International Monetary Fund

Georgia and the IMF

Press Release:
IMF Executive Board Approves Stand-By Arrangement and Stand-By Credit Facility for Georgia with Total Access of up to US$385.6 Million
April 12, 2012

Country's Policy Intentions Documents

E-Mail Notification
Subscribe or Modify your subscription

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

March 27, 2012

GEORGIA: LETTER OF INTENT

March 27, 2012

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

Dear Ms. Lagarde:

1. The attached Memorandum of Economic and Financial Policies (MEFP) outlines the economic and financial policies that the Georgian government and the National Bank of Georgia will implement in 2012–2013 to improve macroeconomic balances and strengthen the resilience of the economy to shocks.

2. The government is fully committed to the policies stipulated in the MEFP and its attachments. These policies are designed to bring the fiscal deficit to 3.5 percent of GDP in 2012, 3.0 percent in 2013 and to below 3 percent in 2014, to facilitate external adjustment through a flexible management of the exchange rate, and to maintain an adequate international reserve cushion against external financing risks.

3. On the basis of these policies and to signal our continued commitment to macroeconomic stability, the Georgian government requests that the Fund support this multi-year program under a Stand-By Arrangement (SBA) for a period of 24 months in the amount of SDR 125 million (83.2 percent of quota) and a Standby Credit Facility for a period of 24 months in the amount of SDR 125 million (83.2 percent of quota). We project our program to be fully financed and intend to treat the SBA and SCF as precautionary.

4. The implementation of the program will be monitored through quantitative performance criteria and structural benchmarks as described in Tables 1 and 2 of the attached Memorandum of Economic and Financial Policies and in the Technical Memorandum of Understanding. There will be four reviews to assess progress in implementing the program and reach understandings on any additional measures that may be needed to achieve its objectives. The first review will be based on

end-June 2012 performance criteria and is scheduled for completion by end-October 2012; the second review will be based on end-December 2012 performance criteria and is scheduled for completion by end-April 2013; the third review will be based on end-June 2013 performance criteria and is scheduled for completion by end-October 2013, and the fourth review will be based on end-December 2013 performance criteria and is scheduled for completion by April 10 2014. The government and the National Bank of Georgia will provide the Fund with the data and information necessary to monitor performance under the program.

5. The Georgian authorities believe that the policies set forth in the attached memorandum are adequate to achieve the objectives of the economic program, and stand ready to take any further measures that may become appropriate for this purpose, in consultation with the Fund in advance of changing any policies set forth in the LOI/MEFP.

6. We authorize the IMF to publish this Letter of Intent and its attachments as well as the accompanying staff report.

Sincerely yours,

/s/
Nika Gilauri
Prime Minister of Georgia

/s/
Dimitri Gvindadze
Minister of Finance of Georgia

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

GEORGIA: MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES (MEFP)

March 27, 2012

1. The economic and financial program supported by a Stand-By Arrangement with the IMF over the period September 2008–June 2011 was successful in stabilizing the economy in the wake of the conflict with Russia and the global financial crisis, and in restoring conditions for strong economic growth. A sizable fiscal stimulus package helped mitigate the economic impact of the crisis and was used to increase the overall productivity of the economy through public infrastructure investment, and to provide housing and social assistance to the Internally Displaced Persons (IDPs). Consistent with the temporary nature of the stimulus package, we have moved rapidly to consolidate Georgia's public finances as the economy began to recover. The government deficit was reduced from 9.2 percent of GDP in 2009 to 3.6 percent of GDP in 2011 and the government debt-to-GDP ratio is back on a declining trend. Supported by prudent macroeconomic policies, economic growth has accelerated to around 7 percent in 2011, while inflation has come down in the low single digits. Flexible management of the exchange rate contributed to the correction of the current account deficit (from 22.6 percent of GDP in 2008 to an estimated 12½ percent of GDP in 2011).

2. In the wake of the crisis the domestic banking sector faced difficulties accessing international capital markets, while also facing loss of deposits—29 percent decline in exchange rate-adjusted terms from peak to trough. This liquidity shock was compounded by a deterioration in the quality of the loan portfolio, with NPLs (IMF definition) increasing from 0.8 percent of the loan portfolio before the crisis to 8.6 percent by mid-2009. Notwithstanding these difficulties, the banking sector was able to weather the crisis well, owing to the strong capitalization of the banks, timely liquidity injections by the central bank, the support of IFIs, and, ultimately, the recovery of confidence. As of December 2011, the deposit base had more than doubled relative to the pre-crisis peak, credit has been growing at a healthy pace, NPLs have declined markedly (to 4.6 percent of the loan portfolio as of December 2011), and financial indicators point to solid capital and liquidity buffers.

