPLs that had been omitted from the database. As soon as this omission was realized, we added the additional LEPLs to the database. Given recent progress (described below), we hereby request a waiver for inadvertently missing this performance criterion.

8. Monetary policy was focused on countering inflation pressures and maintaining the stability of the lari through the first half of 2006. During 2005, reserve money increased only by 19.7 percent, which was well below the target envisaged under the program. In the first half of 2006, reserve money increased by 4.4 percent, less than the 7 percent projected under the program. As noted above, growth of the money multiplier was more rapid than projected. Consequently, broad money growth exceeded our projections. As a result, the twin goals of exchange rate and price stability have recently been in conflict. In recent months, we have further constrained the growth of reserve money in an effort to reduce price pressures, and we have modestly increased required reserves.

9. In the first half of 2006, the lari appreciated by 0.7 percent against the US dollar in real terms, while the nominal effective exchange rate depreciated by 0.8 percent over the same period. Against this background, the NBG was able to accumulate significantly more foreign exchange reserves than projected.

10. In March 2006, we submitted amendments to parliament that prohibit government borrowing from the NBG under any circumstances (structural performance criterion for end-March 2006). These amendments were approved by parliament on May 10, 2006. We also submitted amendments to parliament that remove ownership restrictions on commercial banks and thereby allowing an individual to own 100 percent of a bank (structural benchmark for end-March 2006). These amendments were approved by parliament on March 17, 2006.

11. On March 31, 2006, the executive board of the NBG approved a banking sector development strategy for 2006-09 (structural benchmark for end-March 2006). Subsequently,

this strategy was discussed with commercial banks and the public at large. The strategy aims to increase the level of financial intermediation and the efficiency of the banking sector as a means of increasing confidence in banks. As a result, we expect the gross assets of the banking sector to reach 40 percent of GDP by end-2009 compared to 22 percent as end-2005. To increase the transparency of commercial banks' activities, the NBG has developed special transparency requirements that oblige the banks to publish specific information with predetermined frequency on the NBG's website and in the media.

12. On March 20, 2006, the NBG signed an agreement with government detailing the securitization of government's debt to the NBG (structural benchmark for end-March 2006). Under the terms of this agreement, the securities will be marketable and can be used to conduct open market operations. The government began converting the debt into securities in May and as of end-August, the NBG held a stock totaling GEL 48 million as marketable government bonds, while the remaining GEL 785 million will become marketable gradually every year until 2025. Furthermore, under the terms of the agreement the government debt to the NBG will be reduced every year and will be fully cleared by the end of 2029.

13. In October 2005, we submitted proposed legislation to parliament that would strengthen the fit and proper provisions of the commercial bank law as it pertains to bank owners and managers. These proposals have been subject to lengthy discussion in government. Following consultation with the Fund staff, we have amended the proposed legislation. We will resubmit this legislation to parliament soon and will seek its passage by late 2006.

14. The goal of our privatization program is to transfer ownership of state enterprises and assets to the private sector. This process is progressing better than expected and it now appears that the privatization process will be largely completed by the end of this year. Whereas we expected privatization proceeds of about GEL 338 million this year, we now project that proceeds for the year will be around GEL 1.24 billion.

15. Our efforts to liberalize Georgia's trade regime continue to progress. In July, the Parliament approved a new customs code, which simplifies the customs administration procedures and is compatible with EU standards. Further, in July the Parliament approved the new law on customs tariffs. According to this law, the number of tariff bands will be reduced from 16 to 3. Beginning from September 1, 2006, the maximum tariff will be 12 percent instead of 30 percent. The 12 percent tariff shall be chiefly applied to food, agricultural produce and mineral products. Some agricultural products will be subject to a tariff of 5 percent only. For all other products, tariffs will be eliminated altogether.

16. Consistent with our efforts to restructure the Georgian economy and improve the investment climate, in May 2006 parliament passed a new labor code. The previous code was adopted in 1973 and was an outdated model of employer-employee relationships. The new

code reflects a more liberal and market-oriented approach and we hope will further support business development and job creation.

