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

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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.

GEORGIA: LETTER OF INTENT

September 9, 2008

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C.

Dear Mr. Strauss-Kahn:

In the five years since the Rose Revolution, Georgia's macroeconomic management and cooperation with the International Monetary Fund (IMF) have been excellent. In mid-2004, the IMF approved a Poverty Reduction and Growth Facility (PRGF) arrangement to support a wide range of the economic reforms. The three-year PRGF arrangement, which was completed successfully in September 2007, laid the foundation for our recent strong growth and moderate inflation.

This year, tensions with Russia over the two breakaway regions of Georgia intensified and, in August, culminated in a conflict with Russia. A ceasefire agreement was signed on August 16 and Russian troops began withdrawing on August 22. In addition to the loss of life, systematic destruction of our military infrastructure and damage to personal property, economic activity was disrupted and Georgia's civilian infrastructure was seriously damaged.

Perhaps most damaging to Georgia's near-term growth prospects was the erosion of investor confidence. The government of Georgia is confident that the economy will recover from the conflict as we succeed in sustaining investor confidence. Therefore, it is of the utmost importance that measures be implemented that will reassure both the domestic and foreign business community as soon as possible.

The attached Memorandum of Economic and Financial Policies (MEFP) describes our economic policies and strategies for the next 18 months, which we understand will form the basis for continued IMF support. On the basis of the policies and the specific targets for the next year described herein, and due to the extraordinary external financing requirement created by the conflict with Russia, we hereby request a Stand-By Arrangement for the period of September 2008 to March 2010 in the amount of SDR 477.1 million (approximately \$750 million), equivalent to 317.4 percent of quota.

The government believes that the policies set forth in the MEFP are adequate to achieve the objectives of the program, but it is prepared to consider taking other measures that may become appropriate for this purpose, in consultation with the Fund. During the period of the arrangement, the authorities of Georgia will maintain the usual close policy dialogue with the

Fund, assisted by the continued presence of a resident representative should the IMF decide to maintain the post open.

Sincerely yours,

/s/

Lado Gurgenidze
Prime Minister of Georgia

/s/

Nika Gilauri
Minister of Finance

/s/

David Amaglobeli
Acting President

GEORGIA: MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES FOR 2008 AND 2009

This memorandum sets out the economic and financial policies of the Georgian government for September 2008–December 2009. These policies are the basis for the 18-month IMF-supported Stand-By Arrangement (SBA).

A. Recent Economic Developments

1. Since 2004, we have implemented a policy of comprehensive and exemplary economic reform. At the heart of our reform effort is a commitment to foster economic growth through private sector investment. To this end, we have eliminated barriers to private sector activity by aggressively deregulating the economy, privatizing most state assets, reducing and simplifying taxes, dramatically liberalizing the trade regime, investing in infrastructure, and significantly reducing bureaucratic barriers and as a result reducing corruption. In 2007, we were the leading economic reformer in the world. Our standing in the World Bank and IFC survey of business environments (“Doing Business”) jumped from 137th place in 2004 to 18th in 2008.
2. The macroeconomic results of our efforts have been inspirational and significant. Growth of GDP averaged 8.3 percent during 2004–06, was 12.4 percent last year and 9.3 percent in the first quarter of this year. In large part, Georgia’s extraordinary economic performance has been driven by private capital inflows. In 2004, these inflows were only \$0.5 billion. By 2007, private capital inflows had increased to \$2.3 billion, which is 22½ percent of GDP. Further, FDI inflows come from geographically diverse sources and the breadth of international institutional investors investing in Georgia—over 300—is unusual for such a small country. In April 2008, Georgia successfully issued its first sovereign Eurobond, raising \$500 million in an offer that was heavily oversubscribed.
3. Against a background of rapid economic growth, inflationary pressures are inevitable. In mid-2006, 12-month inflation exceeded 14 percent. Recognizing the social damage of inflation as well as its contribution to macroeconomic instability, we intensified efforts to return to single-digit inflation. Our efforts have been greatly complicated by the global environment of high energy and food prices. Nonetheless, the combination of fiscal and monetary restraint has succeeded in reducing 12-month inflation to 9.8 percent as of end-July this year.
4. On balance, our macroeconomic performance has indeed been impressive. We believe that this record of growth and stability can be continued in the future. In order to overcome the dire consequences of our recent conflict with Russia, we must redouble our efforts to improve macroeconomic conditions and reassure investors that Georgia will continue to be an attractive place for business.