3. The strength of the recovery and the credibility of our economic policies also contributed to a marked improvement of international investor confidence. On April 12, 2011, Georgia issued a 10-year $500-million Eurobond at very favorable terms (7.125 percent yield), establishing an

excellent sovereign benchmark in the international capital markets. The proceeds of the issue were used to buy back most of the $500 million Eurobond maturing in 2013, easing considerably rollover risks. The Georgia Eurobonds trade above par in secondary markets. In December 2011, Georgia's sovereign rating was upgraded to BB- by Fitch and S&P's, and the spread on Eurobonds has narrowed to 450 basis points as of February 2012 (from a peak of 574 basis points in October 2011).

4. Notwithstanding the improvements in the economic and financial situation since 2008, challenges remain:

- Fiscal buffers against potential future shocks need to remain strong through continued fiscal consolidation, while taking into account pressing needs for government spending to upgrade infrastructure and raise pensions closer to the established subsistence minimum.
- Despite strong economic growth over the last decade, the unemployment rate has remained high (16.3 percent at end-2010), warranting additional government action to promote private investment and job creation.
- Balance of payments conditions are stable, but the financing need created by the large current account deficit is a source of vulnerability. While we remain committed to exchange rate flexibility, in the event large external financing shortfalls were to emerge it would be difficult to counter balance of payments pressures through the exchange rate alone, given high financial dollarization.

I. THE ECONOMIC AND FINANCIAL PROGRAM FOR 2012–13

5. The ultimate objective of our economic policies is to promote the creation of jobs and improve the living standards of all Georgians through sustained and inclusive economic growth. Our program for 2012–14 focuses on mutually reinforcing macroeconomic and structural policies to achieve these objectives, consistent with the priorities laid out in October 2011 in the Government's Ten-Point Medium-Term Plan.

6. We believe that the factors that contributed to Georgia's strong rate of economic growth from 2004 to 2008 remain valid today: Georgia consistently ranks near the top of business environment, governance, and reform indicators; it is strategically located as a gateway to the Caucasus and Central Asia; it has a demonstrated track record of sound macroeconomic management; and still has an untapped growth potential from unrealized productivity gains. We

view macroeconomic stability as a cornerstone of our growth strategy. Hence, our program targets a further reduction of the fiscal deficit and the stabilization of inflation in the single digits. Maintaining a flexible exchange rate will also facilitate external adjustment and lessen vulnerabilities to external shocks.

7. We believe that, in addition to providing macroeconomic stability, the government has a role to play in unlocking the growth potential in a number of sectors of the economy, including tourism, energy (hydropower generation, including for export) and agriculture. To unleash this potential and create jobs, we will persist in our endeavor to make Georgia the most attractive investment destination, notably through:

- Continued improvements in the business environment, including by making the tax and customs administrations even more responsive to the needs of taxpayers.
- Public financial support to private investment through the newly created Partnership Fund (PF).
- Ongoing and new initiatives to upgrade job seekers' skills and better attune the education system to the needs of the market economy.
- Public intervention to address market failures and structural impediments in agriculture.
- Public investments to promote tourism and regional integration.

A. Macroeconomic Framework

8. In 2012, annual real GDP growth is projected to remain elevated at at least 5 percent as the result of the high growth observed in the second half of 2011. Reflecting the strength of the macroeconomic framework and the structural policies targeted under the program, we conservatively expect that economic growth will average at least 5½ percent over the medium term, with a significant upward potential.

9. We expect CPI inflation to remain within the National Bank of Georgia's (NBG) target of 6 percent in 2012. However, because of the large weight of basic commodities in the CPI basket, headline inflation will remain inherently vulnerable to commodity price shocks that are outside the control of the monetary authorities.

10. The overall balance of payments was in surplus in 2011, and we expect this to continue in 2012. However, because of the uncertainty of private capital inflows, we have built our medium-

term macroeconomic framework on the conservative assumption that private capital inflows will grow only moderately in USD terms, and converge to around 7–8 percent of GDP in the medium term, compared to 11.4 percent in 2011.

11. [1] Consistent with this assumption and with an anticipated gradual decline of official financial inflows, we project that the current account deficit will also decline to around 7 percent of GDP by 2015–16, from 12½ percent in 2011. This current account adjustment is brought about by the combination of fiscal consolidation, a flexible management of the exchange rate, and structural policies to strengthen competitiveness.

B. External Adjustment and International Reserve Target.

12. Notwithstanding the envisaged external adjustment effort, our external financing needs will remain sizeable in 2013–14, owing to a rise in external debt servicing obligations, mostly to the IMF, which will peak in 2013. The service of the external public debt is projected to reach the equivalent of 10 percent of exports in 2013. Under the program, the repayment of the SBA obligations to the Fund would be made possible by current account adjustment (which would outpace projected financial and capital inflows) and some drawdown of gross international reserves from their current ample level.

13. The increase in net international reserves projected under the program would ensure that the gross international reserve (GIR) coverage of imports and short-term liabilities remain at a safe level. Specifically, we consider that GIR should remain above $2.5 billion during the program period, which would provide coverage for at least 3 months of imports and at least 100 percent of short-term external debt.