17. With recent agreements reached with Austria and Azerbaijan under the auspices of the 2004 Paris Club agreement, we have completed negotiations with all Paris Club creditors, and all non Paris Club creditors except Kazakhstan. Negotiations with Kazakhstan are underway, and we are cooperating with the Paris Club Secretariat in Paris to reach a satisfactory solution in line with our Paris Club commitments within the shortest possible time.

18. Poverty reduction continues to be a priority of this government. Beginning July 1, 2006, we started to administer a health insurance program for socially vulnerable families. Under this program, all families below the poverty line will receive basic health insurance that allows free consultation and essential medical treatment. We had hoped to begin implementation of our targeted poverty reduction program in June (end-June structural performance criterion for the fifth review). Unfortunately, we experienced problems with the registration process for intended beneficiaries and had to delay program implementation. These difficulties were resolved in July and the budget began making payments to vulnerable households in Tbilisi in August 2006. We will also begin making payments to vulnerable households outside of Tbilisi in September. We are confident that the program will be fully operational by the time of the fifth review. Our latest PRSP progress report was submitted to the IMF and the World Bank on August 25, 2006.

Economic Policies for 2006 and 2007

19. Georgia continues to experience wide-ranging economic change. Since the new government took office in early 2004, we have repeatedly demonstrated our commitment to transforming Georgia's economy from a moribund and corrupt one to a dynamic market-oriented system. We have also repeatedly demonstrated our commitment to maintaining macroeconomic stability. The government's economic reform program for 2006 and beyond aims at further improving macroeconomic performance in order to foster broad-based growth in support of poverty reduction. We believe that strong economic growth is the best tool for reducing poverty and fostering such growth lies at the heart of our economic reform program. Our aggressive program of privatization and efforts to enhance the private sector environment continue to yield results. We project real growth of GDP will be about eight percent this year and seven percent in 2007.

20. While we expect continued strong growth this year and in 2007, there are risks. Our domestic wine sector is developing new markets. Although the wine makers' efforts to reorient themselves will not be completed this year, we do not expect that the decline in wine exports shall hinder growth in a substantial way. Additionally, we may face a higher price for gas imported from Russia in 2007. We estimate an increase in the gas prices to the range of \$160-200 per thousand cubic meters from the current \$110. In order to secure our energy

supplies, we have reached an agreement with Azerbaijan to purchase additional gas from the newly operational South Caucasus Pipeline (SCP) starting from initial 60,000,000 cubic meters increasing up to 500,000,000 units within next 5 years. These additional supplies of gas will account for about 15 percent of domestic consumption in 2007, increasing up to 25% by 2011, and will result in an average gas price of between $140 and $170 in 2007. While this is a significant increase over current prices, it can be accommodated without substantially hindering economic growth.

21. We remain committed to keeping inflation in single digits but, given developments to date with regard to supply shocks, the money multiplier, and inflation through July, for the year as a whole we now project consumer price inflation of 10 percent, but are determined to contain 2007 inflation to not more than 6 percent. As noted above, we are taking steps to further slow the growth of monetary aggregates, including by raising the reserve requirements for commercial banks. As a result, we project the rapid growth of the money multiplier to slow significantly and broad money growth will be in line with program targets for 2006.

22. As was true in 2005, our program for enhancing macroeconomic stability will require disciplined fiscal and monetary policies. It will also require careful coordination of policies and the development of monetary policy tools. In order to ensure that our objectives and macroeconomic policies are consistent and well understood, we are in the process of preparing a comprehensive macroeconomic strategy for the next five years. This strategy will complement the MTEF and other strategy documents, and will be developed in consultation with Fund staff.

Fiscal Policy

23. Our continued strong revenue performance in the first half of 2006 serves as the basis for our revised fiscal projections for the remainder of this year and 2007. For 2006, we project an overall fiscal deficit of GEL 341 million, or 2.5 percent of GDP. Financing of the budget will rely on external sources (e.g., World Bank and EBRD) and privatization proceeds. For 2007, as the inflow of privatization revenues decreases, we are projecting an overall fiscal deficit equivalent to 2.1 percent of GDP. However, financing will continue to be provided by privatization, borrowing on concessional terms and a modest drawdown of government deposits.

