Ex post evaluation of MFA operations in Georgia

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List of abbreviations

AIDCO	EuropeAid Co-operation Office
BDD	Basic Data and Directions
BoP	Balance of Payments
CoC	Camber of Control
CA	Current Account
CB	Capacity Building
CFSP	Common Foreign Security Programme
CPI	Corruption Perception Index
CPI	Consumer Price Index
CPS	Country Partnership Strategy
CR	Country Report
CSP	Country Strategy Paper
DSA	Debt Sustainability Analysis
EBRD	European Bank of Reconstruction and Development
EC	European Commission
EDPRP	Economic Development and Poverty Reduction Programme
EEF	Extended Fund Facility
EFA	Exceptional Financial Assistance
EFC	Economic and Financial Committee
ECFIN	Economic and Financial Affairs
ECHO	European Commission Humanitarian Aid Office
EFA	Exceptional Financial Assistance
ENP AP	European Neighbourhood Policy Action Plan
ENPI	European Neighbourhood Policy Instrument
ESAF	Enhanced Structural Adjustment Facility
EU	European Union
FDI	Foreign Direct Investment
FSP	Food Security Programme
GC	General Condition
GDP	Gross Domestic Product
GEL	Georgia Lari
GFS	Government Finance Statistics
GoG	Government of Georgia
GTZ	German Society for Technical Cooperation
IDA	International Development Association
IDP	Internally Displaced Person
IFI	International Financial Institution
IFMC	Increase of Financial Management Capabilities
ILO	International Labour Organisation
IMF	International Monetary Fund

INTOSAI	International Organisation of Supreme Audit Institutions
LEPL	Legal Entities of Public Law
LHS	Left Hand Side
MoF	Ministry of Finance
MoU	Memorandum of Understanding
MFA	Macro Financial Assistance
MCC	Millennium Challenge Corporation
MEFP	Memorandum of Economic and Financial Policies
MTEF	Medium Term Expenditure Framework
NATO	North Atlantic Treaty Organisation
NBG	National Bank of Georgia
NIP	National Indicative Programme
OA	Operational Assessment
PFM	Public Financial Management
PIFC	Public Internal Financial Control
PRGF	Poverty Reduction and Growth Facility
PRSO	Poverty Reduction Support Operation
PSFMR-SP	Public Sector Financial Management Reform Support Project
REER	Real Effective Exchange Rate
RRM	Rapid Reaction Mechanism
PEFA	Public Expenditure and Financial Accountability
RELEX	External Relations
RHS	Right Hand Side
SBA	Stand-By Arrangement
SC	Specific Condition
SDR	Special Drawing Right
SPSP	Sector Policy Support Programme
SWF	Sovereign Wealth Fund
TA	Technical Assistance
TACIS	Technical Assistance for the Commonwealth of Independent States
UK	United Kingdom
UNDP	United Nations Development Programme
USAID	United States Agency for International Development
US$	United States Dollar
VAT	Value Added Tax
WB	World Bank

Preface

This report has been prepared by a team of a consortium led by ECORYS Netherlands in association with CASE - Center for Social and Economic Research (Poland) and Economisti Associati (Italy). The ECORYS consortium has been contracted to conduct an ex-post evaluation of EC Macro Financial Assistance (MFA) provided to Georgia in the period January 2006 to December 2008.

We would like to express our special gratitude to all officials in Tbilisi and other resource persons in the country, to staff members of the IMF and World Bank in Washington DC and Tbilisi, and to EC officials in Brussels and Tbilisi for their cooperation and willingness to contribute to this evaluation by providing us with a good understanding of the facts and events at the time of the MFA operation.

We would also like to thank the Steering Committee for its constructive comments.
Responsibility for the opinions presented in this Draft Final Report is exclusively of the authors and should not be attributed to the Government of Georgia, to the European Commission or to the other IFIs.

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Executive Summary

Background

1. This report presents the results of the evaluation of Macro-Financial Assistance that was provided to Georgia in 2006-2008, based on the Council decision of January 2006. Preceding this MFA operation, Georgia received Exceptional Financial Assistance (EFA) during 1997-2005.

2. On 24th January 2006 the Council provided MFA to Georgia of up to € 33.5 million in the form of grants. The Council Decision and the accompanying Memorandum of Understanding stated that the goal of the assistance is "*to support economic reforms and help Georgia improve debt sustainability*". The € 33.5 million was equal to the undisbursed amount under the EFA 1997-2005.

3. The MFA was related to early repayments of Community outstanding debt (amounting to € 85.5 million). The assistance was to be disbursed in three tranches during the period 2006-2007. All tranches were linked to conditions in the area of PFM reform. The first and second grant instalments (of € 11 million each) were disbursed in August and December 2006. In parallel, Georgia reduced the amount of its outstanding debt to the Community by € 13 and € 15 million respectively. The release of the final MFA-grant (€ 11.5 million) was conditional on the enactment of the draft Law on the Chamber of Control. Given delays in approving the law, the disbursement of the third tranche was postponed to the end of 2008. In addition, the EC offered the Government of Georgia (GoG) to reduce the debt repayment linked to the third tranche from € 17.5 to € 11.5 million (the same amount as the planned disbursement of MFA). In the event, the third tranche was not disbursed because the Chamber of Control Law was not adopted in time. Georgia did not make the early repayment which was linked to the last tranche.

4. The MFA assistance disbursed in 2006 amounted to approximately 20 percent of total official transfers and roughly 40 percent of EC assistance for that year.

5. After the 2003 Rose Revolution the period 2004-2008 reflected strong economic performance underpinned by good progress in economic reforms. The MFA operation took place in this period of strong economic performance, but this period also had it turbulent events. First, continuing geopolitical tensions with Russia over the regions of Abkhazia and South Ossetia resulted in a military conflict in the summer of 2008. Second, the global financial and economic crisis which started in the third quarter of 2008 led, in combination with the aftermath of the military conflict, to a sharp decline in economic growth.

Evaluation objectives and approach

6. The main objectives of this ex-post evaluation of MFA are to (a) assess the impact of the MFA operation in Georgia and (b) to learn key lessons, which can be applied to future interventions and/or the possible need for a reorientation of the present approach.

7. The evaluation focused on three core areas: (i) macroeconomic stabilisation; (ii) sustainability of the fiscal and external financial situation; and (iii) structural reforms. In addition, the implications of the design and implementation of the MFA operation were considered.

8. The evaluation used several analytical instruments: (i) data collection and analysis; (ii) a literature review; (iii) a preparatory questionnaire ahead of the structured interviews; (iv) interviews with key stakeholders; and (v) case studies. The evaluation was based on the triangulation of all the findings resulting from the application of all the evaluation instruments.

Macroeconomic performance

9. Georgia achieved macroeconomic stabilisation in the period 2004-2008. GDP growth accelerated and inflation has been kept under control. Economic performance has been underpinned by large capital inflows, both FDI (related to large-scale privatisation and infrastructure projects) and other capital inflows (e.g. portfolio, loans and grants). These inflows were drawn to the country by responsible macroeconomic policies and structural reforms. Growth decelerated sharply to 2.1 percent in 2008, in the wake of the global crisis and the military conflict with Russia.

10. Sound fiscal policies, together with reforms of the tax and budgetary systems have led to significant fiscal consolidation, raising revenues from 23.1 percent of GDP in 2004 to 30.7 percent in 2008. The overall fiscal balance deteriorated over this period, but high privatisation revenues and foreign financing helped close the gap.

11. The openness of the economy has increased significantly: imports increased from 46.4 percent of GDP in 2003 to 57.7 percent in 2008, while exports remained around 30 percent of GDP during the same period. The resulting trade gap raised the current account deficit from below 10 percent of GDP in 2004-2005 to 22.6 percent in 2008. However, large financial flows (FDI, loans, and grants) have helped to finance the deficit, ensuring the country's external sustainability.

12. The transition to a well-functioning market economy has not been completed yet. Furthermore, the military conflict and global crisis has affected growth prospects substantially, as it resulted in shrinking private capital flows and a deteriorating fiscal balance. Economic growth is projected to be negative in 2009 (-4 percent) and rebound to 2 percent in 2010.

External Sustainability

13. Good relations with IFIs and international donors secured foreign financing and underpinned the success of the first international Eurobond issue in 2008. The short-term outlook worsened considerably for private inflows (FDI and loans) as a result of regional tensions and the global economic and financial crisis. However, Georgia secured US$ 4.5 billion of financing pledges for 2009-2011, mostly from multilateral donors. These financing pledges have significantly improved external sustainability.

14. Georgia has been successful in cutting its public external debt burden from 60 percent of GDP in 1999 to 17.5 percent in 2007. For 2008 and 2009 the debt-to-GDP ratios worsened, as a result of GDP contraction and fiscal deterioration.

15. The most recent IMF projections (July 2009) point to an increase of the total debt and of public debt to respectively 65.1 percent and 41 percent of GDP in 2011, with projected improvements afterwards. While the IMF evaluated the debt solvency ratios as not raising immediate concerns and the debt distress as moderate, the bunching of debt service obligations in 2013 is worrisome. During that year (marked by the maturing of the Eurobonds and peak repurchases of Fund credit), public and total external debt service payments are projected to rise to respectively 25.6 and 46.6 percent of exports.

16. The DSA performed in July 2009 showed that Georgia's debt sustainability is sensitive to the worsening of the terms of new loans, nominal depreciation shocks, lower export growth, and lower non-debt creating flows (FDI, grants). These adverse scenarios are likely to be triggered by a series of risks, such as domestic political instability, the tensions related to the breakaway regions, the failure to meet the fiscal adjustment commitments (due to election year), and a more pessimistic outlook for the duration and severity of the global crisis.

Structural Reforms

17. MFA conditionality focussed on PFM reforms. The 11 MFA conditions can be grouped into three main sub-areas; (1) Budget Preparation, (2) Budget Execution, (3) Transparency and Accountability. The budget preparation conditions focussed on implementation of the MTEF, introduction of policy based budgeting, and capacity building activities of the MoF and the line ministries. The budget execution conditions focussed on international standards of internal accounting, treasury reforms, and a monitoring and reporting system for all LEPLs. The transparency and accountability conditions concentrated on the CoC (new legislation, reorganisation), development of audit instructions and methodology, and introduction of an adequate internal audit and control framework.

18. The MFA conditions made explicit reference to the National PFM Reform Strategic Vision of 2005. A smaller degree of convergence was noted for the LEPL's accountability reform and the internal and external audit functions and mechanisms. These reform conditions originated from the follow-up Operational Assessment and triggers and performance criteria included in WB and IMF programmes.

19. The progress achieved in the areas of budget preparation and execution is impressive: all MFA conditions were fully satisfied. Less progress was achieved in the area of transparency and accountability: the enactment of a new law on the CoC required three years, and was approved after the MFA operation expired; similarly, progress in the area of internal control and audit started to materialize in 2009 only. This discrepancy was due to a lower scope and coherence of cross-conditionality and, more importantly, to a lesser degree of government ownership of the reforms in the area of external and internal audit compared to other MFA supported areas.

Net impact of MFA

20. In the counterfactual scenario we assumed that the GoG would not have considered early debt repayment to the EC without the MFA operation. The counterfactual scenario implies that without the MFA operation the government would not incur the burden of net repayments totalling € 6 million in 2006 (grants of € 22 million minus early debt repayments of € 28 million). On the other hand, in 2009-2013 the GoG would have had to repay € 28 million more compared to the scenario with MFA. Furthermore, we assumed that without MFA most reforms would have been implemented, because the Government had strong reform ownership. However, initial steps in reforming internal audit and controls would probably not have been taken. In addition, the enactment of the new law on the CoC would have probably taken somewhat longer.

21. The counterfactual also takes into account the new MFA operation, which has been under preparation since the fourth quarter of 2008. We assumed that the EC would have offered Georgia a new MFA operation in 2009 that would absorb its outstanding debt towards the EU (without MFA 2006-2008, outstanding debt would have been € 85.5 million). Furthermore, the higher debt stock would lead to € 4.8 million additional interest payments than the actual scenario. The counterfactual leads to a nominal net gain for Georgia of € 12.7 million over 2006-2012. A second counterfactual scenario assumed no MFA operation in 2009/2010. This scenario implies that the € 85.5 million outstanding after 2005 would have to be repaid without any grant support. The additional overall nominal fiscal cost of this scenario would be € 72.8 million. We assumed that this scenario is much less likely.

22. The gain under the first counterfactual scenario would amount to 0.06 percent of fiscal revenues and 0.02 percent of the GDP on average in 2006-2012. The second counterfactual scenario would imply a cost of 0.48 percent of total fiscal revenues and 0.09 percent of the GDP on average in 2006-2012. The annual impact is thus very small, making the likely macroeconomic impact negligible.

23. The impact of the MFA operation on the debt stock was rather small and temporary. The operation contributed to lowering the external debt by a mere 0.45-0.24 percent of GDP over the period 2006-2011.

24. Impact of MFA on PFM reforms was limited. We have identified both a political and an operational reinforcing effect in the cases of internal audit and control and the

enactment of the law on the CoC. Reform conditions in the area of budget preparation hardly had any impact on the reforms. On the other hand, EC technical assistance seemed to have played an accelerating role, bringing a higher value added.

25. The operation resulted in an unexpected effect. The MFA operation required net early debt repayments in the period in which Georgia could easily afford these net repayments. If the EC and Georgia would have kept the regular repayment scheme (2009-2013), the country would have had much more difficulties paying back its debt in the current economic situation. In retrospect it can be concluded that the MFA rescheduling of debt repayment was (unexpectedly) aligned with Georgia's capacity to pay back.