C. Possible Financing Need and Access to IMF Resources

14. Even though our macroeconomic framework is based on prudent assumptions, economic and financial developments are subject to considerable uncertainty, particularly with regard to private capital inflows, export market growth and the price of our commodity exports. We will continue relying on exchange rate flexibility as the first line of defense against unforeseen developments and financing shortfalls. However, in the dollarized domestic context, we also need to avoid disruptive movements in the exchange rate, as they could compromise financial stability. We

[1] Excluding bank inflows related to increase in fx reserve requirements

also stand ready to accelerate fiscal consolidation in the event of financing shortfalls, notably by slowing down capital spending.

15. While we intend to treat the SBA and SCF as precautionary, we would consider drawing under the arrangements in the face of large adverse shocks, which could not be handled solely through exchange rate adjustment, faster fiscal consolidation, and a drawdown of international reserves without compromising financial stability.

16. We consider that our request for total access of SDR 250 million under the SBA and SCF is consistent with these risks.

D. Fiscal Policy

17. The purpose of fiscal policy is to safeguard adequate fiscal buffers and keep the government debt-to-GDP ratio on a steady declining trend by maintaining low deficits, consistent with our commitment under the Economic Liberty Act. Accordingly, we will reduce the fiscal deficit to no more than 3.5 percent of GDP in 2012 and no more than 3.0 percent of GDP in 2013. In nominal terms, this implies that the cash deficit of the general government, as defined in the Technical Memorandum of Understanding (TMU), will not exceed GEL 943 million in 2012 (performance criterion).

18. Consistent with our commitment (under the Economic Liberty Act) to keep current and capital expenses of the government under 30 percent of GDP from 2014 onward, we also intend to maintain expenditures of the general government at around 31 percent of GDP in 2012.

19. Consistent with our pro-growth strategy, medium-term fiscal consolidation efforts will rely essentially on containing government spending. Given the projected increase in the net budgetary cost of pensions (see below), we will control very tightly other government expenditure categories.

20. To strengthen our commitment to sound public finances, we have amended the Economic Liberty Act so as to provide the government with sufficient tax policy flexibility and autonomy to allow it to react properly to unforeseen fiscal shocks, notably if we encounter difficulties in implementing our expenditure-based consolidation strategy.

21. In order to facilitate settlement of the government's external debt service obligations in 2012–14, the ministry of finance has set aside in a dedicated sub-account of the Treasury Single Account sums dedicated to future IMF debt service.

22. To further improve debt management and help develop local financial markets, we have extended the maturity structure of Treasury paper by issuing our first 5-year notes in April 2011 and our first 10-year notes in March 2012. As a sign of our enhanced credibility, foreign investors have also entered into the T-bill market.

23. Public external debt is projected to come down gradually. Since the bulk of the foreign public debt is in the form of long-term official loans on soft terms, the government's external debt servicing costs will remain well within prudent levels (i.e., below 3 percent of GDP) over the medium term and will only increase significantly in 2021, when the US$500 million Eurobond matures.

24. We have decided to increase pension benefits in two steps to narrow the gap relative to subsistence levels. We will also broaden the coverage of health insurance, so as to cover all pensioners, in September 2012. To limit the budgetary impact of these measures, the second pension increase, coming into effect in September 2012, will be provided only to pensioners aged 67 and above.

E. Monetary and Exchange Rate Policies

25. Price stability continues to be the main objective of our monetary policy and the experience of 2011 points to the success we have achieved in anchoring inflationary expectations. Owing to soaring global commodity prices, headline inflation peaked at 14.3 percent (year-on-year) in May 2011, but core inflation (excluding food, beverages, tobacco, and energy) remained subdued throughout the period, at under 2 percent. When the impact of the commodity price hike on headline inflation began to wane, and the risks of second-round effects declined, we began easing the monetary policy rate, from 8 percent to 6.5 percent presently.

26. For 2012, the monetary policy objective is to keep inflation at or below our 6 percent objective. We consider that the policy rate is currently consistent with this objective. Changes in the monetary policy stance will be guided by developments in credit and monetary aggregates complemented by our inflation forecast model. At the same time, to reduce the risks of excessive money creation, we will maintain the net domestic assets of the NBG (TMU definition) below GEL 238 million by end-2012 (performance criterion). While the refinancing (policy) rate remains our primary monetary policy instrument, reserve requirements could also be used, reflecting the fact that the effectiveness of the policy rate is limited by high dollarization levels and thin money and financial markets.

27. We remain committed to a flexible exchange rate, and consider that daily fluctuations of the exchange rate are desirable to prevent the formation of speculative expectations in the foreign exchange market. As was the case in 2011, foreign exchange intervention will be motivated by the need to dampen excess volatility in a thin market, and by our objective of increasing net international reserves (TMU definition) to $1,196 million by end-2012 (performance criterion).

28. As part of our gradual move to a (lite) inflation targeting regime, we have improved the quality of our price statistics and have strengthened the communication with the public. After each monetary policy committee meeting, we provide information to the public on the rationale behind our policy choices. Building on technical assistance and training provided by the IMF, we have developed a general equilibrium model to inform the NBG's decision-making process. Meanwhile, we continue to work to enrich the model to better capture important features of the Georgian economy.