24. The amendment to the 2006 budget law that was approved by parliament in July assumes total revenues and grants equivalent to 24.9 percent of GDP and total tax revenues of 20.8 percent of GDP. In light of our revenue performance in the first half of 2006, we believe that total revenue this year will be higher than budgeted, despite the revenue loss associated with the loss of Russian markets for our exports of wine and mineral water, as well as losses resulting from the enactment of new customs tariffs, which total GEL 40 million for customs tax and GEL 7 million for VAT.

25. The two supplemental budgets approved by parliament contain the major spending initiatives for this year and we will not approve additional expenditures this year. Indeed, to the extent feasible, we will aim to keep expenditures below the budgeted level in an effort to reduce inflation pressures. We are firmly committed to keeping the deficit at or below the target of GEL 341 million. This reflects our commitment to tighten the fiscal stance in order to reduce inflationary pressure. The revised budget deficit is 1.5 percent of GDP below what was targeted in our second supplement.

26. As noted above, we continue to process the stock of arrears from end-2005. Of the GEL 149 in arrears that were claimed as of end-2005, we expect to verify and pay GEL 59 million. When verifying arrears, we will give priority to those payments that will be most beneficial to low-income groups.

27. Despite the significant reduction of customs tariffs in 2007, improvement in tax administration and further legalization of the economy enable us to sustain the volume of tax revenues in 2007 at the projected level, i.e. at 21.5 percent of GDP. Total revenues and grants are projected to be GEL 3.8 billion, i.e. 24.5 percent of GDP. Reflecting the monetary policy objectives, the deficit on a cash basis shall not exceed 2.1 percent of GDP. Therefore, budget expenditures would represent 26.6 percent of GDP and be allocated chiefly to priority areas. Key priorities for 2007 remain rehabilitation of infrastructure, social, healthcare and education sectors. Budget parameters may undergo minor changes as a result of budget discussions in the Parliament.

28. The privatization process is ongoing and should be completed in 2007. The guiding principle for privatization is that the state should own only those properties that are essential for performance of the state functions. Thus far in 2006, we have privatized enterprises in the energy distribution, power generation and communication sectors. Originally, we estimated that proceeds from the sale of these assets would be about GEL 338 million or 2.6 percent of GDP. In the light of strong interest by international investors, we now expect total privatization proceeds for 2006 to be around GEL 1.24 billion, or 9 percent of GDP.

29. As part of our efforts to strengthen property rights and to make Georgia more attractive to foreign investment, we plan further improvements to revenue administration. In 2007, we plan to complete the merger of the Tax and Customs Departments and the Financial Police. This will result in significant efficiency gains and will improve service to taxpayers. We also plan to improve the tax refund process and, by January 1, 2007 to streamline the tax appeal system, thus increasing public confidence in the fairness of the tax administration. In the context of creation of a consolidated tax administration, we are preparing a strategy to modernize tax administration with the objective to build confidence and trust of taxpayers with regard to improved tax services, also concerning tax administering and reliable tax-related investigation procedures.

30. As reforms in Public Finance Management Sector continue, we plan to go further with introducing the Government Finance Statistical Manual 2001 (GFSM 2001) budget classification. In particular, the state budget will use GFSM 2001 functional classification from 2007 and the economic classification from 2008. The full compliance with the GFSM 2001 will be progressively achieved by 2015 as defined in the Accounting Reform Strategy.

31. To mitigate potential fiscal risks of decentralizing LEPLs, we plan to issue new reporting guidelines and are currently in the process of finalizing these requirements. As part of this effort, we have included guidelines on budget preparation and management, and guidance for line ministries on analyzing reports from the LEPLs. We are also proposing legislation that will divide existing central government LEPLs into two categories, those that are part of the general government sector and those that are not for profit. Those LEPLs that are part of the general government sector will adhere to treasury guidelines for reporting, whereas the not-for-profit LEPLs will be subject to the guidelines currently under preparation. Throughout this process, we incorporated the useful comments provided by Fund staff as appropriate. These reporting requirements and guidelines will become effective by January 1, 2007 (structural performance criterion for end-December 2006).