Fiscal performance

5. A key indicator of Georgia's economic success is our greatly improved revenue performance that has allowed us to modernize the state and civil service, enhance the social safety net and invest in infrastructure. In 2003, tax revenues (including social contributions) accounted for only 14.6 percent of GDP. By 2007, tax revenues accounted for 25.8 percent of GDP. This achievement was the result of greatly improved tax administration, a simplified tax code and procedures, better taxpayer services and infrastructure, and, most important, fewer taxes and lower rates.

6. In July 2008, parliament approved legislation stipulating that state budget expenditures should not exceed 29 percent of GDP in 2009 (compared with our budget estimate of 30.3 percent for this year), should decline to 25 percent of GDP by 2011, and remain at or below this level thereafter. Additionally, parliament approved further liberalization of the tax regime and the establishment of two sovereign wealth funds—the Stabilization Fund and the Future Generations Fund—as a means of sheltering surplus revenues.

7. During the first half of 2008, revenue collection exceeded our projections by 2.6 percent and increased by 31.3 percent compared with the same period last year. In the first six months of 2008, privatization proceeds were \$352 million, exceeding the forecast by 68 percent and exceeding substantially the proceeds in any previous calendar year. At the same time, expenditures have been higher than projected because of the need for greater defense spending, which was originally projected to decline as a share of GDP this year. Capital expenditures, as well as social and other expenditures, were in line with targets for the first half of the year. The major part of the Eurobond proceeds were transferred to the Future Generations and the Stabilization Funds. Thus, the effect of these proceeds on the consolidated budget deficit was neutral.

Monetary policy

8. In March 2008, parliament approved amendments to the law governing the National Bank of Georgia (NBG), which make price stability the primary objective of the NBG. Financial stability and support for sustainable economic growth are secondary objectives. The new law also requires the NBG to target single-digit inflation. If this inflation target is not met (with a 2-percentage-point margin of error), then certain sanctions, including possible dismissal of the president of the NBG, are imposed. Moreover, under the new law, banking supervision was separated from the NBG and a unified Financial Supervision Agency was created. The board of the NBG will be downsized from nine to five members and the Monetary Policy Committee was created as the key decision-making body on monetary policy issues.

9. The legislative changes approved by parliament reflect a broad consensus within Georgia that inflation must be controlled. From November 2007 through July 2008, the NBG had been tightening monetary policy. The NBG's main policy rate was introduced and that rate was raised by 500 bps from November 2007 through July 2008. The NBG's certificates of deposits (CDs) and government notes have been used to conduct open market operations. As a result of the development of the interbank lending market due to prior changes in the reserve requirements regulation, the NBG started daily calculation and publication of Tbilisi Interbank Rates (TIBR) for overnight and up to seven-day loans.

10. As a result of these measures, reserve money growth was limited to 21 percent in the 12 months to mid-August 2008, while broad money growth was 28 percent as of end-July 2008. These compare favorably with the figures for end-March 2008 of 22 percent and 51 percent, respectively. While the growth of bank credit was high (55 percent in the 12 months to end-July 2008), it has slowed significantly this year and was only 23 percent in the first seven months of this year.

11. Since late 2007, the NBG has allowed much greater flexibility in exchange rates. For the first seven months of 2007, the nominal exchange rate of the lari against the U.S. dollar appreciated by 3 percent, while in the first seven months of 2008, the nominal appreciation was nearly 13 percent. This policy shift has allowed the NBG to intervene less frequently and subsequently made a significant contribution to our ability to reduce inflation.