29. Since April 2010, we have implemented a broad agenda of monetary and macroprudential measures to promote the use of the local currency (the lari) and the development of local currency markets in Georgia. These measures include the activation of the lari standing facilities and the reform of the refinancing window, the tightening of capital adequacy requirements for unhedged foreign currency lending, the extension of the reserve requirement coverage to external borrowing, and the disclosure requirements for risks associated with foreign currency borrowing. These actions have contributed to deposit and credit dedollarization in 2011–12, and we expect this trend to continue over the medium term.

30. Domestic agents' need for foreign exchange hedging instruments has increased since the introduction of foreign exchange auctions in 2009, which led to higher short-term exchange rate volatility. We plan to support the launching and development of the interbank hedging market by conducting educational activities among financial institutions and their clients, building necessary infrastructure to support pricing, trading and settlement of fx market instruments and further opening up access for international investors to domestic financial markets.

31. To further pursue the objective of interbank market development, we have introduced the integrated Real Time Gross Settlement (RTGS) and Central Security Depository (CSD) systems that enable Delivery-vs-Payment (DvP) transactions with securities. We have further improved the settlement infrastructure and finalized the integration of the Bloomberg and CSD systems for repo operations in 2011. The new law on payment systems, drafted with technical assistance from the

IMF, will be adopted in 2012. It regulates E-payments and financial collateral among other issues. We are also in the process of upgrading payment system oversight functions within the National Bank, based on technical assistance received from the IMF.

32. In order to enhance the safety and efficiency of the international reserves management process, we have implemented a new portfolio management system, covering the front-middle-back office and accounting functionality based on Straight through Processing (STP) principles. The system is IFRS compliant and will allow us to introduce new and more sophisticated financial instruments and investment techniques in the reserves management process, bringing it in line with international best practices. The system became fully operational in June 2011.

33. To bring our official statistics in line with international standards, the NBG will start reporting Financial Soundness Indicator data and metadata to the IMF's Statistics Department for dissemination on the IMF's website. The NBG also aims to improve the quality of data on private loans from non-residents. For that purpose, since the first quarter of 2011, NBG has been receiving information from GEOSTAT on the identity of resident entities holding foreign loans, enabling it to cross-check GEOSTAT and ITRS data and improve quality control.

F. Financial Sector Policies

34. Following losses in 2008–09, the Georgian banking sector returned to profitability in the last quarter of 2009. In 2011, net profits of the banking system (GEL 323 million) more than doubled relative to 2010 (GEL 156 million), resulting in a 2.85 percent return on assets and a 17.3 percent return on equity. Decreasing asset yields (which accounted for negative 43 percent of the increase in net profits) were compensated by improved credit quality (accounting for 56 percent of the increase in net profits). Change in composition of liquid assets and improved cost efficiency contributed by 34 percent and 30 percent of the increase in net profits respectively. Loan portfolio growth had a relatively smaller, but still noticeable effect of 24 percent on profit increase, part of which was driven by decreasing overall liquidity (effect of 3.5 percent).

35. In the post-recession period, the economic recovery and intensified lending activity combined with write-offs and repossessions led to major improvements in the asset quality indicators. Lending activity was initially spurred by inventory build-up in the real economy followed by growth in retail lending and fixed investments. As a result, the share of NPLs in total loans decreased from 18.8 percent (based on the national definition) in June 2009 to 8.62 percent in December 2011 (from 8.3 percent to 4.6 percent based on IMF 90 days overdue definition).

36. Credit growth was accompanied by a slight easing of lending standards following the over tightening during financial distress and intense competition. This drew interest rates on loans down until second half of 2011, when turmoil in the Eurozone began.

37. Capitalization and liquidity are high enough to support further lending growth. The level of financial depth remains low, especially when taking into account the central role played by banks in providing funding to the economy. However, any rapid financial deepening would have to be accompanied by lengthening of loan maturities, decrease in interest rates, and increase in the sectoral/regional financial penetration for the process to be sustainable. Moreover, currency-induced credit risk remains high though covered by capital requirements. At the same time dollarization has decreased noticeably both for loans and deposits.

38. We consider that the banking sector currently has comfortable levels of liquidity. There are no significant repayments due in the short run. Major repayments due in 2012 have already been repaid in February. But the recent turmoil in Europe has affected the local financial system as well, in the sense that only limited amount of additional inflows are expected in 2012, owing to higher cost of borrowing and external resource supply scarcity.

39. To make the liquidity risk management and supervision more risk based NBG has recently adopted the LCR (liquidity coverage ratio) reporting form and started collecting data for performing a quantitative impact study with a view to making LCR the core liquidity monitoring tool in the future. The current form already allows calculation of LCR under Basel III standardized methodology.