Monetary Policy

32. A disciplined monetary program featuring a flexible exchange rate regime is central to our macroeconomic strategy for 2006 and beyond. We had hoped to limit inflation to 6 percent this year, but higher energy costs combined with several exogenous shocks and excess liquidity resulting from higher-than-expected growth in the money multiplier have made it difficult to meet our initial target. Consequently, and with great reluctance, we have revised upward our inflation target for the end-2006 to 10 percent. At the same time, projected growth in the money multiplier has been increased to 11 percent for this year. In light of these revised assumptions, we plan to limit reserve money growth to 14.7 percent and broad money growth to 27.4 percent.

33. For 2007, the NBG's primary objective will be to reduce inflation to not more than 6 percent. In that context, the NBG is now prepared to allow more volatility in the exchange rate by less intervention in the foreign exchange market to counter the market forces. However, the NBG will continue to intervene to avoid excessive fluctuations in the exchange rate.

34. Given the greater-than-expected success of our privatization program, we plan to increase gross foreign reserves to about 2.9 months of imports of goods and services or about $1,030 million by end-2006. For 2007, gross international reserves will increase modestly to $1,089 as the inflow of privatization proceeds ends. The NBG will limit its interventions in the foreign exchange markets in light of the priority objective of reducing inflation.

35. Under the terms of the agreement between the NBG and the government, the government debt to the NBG, totaling GEL 833 million will be gradually converted into

marketable government securities. For 2006, the NBG received GEL 48 million in such securities with maturities of 1 to 3 years. The NBG plans to develop the secondary market for government securities as a means for enhancing its ability to conduct open market operations. In particular, the NBG will form an organized secondary market for the government securities and will regularly conduct open market operations. Furthermore, the NBG has finalized regulations for the issuance of certificates of deposit, has developed corresponding online trading software and will began issuing these instruments in late September.

36. The NBG plans several improvements to its bank supervision program. In recognition of the rapid domestic credit expansion over the past 18 months, we plan to intensify efforts to assess the true quality of the banks' loan portfolios and ensure adequate provisioning. Moreover, we will strengthen the evaluation of internal controls and audit at the banks to establish how effectively they are able to identify potential risks and mitigate these risks on time. The NBG also plans to develop amendments to the legislation to disqualify certain external auditors from bank examination and maintain a "black list" of external auditors. Furthermore, the NBG will be allowed to give specific assignments to the external auditors during the bank inspection and inform the NBG immediately about any discovered irregularities of material importance. The NBG will be allowed to request and obtain all reports and any other materials and information from the external auditor.

37. Consistent with our commitments under the PRGF arrangement, we submitted legislation to parliament in December 2005, aimed at strengthening legislation related to Fit and Proper criteria for bank owners, supervisors and managers. Unfortunately, action has not yet been taken on this legislation. The government and the NBG will take all steps necessary to ensure the passage of Fit and Proper legislation, consistent with international best practices, before end-2006, and we propose that this be a structural performance criterion for end-December 2006 under the program.

38. The rapid growth in commercial bank credits outstanding, while a welcome development, raise concerns about the potential for growing credit risks. To strengthen the NBG's ability to monitor these developments the NBG, in cooperation with commercial bank external auditors, will by end-2006 issue a decree obliging these auditors to include issues of relevance to the NBG in their audits and to report to the NBG (proposed structural benchmark). The NBG will also prepare a draft law on credit bureaus.

39. Further, the NBG plans to intensify its analysis of banking system risks in order to identify and correct for potential problems. For this purpose, the NBG plans to produce and publish its first financial stability report in late August, 2006. Moreover, following the recommendations of the recent FSAP update mission, the NBG has started to collect data on asset prices and deposit and loan concentration; reached an agreement with the Ministry of Finance on the securitization of the government debt to the NBG; prohibited by law direct lending by the NBG to the government; adopted a comprehensive law on microfinance

institutions and introduced regular meetings with commercial bank managers and supervisory board members.

