International Monetary Fund

Georgia and the IMF

Press Release:
IMF Completes First Review Under the Stand-By Arrangement for Georgia
December 16, 2008

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Georgia: Letter of Intent and Technical Memorandum of Understanding

November 28, 2008

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

November 28, 2008

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

Dear Mr. Strauss-Kahn:

1. In September 2008, the International Monetary Fund (IMF) approved a Stand-By Arrangement for Georgia to assist with recovering from the economic dislocation caused by the conflict with Russia. This support proved invaluable in the months immediately following the conflict and we are grateful to the IMF for the support and especially the expeditious manner in which the program was approved.

2. This letter of intent describes our economic strategy and the range of economic policies that we plan to implement during the remainder of 2008 and in 2009. We are, of course, committed to fulfilling the commitments made in the Letter of Intent dated September 9, 2008. Further, we affirm our commitment to implementing policies that will ensure macroeconomic stability characterized by private sector led growth in an environment of low inflation. This will facilitate restoration of investor confidence and renewed access to capital markets. We believe that achieving sustainable economic growth is the best means of improving the living standards of Georgians and reducing poverty in a united country.

Recent Economic Developments

3. Economic performance during the first half of 2008 was robust. Real GDP grew by 8.5 percent in the 12 months to end-June 2008. As in past years, this strong performance was due mainly to large private capital inflows. In the first six months of 2008, private capital inflows totaled USD 1.6 billion, which is the largest amount recorded in any six-month period. Despite strong growth, disciplined monetary and fiscal policies kept inflation at 9.8 percent for the 12 months ending in July.

4. During the first half of 2008, the NBG tightened monetary policy in response to inflationary pressures. Reserve money growth was 19 percent in the 12 months to mid-August 2008, while broad money growth was 28 percent over the same period. Greater flexibility in exchange rates was allowed with the result that the lari appreciated by 12 percent in nominal terms against the dollar in the first seven months of this year.

5. Tax performance was also strong during the first half of 2008 with revenue collection increasing by 31.3 percent compared with the same period last year. At the same time, expenditures were higher.

6. The conflict with Russia in early August had serious economic, social and political consequences. The immediate economic consequence was the disruption of our transport infrastructure, which severely hindered economic activity, and a slowdown in foreign inflows. As a result, we estimate that growth in the third quarter was barely positive. Because of these dislocations, 12-month inflation spiked in August—12.8 percent—but has since subsided to 7 percent for the 12 months ending in October.

7. The current account deficit was about USD 1.7 billion in the first half of 2008. This reflects mainly the financing requirements associated with FDI-related imports. With the slowing of FDI in the second half of this year, we expect that FDI-related imports will also decline in the coming months, but there will be higher imports related to urgent humanitarian and reconstruction needs. Overall, the current account deficit is set to narrow considerably in the second half of the year.

8. The financial sector expansion was slowing prior to August as part of a policy to slow the growth of monetary aggregates and inflationary pressures. The immediate consequence of the conflict was an outflow of deposits and increased dollarization. Reflecting the underlying strength of the sector and public confidence, by the end-October the banking system recovered a considerable share of the lost deposits.

9. On balance, our record of growth and stability performance was indeed impressive before the conflict with Russia, and we believe that it will resume in the near future. In order to overcome the dire consequences of the conflict with Russia and the global economic crisis, we plan to redouble our efforts to improve macroeconomic conditions and reassure investors that Georgia will continue to be an attractive place for business.

Macroeconomic Policies for 2009

10. Without question, the major macroeconomic challenge facing Georgia is restoring investor and consumer confidence and, in turn, private capital inflows. We recognize this will be a daunting task especially in the context of the global economic crisis. Nonetheless, we are committed to maintaining macroeconomic stability and to intensifying our economic reform process as the main vehicle of resuming strong growth. We anticipate—on the basis of the generous pledges made at the recent donor meeting in Brussels—that significant financial support will be available to Georgia very soon, notably budget support from the U.S. These resources will support a wide range of mainly capital expenditures necessitated by the conflict and needed for establishing a foundation for sustained economic growth. They will also help close the balance of payments gap stemming from the expected decline in

private inflows. The expansionary fiscal effects will also allow us to offset the contractionary consequences of the conflict and the global economic environment, establishing a foundation for sustained economic growth.

11. For 2008, we project an overall fiscal deficit of GEL 1,158 million (performance criterion for end-December) or about 6.0 percent of GDP. The main emphasis of budget expenditures in the remainder of 2008 and next year will be increased and improved social spending and reconstruction of damaged infrastructure. For 2009, we expect a fiscal deficit of GEL 1,470 or about 6.8 percent of GDP which can be accommodated within the SBA's indicative target. This ceiling would be reviewed in the context of subsequent program reviews. The Government of Georgia is fully committed to manage the financial assistance from the donor community in an efficient and transparent manner.

12. The combination of a tight monetary stance in the first half of 2008 and the current economic slowdown have significantly eased inflationary pressures. For 2009 we project growth in reserve money of 12 percent and we are targeting growth of the broader monetary aggregates of 17 percent for M2 and 15 percent for M3.