12. As the economy has modernized and re-industrialized with the support of large capital inflows, the current account deficit has increased. In 2007, the current account deficit was \$2.0 billion or about 20 percent of GDP. In the first half of 2008, we estimate the deficit was about \$1.5 billion. In large part, the current account deficit has been self-financing, since about 60 percent of capital inflows is for import financing. Over the past four years, we have seen a significant diversification of exports and average annual growth of 26 percent (2003–07). To aid export growth, we have negotiated a free-trade agreement with Turkey (which is awaiting ratification by Turkey), requested a free-trade agreement with the U.S., and are benefiting from GSP+ with the EU.

Structural reform

13. In addition to the foregoing reforms, we have given especial emphasis to structural reform as a means of fostering competitiveness and growth.

14. In order to improve the quality of financial sector regulation, we created the Financial Supervision Agency (FSA). The FSA is a fully independent agency with its own supervisory board. The FSA is currently in the process of implementing a system of consolidated supervision of banks, insurance companies and securities firms.

15. An early activity of the FSA was to strengthen and refine our AML/CFT legislation. The relevant legislation was approved by parliament in March this year. In July, MONEYVAL completed its biannual review of Georgia and fully endorsed our AML/CFT legislation framework. We have also modified our banking laws with respect to fit and proper requirements for managers and owners. As a result, we no longer take a relatively simplistic approach of assessing the nominal owners and, in addition, identify and assess the actual beneficial owners of the institutions.

16. In an effort to increase the professionalism and efficiency of the NBG, we recently restructured and downsized the central bank. Since October 2007, total staff at the NBG has been decreased by 350 or about 56 percent. We believe that a more professional central bank will enhance our ability to achieve our main policy objectives and boost public confidence. These measures will also contribute to macroeconomic stability and long-term sustainable economic growth of the Georgian economy.

17. In addition, we have implemented numerous other structural reforms that are vital to economic growth, including deregulating the natural gas market; streamlining securities regulation; demutualizing the stock exchange; removing operational constraints in and facilitating entry into financial markets; liberalizing the issuance of building permits; simplifying export and import procedures; passage of a new law on insolvency and new foreclosure procedures; further simplifying business registration procedures; and introducing a comprehensive healthcare sector reform that entails full privatization of health care provision facilities and provides health care insurance for low-income groups.

B. Economic Policies Going Forward

18. Georgia is committed to enhancing macroeconomic stability and fostering economic growth through private sector investment. While we recognize the critical role of the public sector, especially in the realm of improving conditions for vulnerable groups, we believe that economic growth can only be led by the private sector. Hence, our emphasis is on creating an environment that is highly conducive to private sector growth. At the same time, we aim to improve the quality of government services whilst limiting the overall size of public expenditures.

19. The macroeconomic outlook has deteriorated sharply as a result of the conflict.

- Prior to the conflict, we were projecting continued high real GDP growth (about 9 percent) in 2008 and lower inflation of 8 percent by the end of the year. The medium-term prospects were strong. While we believe we may still be able to maintain our 2008 inflation objective, the expected sharp slowdown in private inflows (from \$1.5 billion in the first half of the year to \$0.5 billion in the second half) would lead to lower real economic growth (now projected at only 3½ percent).

- Private inflows are anticipated to pick up modestly in 2009 (to \$1.7 billion), which could support real GDP growth of 4 percent. Inflation would remain in single digits but the narrowing of the external current account deficit is not expected to be commensurate with the slowing of economic growth, reflecting the impact of higher imports for reconstruction, and high import prices.
- In the medium term, inflows are expected to recover and sustain higher investment, while export growth is expected to increase gradually. As a result, real GDP growth is projected to recover to mid single digits, while inflation would decline gradually.
- Under this scenario, in the absence of increased international support, Georgia's international reserves would decline sharply over the remainder of this year and next, to a level that would cover just a few weeks of imports. This would substantially weaken Georgia's external position. Strong international support will therefore be essential to allow the maintenance of an adequate level of reserves, covering 2¾ months of imports by end-2009. The financing gap of about \$1.2 billion over the 2008–09 period is expected to be covered by the IMF SBA and by grants and concessional financing provided by other IFIs and bilateral donors and creditors.