40. The effectiveness of monetary policy depends largely on the transparency of the NBG and its actual policies and operations. The NBG is currently in the process of reinvigorating research and analysis activities. It is also publishing monthly monetary and fiscal reviews, and recently began publishing quarterly inflation reports. These reports will serve as a major communication tool with the public and will allow us to convey the message that the NBG's main goal is price stability and a more flexible exchange rate regime. Furthermore, the inflation reports will allow the NBG to explain to the public about the environment in which monetary policy is formulated and about its specific policy actions.

41. We recognize that reliable statistical data is critical for the effective policy formulation and implementation. As Georgia becomes a more open economy and macroeconomic risks stemming from the external sector increase, the reliability of the balance of payment data becomes crucial. Therefore, it has been agreed that the NBG will initiate an effort to improve the quality of balance of payments data and will be solely responsible for the collection and analysis of balance of payments statistics. As a first step, and in accordance with a recommendation of a recent IMF technical mission, responsibility for this data will be transferred from the Department of Statistics of Ministry of Economic Development to the NBG. Additionally, we will issue the necessary decrees and resolutions by end-September 2006 (a proposed benchmark), and will have the newly established unit in the NBG fully operational no later than end-December 2006.

Structural Reforms

42. The government recognizes the importance of an aggressive structural reform program as a means of fostering growth and international competitiveness. Of particular importance is the need to improve the business environment and strengthen the protection of property rights.

43. For the purpose of increasing the quality of official statistics, we have developed relevant legislation taking into consideration the fundamental principles of official statistics and it will be patterned on the laws of UN and EU on official statistics, best European practices of legislation in the field of official statistics and other international acts.

Program Monitoring

44. Completion of the fifth review under the PRGF arrangement, scheduled for early 2007, will require observance of the structural performance criteria for end-September 2006 shown in Table 1 and the quantitative performance criteria for end-September 2006 in Table 2. The review will focus on progress in reducing inflation, strengthening monitoring and reporting of financial activities of LEPLs, reforms in tax and customs administration, and progress in financial sector reforms. It will also take stock of ongoing and planned steps to

add momentum to structural reforms, especially in the areas of energy, public sector operations, the business climate, and trade liberalization.

Table 1. Georgia: Quantitative Performance Criteria and Indicative Targets, 2006–07 1/ 2/

	Cumulative Change from End-December 2005								
	Mar. 2006		Jun. 2006		Sep. 2006		Dec. 2006		Mar. 2007
	Performance Criteria	Actual	Indicative Targets	Prelim.	Performance Criteria	Revised	Indicative Targets	Revised	Performance Criteria
	(In millions of lari)								
1. Quantitative targets									
Ceiling on cash deficit of the general government	34.7	3.0	65.4	155.0	138.2	252.0	345.6	342.0	393.0
Ceiling on net credit of the banking system to the general govt. (NCG)	0.0	-112.1	-17.7	-88.4	-50.7	-135.6	37.0	-872.4	-841.4
Ceiling on reserve money	42.9	-22.5	70.8	43.2	157.4	118.3	250.4	150.4	141.2
	(In millions of U.S. dollars)								
Floor on total net international reserves (NIR) of the NBG	1.8	16.3	40.2	61.2	118.7	134.5	151.6	559.8	526.2
Ceiling on contracting or guaranteeing of									
A. Nonconcessional medium- and long-term external debt	20.0	0.0	20.0	n.a.	20.0	20.0	20.0	20.0	25.0
B. Short-term external debt (less than one year)	0.0	0.0	0.0	n.a.	0.0	0.0	0.0	0.0	0.0
Ceiling on accumulation of external arrears	0.0	0.0	0.0	n.a.	0.0	0.0	0.0	0.0	0.0
	(In millions of lari)								
2. Indicative target									
Ceiling on net domestic assets (NDA) of the NBG	39.5	-52.6	-3.5	-70.0	-62.2	-130.6	-30.1	-885.3	-832.3

Sources: Georgian authorities; and Fund staff estimates.

1/ Section 1 of this table shows quantitative targets for 2006; for stock variables, they are based on cumulative changes from end-December 2005 projections. The indicative target is shown in Section 2.
2/ Quantitative targets for 2006 are based on accounting exchange rates of GEL 1.85/US$, US$1.46/SDR, and US$1.21/EUR.