Design and implementation

26. This MFA operation was exceptional, as it did not originate from a residual balance-of-payments financing need. In our view, there were valid reasons to opt for a more flexible use of the MFA instrument rather than a more strict approach in which MFA would be granted only in case of a residual financing gap. Against this background, we suggest that DG ECFIN should promote formally the concept that the MFA instrument could be initiated for other reasons than having a residual financing gap. DG ECFIN could adjust its Vademecum on EC macroeconomic assistance to third countries and propose changes to the Genval criteria to allow for this

27. The initial timing of the MFA operation was fortunate as a new ambitious government came into power in 2004 with a substantial reform agenda and an uncertain future debt position. However, at the end of 2005, when the draft Council Decision was prepared, the debt position had improved substantially and further improvements were expected. At that time the MFA operation was not reconsidered. We suggest that in cases of long preparation process DG ECFIN should build in more decision moments to allow for a reconsideration of the rationale of the proposed MFA operation, similarly to the process of decision on disbursement of tranches.

28. Conditionality in this MFA operation focussed only on one reform area: PFM. This helped to reinforce the PFM reform focus of other donors and supported the efforts of the new government. Furthermore, it allowed DG ECFIN staff to play a knowledgeable and supportive role in an area of internal expertise. The experience of the MFA operation in Georgia has showed the benefits of selecting very limited focal reform areas. Therefore, we suggest that DG ECFIN continue with this focussed approach when deciding on conditionality.

29. The MFA operation appeared to be closely aligned to other EC instruments. The MFA operation in Georgia filled the gap between the phasing out of the FSP (which contained a high degree of budgetary support) and the launch of ENPI sector policy budget support programme. The MFA allowed the EC to continue its policy dialogue with the government.

30. The third tranche was not disbursed, due to non fulfilment of the condition related to the law on the CoC. Although the EC had the option to grant a waiver, it decided to

let the operation expire. Pressing for the reform and the unwillingness to provide a waiver gave a strong EC signal to Georgia, but did affect the 'one voice' donor community approach, which was followed from the start of the MFA operation. The different view of the World Bank resulted in mixed messages to the government. We suggest that DG ECFIN adopt a more structured approach to granting waivers. Such approach may include measures allowing the EC more manoeuvring space and therefore flexibility in implementation of a MFA operation without having to consider the possible opinions of the EFC and subsequently the ECOFIN Council. The idea of having a framework regulation for MFA operations could be considered, as this will , among other, address a more structured and flexible approach to granting waivers. Another approach would be to make more explicit in the MoU the circumstances under which a waiver may be provided.

31. Progress in the area of internal control and audit was low during the MFA operation. Most stakeholders held the view that in the period 2004-2008 it was too early to stimulate internal audit and control developments. The EC included this area of reform in its conditions related to the FSP, MFA, and ENPI. In our view, the pioneer activities promoted by the EC allowed to GoG to start addressing a relevant and truly complex issue. We recommend that DG ECFIN should continue to require the development of good internal control and audit systems in future MFA operations, even if the level of development in this field is very low.

Résumé

Contexte

1. Ce rapport présente les résultats de l'évaluation de l'assistance macro financière (AMF) qui a été fournie à la Géorgie entre 2006 et 2008, sur base de la décision du Conseil de janvier 2006. Précédemment à cette AMF, la Géorgie a reçu une aide financière exceptionnelle (AFE) au cours de la période 1997-2005.

2. Le 24 janvier 2006, le Conseil a octroyé une AMF à la Géorgie d'un maximum de € 33,5 millions, sous forme de subventions. La décision du Conseil et le mémorandum d'entente connexe ont déclaré que l'objectif de l'assistance était de « *soutenir les réformes économiques et d'aider la Géorgie à améliorer la viabilité de la dette* ». Les € 33,5 millions correspondaient au montant non versé de l'AFE pour la période 1997-2005.

3. L'AMF était liée à des remboursements anticipés de la dette en cours de la communauté (s'élevant à € 85,5 millions). L'aide devait être versée en trois tranches pendant la période 2006-2007. Toutes les tranches étaient soumises à des conditions liées à la réforme GFP (gestion des finances publiques). La première et deuxième tranche de subventions (de € 11 millions chacune) ont été décaissées en août et décembre 2006. En parallèle, la Géorgie a réduit le montant de sa dette en cours à la Communauté respectivement de € 13 et 15 millions. Le versement de la dernière tranche de l'AMF (€ 11,5 millions) était subordonné à l'adoption du projet de loi sur la Chambre de contrôle (CdC). Compte tenu des retards dans l'approbation de la loi, le décaissement de la troisième tranche a été remis à la fin du 2008. De plus, la CE (Commission européenne) a proposé au gouvernement de Géorgie (GdG) de réduire le remboursement de la dette liée à la troisième tranche de € 17,5 à 11,5 millions (un montant identique au versement de l'AMF initialement prévu). En l'occurrence, la troisième tranche n'a pas été versée parce que la loi sur la Chambre de contrôle n'a pas été adoptée à temps. La Géorgie n'a pas exécuté le remboursement anticipé associé à la dernière tranche.

4. L'assistance macro financière décaissée en 2006 s'élève à environ 20 pour cent du total des transferts officiels et à environ 40 pour cent de l'aide communautaire pour cette année.

5. Après la « révolution des roses » en 2003, la période 2004-2008 a été marquée par d'importantes performances économiques, étayées par des avancées significatives dans les réformes économiques. L'opération de l'AMF a eu lieu au cours de cette période de forte performance économique, mais qui a également été marquée

d'événements tumultueux. Premièrement, la persistance des tensions géopolitiques avec la Russie sur les régions d'Abkhazie et d'Ossétie du Sud s'est soldée par un conflit militaire à l'été 2008. Deuxièmement, la crise économique et financière mondiale qui a commencé au troisième trimestre de 2008, combinée aux séquelles du conflit militaire, a provoqué un net recul de la croissance économique.

Objectifs et approche d'évaluation

6. Les principaux objectifs de cette évaluation ex-post de l'AMF visent à (a) évaluer l'impact des opérations AMF en Géorgie et à (b) tirer les enseignements majeurs, qui peuvent être appliqués à de futures interventions et/ou de l'éventuelle nécessité d'une réorientation de l'approche actuelle.

7. L'évaluation a été concentrée sur trois domaines essentiels: (i) la stabilisation macroéconomique, (ii) la viabilité de la situation financière fiscale et extérieure, et (iii) les réformes structurelles. De plus, les implications de la conception et la mise en œuvre des opérations AMF ont été examinées.

8. L'évaluation faisait usage de plusieurs instruments d'analyse: (i) collecte et analyse des données, (ii) une revue de la littérature, (iii) un questionnaire préparatoire avant les entretiens structurés, (iv) des entretiens avec des intervenants clés, et (v) des études de cas. L'évaluation était basée sur la triangulation de tous les constats résultant de l'application de tous les instruments d'évaluation.

Résultats macroéconomiques

9. La Géorgie est parvenue à la stabilisation macro-économique au cours de la période 2004-2008. On y a observé une croissance du PIB (produit interne brut) et l'inflation a été maintenue sous contrôle. La performance économique a été stimulée par l'afflux de capitaux, à la fois des investissements étrangers directs (liés à de privatisation à grande échelle et aux projets d'infrastructure) et d'autres entrées de capitaux (portefeuilles de titres, prêts et subventions). Ces entrées de capitaux ont été attirées au pays par des politiques macroéconomiques responsables et des réformes structurelles. La croissance s'est fortement ralentie à 2,1 pour cent en 2008, dans le sillage de la crise mondiale et du conflit militaire avec la Russie.

10. Des politiques budgétaires saines, combinées à des réformes des systèmes fiscaux et budgétaires, ont conduit à un assainissement budgétaire important, conduisant à une augmentation des recettes de 23,1 pour cent du PIB en 2004, à 30,7 pour cent en 2008. La balance fiscale générale s'est détériorée sur la période, mais les revenus accrus de la privation et les financements étrangers ont aidé à réduire l'écart.

11. L'ouverture de l'économie a augmenté de façon significative: les importations ont augmenté de 46,4 pour cent du PIB en 2003, à 57,7 pour cent en 2008, tandis que les exportations se sont maintenues autour de 30 pour cent du PIB pendant la même période. Le déficit de la balance commerciale a provoqué une hausse du déficit du compte courant de moins de 10 pour cent du PIB en 2004-2005, à 22,6 pour cent en

2008. Toutefois, d'importants flux financiers (investissements étrangers directs, prêts et subventions) ont aidé à financer le déficit, contribuant ainsi à la viabilité extérieure du pays.

12. La transition vers une économie de marché fonctionnelle n'a pas encore été achevée. En outre, le conflit militaire et la crise mondiale ont affecté les perspectives de croissance de façon appréciable, car elles ont conduit à l'amenuisement des flux de capitaux privés et à une détérioration de l’équilibre financier. La croissance économique devrait être négative en 2009 (-4 pour cent) et remonter à 2 pour cent en 2010.

Viabilité extérieure

13. Les bonnes relations avec les IFI (institutions financières internationales) et les donateurs internationaux ont garanti le financement étranger et ont favorisé la réussite de la première émission d'euro-obligations internationales en 2008. Les perspectives à court terme se sont considérablement dégradées pour les apports privés (investissements étrangers directs et les prêts) en raison de tensions régionales et de la crise économique et financière mondiale. Cependant, la Géorgie a obtenu 4,5 milliards dollars américains de promesses de financement pour la période 2009-2011, pour la plupart issues de bailleurs de fonds multilatéraux. Ces promesses de financement ont considérablement amélioré la viabilité extérieure.

14. La Géorgie a réussi à réduire la charge de la dette extérieure publique, de 60 pour cent du PIB en 1999, à 17,5 pour cent en 2007. Pour 2008 et 2009, les ratios dette-PIB se sont détériorées, suite à la contraction du PIB et à la détérioration des finances publiques.

15. Les prévisions les plus récentes du FMI (Fond monétaire international) (juillet 2009) indiquent une augmentation de la dette totale et de la dette publique à respectivement 65,1 pour cent et 41 pour cent du PIB en 2011, avec une amélioration éventuelle par la suite. Alors que le FMI n’a pas considéré les ratios de solvabilité de la dette comme une source d’inquiétude immédiate et la détresse de la dette comme étant immodérée, la concentration des échéances du service de la dette en 2013 est, en revanche, inquiétante. Au cours de cette année (marquée par la maturation des euro-obligations et la valeur maximale des rachats des crédits), les paiements de la dette publique et extérieure devraient connaître une augmentation à respectivement 25,6 et 46,6 pour cent des exportations.

16. L’analyse de viabilité de la dette réalisée en juillet 2009 a montré que la viabilité de la dette de la Géorgie est sensible à la détérioration des termes de nouveaux prêts, aux chocs de dépréciation nominale, à une plus faible croissance des exportations, et à une diminution des flux qui ne résultent pas dans une dette (investissements étranger directs, subventions). Ces scénarios défavorables sont susceptibles d’être déclenchés par une série de risques, tels que l'instabilité politique intérieure, les tensions liées aux régions séparatistes, l'incapacité à respecter les engagements d'ajustement budgétaire (en raison des élections), et une vision plus pessimiste quant à la durée et la gravité de la crise mondiale.

Réformes structurelles

17. La conditionnalité de l'AMF s'est concentrée sur les réformes de la GFP. Les 11 conditions de l'AMF peuvent être regroupées en trois grandes sous-catégories; (1) la préparation du budget, (2) l'exécution du budget, (3) la transparence et la responsabilité financière. Les conditions relatives à la préparation du budget sont axées sur la mise en œuvre du CDMT (cadre de dépenses à moyen terme), l'introduction de la budgétisation basée sur les politiques et les activités de renforcement des capacités du ministère des Finances et des ministères sectoriels. Les conditions relatives à l'exécution du budget sont axées sur les normes internationales de comptabilité interne, des réformes du Trésor, et d'un système de suivi et de rapportage pour tous les entités de droit public. Les conditions liées à la transparence et la responsabilité financière se concentrent sur le CdC (nouvelle législation, réorganisation), le développement des instructions et de la méthodologie des audits, et l'introduction d'un contrôle interne adéquat et d'un cadre de contrôle.

18. Les conditions de l'AMF ont fait explicitement référence à la Vision stratégique de la réforme nationale de la GFP de 2005. Un degré de convergence moindre a été observé pour la réforme de la responsabilité financière des entités de droit publique et les fonctions et mécanismes d'audit interne et externe. Ces conditions de réforme provenaient du suivi de l'évaluation opérationnelle et des critères de performance inclus dans les programmes de la Banque mondiale et du FMI.

19. Les progrès réalisés dans les domaines de la préparation et de l'exécution du budget sont impressionnants: toutes les conditions de l'AMF ont été parfaitement remplies. Moins de progrès ont été accomplis dans le domaine de la transparence et la responsabilité financière: la promulgation d'une nouvelle loi sur la CdC a nécessité trois ans et a été approuvé après l'arrivée à échéance de l'opération AMF. Les progrès dans le domaine du contrôle interne et d'audit n'ont seulement commencé à se concrétiser qu'en 2009. Cet écart est dû à une plus faible portée et une moindre cohérence de la conditionnalité croisée et, plus important encore, à un degré moindre d'appropriation gouvernementale des réformes dans le domaine de l'audit externe et interne, par rapport aux autres domaines subventionnés par l'AMF.

Impact net de l'AMF

20. Dans le scénario comparatif, nous avons supposé que le gouvernement de Géorgie n'aurait pas envisagé la possibilité d'un remboursement anticipé de la dette à la CE sans l'opération AMF. Le scénario comparatif implique que, sans l'opération d'AMF, le gouvernement n'aurait pas dû faire des remboursements nets s'élevant au total à € 6 millions en 2006 (subventions de € 22 millions, soustraites des remboursements anticipés de la dette à hauteur de € 28 millions). D'autre part, au cours de la période 2009-2013, les GdG auraient dû rembourser € 28 millions de plus, en comparaison au scénario avec l'AMF. En outre, nous avons estimé que sans l'AMF, la plupart des réformes auraient de toute façon été mises en œuvre, en raison de l'importante appropriation des réformes par le gouvernement. Toutefois,

les premières mesures de réforme de l'audit et des contrôles internes n'auraient probablement pas été prises. Par ailleurs, la promulgation de la nouvelle loi sur la CdC aurait probablement nécessité un peu plus de temps.