Fiscal policy

20. Consistent with the legislative changes approved by parliament this year, we are committed to minimizing the size of the fiscal footprint on the economy, ensuring fiscal prudence and preventing the underlying fiscal stance from contributing to inflationary pressures. Nonetheless, we are committed to rebuilding the infrastructure damaged by the conflict, which will require an increase in reconstruction-related spending. Given that we expect that much of this spending will be financed by donor grants, we feel that it can be accommodated within a sound macroeconomic framework that would help spur domestic demand while maintaining price stability. While some temporary increase in the fiscal deficit is inevitable during 2008 and 2009, we are determined to return to our medium term strategy of containing our fiscal footprint fiscal as soon as feasible.

21. For 2008, we will endeavor to delay all nonessential expenditures and will ensure that the overall fiscal deficit as defined in the attached Technical Memorandum of Understanding (TMU) is less than 6 percent of GDP (subject to quarterly performance criteria for end-September and end-December). This overall deficit includes the initial reconstruction spending that will be carried out in 2008. It will be subject to an upward adjustor of at most 2 percent of GDP, in the event that concessional donor financing exceeds currently declared commitments.

22. The government will submit to parliament a state budget for 2009 that will target a fiscal deficit of no more than 3¾ percent of projected GDP, with an upward adjustor of no

more than 3 percent of GDP in the event that concessional donor financing exceeds currently declared commitments (structural benchmark for end-December 2008).

23. In addition to implementing the legally required tax rate reductions, we will not introduce any new taxes, duties or fees, or increase any tax rates in 2009.

24. We will submit to parliament legislation to upgrade the Budget System Law (BSL) to an organic law (structural performance criterion for end-June 2009). Further, we will ensure that direct purchases of civilian good and services will not be more than 15 percent of overall approved expenditures for each state agency.

25. We will limit the contracting of public and publicly-guaranteed non-concessional external debt to no more than \$250 million during the remainder of 2008 and \$250 million during the first half of 2009 (subject to quarterly performance criteria). Additionally, during 2009, we will not increase public and publicly guaranteed domestic debt by more than GEL 100 million.

26. The Basic Data and Directions (BDD) document is being developed so that it sets out with greater clarity the government's medium-term fiscal and public expenditure strategies and plans. The quality of the BDD analysis will be improved and extended to include realistic resource ceilings for subsequent detailed budget planning. The BDD will also be disseminated more widely. The Ministry of Finance of Georgia will ensure that medium-term action plans are extended to include all spending agencies and will include clear statements of strategic directions (goals) and performance indicators (performance indicators will be developed for at least three ministries in 2010), as well as detailed costing. We will continue to improve the budget process and format, consistent with the findings of the World Bank and European Commission Public Expenditure Framework Assessment (PEFA).

27. The processing of financial transactions is being improved, with the Treasury Single Account (TSA) established and most revenues and expenditures flowing through a single process. During 2009, we will consolidate foreign currency deposits into a single account at the NBG and make progress towards implementation of a modern E-Treasury system.

28. In 2007, the Revenue Service of the Ministry of Finance of Georgia (RS) was formed and began developing risk based customs control and tax audit systems. In 2009, the RS will finish the implementation of the risk management system and will initiate risk assessment based tax audits. For the full implementation of risk-based custom controls, a post-clearance system needs to be introduced. This requires amendments to the Customs Code, which we will submit to parliament by June 2009 in conjunction with modernization of the Tax Code.