Table 2. Georgia: Structural Performance Criteria (*) and Structural Benchmarks, 2006–07	
Measure	Timing
Adopt financial reporting guidelines for all not-for-profit LEPLs. (*) (MEFP, para 31)	End-December 2006
Enact legislation bringing Georgian Fit and Proper regulations in line with international best practices. (*) (MEFP, para 37)	End-December 2006
Submit to parliament a draft law on Official Statistics. (MEFP, para 41)	End-March 2007
Prepare a strategy for modernizing tax administration. (MEFP, para 29)	End-March 2007
The NBG will issue a regulation requiring bank external auditors to include issues of relevance to the NBG in their audits and report to the NBG. (MEFP, para 38)	End-March 2007

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 and structural performance criteria and indicative targets, as well as respective reporting requirements for the arrangement supported under the Poverty Reduction and Growth Facility (PRGF). These performance criteria and targets are reported in Tables 1 and 2 of the Memorandum of Economic and Financial Policies (MEFP), attached to the Letter dated September 13, 2006.

2. The quantitative performance criteria (ceilings and floors) and indicative targets listed in Table 1, Sections 1 and 2, of the MEFP are defined as cumulative changes from end-December 2005.

Quantitative Performance Criteria, Indicative Targets, and Continuous Performance Criteria: Definitions and Reporting Standards

A. Definition of the General Government and the Public Sector

3. The general government is defined as the central government, local government, extra-budgetary funds, and LEPLs. The public sector consists of the general government, and the National Bank of Georgia (NBG).

B. Definition of Domestic Expenditure Arrears

6. **Definition:** Domestic expenditure arrears are defined as arrears incurred by the central and local governments on expenditure items, excluding external debt service payments. Measurement of the stock of verified central government expenditure arrears will be based on the following principles: (a) goods and services have been received; (b) the bill for payment has been received; and (c) the due-for-payment date has passed, and the bill has remained unpaid beyond the normal or agreed period of credit. Expenditure arrears of local governments are measured by the local budget department of the ministry of finance, and according to the same definition as above. The stock of unverified arrears will be based on the following principles: (a) the bill for payment has been received, (b) the due-for-payment date has passed, and the bill has remained unpaid beyond the normal or agreed period of credit, and (c) the receipt of goods and services related to the claim has not yet been verified.

7. **Supporting material:** The treasury department of the ministry of finance will provide to the IMF monthly data on the stock as well as flow clearance of domestic expenditure arrears of the central and local governments. The monthly data on the stock as well as the flow clearance of arrears provided will include a detailed breakdown by economic classification for central government and will be provided within 4 weeks. No economic classification for the stock or flow clearance of local government arrears will be required.

The local budget department of the ministry of finance will provide to the IMF information on monthly spending by the local budgets.

C. Ceiling on the Cash Deficit of the General Government

8. **Definition:** The cash deficit of the central and local governments will be measured from the financing side, and will be defined as equal to the total financing. Total financing will be defined as the sum of (i) domestic financing from banks and non-banks, (ii) external financing, and (iii) privatization receipts. Privatization receipts consist of all transfers of monies received by the central and local governments in connection with the sale of central or local government assets. This includes receipts from leases and the sale of licenses for more than 10 years. Domestic financing consists of all bank and non-bank financing to the central and local government. External financing is defined as the total of disbursements, macroeconomic support, net change in external arrears, minus amortization. Disbursements include all project financing (capital expenditure and net lending) and balance of payments support (excluding grants) received by the budget. Amortization includes all external debt-related payments of principal; amortization to external creditors via third parties is accounted for at the time and in the amount of payment by the budget to the third party, rather than at the time of recognition of amortization by the external creditor.

10. **Supporting material:** Data on privatization receipts 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. The data will be consistent with the revenue account(s) in the NBG. Data on domestic bank and nonbank financing will be provided to the Fund by the NBG. A table on external project financing will be provided to the IMF monthly by the debt unit at the ministry of finance (specifying projects by creditor) within two weeks of the end of each month. All external financing data in the budget will be consistent with the detailed data and projections provided by the debt unit at the ministry of finance at the time the budget is submitted to parliament.