13. In order to maintain macroeconomic stability and confidence, we decided to defend the domestic currency in the midst and aftermath of the conflict with Russia. The exchange rate stabilized without intervention by the central bank during most of September, but due to the global erosion of confidence we again had to intervene to maintain stability in the foreign exchange market. Nonetheless, the exchange rate depreciated by 16 percent in early November and we remain committed to a more flexible exchange rate regime. Priority will be given to maintaining the targeted level of net international reserves under the program. Our monetary policy will be managed accordingly to meet our inflation target.

14. The financial sector once again demonstrated its robustness and resilience to the two shocks that developed from the beginning of August. That has been possible due to the health of the banking sector, i.e. high liquidity position and capitalization of banks. Since the conflict erupted, banks responded by shrinking their balance sheets and taking a more cautious approach to lending due to changed perception of risks. At the same time the liquidity situation of banks strengthened because of the conservative lending policies and the liquidity injections of the central bank. Thus, we believe that as banks ultimately secure long-term funding from the international financial institutions they will resume private sector lending.

15. Under the terms of the memorandum of understanding between the NBG and the FSA that was signed in October (structural benchmark for end-October), we have established a Joint Financial Sector Committee (JFSC). It is envisioned that the JFSC will be the main vehicle for discussing and analyzing issues related to the financial sector.

16. We commit to implementing the recommendations of the recent update safeguards assessment report within the agreed deadlines. In particular, we will reconstitute the NBG's Audit Committee with only non-executive members, and require the internal audit department to audit the monetary data reported to the Fund at each test date and at the financial year-end.

Program Monitoring

17. All performance criteria for the First Review under the Stand-By Arrangement were met. We request the completion of the First Review and express our intention not to draw the SBA purchase that will be available at the completion of the first review. We will maintain the usual close policy dialogue with the Fund and stand ready to take additional measures as appropriate to ensure the achievement of the program objectives. The third and fourth reviews are scheduled for end-May 2009 and end-August 2009. We request the modification of the performance criteria for end-December 2008, on which the next quarterly review will be based (attached Tables 1 and 2).

18. We authorize the IMF to publish the Letter of Intent and its attachments as well as the related staff report.

Sincerely yours,

/s/	/s/	/s/
Grigol Mgaloblishvili	Nika Gilauri	David Amaglobeli
Prime Minister of Georgia	Minister of Finance	Acting President of the NBG

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

	Cumulative Change from End-June 2008						Cumulative Change from End-December 2008			
	Sep-08			Dec-08			Mar-09		Jun-09	
	PC	Actual	Diff.	Orig. PC	Rev. PC		Orig. targets	PC	Orig. targets	PC
					(In millions of lari)					
Ceiling on cash deficit of the consolidated government	537	444	93	603	627	3/	141	229	469	517
					(In millions of U.S. dollars)					
Ceiling on contracting or guaranteeing of new nonconcessional external debt by the public sector	0	0	0	250	250		250	250	250	250
					Stocks at the end of the period					
					(In millions of lari)					
Ceiling on net domestic assets (NDA) of the NBG 1/	765	452	313	989	214		878	295	904	329
					(In millions of U.S. dollars)					
Floor on net international reserves (NIR) of the NBG 1/	602	848	-246	537	851		572	836	639	861
Ceiling on accumulation of external arrears 2/	0	0	0	0	0		0	0	0	0

Source: Georgian authorities; and Fund staff estimates.

1/ Actual figures for September 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.
3/ The 2008 deficit PC remains unchanged except for Lari 24 million which was added to reflect the fact that a grant financed pre-payment of debt to the EU was postponed.

Table 2. Georgia: Structural Benchmarks and Performance Criteria

Action	Timing
FSA and NBG to sign and implement a memorandum of understanding to strengthen cooperation.	End-October 2008 Done
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: REVISED TECHNICAL MEMORANDUM OF UNDERSTANDING

November 28, 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 and Table 1 attached to the letter of intent dated November 28, 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:**

  - For 2008, the fiscal deficit target will be adjusted upward for any excess in foreign borrowing by the consolidated government relative to the projected amounts presented in Table 2. The upward adjustor shall not exceed 387 million Georgian lari.

  - For 2009, the fiscal deficit target will be adjusted downward for any shortfall in foreign borrowing by the consolidated government relative to the projected amounts (Table 2). In addition, the fiscal targets for each quarter of 2009 will be adjusted upward by the overperformance of the fiscal deficit relative to the target for end-December 2008, up to a ceiling of lari 479 million.

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]

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[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. A web-based grant element calculator is available at http://www.imf.org/concessionality.

[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

(continued)

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.

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. Official external payment arrears are defined as unpaid debt service by the consolidated government and the NBG beyond 30 days after 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)

December 31, 2008 2/	50.4
March 31, 2009	41.3
June 30, 2009	153.1
September 30, 2009	314.4
December 31, 2009	561.3

1/ For 2008, cumulative starting from June 30, 2008.
For 2009, cumulative from the beginning of the calendar year.
2/ In line with the borrowing assumption in the original program.

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."