29. The RS will continue to give priority to improving taxpayer services. The MoF will ensure that the e-filing system is developed further and captures all types of taxes by 2009. Additional effort will be made to develop electronic systems in tax administration (e.g. e-lean

system), in order to increase the efficiency in tax arrears collection. We will seek to receive, in 2008 Q4, technical assistance and consultancy services to prepare for the transition by 2012 to the self-assessment regime with regard to personal income tax, delivering a seamless online and offline service to tax resident individuals regardless of their location.

30. Over the past two years, the tax disputes internal resolution system proved its effectiveness, but rising number of tax disputes (reflecting increased taxpayer confidence in the MoF dispute resolution committee) need to be addressed. The MoF will finish the necessary structural reforms in 2009, which will establish an independent dispute resolution office within the MoF, and a hearing system.

31. To increase transparency, from 2009 the Ministry of Finance will produce annual reports on (i) consolidated (including government, LEPLs, and state-owned enterprises) public expenditures and (ii) public arrears and debt. The government of Georgia will ensure the information on revenues/expenditures of the public services providing LEPLs is transparent and is provided in the state budget.

Monetary policy

32. We are strongly committed to low inflation and, in the current environment, believe that maintaining single-digit inflation and reducing it gradually in the medium term is essential. To aid with our efforts to meet inflation targets, we plan to adopt an inflation-targeting regime during 2009. Although we realize that there are certain constraints in implementing full-fledged inflation targeting immediately, we believe our efforts will be successful in ensuring low and stable inflation in the medium term. In the immediate future, our monetary policy will be guided by quarterly targets (performance criteria) for the net international reserves and net domestic assets of the National Bank of Georgia, as set out in the TMU.

33. We are concerned about the impact on bank liquidity of the loss of confidence resulting from the conflict. In the wake of the conflict, the NBG waived the reserve requirements on a temporary basis, and activated an uncollateralized lending facility. To help preserve financial stability and ensure a smooth functioning of the payments system, we intend to enhance our instruments for liquidity management.

34. Now that the immediate emergency is over, we will develop and publish a liquidity management framework that outlines the objectives of liquidity management, describes the instruments, and assigns the instruments to these objectives (structural benchmark for end-March 2009). This framework, which would also facilitate the implementation of the inflation-targeting regime, will *inter alia* (i) provide a clearer planning horizon for banks by enforcing the reserve requirement while adjusting the rate to the liquidity needs of the system and (ii) introduce a refinancing mechanism as the main liquidity providing instrument at interest rates determined by the market .

35. We will also revise the NBG lender of last resort (LOLR) facility to ensure that the availability of LOLR would not encourage excessive risk-taking by financial institutions. To minimize moral-hazard concerns, it is the NBG's policy to provide LOLR only to those institutions that are judged by the FSA to be solvent. We will also be more specific about the limits and size of the LOLR facility. The revised LOLR framework will be finalized by end-December 2008 (structural performance criterion).

36. We are fully committed to a flexible exchange rate policy. During the crisis-management period, the NBG defended the lari to prevent further uneasiness in the market. Under the SBA, a first drawing would serve to replenish reserves. Under the program, priority will be given to maintaining the targeted level of international reserves, and the exchange rate will be allowed to adjust to a shortfall in foreign inflows in the remainder of 2008 and 2009.

37. We plan to continue building a modern central bank. To this end, we plan to strengthen our human resource management practices, introduce a new payments system for commercial banks and the treasury, automate our banknote processing system, build a new cash center, introduce new investment management and accounting software, strengthen cooperation with partner central banks, and start participation in the World Bank RAMP project.

Structural reforms

38. We recognize the importance of continued structural reform as a means of enhancing competitiveness and fostering economic growth. Our goal is to remain among the world's top economic reformers by pursuing vigorous free-market structural reform consistent with the Anglo-Saxon economic model.