40. We have embarked on a gradual transition to risk-based forward-looking supervision. High capital and liquidity requirements pre-crisis proved to be a good buffer against shocks, but they also led to higher intermediation margins. Moreover, system-wide conservative requirements were not always sufficient as the shock absorption capacity of the banks differed according to their respective risk management practices. To facilitate the transition towards risk-based supervision, we have changed the organizational structure of the NBG to enable a more efficient use of limited human resources by creating divisions that assess system-wide risks (credit, financial/macroprudential, operational) and assist the Banking Supervision Department in evaluating commercial banks' overall risk profile. To ensure the adequacy and consistency of bank evaluations, we developed benchmarking procedures, according to which all risk areas are benchmarked by the (same) relevant specialists. The exercise has already been done for several banks.

41. We have initiated, through the Operational Risk and Information Processing Division, the development of an operational risk assessment framework for banks. For the first time, NBG's operational risk assessment includes detailed examination reports and assessment of the commercial banks' overall operational risk profile. The initial operational risk assessment of banks is to be completed by the end of June, 2012. The framework covers, inter alia, IT-related supervisory topics such as business continuity and contingency planning, as well as risks associated with outsourcing and offshoring of critical business processes. The new framework aims to ensure convergence to the Basel principles for the effective management of operational risk.

42. In order to reduce information costs and promote cross-product and cross-bank comparability of the financial products, we have introduced, in June 2011, a consumer protection framework. The Georgian banks are now obliged to disclose to borrowers more information on loans, such as the effective interest rate, currency induced credit risk, contract amendment rights and other information. Additionally, bank customers are now able to submit complaints straight to the NBG. Some of the identified shortcomings on the retail market are going to be addressed through legislative changes, which will be drafted by the end of 2012. Analysis of the consumer complaints data also contributes to strengthen supervision through the identification of related operational and retail credit risks.

43. In the medium term, we aim to converge to the Basel II/III framework consistent with our move to risk-based supervision. In this regard we have collected data from each bank and performed quantitative impact study of Basel II/III compliance on regulatory capital. Preliminary findings show that the industry has enough quality capital to comply with even Basel III requirements. The major challenge in the transition process will be adoption of Pillar 2, since this will be new both for the banks and the regulators. After implementing Basel II there will be limited additional effort needed to move to Basel III, since the three major differences of Basel III compared to Basel II (capital amount/definition, treatment of trading book, and liquidity coverage ratio) are not an obstacle for Georgia: (i) all of Georgian banks' core capital already qualifies under Basel III definition (even after Basel III deductions from Common Equity Tier 1 (CET 1) capital); (ii) the trading book is virtually nil in banks' balances; and (iii) liquidity requirements are already quite conservative and their adaptation to Basel III requirements would not require much additional effort as the LCR reporting form is already in place.

44. Substantial work has been performed to harmonize current disclosure rules and make them Basel compliant, but the regulatory infrastructure for Pillar 3 still needs further fine-tuning.

45. To facilitate macroprudential supervision and transition to Basel III, we are currently developing a new framework that utilizes microprudential data for macroeconomic policy, and evaluates the effects of macroeconomic shocks on microprudential regulation. In particular a framework that defines the need for countercyclical buffers according to Basel III has already become operational (countercyclical policy measures have already been taken previously by adjusting FX risk weights). The guidelines from the Basel Committee on Banking Supervision for identifying Global Systemically Important Banks (G-SIBs) have slightly been adapted to the local environment (by adding, for example, geographical outreach and sector coverage as systemic indicators). Calculation of countercyclical and systemic risk buffers is currently only performed for monitoring purposes.

46. The macroprudential framework will be further updated by the end of March-2012 and it will integrate macroeconomic scenarios with a micro-level borrower assessment. The macroprudential division will define stress scenarios according to the state of the economy (for example, just after a negative shock the scenarios will be milder compared with overheating phases). The scenario will typically assume stress on exchange rate and collateral values with varying degrees of output stress for different sectors of the economy. This information will be used by the Credit Risk division which will perform the micro-level stress tests. These inputs will be used by the bank supervisors to conduct stress tests on the bank portfolio and to assign ratings to the borrowers according to their resilience to stress. This exercise will improve upon the existing framework by differentiating standard loans in three different categories. The rating of the portfolio will be used in Pillar 2 within the new regulatory framework and additional capital requirements will be required for the banks with less stress-resilient portfolios. The banks themselves will be familiar with the methodology and will be required to perform micro-level stress tests deriving from macro scenarios.

47. We intend to preserve a "light touch supervision" approach towards the non-banking sector, which is at its initial stage of development. However, for the insurance sector, we envisage further harmonization of the legislation and of the supervisory methods with the Solvency I/II principles.

48. Following the intense upgrade of our supervisory structures and approach, we consider that a stock taking exercise is helpful in evaluating our framework and practices relative to international standards. To that end, we started a self-assessment of the supervisory framework and practices in

July 2011. We have completed drafts for 16 out of the 25 Basel core principles. The anticipated date of completion of the self-assessment is July 2012.