21. Le scénario comparatif tient également compte de la nouvelle opération de l'AMF, qui était en cours de préparation depuis le quatrième trimestre 2008. Nous avons supposé que la CE offrirait, une nouvelle AMF en 2009 à la Géorgie, qui permettrait d'absorber la dette de ce pays envers l'UE (sans AMF 2006-2008, la dette en cours aurait été de € 85,5 millions). En outre, l'encours plus élevé de la dette aboutirait à un supplément en intérêts à payer de € 4,8 millions, par rapport au scénario actuel. Le scénario comparatif conduit à un bénéfice nominal net pour la Géorgie de €12,7 millions sur 2006-2012. Un deuxième scénario comparatif supposait qu'aucune opération AMF n'aurait lieu en 2009/2010. Ce scénario implique que les € 85,5 millions restant dus après 2005 devraient être remboursés sans le soutien de la moindre subvention. Le coût budgétaire nominal total supplémentaire de ce scénario serait de € 72,8 millions. Nous avons supposé que ce scénario était moins probable.

22. Le bénéfice dans le premier scénario comparatif correspondrait à 0,06 pour cent des recettes fiscales et à 0,02 pour cent du PIB pour la période 2006-2012. Le deuxième scénario comparatif impliquerait un coût de 0,48 pour cent du total des recettes fiscales et de 0,09 pour cent du PIB pour la période 2006-2012. L'impact annuel est donc très faible, au même titre que l'impact macroéconomique.

23. L'impact de l'opération de l'AMF sur l'encours de la dette a été assez faible et temporaire. L'opération a contribué à réduire la dette externe de quelque 0,45-0,24 pour cent du PIB sur la période 2006-2011.

24. L'impact de l'AMF sur les réformes de la GFP a été limité. Nous avons observé un effet de renforcement à la fois politique et opérationnel en ce qui concerne l'audit et le contrôle interne et la promulgation de la loi sur la CdC. Les conditions de réforme dans le domaine de la préparation du budget n'ont guère eu d'impact sur les réformes. D'autre part, l'assistance technique communautaire semble avoir joué un rôle d'accélérateur, en apportant une valeur ajoutée plus élevée.

25. L'opération a abouti à un effet inattendu. L'opération AMF a demandé des remboursements nets anticipés à un moment où la Géorgie pouvait facilement se les permettre. Si la CE et la Géorgie avaient gardé le régime de remboursement prévu (2009-2013), le pays aurait eu beaucoup plus de difficultés à rembourser sa dette dans la situation économique actuelle. Rétrospectivement, on peut conclure que le rééchelonnement du remboursement de la dette AMF était (de façon inattendue) alignée avec la capacité de la Géorgie à rembourser.

Conception et mise en œuvre

26. Cette opération AMF a été exceptionnelle, car elle ne provenait pas d'une nécessité de financement du déficit de la balance des paiements résiduel. À nos yeux, il y avaient de bonnes raisons d'opter pour la flexibilité de l'instrument de l'AMF, plutôt

que pour une approche plus stricte, dans laquelle l'AMF ne serait accordée que dans le cas d'un déficit de financement résiduel. Dans ce contexte, nous suggérons que la DG ECFIN soutienne officiellement la possibilité que l'instrument d'AMF puisse être choisi pour des raisons autres que celle d'un déficit de financement résiduel. Le vade-mecum sur l'assistance macroéconomique communautaire pour les pays tiers et les critères de Genval pourrait être ajusté afin de permettre cette possibilité.

27. Le calendrier initial de l'opération d'AMF a eu la chance de pouvoir compter sur l'arrivée au pouvoir en 2004 d'un nouveau gouvernement ambitieux, doté d'un programme de réforme substantielle et d'une position d'endettement futur incertaine. Toutefois, fin 2005, lorsque le projet de décision du Conseil a été établi, l'endettement s'était nettement amélioré et de nouvelles améliorations étaient attendues. À cette époque, l'opération d'AMF n'avait pas été remise en cause. Nous suggérons que dans les cas de long processus de préparation, la DG ECFIN introduise des étapes dans le processus de décision qui permettent de réexaminer la justification de l'opération AFM, à l'instar du processus de décision sur le décaissement des tranches.

28. La conditionnalité dans cette opération AMF portait sur un domaine de réforme unique: la GFP. Cela a permis de renforcer la focalisation d'autres bailleurs sur la réforme de la GFP et d'appuyer les efforts du nouveau gouvernement. En outre, cela a permis au personnel de la DG ECFIN de jouer un rôle d'appui de façon compétente dans un domaine d'expertise interne. L'expérience de l'opération d'AMF en Géorgie a démontré les avantages de la focalisation de la réforme sur des zones d'intervention très limitée. Par conséquent, nous suggérons que la DG ECFIN poursuive dans cette voie lorsqu'elle prend des décisions relatives à la conditionnalité.

29. L'opération de l'AMF semble être étroitement alignée avec d'autres instruments communautaires. L'opération d'AMF en Géorgie a comblé le vide entre la suppression progressive du PSA (programme sécurité alimentaire) qui contenait un degré élevé de soutien budgétaire et le lancement du programme de soutien à la politique sectorielle budgétaire IEVP (Instrument européen de voisinage et partenariat). L'AMF a permis à la CE de poursuivre son dialogue politique avec le gouvernement.

30. La troisième tranche n'a pas été versée, en raison de non-respect de la conditionnalité liée à la nouvelle loi sur la CdC. Bien que la CE disposât de la possibilité d'accorder une dérogation, elle a décidé de laisser expirer l'opération. La pression exercée à l'égard de la réforme et la réticence à accorder une dérogation a donné un signal communautaire fort à la Géorgie, mais cela a également affecté le caractère unanime de l'approche de la communauté des bailleurs, qui a été suivie dès le début de l'opération de l'AMF. Le point de vue différent de la Banque mondiale a conduit à des messages contradictoires à l'adresse du gouvernement. Nous suggérons que la DG ECFIN adopte une approche plus structurée en matière d'octroi de dérogations. Une telle approche peut déboucher sur des mesures conférant à la CE un champ de manœuvre plus important et donc une certaine flexibilité dans la mise en œuvre d'une opération d'AMF, sans avoir à considérer les

avis de la CEF (Comité économique et financier) et, dans un deuxième temps, du Conseil ECOFIN. L'idée d'avoir un règlement-cadre pour les opérations d'AMF pourrait être envisagée, vu qu'elle sera à même d'établir, entre autres, une approche plus structurée et plus souple lors de l'octroi de dérogations. Une autre approche serait de rendre plus explicites les circonstances dans lesquelles une dérogation pourrait être octroyée au sein du mémorandum d'attente.

31. Les progrès dans le domaine de l'audit et du contrôle interne ont été faibles au cours de l'opération d'AMF. La plupart des interlocuteurs ont estimé qu'au cours de la période 2004-2008, il était prématuré de s'engager dans le développement d'audits et des contrôles internes. La CE a inclus ce domaine de réforme dans ses conditions relatives à la PSA, l'AMF, et l'IEVP. À nos yeux, les activités promues par la CE ont permis au GdG de commencer à aborder ce problème pertinent et réellement complexe. Nous recommandons que la DG ECFIN continue d'exiger la mise sur pied de systèmes d'audit et de contrôle interne adéquats dans les opérations d'AMF à venir, même si le niveau de développement dans le domaine concerné est très faible.

1 Introduction

The report is structured as follows:

- Chapter 2 outlines the evaluation objectives, evaluation approach, and methods that are being used in the ex-post evaluation;
- Chapter 3 presents a historical overview of relevant MFA events and describes the background of the MFA operation;
- Chapter 4 analyses macroeconomic developments in Georgia;
- Chapter 5 presents a forward-looking analysis of the gross impact of MFA on external and fiscal sustainability;
- Chapter 6 discusses the gross impact of MFA on structural reform;
- Chapter 7 sets out two case studies that provide in-depth analysis of the cause-and-effect relations of structural conditions related to external audit and the Legal Entities of Public Law;
- Chapter 8 presents an assessment of the net impact of the MFA operation on macroeconomic, structural and external sustainability;
- Chapter 9 considers implications of the design and implementation of the operation on its efficiency and effectiveness.

The annexes include an overview: of interviewed key stakeholders (Annex I), document data sources (Annex II), IMF review (Annex III), WB programmes (Annex IV), History of Events (Annex V), MFA and WB/IMF conditionality (Annex VI), MFA conditionality and the Georgian PFM Strategy (Annex VII), and MFA conditionality and related synergies (Annex VIII).

2 Evaluation objective and approach

2.1 Objective of the Evaluation

Under its Financial Regulation (Article 27.4), the European Commission (EC) is legally obliged to evaluate "all programmes and activities which entail significant spending".[1] This also applies to MFA. The main objectives of this ex-post evaluation of MFA is to (a) assess the effects of the MFA operation in Georgia and (b) to learn key lessons, which can be applied to future interventions and/or the possible need for a reorientation of the present approach.

The evaluation is therefore both backward and forward looking, enabling the EC to draw key lessons for the future.

2.2 Evaluation approach and method

2.2.1 Evaluation questions

Table 2.1 contains the main evaluation questions as stated in the Term of Reference and the *Guidelines for the Ex-Post Evaluation of MFA Operations*.

Table 2.1 Generic evaluation questions from the Guidelines

Nr.	Evaluation Question
Q1	To what extent has the MFA been effective in terms of the short-term macroeconomic stabilization of the country concerned?
Q2	To what extent has the MFA been effective in terms of supporting structural reform?
Q3	What have been the indirect and/or unexpected effects of the MFA?
Q4	To what extent has the MFA contributed to returning the external financial situation of the country concerned to a sustainable path over the medium to longer-term?
Q5	How has the way in which the MFA operation was designed and implemented conditioned its effectiveness and efficiency?

1 Article 27.4 of COUNCIL REGULATION (EC, Euratom) No 1605/2002 of 25 June 2002 on the Financial Regulation applicable to the general budget of the European Communities, OJEC L248 of 16/09/2002.

The evaluation questions broadly focus on three core areas of impact:
1. Macroeconomic stabilisation;
2. Sustainability of the external financial situation;
3. Structural reforms.

For each domain, the effects are assessed over a specific time horizon:
- the effects on macroeconomic stabilisation and structural reforms on the economy and institutions on short and medium term (within 4 years of the first disbursement);
- the effects on external financial situation on medium to long term (3 or more years after the initial disbursement).

The first two disbursements took place in 2006 and the MFA operation in Georgia officially ended in December 2008. Therefore, we have to analyse expected effects on external financial sustainability and structural effects based on projections.

2.2.2 Evaluation approach

For the attribution of effects to the MFA operation, we followed a five step approach in accordance with the Guidelines for ex-post evaluation of MFA.

The **first step** was to describe the MFA operation in terms of its design, objectives and its relevance.

The **second step** was to identify the gross macroeconomic and structural effects. These gross effects are equal to the observed developments after the disbursement of the grant.

The **third step** was to establish a counterfactual situation. This refers to the most likely scenario in the domain of macroeconomic stabilisation and structural reform when no MFA would have been granted to Georgia. In order to establish the counterfactual situation, based on the Guidelines, we answered the following questions:

Table 2.2 Additional subsidiary evaluation questions to determine the counterfactual

No	Question
Q 0.1	What arrangement would have been implemented if the MFA had not been granted?
Q 0.2	What are the structural and macroeconomic effects of the most likely implementation scenario?

In determining the counterfactual situation, we also included the analysis of the unexpected and indirect effects of the MFA operation. This third step was based on interviews with key stakeholders of the IFIs and of the Georgian government.

The **fourth step** involved the determination of the net effects of the operation. The net effects follow out of the comparison between observed developments and the counterfactual situation.

In the **final step**, conclusions were drawn on the design of the MFA approach.

2.2.3 Evaluation methods

To conduct the five steps of the evaluation approach, we collected data by means of a variety of evaluation methods (see Table 2.3).

Table 2.3 Data collection methods to answer the evaluation questions

Evaluation steps	Core areas	Questions	Methods
Step 1 to describe the MFA operation in terms of its design, objectives and its relevance		Q 1.1 Q 2.1 Q 2.2	• Document analysis of EC files • Interviews with key officials
Step 2 to identify the gross macroeconomic and structural effects	• Macro economic stabilisation • Structural reform • External sustainability	Q 1.2 Q 2.3 Q 3.1 Q 3.2 Q 4.1 Q 4.2 Q 4.3	• Document analysis • Interviews with key officials • Macro economic analysis • Case study
Step 3 to establish a counterfactual situation		Q 0.1 Q 0.2	• Interviews with key officials • Case study
Step 4 to determine the net effects of the operation	• Macro economic stabilisation • Structural reform • External sustainability	Q 1.3 Q 2.4 Q 2.5 Q 4.4	• Desk analysis
Step 5 to draw conclusions on the design of the MFA		Q 5.1	• Desk analysis • Stakeholders workshop

In evaluations of other MFA operations we have used a Delphi Questionnaire to verify our findings from interviews. This evaluation instrument was not used in this evaluation owing to the relatively small group of key stakeholders and the low response rate to the first Delphi Questionnaire.

In addition, due to the specific characteristics of this MFA, the potential macroeconomic impact is considered to be very limited. Therefore, we did not apply macroeconomic modelling as an evaluation instrument to assess net macroeconomic impact for this evaluation.