39. We will continue our policy of aggressively privatizing state-owned assets. By the end of 2009, we intend to privatize at least two-thirds of the shares of the Georgian State Electricity Company; at least 24 percent of Poti Sea Port; Georgian Post; about 100,000 hectares of agricultural land; several regional airports; and numerous other state-owned assets.

40. In order to maintain the competitiveness of the Georgian economy and to encourage further capital inflows, we will avoid introducing any laws or regulations that may reduce labor market flexibility, including the labor code. Additionally, in order to address the structural labor market shortages with regard to certain categories of professionals and to enhance Georgia's appeal as a tourism and retirement destination, we will further liberalize our migration and employment policy.

41. Regarding the financial sector, we are especially pleased with the overall stability and resilience the sector has demonstrated during the recent conflict. The NBG and FSA worked

well together to ensure the smooth operation of the payments system, as well as maintain public confidence in the lari and the banks. The FSA has started to assess any potential vulnerabilities in the banking sector emerging after the conflict by conducting on-site inspections. It is evaluating banks' liquidity positions and loan portfolios, looking into the situation of the main borrowers. Next, the FSA will make sure that the banks have contingency plans readily available to mitigate potential liquidity and capital pressures in the near future.

42. We recognize the need to strengthen further the cooperation between the FSA and the NBG. Accordingly, these two institutions will sign and implement a memorandum of understanding (structural benchmark for end-October 2008). This memorandum will define the areas of cooperation and accountability between the two institutions, containing inter alia practical and legal arrangements for information exchange on individual institutions' data, specific requirements to share promptly any possible irregularities in the financial system, and opportunities to review newly planned regulations before they are enacted.

43. Further, to strengthen the independence of the FSA and NBG, we will appoint the remaining members to the FSA board by end-June 2009 (structural benchmark for end-June 2009) and restructure the NBG board by end-2009. Additionally, we will submit to parliament during the fourth quarter of 2008 a Financial Code that will unify and consolidate banking, insurance, and securities regulation while avoiding any additional regulatory burden on financial institutions that is not envisaged in the recently passed legislation.

44. We will continue to build capacity at the FSA to adopt modern practices of risk-based supervision on a consolidated basis. We would welcome a streamlined and focused Financial Sector Assessment Program (FSAP) update mission in the second half of 2009 to assess developments in the financial sector and review the new regulatory framework.

45. In order to avoid an unnecessary regulatory burden on enterprises operating in Georgia, in the aftermath of the conflict with Russia we will avoid any amendments to or new legislation or regulation in the areas of anti-trust policy and consumer protection, as we believe any such measures would be meaningless for a small open economy like Georgia.

46. Among the other structural reforms we plan to introduce in the near future are a modern regulatory framework for water utilities; further energy sector deregulation; modernizing regulations for the use of forests and mineral resources; and implementing a merit based civil service reform. Of particular importance is our commitment to continue healthcare reform, including the completion of hospital and financing reform, licensing medical professionals and education, and reduce regulatory barriers to the entry of pharmaceuticals.

47. We will introduce a new draft Law on Statistics to parliament by year-end 2008, with the aim of creating a modern and independent statistical service that is able to deliver

relevant and high quality statistics. An supervisory board will be established, including independent board members, and an advisory panel will be set up to oversee improvements in methodology and effectiveness.

C. Program Monitoring

48. The program will be subject to quarterly reviews, and quarterly performance criteria as set out in the TMU. Completion of the first two reviews under the SBA, scheduled for November 2008 and February 2009, will require observance of the quantitative performance criteria for end-September and end-December 2008 in Table 1 and the structural performance criteria for end-December 2008 shown in Table 2.