G. Public Financial Management

49. In order to improve the efficiency of the overall public sector and limit risks to public finances, we intended to reinforce our monitoring of state-owned enterprises (SOEs) and state agencies (Legal Entities of Public Law, or LEPLs) at the level of the ministry of finance. The ministry will collect this information and produce an annual report of the financial flows for each of the 5 largest SOEs as well as an annual report consolidating the financial flows of the 5 largest LEPLs. The first reports will cover 2011 financial accounts and will be completed by June 30, 2012 (structural benchmark). Starting in 2013, reports will include an assessment of fiscal risks in relation to the SOE and LEPL operations.

50. We have also made significant progress in our long-term public financial management reform agenda by improving public finance and debt management information systems and harmonizing reporting and accounting standards among central government spending entities.

H. Partnership Fund

51. In order to promote private investment, we have established a partnership fund (PF), with the objective of providing co-financing (in the form of minority equity or debt financing) in situations in which the private sector cannot mobilize sufficient funding from the market without some form of state participation. State participation can help address market failures and mitigate perceived risks. As such, we consider that the PF can help unlock private investment into new greenfield projects, consistent with our private sector-led growth strategy. PF commenced co-financing projects in 2011, based on already identified potential investments in hydropower and on completed and ongoing feasibility studies for projects in agriculture, manufacturing and real estate.

52. The PF is incorporated as a joint stock company and thus has a profit maximizing objective. It is intended to contribute to the financing of private sector projects, through minority equity participations, lending or guarantees. It can also initiate feasibility studies for projects that can attract foreign investors. Its operations will be undertaken without any state guarantees and solely on its own account. We have taken steps to ensure proper accountability and oversight. In particular, we will publish and transmit to the Supervisory Board, which is chaired by the Prime Minister, the audited financial statements of the PF on a semiannual basis, starting with the publication of the end-2011 statements by end-September 2012 (structural benchmark). Financial statements will be

IFRS-compliant and audited by a reputable auditor. We also intend to have the PF rated by credit rating agencies. We have requested technical assistance from the IMF to identify ways in which we can further strengthen governance, oversight and transparency of the PF, consistent with best financial management practices. The current organizational structure, investment mandate, reporting and accountability obligations of the PF are explained in Schedule 1.

53. The PF has been capitalized through the transfer of government shares in state enterprises. The following shares have been or are in the process of being transferred to the PF: 24 percent of Georgian Railway (GR); 24 percent of Georgian Oil and Gas Corporation (GOGC), 49 percent of Georgian State Electrosystems (GSE), and 49 percent of Electricity System Commerical Operator (ESCO). We estimate the total value of assets held by the PF to exceed GEL 400 million ($240 million). While we consider that the resources of the PF are currently sufficient for its operations, we might consider transferring additional resources or assets to the PF. We will discuss with the IMF any such transfer ahead of time. The financial operations of the PF will be monitored through a zero deficit ceiling, as defined in the TMU (performance criterion).

I. Tax Policy and Revenue Administration

54. The reform of tax and customs administration has been part of our broader fight against corruption, with a view to replacing arbitrary payments with a healthy tax payment culture. We consider that even treatment under the tax law is essential to maintaining a level playing field in the private sector, which ultimately promotes competition and growth. For this reason, we have placed considerable effort into fighting tax evasion, which has contributed to higher voluntary compliance rates.

55. At the same time, it is important for the private sector to be able to rely on a transparent and fair system. Accordingly, our objective is to transform state institutions from watchdog structures focused on identifying violations, into entities that that help businesses operate in a fair and lawful environment. To that end, we will continue to consult intensively with business representatives. As an innovative approach, taxpayers are provided with a draft tax assessment letter before the tax is formally assessed, so that they can sort out issues with the Revenue Service's Audit Department. We have also made progress toward simplifying dispute resolution through streamlined mediation process, which now allows the taxpayer to review and to change the draft tax assessment letter by presenting adequate evidence. By easing the burden of tax compliance, we expect to increase overall tax collection.

56. The following reforms have been recently introduced, or are under way, to foster tax and customs compliance and further improve confidence in the tax and customs system:

- Electronic tax payment services (the bulk of taxpayers now rely on the web portal). Electronic services include filing tax returns, issuing tax invoice, filing tax appeal etc.
- Establishment of customs clearance zones with capacity to process large volumes of cross-border trade in a time-efficient manner.
- Creation of tax ombudsman office for better protection of taxpayers' rights.
- Regional tax inspectors/advisors to provide well tailored and timely guidance to taxpayers throughout the country.
- Introduction of electronic (rather than paper) excise stamps.
- Advance tax ruling practice–taxpayers can obtain an advance tax ruling for the interpretation of the tax code provisions, which will be binding for the tax authority.
- Private tax audit option–tax audit may be carried out by qualified tax consulting firms or individual tax consultants.
- Private tax agent to assist with tax compliance.
- Introduction of GPRS-equipped cash registers to improve monitoring of retail transactions and alleviate the need for tax audit.
- Introduction of "Good Faith" principle which allows to waive sanctions for mistakes resulting from the lack of knowledge rather than willful tax avoidance.