3 MFA Operation in Georgia

3.1 MFA Economic and political context

After Georgia gained independence from the Soviet Union in 1991, the country experienced a steep real GDP decline of almost 75 percent. In the following decade, the Government started a first phase of fiscal, financial, and structural reforms (e.g. privatisation of state-owned enterprises), and took steps towards price stabilisation and liberalisation. However, during this period, reforms were hampered by civil war and weak governance. Nevertheless, during 2000-2003, real GDP growth averaged around 6 percent and inflation around 5 percent. Meanwhile, low tax collections due to mismanagement and poor tax administration led to rapidly rising domestic arrears. The country was caught in a poverty trap, suffering from corruption and weak implementation of economic and institutional reforms.

Following the Rose Revolution in 2003, the new Government that took office in 2004 initiated a new phase of reforms. These reforms aimed at reducing corruption in tax and customs administration, creating a business-friendly environment, and improving governance in the public sector by restructuring the civil service, strengthening management in state-owned enterprises, and accelerating privatisation. As a result of these reforms, revenue collection improved substantially, enabling an increase in government expenditures and the clearing of arrears. Tax and non-tax revenues rose by about approximately on average 35 percent per year[2], to 29.3 percent of GDP in 2007.

Economic growth during 2004-2006 averaged about 8.3 percent, reaching 12.3 percent in 2007, while inflation remained in the single digits (see Table 3.1). Total public expenditures increased from 19 percent of GDP in 2004 to 29.3 percent of GDP in 2007. This enabled increases in expenditures in all sectors, in particular in the social sector, health, education, defence and transport (road) infrastructure, without affecting fiscal sustainability. Public debt was reduced from 46.5 percent of GDP in 2003 to 17.5 percent in 2007. In 2008, the economy was heavily affected by the Russia-Georgia armed conflict, and subsequently by the global financial and economic crisis. Nevertheless, real growth was still about 2.1 percent in 2008, but for 2009 it is expected that the economy would contract by 4 percent.

2 Revenue increased with 13 percent in 2003, 66 percent in 2004, 25 percent in 2005, and 30 percent in 2006.

Table 3.1 Selected Economic Indicators for Georgia 2004-2009

	2004	2005	2006	2007	2008*	2009*
Macroeconomic indicators						
GDP growth (annual %)	5.9	9.6	9.4	12.3	2.1	-4.0
Consumer Prices (annual percentage change)	5.7	8.3	9.2	9.2	10.0	1.8
Exchange rate (lari/dollar, period average)	1.92	1.81	1.78	1.66	1.48	1.67***
Unemployment rate (in %)	12.6	13.8	13.6	13.3	16.5	↑**
Fiscal indicators						
Revenues (as % of GDP)	23.1	24.4	26.7	29.3	30.7	29.6
Government balance (% GDP)	2.4	-1.6	-3.0	-4.7	-6.3	-9.4
Public debt (% GDP)	46.4	34.2	27.6	22.1	25.0	36.9
External public debt (% GDP)	36.2	27.1	21.9	17.5	20.9	32.0
Balance of Payments						
Current account balance (% of GDP)	- 6.9	- 11.1	-15.1	-19.7	-22.7	-16.0
Current account balance (million US$)	- 354	-710	-1175	-2009	-2915	-1759
Trade balance (million US$)	-916	-1214	-2019	-2896	-3833	-2775
Gross international reserves (in months of next year's imports of goods and services)	1.3	1.3	1.8	2.2	3.2	3.9

Sources: IMF

* Figures for 2009 are based on IMF projections from Country Report No. 09/267, July 2009

** For 2009 unemployment is expected to rise. In Georgia about two-thirds of the working age population is self-employed, which may result in underestimation of the unemployment figures.

*** Actual, average over January – October 2009

Reforms

The business environment has improved significantly since 2003, as shown by Georgia's high rankings in the World Bank's Doing Business survey: Georgia has been among the top ten reforming countries for the last four years. In 2007, Georgia became the number one economic reformer. Since 2006 Georgia significantly improved its ranking in the Ease of Doing Business index, moving from 112th place to 11th place in the 2010 Doing Business survey (see Table 3.2).

Table 3.2 Doing Business Indicators 2010, Georgia

Georgia	Rank
Ease of Doing Business Rank	11
Starting a Business	5
Dealing with Construction Permits	7
Employing Workers	9
Registering Property	2
Getting Credit	30
Protecting Investors	41
Paying Taxes	64
Trading Across Borders	30
Enforcing Contracts	41
Closing a Business	95

Source: World Bank

Most recent reforms were in the area of construction and trade. In 2008-09 Georgia eased the process for dealing with construction permits, while the documentation requirements for imports and exports were simplified. The cost of trade significantly declined.

The EBRD transition indicators also have showed progress in improving the business environment In 2004-2005 the country made progress with large scale privatisation, enterprise restructuring and banking reform (see Table 3.3). In 2006, the EBRD transition indicators showed Georgia roughly in line with the EBRD average.[3] In 2008 the country ranked 21st and in 2009 15th in the transition indicators, out of 29 countries.[4]

[3] See EBRD Transition Report 2006.
[4] 2008 and 2009 rankings are based upon a new methodology and include three additional countries.

Table 3.3 EBRD transition indicators Georgia

	Large scale privatisation	Small scale privatisation	Enterprise restructuring	Price liberalisation	Trade & Forex system	Competition Policy	Banking reform & interest rate liberalisation	Securities markets & non-bank financial institutions	Overall infrastructure reform
1991	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
1992	1.00	1.00	1.00	3.33	1.00	1.00	1.00	1.00	1.00
1993-94	1.00	2.00	1.00	3.67	1.00	1.00	1.00	1.00	1.00
1995	2.00	3.00	2.00	3.67	2.00	1.00	2.00	1.00	1.00
1996	3.00	4.00	2.00	4.00	3.00	2.00	2.00	1.00	1.00
1997	3.33	4.00	2.00	4.00	4.00	2.00	2.33	1.00	1.67
1998	3.33	4.00	2.00	4.33	4.00	2.00	2.33	1.00	2.00
1999	3.33	4.00	2.00	4.33	4.00	2.00	2.33	1.00	2.33
2000-03	3.33	4.00	2.00	4.33	4.33	2.00	2.33	1.67	2.33
2004	3.33	4.00	2.00	4.33	4.33	2.00	2.67	1.67	2.33
2005	3.67	4.00	2.33	4.33	4.33	2.00	2.67	1.67	2.33
2006	3.67	4.00	2.33	4.33	4.33	2.00	2.67	1.67	2.33
2007-08	4.00	4.00	2.33	4.33	4.33	2.00	2.67	1.67	2.33

Source: EBRD

Notwithstanding the improvements in the business environment, the costs of tax compliance and the costs of transactions across borders are still too high and act as impediment for further private sector development in the country.[5] Furthermore, the infrastructure gaps remain an impediment as well.

Most recent changes in the real and financial sectors have occurred in the post-Rose Revolution period. But, despite the strong economic performance underpinned by good progress in economic reforms, poverty has remained unchanged, notably due to lack of development in rural areas. According to the World Bank, poverty is expected to increase further from 23.7 percent in 2007 to 27.1 percent in 2009, while extreme poverty is projected to increase from 9.3 percent in 2007 to 11.9 percent in 2009. The political conflict and the global financial and economic crisis have led to increasing numbers of new Internally Displaced Persons (IDPs), higher unemployment, and increased poverty incidence.

Among the political factors hindering Georgia's economic development are the continuing tensions over the regions of Abkhazia and South Ossetia, and the resulting poor relations with Russia. Shortly after the new Government took office in 2004, Russia banned Georgian products, and closed the border between Georgia and Russia. In 2006,

5 See World Bank, Programme Document for a Proposed Credit in the amount of SDR 57.2 million to Georgia for a First Development Policy Operation, June 2009, p. 33.

the Russian government indefinitely suspended all transport links and postal communication with Georgia. This led to a sharp slowdown in export growth, but the overall impact on economic growth was mitigated by significant inflows of private capital. In addition, in the beginning of 2007, Gazprom more than doubled the price for gas deliveries to Georgia, to the level charged to Western European countries. Finally, last summer, geopolitical tensions led to an armed conflict between Russia and Georgia. While the fighting has ended, tensions remain, notably following the visit of Russia's President to North Ossetia in July 2009.

The conflict, and the subsequent global financial and economic crisis, led to a drastic fall in investors' confidence. Foreign direct investment, which had been a key source of economic growth in recent years, declined sharply. Despite the measures undertaken to cushion the negative impact of the recent conflict, e.g., some fiscal stimulus and easing of liquidity conditions, financial indicators deteriorated. Uncertainty related to future private inflows, combined with a possible reduction in remittances and a slowdown of trade activity has affected economic growth negatively, creating further pressure on the public finances and on the balance of payments. The most recent (June) projections of the World Bank as well as the latest IMF estimates show a higher decline in FDI, exports of goods and services, and workers' remittances than estimated at the time of the Donor Conference in October 2008. Workers' remittances declined by 22 percent in the first four months of 2009 compared to the same period in 2008. At the same time, due to lower economic growth, the current account deficit is expected to be somewhat narrower than initially estimated.

With regard to the public finances, the weakening economy has significantly affected tax revenues, leading to higher budget deficits. For this year and next year the resulting gaps will be covered by expenditure consolidation and some budget support, depending on fulfilment of pledges made during the donor conference. The Georgian authorities are also using the proceeds of the Eurobond issue of 2008 (see Chapter 4) and additional privatisation in the transport sector to cover gaps. These are, however, one-off sources of financing. Therefore, debt problems related to future repayments of international loans and of the Eurobond cannot be ruled out. According to the IMF, to rollover the Eurobond, the government will need to regain access to capital markets, which will rest considerably on achieving a sustainable fiscal position by 2012.

3.2 Macro Financial Assistance to Georgia

The focus of this evaluation is on the Macro-Financial Assistance that was provided to Georgia in 2006, based on the Council decision of January 2006. Preceding this MFA operation, Georgia received Exceptional Financial Assistance (EFA) during 1997-2005.

3.2.1 Exceptional Financial Assistance to Georgia during 1997-2005

In November 1997, the Community adopted a decision to provide EFA to Armenia and Georgia in view of their difficult political, economic, and financial situation, including their inability to service their financial obligations towards the Community.[6] In August 1998, with Georgia having fully settled its arrears towards the Community (€ 131 million) and in the context of the agreement reached between the IMF and the country's authorities on a third annual arrangement under the Fund's Enhanced Structural Adjustment Facility (ESAF), the Commission disbursed the first tranche of the EFA (€ 110 million in loans and € 10 million in grants).

The implementation of the second tranche of this assistance (grant tranche of € 9 million), which was scheduled for the end of 1998, was postponed to early 1999 as a result of disappointing implementation of the IMF programme, notably with respect to targets for tax collection rates and exchange rate policy. The second grant tranche was disbursed only in September 1999. This disbursement was subject to a € 10 million reduction by Georgia in its outstanding financial obligations towards the Community (€ 110 million) and to the implementation of the macro-economic programme supported by the IMF.

The structural conditionality for the 2001 grant included conditions on improvement in tax collection rates, reduction of arrears on salaries, pensions and social expenditure, privatisation of the remaining electricity distribution and generation companies and of the telecommunications, and review of bankruptcy legislation. Although substantial progress was made in most of these areas during 2001, insufficient progress was achieved in customs revenue collection, energy sector reform, and privatisation. Therefore, the Commission decided in December 2001 to disburse only € 6 million, after an early principal repayment of € 8 million was made by Georgia on its outstanding debts towards the Community. In 2004, when the new government embarked on a new programme of reforms, another € 6.5 million was disbursed (see Table 3.4) against an identical EU debt repayment from Georgia. The remaining € 33.5 million was not disbursed within this assistance package.

6 Council Decision 97/787/EC – OJ L 322 of 25.11.1997.

Table 3.4 Exceptional financial assistance during 1997-2005

MFA package	Date of approval	Date of disbursement	Loan/Grant	Conditions	Linked to
1997- 2005	November 1997		€ 65 million grant € 110 million loan		
1st tranche		August 1998	€ 10 million grant € 110 million loan	• Settle outstanding financial obligations • Structural reform conditions	IMF's Enhanced Structural Adjustment Facility
2nd tranche		Sept 1999	€ 9 million grant	• Settle outstanding financial obligations	Macro-economic programme supported by the IMF
3rd tranche		December 2001	€ 6 million grant	• Settle outstanding financial obligations • Structural reform conditions	
4th tranche		2004	€ 6.5 million grant	• Structural reform conditions	

Source: EC

3.2.2 Macro-Financial Assistance to Georgia during 2006-2008

The new MFA programme was prepared in 2004 and 2005. The initial proposal, which was sent to the Economic and Financial Committee (EFC) in October 2004, comprised assistance to Armenia, Georgia, and Tajikistan. The proposal noted that it was not a traditional MFA operation intended to cover residual financing needs over and above resources provided by the International Financial Institutions, as the assistance was related to early repayments of Community outstanding debt (amounting to € 85.5 million). The EFC provided critical comments on this proposal, which were related to the Genval criteria (including exceptional character, burden sharing). Subsequently a new Commission proposal was drafted which related solely to Georgia.

On 24th January 2006, the Council decided to provide macro-financial assistance to Georgia of up to € 33.5 million in the form of grants, divided in three tranches.[7] The assistance was conditional upon early repayment of part of Georgia's debt to the European Union, drawing on expected significant privatisation receipts. The main reason for early debt repayment was to improve medium term debt sustainability, an idea supported by the IMF. Total early debt repayments would be a little higher than the MFA grants. The amount of debt repayment linked to each tranche was planned to increase gradually over time, as it was assumed that the country would grow gradually and would thus be able to repay more.

[7] Council Decision 2006/41/EC.