49. We authorize the IMF to publish the Letter of Intent and its attachments, and the related staff report.

Table 1. Georgia: Quantitative Performance Criteria and Indicative Targets, 2008–09

	Jun-08 Actual /2	Cumulative Change from End-June 2008		Cumulative Change from End-December 2008		
		Sep-08	Dec-08	Mar-09	Jun-09	
		Performance Criteria Prog.	Performance Criteria Prog.	Indicative targets Prog.	Indicative targets Prog.	
			(In millions of lari)			
Ceiling on cash deficit of the consolidated government	...	537	603	141	469	
			(In millions of U.S. dollars)			
Ceiling on contracting or guaranteeing of new nonconcessional external debt by the public sector	0	250	250	250	
			Stocks at the end of the period			
			(In millions of lari)			
Ceiling on net domestic assets (NDA) of the NBG 1/	36	765	989	878	904	
			(In millions of U.S. dollars)			
Floor on net international reserves (NIR) of the NBG 1/	1,060	602	537	572	639	
Ceiling on accumulation of external arrears 2/	0	0	0	0	0	

Sources: Georgian authorities; and Fund staff estimates.

1/ Actual figures for June 2008 and quantitative targets are based on program exchange rates.

2/ The continuous performance criterion for external arrears is defined in paragraph 14 of the TMU.

Table 2: Structural Benchmarks and Performance Criteria

Action	Timing
FSA and NBG to sign and implement a memorandum of understanding to strengthen cooperation.	End-October 2008
NBG to introduce revised LOLR facility (structural performance criterion).	End-December 2008
Submission to parliament of a state budget for 2009 with an overall fiscal deficit of no more than 3¾ percent of projected GDP (subject to an adjustor of at most 3 percent of GDP as set out in the TMU).	End-December 2008
NBG to develop and publish a liquidity management framework, including the introduction of a refinancing mechanism as the main instrument to provide liquidity.	End-March 2009
Appointment of the remaining members to the FSA board.	End-June 2009
Submission to parliament of a law to upgrade the Budget System Law to an organic law (structural performance criterion).	End-June 2009

GEORGIA: TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)

September 9, 2008

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 Stand-By Arrangement (SBA). These performance criteria and indicative targets are reported in Tables 1 and 2 of the Memorandum of Economic and Financial Policies (MEFP), attached to the letter dated September 9, 2008.

2. The exchange rate for the purposes of the program of the Georgian lari to the U.S. dollar is set at GEL 1.41 = \$1. The corresponding cross exchange rates are provided in Table 1.

Consolidated Government and the Public Sector

3. **Definition:** The consolidated government is defined as the central government, local governments, extrabudgetary funds, public services providing general government system LEPLs, and the Sovereign Wealth Funds (Future Generations and Stable Development Funds). In case the government establishes extrabudgetary funds, they will be consolidated within the consolidated government. The public sector consists of the consolidated government and the National Bank of Georgia (NBG).

4. **Supporting material:** The Treasury Department of the Ministry of Finance (MOF) will provide to the IMF detailed information on monthly revenues, expenditures, and arrears of the consolidated government. In addition, data will be provided on the cash balances in the accounts of the Ministry of Finance.

Quantitative Performance Criteria, Indicative Targets, and Continuous Performance Criteria: Definitions and Reporting Standards**A. Ceiling on the Cash Deficit of the Consolidated Government**

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

- Net domestic financing consists of bank and nonbank financing to the consolidated government which will be defined as follows:
 - (i) Loans provided by commercial banks to the consolidated government minus accounts held by the consolidated government at commercial banks. These accounts and loans will be monitored based on the NBG's monetary survey. Any other

securities issued by the consolidated government (for example, promissory notes) are also included in domestic financing.

(ii) Loans provided by the NBG to the consolidated government minus accounts of the consolidated government held at the NBG in lari and foreign currency. Accounts that are outside of the MOF's control are excluded from domestic financing. These accounts include VAT refund account; earmarked grants account; account for state agencies deposits; account for local government revenues for the day to be transferred to their account; national disaster fund account; and investment grant and credit account. As of June 30, 2008, cash balances in these accounts were Lari 160.5 million. These accounts will be monitored based on the changes in cash balances as recorded by the Treasury Department.