J. Poverty Reduction and Development Vision

57. The sum of the policies described above is intended not only to solidify macroeconomic stability but also to set the foundations for sustainable growth, enhanced competitiveness and poverty reduction. In 2003–11, Georgia sustained broad-based growth dynamics, with average annual real GDP growth rate of around 7 percent. Combined with a strengthening of the national currency, this growth has resulted in an impressive increase in per capita income from $919 in 2003 to $3,215 in 2011. The path toward reducing poverty in Georgia is through creation of job opportunities by promoting and rewarding private sector initiative, building infrastructure, and providing quality education and access to basic services. We shall continue our reforms to further reinforce Georgia's function as a 'Regional Hub Economy'. In this respect, we are firmly committed

to maintaining: (a) solid sovereign balance sheet, (b) business-friendly environment with low levels of taxation, efficient tax and customs administration and a level-playing field for private businesses, fostering our competitive edge and development of the private enterprise, (c) efficient and pro-business government; (d) stable and conservatively managed banking sector, and (e) multi-modal maritime, land and air access infrastructure for trade logistics and manufacturing. These policies and the structural reforms that we implemented in Georgia create excellent preconditions for transforming Georgia into a full-fledged hub economy which would be attractive to investors—domestic and foreign alike—who wish to do business in Georgia, through Georgia, and from Georgia with the region and the world.

Table 1. Georgia: Quantitative Performance Criteria (PC) and Indicative Target, 2012

	Jun-12	Dec-12
	PC	PC
	(Cumulative change since the beginning of the year, in millions of lari)	
Ceiling on the cash deficit of the general government	190	943
Ceiling on the cash deficit of the Partnership Fund	0	0
	(End-period stock, in millions of lari)	
Ceiling on the net domestic assets (NDA) of the NBG 1/	99	238
	(End-period stock, in millions of U.S. dollars)	
Floor on the net international reserves (NIR) of the NBG 1/	1,116	1,196
	(Cumulative change since the beginning of the year, in millions of U.S. dollars)	
Ceiling on the accumulation of external arrears 2/	0	0
	Ind. Target	Ind. Target
	(Cumulative change since the beginning of the year, in millions of U.S. dollars)	
Ceiling on contracting or guaranteeing of external debt by the public sector	800	1,100

Sources: Georgian authorities; and Fund staff estimates.

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

2/ The continuous performance criterion for external arrears is defined in paragraph 22 of the TMU.

Table 2. Georgia: Structural Benchmarks, 2012

Action	Proposed Time Frame
The Ministry of Finance will provide to the IMF an annual report of the financial flows for each of the 5 largest SOEs as well as an annual report consolidating the financial flows of the 5 largest LEPLs.	The reports covering 2011 will be provided to the IMF by end-June 2012
The Partnership Fund will publish and transmit to its Supervisory Board its audited IFRS-compliant financial statements for 2011.	End-September 2012

Schedule 1 to the MEFP: The Partnership Fund

I. ORGANIZATION AND OPERATIONAL STRUCTURE

A. Legal Structure

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

B. Corporate Governance

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

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

II. CORPORATE MANDATE AND PORTFOLIO MANAGEMENT

A. Corporate Mandate

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

B. Portfolio Management Strategy

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

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

C. Project Development Methodology

The PF will only participate in projects in which a corporate investor, with sufficient experience in industry, expresses its willingness to take an equity participation that represents at least 51 percent of the project's total equity and 25 percent of the total necessary financing. The PF's financial participation will be limited to 49 percent of the project's total equity and 25 percent of the total necessary financing, since most projects would also attract debt financing. In rare instances in which debt-financing cannot be mobilized (e.g., owing to long project gestation periods before positive cash flow can be generated) and all of the financing is in the form of equity, the share of the PF's in total financing can rise to 49 percent, equivalent to its contribution to start-up equity.

Investment projects can be initiated either by a corporate investor or by the PF:

- In the former case, the corporate investor commits to provide a majority equity participation representing more than 25 percent of the project's total financing need and requests the PF to provide a financial participation sufficient to ensure that the senior lender will be willing to provide the senior loan. The PF can consider participating in such arrangements, within the aforementioned limits, on the condition that the project's business plan has been validated by a third-party consultant. The project's feasibility and risks are assessed by the investment board and the risk management committee, before being approved by the supervisory board; and
- In the latter case, the PF hires a reputable consulting organization, either from corporate finance or industry specific advisory services, to assess the feasibility of the project. On this basis, the investment board decides whether to bring the project to the supervisory board for approval, while the risk committee assesses the associated risks. If the project is approved, the consulting organization is charged to find a private partner willing to take a majority equity

participation in the project. If such a partner can be found, the project is presented to potential senior lenders.

III. REPORTING AND AUDITING

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

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

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

Fiscal risks associated with the PF will be limited since:

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

GEORGIA: TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)

March 27, 2012

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

2. These performance criteria and indicative targets are reported in Table 1 attached to the Letter of Intent dated March 27, 2012. The exchange rate for the purposes of the program of the Georgian lari to the U.S. dollar is set at GEL1.67 = $1. The corresponding cross exchange rates are provided in Table 1.