Initially, repayments were planned to be more or less the same amount needed to reduce the debt to the EC in the medium term. However, the Georgian authorities went beyond that, i.e. offered early repayment of old debt to EC in an amount higher than the total planned MFA. The repayment amount was mainly determined by two other factors: (i) constraints with regard to the grant amount the EC was able to commit;[8] and (ii) Georgia's ability to finance a net repayment in their budget.

The first and second grant instalments were disbursed in August and December 2006, divided in two tranches of € 11 million each. In parallel, Georgia reduced the amount of its outstanding debt to the Community by € 13 and € 15 million respectively. Under the MFA operation, the Commission focused its policy dialogue with the Georgian authorities on Public Finance Management (PFM), which was considered to be a top priority for reform and supported by the World Bank and many other international and bilateral donors. Consequently, the Commission cooperated closely with the World Bank, which was also supporting the strengthening of public sector accountability, efficiency, and transparency under its series of Poverty Reduction Support Operations (PRSO).

The reform process progressed unevenly. Budget planning and execution reforms went smoothly following previous major reform efforts, whereas progress in the area of internal controls and internal audit lagged, partly due to the political turmoil that led to the presidential elections in January 2008. The release of the final MFA-grant (€ 11.5 million) was conditional on the enactment of the draft Law on the Chamber of Control, which had been firstly submitted to parliament in 2006. The EC offered the Government of Georgia to reduce the debt repayment linked to the third tranche from € 17.5 to € 11.5 million (same amount as the planned disbursement of MFA). In the event, the Chamber of Control Law was not adopted in time, so the third tranche was never disbursed. As a consequence, Georgia did not make the early repayment of € 17.5 million (or the offered alternative of € 11.5 million), which was linked to the last tranche. The Law was adopted in January 2009, after the MFA agreement had expired. Annex V provides a chronological overview of events which are related and/or relevant to the MFA operation. Table 3.5 summarises the main characteristics of the MFA operation.

8 No new money was committed; just € 33.5 million; the same amount as the undisbursed amount of the previous EFA operation.

Table 3.5 The MFA operation in Georgia during 2006-2008

Package	Date of approval	Date of disbursement	Loan/Grant	Condition	Linked to
2006-2007	Jan 2006		€ 33.5 million grant		World Bank's PRSO and IMF PRGF programme; Early principal repayments in the amount of € 45.5 million
1st tranche		August 2006	€ 11 million grant	• Early debt repayment to the EU of € 13 million • PFM reforms	
2nd tranche		December 2006	€ 11 million grant	• Early debt repayment to the EU of € 15 million • PFM reforms	
3rd tranche		Not disbursed; was planned H1/2007	€ 11.5 million grant	• Early debt repayment to the EU of € 17.5 million • PFM reforms	

Source: EC

3.3 Total international financial assistance support to Georgia

Support 2004-2008

Table 3.6 provides an overview of all financial assistance to Georgia in the period 2004 to 2008. This table shows that in 2006, the MFA assistance amounted to approximately 20 percent of total official transfers.

Table 3.6 Quantitative analyses of the total international financial Assistance for Georgia (in millions of US$ and Euros)

	2004	2005	2006	2007	2008
Total support					
• Official transfers (in millions of US$)	74	147	140	138	365
• Official transfers (in millions of €)			112		
EU MFA					
• Grant (in millions of €)			22		
EU MFA as % of total official transfers			**App. 20%**		

Source: Balance of Payments, various IMF country reports; Exchange rate 2006 from ECB (€ 1 = US$ 1,2556)

Besides the EU, the IFIs, and European bilateral donors, assistance from the US Government has been significant. Through USAID, US$ 86 million was provided in 2005 and US$ 66 million in 2006, targeted for projects focussing on economic growth, energy and environment, democracy and governance, health and social development, and support for civil society. In addition, the US Government is providing a five-year US$ 295.3 million grant through the Millennium Challenge Corporation (MCC), which includes complementary actions for rehabilitating regional infrastructure and promoting local enterprise development.

Support 2008-2010

In light of the sudden decline in capital inflows, the international community through an October 2008 Donors' Conference provided pledges of financial support in the amount of US$ 4.5 billion (or € 3.44 million) over the period 2008–2010 (see Table 3.7). This financial assistance should help Georgia to meet its external financing needs, to maintain its macro stability; to rebuild its damaged infrastructure; and to cope with the downturn of the economy and the substantial social needs of the rising displaced population. The EU pledged a package of up to €500 million for the period 2008-2010. International financial institutions announced contributions in the amount of US$ 2.4 billion, beyond the US$ 750 million credit extended as part of the IMF's stand-by programme in September 2008. The United States Government pledged US$ 1 billion, comprising support to the budget (25 percent), infrastructure projects, humanitarian assistance and other areas.

Table 3.7 Donor pledges for 2008-10 by sector (in millions of US$)

Sector	Amount pledged
Banking	853
Transport	682
Budget and Macro-financial Support	586
Energy	381
Internally Displaced Persons	350
Private and Financial Sector	252
Urban and Municipal	211
Immediate	100
Other	355
Not Allocated	766
TOTAL	**4,536**

Source: World Bank

3.4 EU support to Georgia

3.4.1 Total EU support

The EU support to Georgia is related to the neighbourhood policy of the EU in the region. Table 3.8 provides an overview of all EU support to Georgia in the active MFA period.

Table 3.8 Total EC assistance to Georgia, 2004 - 2007 (in millions of Euros)

Assistance	2004	2005	2006	2007
TACIS	25	0	20	
ECHO	4	2	2	
Food Security Programme	12	10	10	
Rehabilitation in conflict zones	2	2	2	
European Initiative for Democracy & Human Rights	2	2	2	
CFSP and RRM	5			
Other instruments	2	1	2	
ENP NIP				24[9]
• *SPSP (first tranche)*				*5*
Macro Financial Assistance	0	0	22	0
Total	**52**	**17**	**60**	
MFA			**22**	
% MFA of total EC assistance			**37%**	

Source: EC Country Strategy Georgia, 2007

According to the table, the MFA grant amounted to almost 37 percent of total EU assistance in 2006, the only year in which assistance was disbursed.

For 2008, the EU committed an amount of €181.9 million and Georgia received almost the full amount, except for the unpaid last MFA tranche of € 11.5 million (€ 181.9 - € 11.5 = € 170.4 million). The focus of the assistance was, among others, support to an effective response to the needs of the Internally IDPs. In 2008 Georgia received exceptional targeted budget support from the EU for this purpose. A first tranche of € 10 million and a second tranche of € 51.5 million were committed. The goal of this financial support was to build houses for the IDPs. The support would be provided ex-post to the Georgian authorities, i.e. it would be paid upon invoices. The complete overview of 2008 EC assistance is provided in Table 3.9.

9 € 24 million allocation / commitment made in 2007 but leading to cash outlays over 2007-2009 period.

Table 3.9 Total EC assistance to Georgia, 2008 (in millions of Euros)

EC assistance	Amount
Internally Displaced persons:	98.7
• *UN Flash Appeal*	*21.0*
• *Grants, direct (sector) budget support and contributions to Municipal Development Fund*	*77.7*
Core Recovery of Georgian economy, including €36.6 million for ongoing assistance under various programmes in the area of education economic rehabilitation of conflict regions, democracy and human rights non-state actors and investment projects	47.8
EU Monitoring Mission in Georgia, launched on 1 October 2008	35.4
TOTAL	**181.9**

Source: European Commission

For 2009, under the ENPI budget, € 50 million is in the pipeline to support IDPs, including a planned reinforcement of the ENPI budget line of € 19 million. In addition, the regular ENPI 2009 bilateral programme, which amounts to € 30.4 million, is planned to be adopted in the autumn of 2009. It includes, inter alia, a sector budget support programme in the area of vocational education & training, in the amount of € 19 million. Moreover, the Commission is preparing for 2009 a new MFA operation to support Georgia's post-conflict economic recovery with a maximum total grant of € 46 million. The first tranche of the MFA grant is scheduled to be disbursed by the end of 2009 in order to contribute to filling the budgetary gap. Final figures in disbursements in 2009 will be known at the end of the year. For instance, the final review of the sector budget support assistance is planned by year's end and it is not clear yet whether the full amount will be disbursed.

3.5 IMF and World Bank programmes with Georgia

3.5.1 International Monetary Fund

In June 2004, shortly after the Rose Revolution, the IMF approved a three-year Poverty Reduction and Growth Facility (PRGF) arrangement in the amount of SDR 98 million (about US$ 150.3 million), to support the government's economic programme. The funds were released in seven instalments over 2004-2007. A first instalment of SDR 14 million was disbursed upon approval of the PRGF by the IMF Board in June 2004.

The IMF approved an 18-month Stand-By Arrangement (SBA) for SDR 477.1 million (US$ 750 million) in September 2008, to help restore investor confidence in the wake of the armed conflict with Russia in August 2008. A first instalment of SDR 161.7 million (US$ 250 million) was disbursed upon approval. While the first review of the programme was favourable, the instalment was not drawn by the Georgian authorities, given expected donor financing and the availability of resources transferred from the Sovereign Wealth Funds (SWFs). In March 2009 SDR 126.2 million (US$ 186.6 million) was disbursed after the second review of the programme[10] and in September 2009 an additional SDR 94.6 million (US$ 148 million) was disbursed following the approval of the third review.

In August 2009, due to the security and global financial and economic crisis the IMF approved an augmentation of access by SDR 270 million (around 180 percent of quota), of which SDR 200 million would be available in 2010. The IMF arrangement was also extended through June 2011. The next IMF review mission is scheduled for October 2009.

Annex III presents an overview of all review missions that took place under the IMF 2002 programme and the IMF 2006 Programme. Table 3.10 summarises the disbursements made to Georgia for the 2004-2009 period.

Table 3.10 Georgia: Transactions with the Fund (in millions of SDRs)

Year	GRA Disbursements	PRGF-ESF Disbursements	Total Disbursements
2009	220.8		220.8
2008	161.7		161.7
2007		28	28
2006		28	28
2005		28	28
2004		14	14

Source: IMF

3.5.2 The World Bank

The World Bank initiated in 2005 Georgia's Country Partnership Strategy (CPS) for FY06–09, linked to the government's Economic Development and Poverty Reduction Program (EDPRP). The CPS aims at:
- generating growth and creating jobs by removing barriers to private sector development and improving infrastructure, finance and markets;
- enhancing human development and social protection through improved education, health, social protection, and community services;
- strengthening public sector management and budgetary processes to enable Georgia to better plan and meet its own development goals.

Part of the CPS was a series of budget support operations. The PRSOs comprised four pillars:
- strengthening public sector accountability, efficiency, and transparency;
- improving electricity and gas sector services;
- improving environment for private sector development;
- improving social protection, education, and health care services.

The focus of Pillar I was to improve the functioning of the state following the Rose Revolution.

[10] In total the planned disbursements for the first and second review of the programme

Table 3.11 provides an overview of the World Bank PRSO disbursements for the period 2005-2008. The first PRSO was approved in September 2005[11]. The second PRSO IDA credit was approved by the World Bank's Board in October 2006. The third PRSO IDA credit was approved in June 2007. The fourth PRSO was approved in May 2008. In response to the August conflict with Russia and to help Georgia sustain its overall reform program in the face of unanticipated strains to the 2008 budget, a Supplemental Financing to Georgia's PRSO IV in the amount of US$ 40 million was approved in October 2008. Table 3.11 summarises the disbursed PRSO amounts for 2005-2008.

Table 3.11 Georgia: World Bank PRSO disbursements 2005-2008 (in millions US$)

	2005	2006	2007	2008	Total
PRSO I, II, III and IV	20	20	20	20	**80**
Supplemental financing to PRSO IV				40	**40**
Grand total	20	20	20	60	**120**

Source: World Bank

The PFM reforms attached to the MFA operation were strongly linked to the objectives in the first PRSO pillar.

Pillar 1: Public expenditure management reforms will improve the budgetary process and the efficiency and transparency in the use o f public resources. This Pillar pays particular attention to improving the procurement and financial management aspects which in addition to improving efficiency and transparency in the use of resources will reduce the scope for corruption. Similarly reforms in public administration, particularly civil service reform, are aimed at curbing corruption on the demand side while improving public service delivery. Reforms in intergovernmental fiscal relations will also strengthen these areas at the local level in addition to improving public service delivery.

The PRSO programme of the World Bank was closely coordinated with the IMF programmes. The Public Sector Financial Management Reform Support Project (IDA grant pooled together with resources from other bilateral donors) provided technical assistance and capacity building in support of the first pillar of the PRSO programme.

In June 2009 the World Bank proposed a new series of three Development Policy Operations focussing on three pillars: (i) Improving the efficiency and effectiveness of public finances; (ii) Improving the effectiveness of the social safety net; and (iii) Improving the external competitiveness. The first operation amounts to US$85 million and was approved in the beginning of July 2009. The first – PFM - pillar focuses on strengthening result-oriented budgeting and increasing the efficiency of public investment through better public investment programming.

Besides the PRSO programme the World Bank has been supporting Georgia through other programmes and projects (see Table 3.12). In the period 2005-2007, total annual lending to Georgia amounted to more than US$ 320 million on average. The disbursed amounts per year in total were 3 to 3.5 higher than the PRSO disbursements only. Annex

[11] US$ 13.5 million was a regular IDA credit and US$ 6.5 million was an IDA grant

IV presents a comprehensive overview of the World Bank programmes and projects in the period 2005-2008.

Table 3.12 Georgia: World Bank Total lending amounts, disbursement and repayments (in millions US$)

	2005	2006	2007	2008	2009
Total outstanding lending amount	341.29	302.89	319.69	262	n/a
Number of projects (active)	18	19	19	15	11
New lending amount per year	23	35	74	60.7	170
Disbursements	65.42	75.39	70.49	95.98	n/a
Repayments	0.74	2.7	5.63	8.95	n/a

Source: World Bank

The new CPS for Georgia for 2010-2013 envisages financing of about US$ 740-900 million over the four year period. The CSP includes the new series of Development Policy Operations.