D. Ceiling on Reserve Money

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

12. **Supporting material:** The NBG balance sheet is to be transmitted to the IMF on a monthly basis, within two weeks of the end of the month.

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

13. **Definition:** Net credit of the banking system to the general government includes net credit to the general government from the NBG and the deposit money banks. Credit to the government includes all loans to the general government and all treasury bills issued by the

general government held by the banking system. Net credit to the government is defined as credit to the government less deposits of the general government in the banking system.

14. **Supporting material:** The NBG will provide the monetary survey to the IMF on a monthly basis within three weeks of the end of each month. The NBG will also provide to the IMF information on the activities of the treasury bill market, including the breakdown of treasury bill holdings by banks and non-banks.

E. Floor on Net International Reserves of the NBG

15. **Definition:** Net international reserves (NIR) of the NBG in U.S. dollars are defined as foreign assets minus foreign liabilities of the NBG, using program assumptions on bilateral exchange rates (GEL 1.85 per U.S. dollar, US$1.46 per SDR, and US$1.21 per euro). Foreign assets of the NBG include gold, gross foreign exchange reserves, SDR holdings, and the reserve position in the Fund. Gross foreign exchange reserves of the NBG are defined as liquid, convertible currency claims of the NBG on nonresidents that are readily available. Pledged or otherwise encumbered assets, including, but not limited to, assets used as collateral (or guarantee for third party external liabilities) are excluded from foreign assets. Foreign liabilities include the use of IMF resources and any other liabilities of the NBG.

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

F. Ceiling on Contracting or Guaranteeing of New Nonconcessional Medium- and Long-Term External Debt by the Public Sector (with Original Maturity of One Year or More)

17. **Definition:** Nonconcessional external loans are defined as loans from lenders other than the IMF with a grant element of less than 35 percent of the value of the loan. The grant element is to be calculated by using currency-specific discount rates reported by the OECD (CIRRs).[1] For maturities of less than 15 years, the grant element will be calculated based on six-month averages of commercial interest rates. For maturities longer than 15 years, the grant element will be calculated based on 10-year averages. This performance criterion applies not only to debt as defined in point No. 9 of the IMF's Guidelines on Performance Criteria with Respect to External Debt (Decision No. 12274-(00/85) August 24, 2000) but

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

also to commitments contracted or guaranteed for which value has not been received.[2] Previously contracted nonconcessional external debt that has been rescheduled will be excluded from the definition of "new debt" for the purposes of this performance criterion.

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

G. Ceiling on Contracting or Guaranteeing Short-Term External Debt by the Public Sector (With Original Maturity of Less than One Year)

19. **Definition:** This performance criterion applies to debt as defined in point No. 9 of the IMF's Guidelines on Performance Criteria with Respect to External Debt (Decision No. 12274-(00/85) August 24, 2000), see footnote 5, as well as to commitments contracted or guaranteed for which value has not been received.

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

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

H. Non-Accumulation of External Arrears

21. **Definition:** During the period of the arrangement, the general government and the NBG will not accumulate any new external payment arrears on debt service obligations to official creditors, including the IMF and the World Bank. Official external payment arrears are defined as unpaid debt service by the general government and the NBG beyond the due date. This definition excludes debt subject to rescheduling under the July 2004 Paris Club agreement or as agreed under a bilateral agreement with a creditor. The performance criterion on non-accumulation of external debt is continuous.

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

I. Indicative Target for the Ceiling on Net Domestic Assets of the NBG

23. **Definition:** Net domestic assets of the NBG are defined as the difference between its net foreign assets and reserve money. Net domestic assets are defined as the sum of net claims on the government (the sum of loans and treasury bills purchased by the NBG, less deposits of the government with the NBG), claims on banks, claims on the rest of the economy, and other items net (comprising the NBG capital accounts, net unclassified assets, counterpart funds and exchange rate revaluation).

24. **Supporting material:** The NBG will provide to the IMF its balance sheet, which includes data on its net domestic assets, on a monthly basis within two week of the end of each month.