I. GENERAL GOVERNMENT AND THE PUBLIC SECTOR

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

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

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

A. Quantitative Performance Criteria and Indicative Targets

5. The quantitative performance criteria and indicative targets specified in Table 1 attached to the Memorandum of Economic and Financial Policies (MEFP) are:

- a performance criterion (ceiling) on the cash deficit of the general government;
- a performance criterion (ceiling) on the cash deficit of the Partnership Fund;
- a performance criterion (ceiling) on the net domestic assets (NDA) of the NBG;
- a performance criterion (floor) on the net international reserves (NIR) of the NBG;
- a continuous performance criterion (zero ceiling) on the accumulation of external arrears; and
- an indicative target (ceiling) on the contracting and guaranteeing of new total external debt by the public sector.

6. The performance criteria and indicative targets are monitored semi-annually on a cumulative basis from the beginning of the calendar year (with the exception of the NIR and NDA targets, which are monitored in terms of stock levels), while the continuous performance criterion is monitored on a continuous basis.

B. Ceiling on the Cash Deficit of the General Government

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

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

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

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

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

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

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

8. **Adjustor:** The ceiling on the cash deficit of the general government will be adjusted upward/downward by 100 percent for any excess/shortfall in on-lending by the government of the disbursements of the Black Sea Transmission Network project loans relative to the projected amounts presented in Table 2.

9. **Supporting Material:**

- Data on domestic bank and nonbank financing will be provided to the IMF by the NBG and the Treasury Department of the MOF within four weeks after the end of the month.
- Data on external project financing as well as other external borrowing will be provided to the IMF monthly by the Debt Unit at the MOF (specifying projects by creditor) within two weeks of the end of each month.
- Data will be provided at the actual exchange rates.
- Data on privatization receipts of the general government will be provided by the Treasury Department of the MOF to the IMF on a monthly basis within two weeks of the end of each month.
- Data on securitized debt sold by the NBG, including the securities that have been purchased by nonbanks, will be reported by the NBG on a monthly basis within two weeks of the end of each month.

C. Ceiling on the Cash Deficit of the Partnership Fund

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

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

12. The PF's expenditures comprise all current and capital expenditures. Current expenditures comprise compensation of employees, use of goods and services, transfers to other entities, other account payables and domestic and external interest payments. Capital expenditures will comprise the net acquisition of nonfinancial assets, as defined under GFSM 2011. The PF's purchases of financial assets (e.g. lending and equity participations) will not be considered part of its expenditures.

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

D. Floor on the Net International Reserves of the NBG

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

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

- Upward/downward by 50 percent for any excess/shortfall in the balance of payments support loans and balance of payments support grants relative to the projected amounts presented in Table 3.
- Upward/downward by 50 percent for any excess/shortfall in the disbursements of the project loans and project grants to the Treasury Single account at the NBG relative to the projected amounts presented in Table 3.

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

E. Ceiling on Net Domestic Assets of the NBG

17. **Definition:** Net domestic assets of the NBG are defined as the difference between reserve money and NIR as defined above in paragraph 14. Therefore, the ceiling on NDA is defined as projected reserve money (as defined in Table 4) minus the target NIR.

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

- Upward/downward by 50 percent for any shortfall/excess in the balance of payments support loans and balance of payments support grants relative to the projected amounts presented in Table 3.
- Upward/downward by 50 percent for any shortfall/excess in the disbursements of the project loans and project grants to the Treasury Single account at the NBG relative to the projected amounts presented in Table 3.

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

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

20. **Definition:** External debt is defined as set forth in point No. 9 of the Executive Board Decision No. 6230-(79/140), as revised on August 31, 2009 (Decision No. 14416-(09/91)).[1] External

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

debt is defined as debt contracted by the public sector with nonresidents other than the IMF. Previously disbursed external debt that has been rescheduled will be excluded from the definition of "new debt" for the purposes of this performance criterion.

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

G. Continuous Performance Criterion on Accumulation of External Arrears

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

23. **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	0.65
GEL	Georgian lari	1.67
EUR	Euro	0.77

Table 2. Projected On-Lending by the Government of the Disbursements of the Black Sea Transmission Network Project Loans 1/
(In millions of lari)

	On-Lending by the Government of the Disbursements of the Black Sea Transmission Network Project Loans
June 30, 2012	50.9
December 31, 2012	151.8

1/ Cumulative from the beginning of the calendar year.

Table 3. Projected Balance of Payments Support Financing 1/
(In millions of U.S. dollars)

	Balance of payments support loans and balance of payments support grants	Project loans and project grants
June 30, 2012	0.0	109.2
December 31, 2012	85.4	234.0

1/ Cumulative from the beginning of the calendar year.

Table 4. Projected Reserve Money
(End-of-period stock, in millions of lari)

June 30, 2012	1,963.0
December 31, 2012	2,235.4