4 Macroeconomic stabilisation

4.1 Introduction

In this Chapter we address the first group of evaluation questions linked to the area of macroeconomic stabilisation (see Table 4.1).

Table 4.1 Relevant evaluation questions for analysing macroeconomic stabilisation

	Impact on macroeconomic stabilisation
1	What are the short and medium-term macroeconomic objectives of the assistance? (Q1.1)
2	To what extent have the short and medium-term macroeconomic objectives of the assistance been achieved? (Q1.2)

4.2 Objectives of intervention

1: What are the short and medium-term macroeconomic objectives of the assistance?

The Council Decision of January 24th 2006 and the accompanying Memorandum of Understanding stated the goal of the assistance is "*to support economic reforms and help Georgia improve debt sustainability*" (06/41/EC) alternatively termed also as "*to help reduce external indebtedness*" (MoU, ECFIN/D/3/2006/REP/50705). The Council views the extension of the MFA grant as "*an appropriate contribution of the Community to the implementation of poverty reduction and growth strategies*". The MFA assistance intended to complement and reinforce assistance provided by other IFIs and bilateral donors in support of the Georgian authorities' economic stabilisation and reform programs.

4.3 Gross impact – actual macroeconomic outcomes

2: To what extent have the short and medium-term macroeconomic objectives of the assistance been achieved?

The key objective of improving Georgia's debt sustainability was achieved automatically by attaching the early debt repayments to subsequent MFA tranches. The country met this conditionality for the first two tranches and repaid € 28 million (or 61.5 percent of the requested total amount), thus directly and effectively improving its current and future debt position.

We analyse a set of general economic indicators included in the MoU to monitor macroeconomic and financial developments and policies during the MFA period (Table 4.2).

Table 4.2 Macroeconomic indicators

Macroeconomic stabilisation	Effect Indicators
Macro economy	Growth rates in GDP and components Inflation Interest rate Exchange rate
Fiscal sector: Public finance	Level of government revenue Level of government expenditure Deficit Financing of the deficit
Balance of payments	Current account deficit Components of current account: exports, imports, current transfers Inflow of foreign direct, portfolio and other investment International reserves
Financial volatility and BoP sustainability	Domestic and foreign debt Debt service payments Foreign-currency debt ratings Liabilities of banks

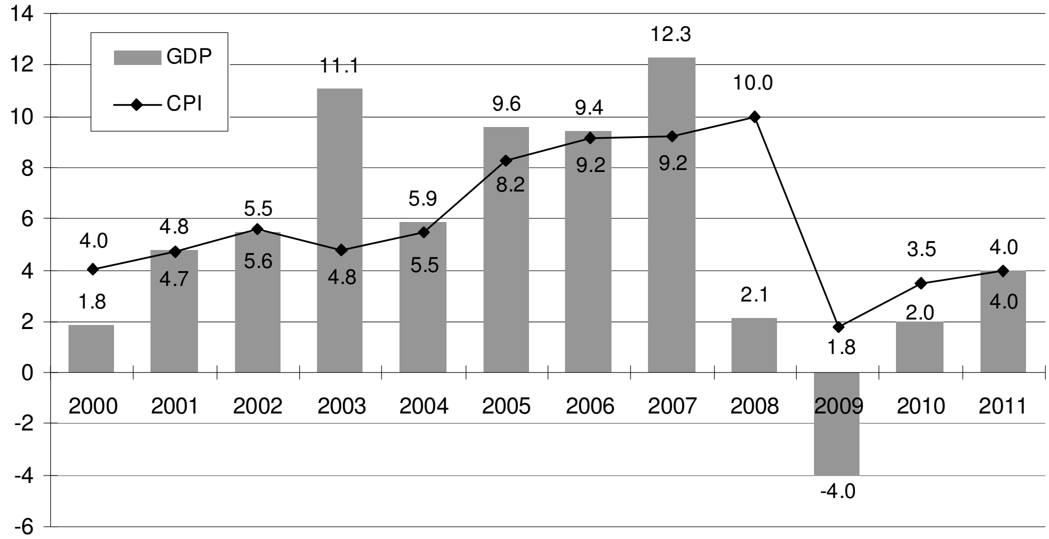
This section presents the impact on macroeconomic stabilisation, based on the effect indicators in the area of macro economy, public finance and balance of payments. Chapter 5 analyzes the effect indicators related to balance-of-payments and external debt sustainability.

4.3.1 Macro economy

Economic growth

Georgia has experienced a period of robust economic expansion in recent years, with GDP growth accelerating from 3.6 percent on average during 1998-2002 to 9.6 percent during 2003-2007. In the wake of the global financial crisis, growth decelerated sharply to 2.1 percent in 2008 and is projected to be a negative 4 percent in 2009, before a small recovery in 2010 (see Figure 4.1). Buoyant economic growth was underpinned by large capital inflows in the form of massive FDI related to large-scale privatisation, as well as other capital inflows (e.g. portfolio and loans). These inflows were encouraged by the improved macroeconomic policies and structural reforms implemented by the GoG, including the simplification of the tax system, liberalisation of the customs regime and reduction of corruption and red tape.

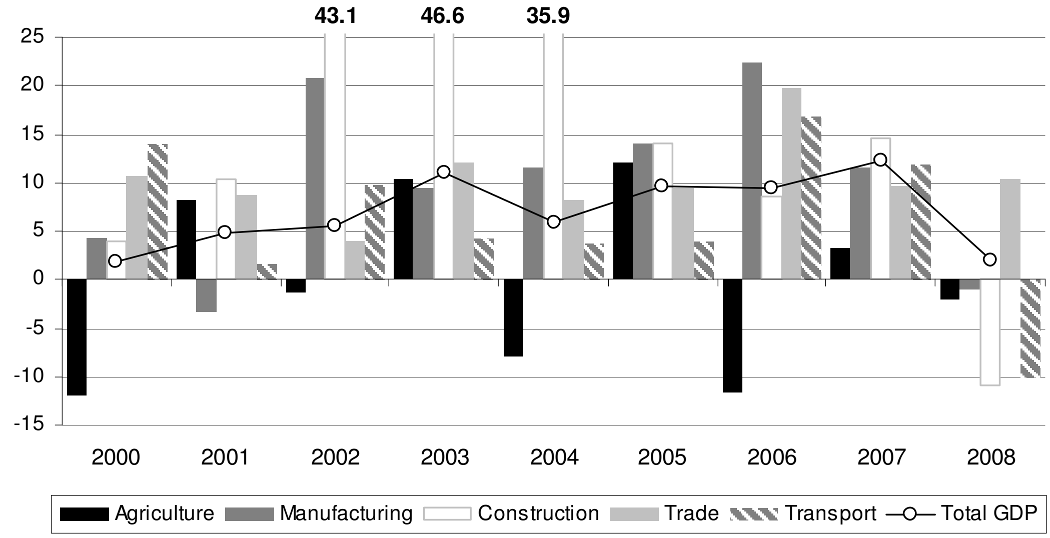
Figure 4.1 GDP growth (in percent) and CPI inflation (annual average percentage growth) 2000-2008, with projections for 2009-2011



Source: IMF Projections for 2009-2011 date back to July 2009 (IMF CR09/267). Inflation projections for 2010 has been upward adjusted from 3.2 percent to 3.5 percent. This adjustment is based on information received from IMF in Tbilisi (December 2009)

Figure 4.2 shows economic growth by sector for the period 2000-08. In line with trends in most transition economies, growth has been particularly high in the service sectors (e.g. trade, construction, telecommunications and financial intermediation) but low in agriculture. The different expansion rates over the past five years led to significant structural changes in the economy: the share of agriculture was halved between 2003 and 2008 (to 10.3 percent in 2008), while trade became the largest sector, accounting for 16.1 percent in 2008 (up by 2 percentage-points from 2003). Manufacturing kept its share relatively stable at just below 10 percent (although production remains concentrated in a few industries such as food processing, metals and machinery) while the share of transportation dropped by over 3 percentage-points since 2003. Construction expanded rapidly during 1996-2005, benefiting from large pipeline infrastructure projects and, more recently, the real estate boom, but decelerated sharply in the wake of the 2008 financial crisis.

Figure 4.2 Economic growth: total GDP and main market sectors 2000-2008 (in percent)

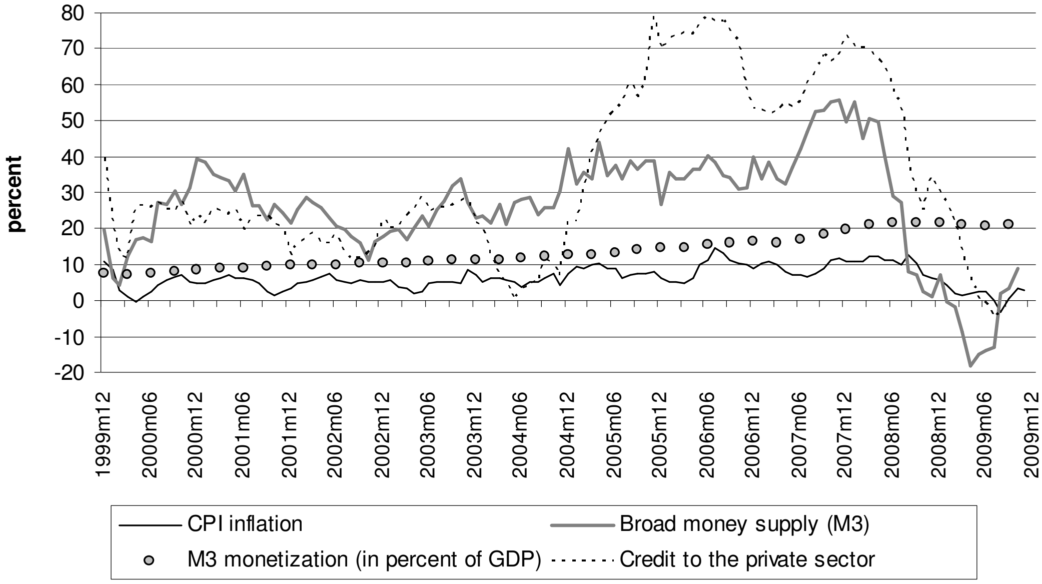


Source: National Bank of Georgia

Inflation, money and credit

Consumer price inflation has been kept under control at one-digit levels for most of the decade (see Figure 4.3). Prices of tradables have been restrained by the appreciating currency, but the overall inflation index remains extremely dependent on global commodity prices, as food and energy make up more than half of the Georgian consumer basket. Inflation rose in early 2006 and remained above 10 percent during most of the period 2006 - mid 2008, fuelled by global commodity price hikes and heightened demand pressured related to accelerating credit to households (Figure 4.4). This trend was reversed in mid-2008 amid the military conflict with Russia and the sharply deteriorating international economic outlook, which put downward pressure on commodities' prices and weakened consumer demand. Inflation is projected to reach 1.8 percent on average in 2009, the lowest in a decade, before rebounding to 3.2 percent in 2010 and 4-5 percent thereafter.

Figure 4.3 CPI inflation, broad money (M3) and credit to the private sector (year on year percentage changes) as well as M3 monetization (in percent of GDP).



Source: National Bank of Georgia

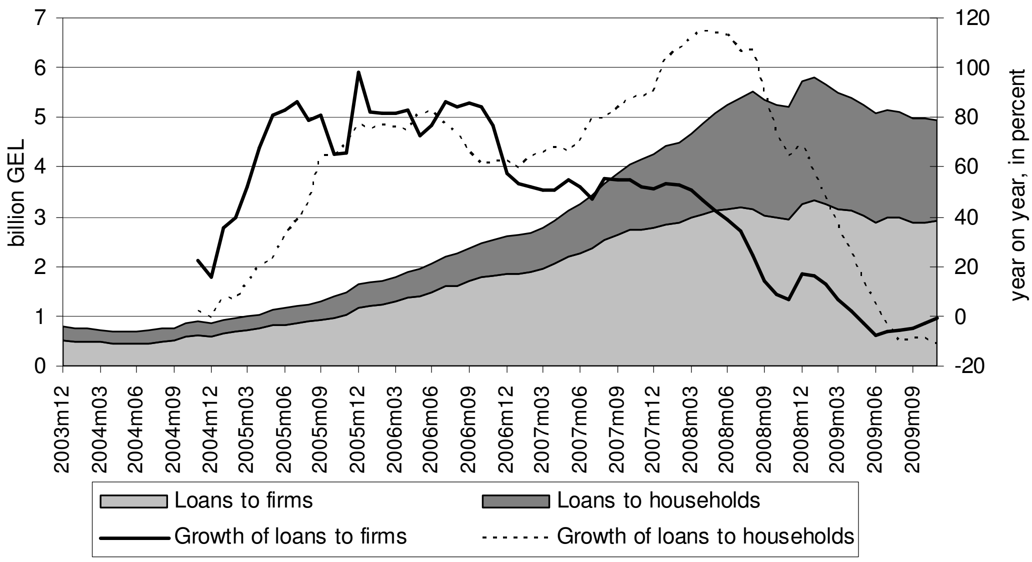
Macroeconomic stabilisation, the strong lari and financial sector development helped to lower the extreme dollarization of deposits from 90 percent in mid 2000 to 60 percent in mid 2008. The crisis and ensuing devaluation of the lari reversed this trend and pushed dollarization above 70 percent by end 2008. In parallel, growing confidence in the domestic currency facilitated the process of re-monetisation of the economy. The share of road money supply (M3) in GDP rose from 8 percent in 1999 to 22 percent in mid-2008, but declined slightly in late 2008 and 2009 as a result of the financial crisis.