(iii) Treasury bills that have been securitized and sold by the NBG, including the bills that have been purchased by nonbanks.

- Net external financing is defined as the total of loans disbursed to the consolidated government for balance-of-payments support and project financing (capital expenditure and net lending), net change in external arrears, change in the accounts of the consolidated government abroad, including the accounts of the Sovereign Wealth Fund, minus amortization. Amortization includes all external debt-related payments of principal by the consolidated government. 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.
- 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, including privatization proceeds which were transferred to the Sovereign Wealth Funds. This includes receipts from the sales of shares, the sale of assets as well as leases and the sale of licenses with duration of 10 years and longer.

6. **Adjustor:** The fiscal deficit target will be subject to an upward adjustor of up to 388 million Georgian lari (equivalent to 2 percent of projected GDP) for 2008 and 652 million lari (equivalent to 3 percent of projected GDP) for 2009, in the event that concessional donor financing exceeds current declared commitments (Table 2).

7. **Supporting material:**

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

- Data on external project financing as well as other external borrowing will be provided to the IMF monthly by the Debt Unit at the MOF (specifying projects by creditor) within two weeks of the end of each month.
- Data will be provided at the actual exchange rates.
- Data on the accounts of the Sovereign Wealth Funds will be provided by the NBG.
- Data on privatization receipts will be provided by the Treasury Department of the MOF to the IMF on a monthly basis within two weeks of the end of each month. The data will be consistent with the revenue account(s) in the NBG.
- Data on treasury bills that have been securitized and sold by the NBG, including the bills that have been purchased by nonbanks, will be reported by the NBG on a monthly basis within two weeks of the end of each month.

B. Floor on the Net International Reserves of the NBG

8. **Definition:** Net international reserves (NIR) of the NBG in U.S. dollars are defined as foreign assets minus foreign liabilities of the NBG. Foreign assets of the NBG include gold, gross foreign exchange reserves, 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 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 shall be defined as outstanding liabilities to the IMF and any other liabilities of the NBG. This defined, the definition of NIR excludes foreign assets stemming from foreign currency deposits of financial institutions at 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 on paragraph 2 above. The stock of NIR amounted to \$1,060 million as of end-June 2008 (at the program exchange rate).

9. **Supporting material:** Data on net international reserves (both at actual and program exchange rates) and on net foreign financing (balance of payments support loans; cash grants to the consolidated government; amortization (excluding repayments to the IMF); interest payments on external debt by the MOF and the NBG) 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.

C. Ceiling on Net Domestic Assets of the NBG

10. **Definition:** Net domestic assets of the NBG are defined as the difference between its net foreign assets and reserve money. Thus defined, the net domestic assets are 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). Performance against the NDA target will be measured at program exchange rates.

11. **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 weeks of the end of each month. Data will be provided using both actual and program exchange rates.

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

12. **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 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.

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.

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 and 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.”

13. **Supporting material:** Details of all new commitments and government guarantees for external borrowing, with detailed explanations, will be provided by the MOF to the IMF on a monthly basis within two weeks of the end of each month. Data will be provided using actual exchange rates.

E. Continuous Performance Criteria on Nonaccumulation of External Arrears

14. **Definition:** During the period of the arrangement, the consolidated 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 consolidated government and the NBG beyond the due date. The performance criterion on nonaccumulation of external debt is continuous.

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

Table 1. Program Exchange Rates

	Currency Name	Currency/US\$
SDR	Special Drawing Rights	1.58
GEL	Georgian lari	1.41
EUR	Euro	1.48

Table 2. Projected Foreign Borrowing of the Consolidated Government 1/ (in millions of U.S. Dollars)

September 30, 2008	8.7
December 31, 2008	50.4
March 31, 2009	7.0
June 30, 2009	29.4

1/ Cumulative from June 30, 2008 for 2008; for 2009, cumulative from the beginning of the calendar year.