Broad money was growing well above 10 percent year-on-year for most of the decade but accelerated markedly only in 2004 on the back of a credit boom (Figure 4.3). The credit expansion was fuelled partly by the improving economic outlook and was largely financed through foreign borrowing, due to the insufficient domestic deposit base, which covered only roughly half of credit to non-government.

Foreign investment in the banking sector picked up in 2005, launching a process of consolidation that resulted in the decline of the number of banks from 247 in 1995 to 21 in 2008. In parallel, the rate of annual credit expansion increased considerably from below 10 percent in 2004 (on average) to 80 percent in late 2005. Initially loans to firms grew faster than those to households (Figure 4.4). Starting in early 2007 the trends in both types of loans diverged, with loans to firms decelerating gradually and loans to households surging at rates above 100 percent year on year, fuelled by rapidly expanding mortgage credits. Overall, the credit boom, which lasted from late 2004 until mid 2008, raised the ratio of loans to GDP from 9 percent in 2004 to 21 by mid-2008.

The financial crisis put an abrupt halt on credit expansion. Credit growth to firms and households decelerated sharply between mid-2008 and mid-2009, becoming negative in the third quarter of 2009. Although the crisis led to the deterioration of the quality of bank assets and exposed the vulnerabilities of the banking sector in Georgia, the IMF assessed the liquidity and solvency indicators as satisfactory and suggested that the key risks related to larger depreciation shocks (IMF CR 09/267).

Figure 4.4 Loans to firms and households: stocks in billions of GEL and year on year growth rates, 2003-2009



Source: National Bank of Georgia

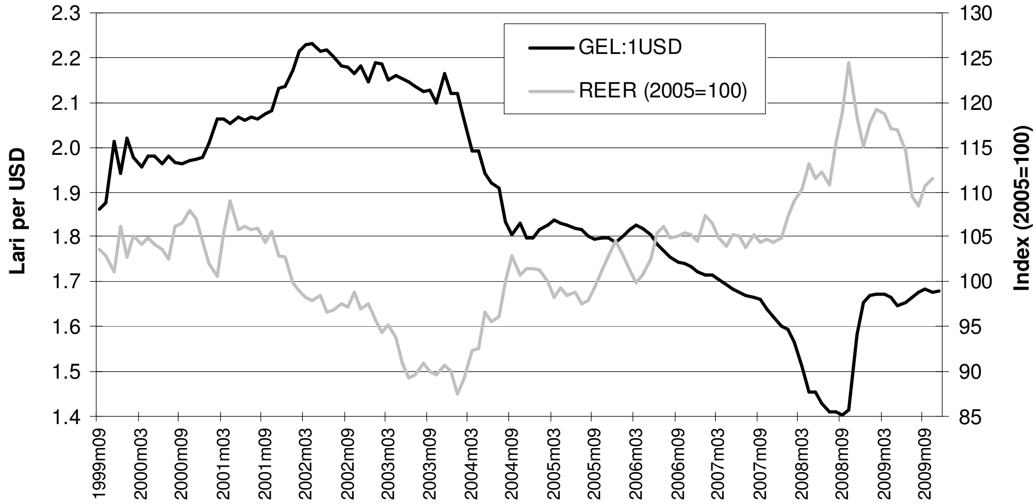
Exchange rate developments

Figure 4.5 presents the exchange rate development of the lari vis-à-vis the US$ and the real effective exchange rate (REER) from 2000 to September 2009. After depreciating moderately in 2000 and 2001 the lari entered an appreciation trend in early 2002 as a result of an increasing confidence in the rapidly expanding Georgian economy and the related massive capital inflows. The lari stabilised from mid-2004 until early 2006 and resumed strengthening in mid-2006.

Following accelerating appreciation in the first half of 2008, a temporary peg was introduced by the authorities during the August 2008 conflict. Rapidly shrinking reserves related both to the the armed conflict and to the global crisis forced the Government to devalue the lari by 17 percent in November 2008. The currency has been relatively stable since then.

The REER has broadly mirrored nominal US$ exchange rate developments after 2003. All in all, the lari appreciated by nearly 30 percent between 2003 and October 2008 with the November devaluation reversing the trend somewhat. After closely managing the exchange rate during most of the decade, in March 2009 the Georgian authorities introduced auctions that give the market a greater role in the determination of the exchange rate. This relaxation in the exchange rate regime led to its reclassification by the IMF as “other managed” from “stabilized”.

Figure 4.5 Average monthly exchange rate of lari vis-à-vis US$ and the Real Effective Exchange Rate Index (2005=100) * 1999-2009



Source: National Bank of Georgia

(An increase in the index means exchange rate appreciation)

4.3.2 Fiscal sector: Public Finance

The fiscal sector in Georgia underwent a series of strategic reforms since 2004, including introduction of a new tax code, the unification and lowering of tax rates, as well as important changes to excise tax and the VAT. Combined with strict anti-corruption measures, these reforms reduced the size of the unregistered economy and laid the foundation for the sound economic growth and substantial fiscal consolidation. As a result tax revenues rose from 14.6 percent of GDP in 2003 to 25.8 percent in 2007.

Table 4.3 Annual Consolidated Government Operations, 2002-2013 (in percent of GDP)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Revenues	**16.2**	**16.0**	**23.1**	**24.4**	**26.7**	**29.3**	**30.7**	**29.6**	**26.9**	**26.9**
o/w										
Taxes	15.1	14.6	19.7	20.8	22.9	25.8	24.9	24.4	23.7	23.8
Grants	0.3	0.6	1.3	0.9	1.2	0.6	3.2	3.0	1.5	1.3
Current expenditures	**15.6**	**14.7**	**15.8**	**20.1**	**20.7**	**25.0**	**28.5**	**29.8**	**27.3**	**25.4**
o/w										
Wages	3.0	3.4	4.2	4.7	4.1	4.0	5.3	6.1	5.7	5.6
Goods and services	5.3	3.6	3.3	4.9	5.6	9.3	8.4	5.3	4.7	4.0
Subsidies	0.8	1.2	2.2	3.8	2.8	2.3	2.7	2.5	2.4	2.2
Social expenses	4.5	4.5	4.4	4.8	5.1	5.0	7.2	8.2	8.3	8.1
Interest	2.0	2.0	1.4	1.0	0.8	0.6	0.6	1.0	1.2	1.4
Operational Balance	**0.7**	**1.3**	**7.3**	**4.3**	**5.9**	**4.2**	**2.2**	**-0.2**	**-0.5**	**1.5**
Capital spending & net lending	2.0	2.8	4.9	5.9	9.0	9.0	8.6	9.3	6.9	6.3
Overall balance	**-1.4**	**-1.5**	**2.4**	**-1.6**	**-3.0**	**-4.7**	**-6.3**	**-9.4**	**-7.3**	**-4.8**
Total financing	1.4	1.5	-2.4	1.6	3.0	4.6	6.2	9.4	7.3	4.8
Domestic	-0.6	0.1	-3.4	-1.7	-1.7	-0.8	-2.5	2.8	0.0	1.6
Borrowing	0.0	3.1	1.6	0.3	0.0	0.0	0.0	0.9	3.2	4.1
Amortization	-0.6	-2.8	-4.1	-1.4	-0.5	-0.2	-0.2	-0.2	-2.8	-2.4
External	1.8	1.1	0.3	-0.3	-0.4	0.2	5.0	4.2	6.4	2.3
Borrowing	2.3	1.7	1.8	1.1	1.3	1.0	5.6	5.0	7.1	2.9
Amortization	-0.5	-0.6	-1.5	-1.4	-1.7	-0.8	-0.3	-1.0	-0.7	-0.6
Privatization	0.2	0.4	0.7	3.6	5.2	5.2	3.7	2.5	1.0	0.9

Source: IMF. Projections for 2009-2011 date back to July 2009 (IMF CR09/267)

Buoyant tax collection enabled increases in most categories of current government spending, including wages, pensions and material expenses (see Table 4.3). It also allowed for a tripling of capital spending between 2003 and 2007 and for repaying most of the accumulated arrears.

An increasing part of the budget resources was used for defence as Georgia's unstable regional situation and NATO aspirations prompted the Government to invest in its army. Defence spending reached 9 percent in 2007 (36 percent of total expenditure) and is very likely to have increased further in 2008. Spending on education increased as well from 0.5 percent of GDP in 2001 to 2.5 percent in 2006 (with a slight downward correction in 2007); health expenses rose less - from 0.5 percent in 2001 to 1.4 percent in 2005 and remained stagnant since then clearly losing priority within the budget (as evidenced by the decline of its share in total expenditure from 8.1 percent in 2005 to 5.9 percent in 2007). Expenditure on general public services (among others, composed of public debt transactions and transfers between government levels) fell dramatically in 2005 as a consequence of prioritising defence, economic affairs[12] and social protection.

[12] This category is composed of spending on specific sectoral policies (industry, energy, transport, etc.). The rise in spending on economic affairs since 2005 can be largely linked to costly infrastructural projects in the area of energy.

Table 4.4 Structure of Central Budget Spending*, 2002-2007 (in percent of GDP and in percent of total spending)

	2001	2002	2003	2004	2005	2006	2007	2001	2002	2003	2004	2005	2006	2007
	In percent of GDP							In percent of the total						
General public services	3.5	4.6	4.0	5.1	1.6	2.0	1.6	40.4	45.2	46.0	41.3	8.9	8.8	6.5
Defence	0.5	0.6	0.7	1.6	3.3	5.2	8.8	6.3	6.4	8.1	13.1	19.1	23.4	35.9
Public order and safety	1.2	1.1	1.3	2.4	2.3	2.7	4.0	13.6	10.6	14.4	19.5	13.1	12.0	16.4
Economic affairs	0.4	0.6	0.6	0.5	3.3	3.4	1.0	5.0	6.1	7.1	4.4	18.9	15.3	4.2
Environmental protection	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.7
Housing and community amenities	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.7	0.6	0.7	0.2	0.0	0.0	0.1
Health	0.5	0.7	0.1	0.6	1.4	1.5	1.4	5.8	6.7	1.4	4.5	8.1	6.7	5.9
Recreation, culture,religion	0.3	0.4	0.3	0.3	0.4	0.5	0.6	3.5	3.5	3.3	2.8	2.0	2.3	2.3
Education	0.5	0.6	0.5	0.7	0.7	2.5	2.3	5.5	5.8	5.5	5.4	3.8	11.3	9.2
Social protection	1.6	1.5	1.2	1.1	4.6	4.5	4.6	19.2	15.1	13.5	8.8	26.0	20.2	18.8
Other	0.4	0.4	0.4	0.4	0.4	0.5	0.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total	**8.9**	**10.5**	**9.1**	**12.7**	**17.9**	**22.8**	**25.2**	**100**	**100**	**100**	**100**	**100**	**100**	**100**

Source: IMF GFS

*The ratios of total spending in percent of GDP refer to central budget spending and are therefore lower than respective ratios in Table 4.3 which refer to consolidated budget spending.

Overall, the total budget balance deteriorated remarkably in recent years, from a surplus of 2.4 percent of GDP in 2004 to a deficit of 6.3 percent in 2008 and 9.4 percent projected for 2009.

During 2005-2007 the deficit was comfortably financed through robust privatisation receipts, which exceeded the overall balance by up to 2 percent of GDP. A gradually shrinking pool of enterprises to be privatised, coupled with the crisis-triggered aversion of potential investors cut down privatisation receipts considerably in 2008 and 2009. Over the medium term, privatisation receipts are projected to decline further to a mere 0.4 percent of GDP 2013.

The fiscal response of the Government to the crisis was to keep the absolute level of spending in 2009 in line with earlier projections. However, given the lower nominal GDP, this meant higher spending-to-GDP ratios and a deteriorating fiscal balance. The scale of the fiscal deterioration (-9.4 percent of GDP) raised serious external debt sustainability concerns and prompted the Government to prepare a decisive fiscal adjustment package. The ambitious fiscal consolidation programme supported by the IMF is planned for 2010-2013, when the economy is expected to recover from the 2009 recession. Current expenditures will be cut by as much as 4.6 percent of GDP largely through freezing of the real wage bill, lower defence spending, savings on goods and services, and reduced capital spending.

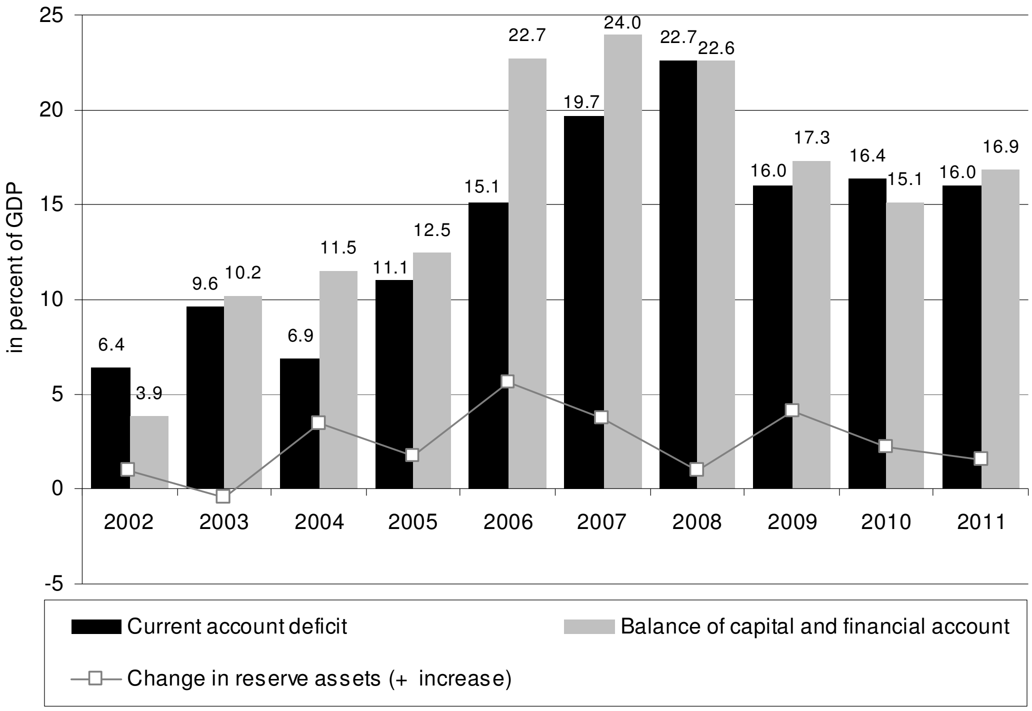
This fiscal consolidation programme is viewed as a key policy element to reduce external debt sustainability concerns and increase confidence of financial markets in order to regain access to international capital markets in the near future.

4.3.3 Balance of Payments

Balance of payments developments

While current-account deficits have been large since independence, they started to widen progressively in the wake of the Rose Revolution, from below 10 percent of GDP until 2004 to over 22 percent in 2008 (Figure 4.6). This deterioration was almost entirely attributed to the worsening merchandise trade deficit, which more than doubled between 2002 and 2008, reaching a massive 30 percent of GDP in 2008. Trade in services and current income payments remained insignificant (with the exception of 2006), while current transfers have had a positive impact on the current account: international grants and migrant workers' remittances contributed to lower the deficit by 4-9 percent of GDP (see Figure 4.6).

Figure 4.6 Main Balance of Payments accounts as percent of GDP 2002-2008 with projections for 2009-2011*



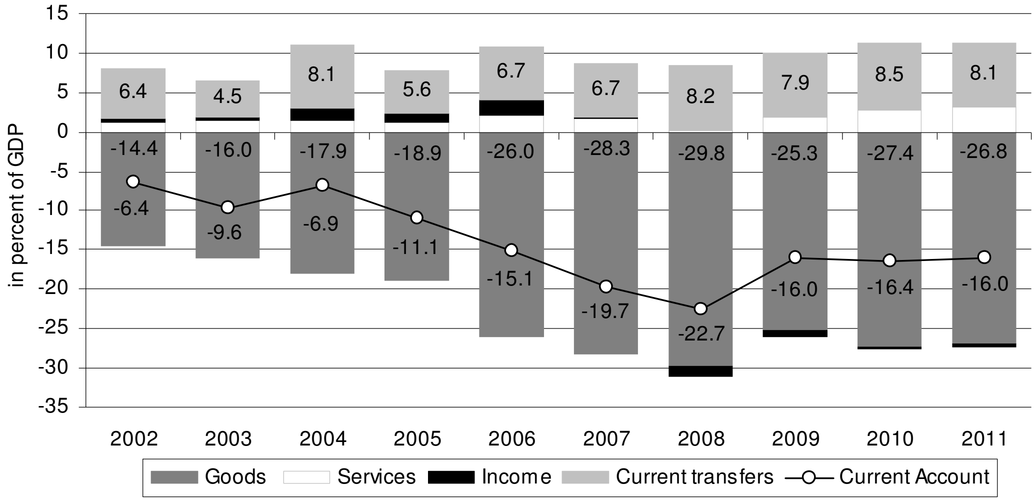
Source: National Bank of Georgia and IMF CR 09/267 for projections

* projections for 2009-2011 dated July 2009.

Capital inflows have become increasingly important over the years as evidenced by Figure 4.8. Improvement of the business environment, large scale privatisation and infrastructure (pipelines) projects, and the country's positive overall outlook in the wake of the Rose Revolution have triggered large capital inflows. FDI was the dominant form of capital inflows, reaching 8-10 percent of GDP in 2003-2005 (largely due to pipeline investments) then rising above 15 percent of GDP in 2006 and 2007, and averaging an impressive 12 percent during 2004-2008. Most FDI during the last two years (2007-2008) was directed to transport and telecommunications (23.5 percent), the energy sector (18.4 percent) and industry (16.9 percent). Significant flows went also to construction (6.4 percent) and real estate (8.6 percent).

Other financial account flows started to pick up in 2006: portfolio investments rose to 1.8 percent in 2006 and 9.7 percent in 2008 while other investments – comprising mainly banking loans – surged from negligible levels until 2004 up to 5.8 percent and 7.5 percent of GDP in 2007 and 2008, respectively, reflecting accelerating demand for credit from Georgian firms and households. The increased private flows helped sustain a positive overall balance of payments since 2003 and enabled the gradual build up of international reserves.

Figure 4.7 Components of the current account of the balance of payments, as percent of GDP, 2002-2008 and projections for 2009-2011*

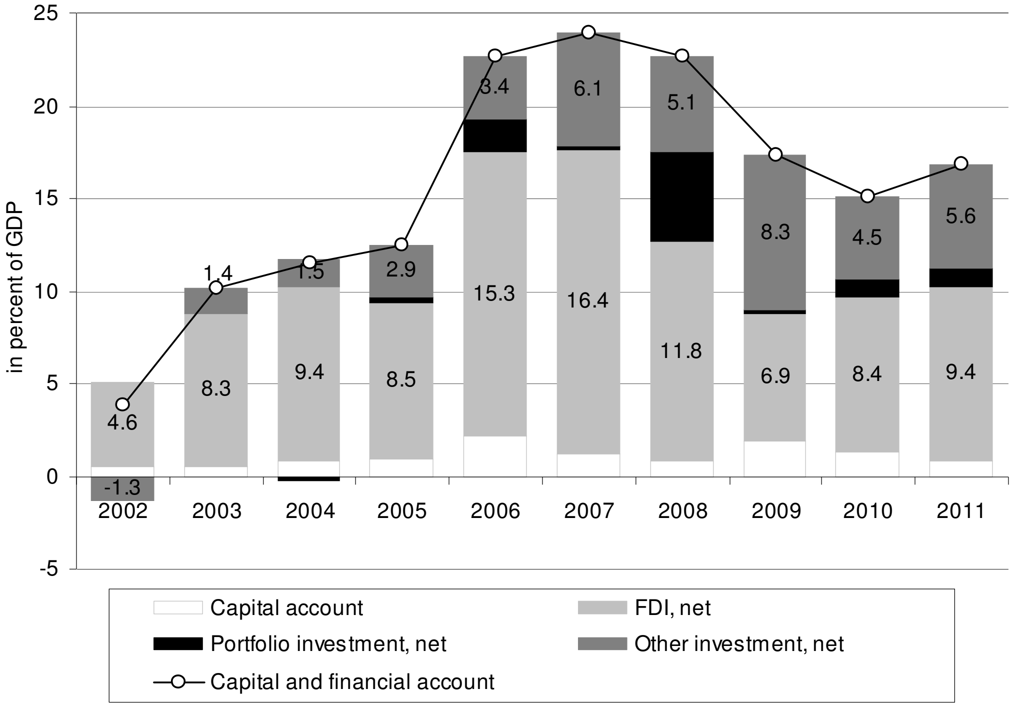


Source: IMF data for 2002-2008 and CR09/257 for projections 2009-2011

* projections for 2009-2011 dated July 2009.

The IMF projects a significant contraction in balance of payments flows over 2009-2013. The global crisis led to a sharp decline in merchandise flows and FDI which is projected to fall to 6.9 percent of GDP in 2009 (the lowest since 2002) and remain below 10 percent until 2014. For more details on the balance of payment outlook see Section 5.3.

Figure 4.8 Key components of the capital and financial account of the balance of payments, as percent of GDP, 2002-2008 and projections for 2009-2011*

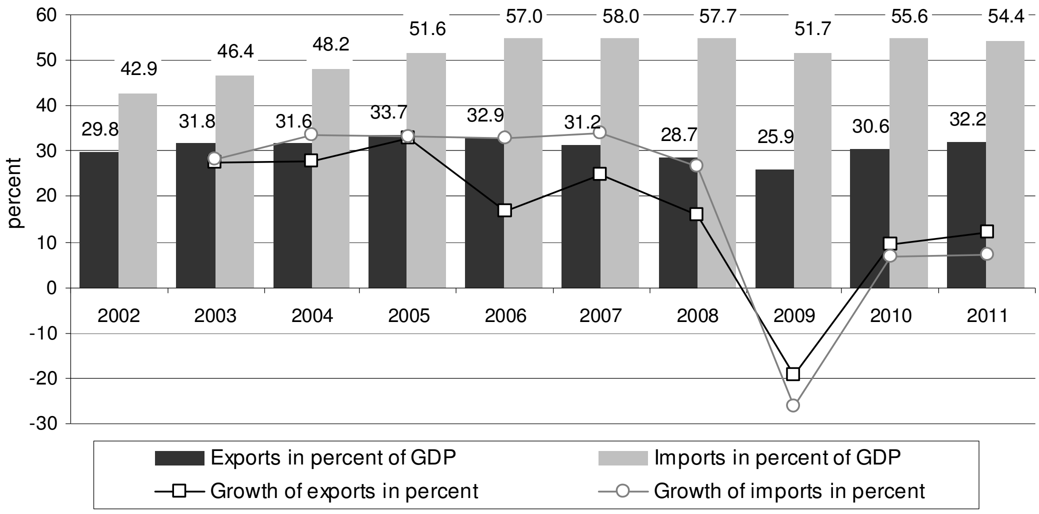


Source: IMF data for 2002-2008 and CR09/257 for projections 2009-2011
* projections for 2009-2011 dated July 2009.

4.3.4 Foreign Trade

The Georgian economy became significantly more open in the last decade. Trade flows have been increasing much faster than GDP on average, resulting in the rising importance of foreign trade for the economy (Figure 4.9). Georgian export's share in GDP increased from 16.5 percent in 1998 to 33.7 percent in 2005. The Russian sanctions of 2006 reversed this trend causing the exports share to decline by 5 percentage-points since 2005 to 28.7 percent in 2008. Imports on the other hand have been rising steadily from 37 percent in 1998 to 58 percent in 2007-2008 fuelled by rising domestic demand – particularly following the post-Rose-Revolution investment and consumption boom. The resulting widening gap between imports and exports indicates persistent structural deficiencies of the Georgian economy. The massive FDI inflows in the past couple of years have so far failed to provide a sufficiently durable boost to exports that would facilitate a reorientation of trade towards new markets following the Russian sanctions.

Figure 4.9 Exports and imports as percent of GDP 2002-2008 with projections for 2009-2011*



Source: IMF data for 2002-2008 and CR09/257 for projections 2009-2011

* projections for 2009-2011 date back to July 2009.

Exports

Georgia's exports are dominated by low value-added products and concentred in a few sectors, making the country vulnerable to global demand and terms of trade swings (see Table 4.5). Over the years, export shares have indeed shifted in line with a combination of global price and demand changes, changing domestic capacities, and the regional political context. Base metals and related articles (including ferrous metals, copper, iron and steel) acquired a strong leading position among all Georgian export goods with a 39 percent share in total exports in 2008. Performance was boosted by the 2006-mid 2008 commodity price surge, but was hurt subsequently by the global crisis. The Russian sanctions cut the share of beverages and spirits in Georgian exports from nearly 20 percent in 2003-2005 down to 9.2 percent in 2008, reflecting the difficulties in accessing new markets for Georgian wine and mineral waters. On the other hand, mineral products (e.g. cement), chemical products (fertilizers) and machinery & equipment have gradually increased their importance over the last decade.

The major shift in the geographical structure of Georgian exports occurred in 2006 when Russia ceased to be the leading export destination for Georgian goods after the trade embargo. Since then, Turkey and Azerbaijan have become the main destinations for Georgian exports: Turkey absorbs the bulk of Georgia's exports of scrap metals, while Azerbaijan is the main market for Georgian cement.

Table 4.5 Structure of exports and imports by goods (in percent of the total)

	1995-2000	2001	2002	2003	2004	2005	2006	2007	2008	2009*
Exports of goods										
Beverages and spirits	12.5	16.9	17.4	19.2	15.7	19.0	12.8	11.6	9.3	10.7
Food except beverages and sprits	17.9	9.4	12.9	16.5	15.6	16.1	12.3	12.6	7.5	14.9
Mineral products	18.8	16.8	11.1	12.2	10.5	9.8	15.1	15.5	16.7	13.0
Chemicals	9.4	5.1	6.4	6.0	6.8	6.7	8.2	9.4	10.3	9.0
Metals	24.0	29.9	28.9	29.4	29.1	27.2	28.9	33.0	39.0	31.1
Machinery and equipment& vehicles	7.0	6.4	4.1	4.4	5.3	7.3	11.0	11.3	12.6	12.6
Other	22.9	32.4	36.5	31.5	32.7	32.9	24.6	18.3	13.9	19.4
Imports of goods										
Food (incl. beverages and sprits)	30.2	20.8	20.6	18.3	21.2	17.6	16.5	16.0	14.9	17.5
Mineral products	29.2	21.4	21.4	18.6	18.0	20.8	20.2	18.9	19.7	18.3
Chemicals	6.8	10.7	12.4	10.6	9.0	8.5	7.5	6.8	7.0	8.7
Metals	4.9	6.0	4.6	12.9	10.1	6.5	7.8	12.2	8.3	13.4
Machinery and equipment	6.1	9.6	9.4	10.7	10.8	10.6	9.5	10.1	9.6	9.2
Vehicles	12.3	14.0	16.1	14.3	16.1	18.9	19.7	17.9	22.7	15.3
Other	10.5	17.5	15.4	14.5	14.9	17.2	18.8	18.1	17.7	17.7

Source: National Bank of Georgia

* Jan-Oct 2009

Imports

The structure of imports underwent significant change in the second half of the 1990s as Georgia moved from imports of oil and food (responsible jointly for 58 percent of all imports in 1995) to a more diversified structure including more investment and consumer industrial goods. Since 2000 the import shares of foodstuffs have been gradually decreasing, while those of consumer, intermediate and investment goods have been rising. Some imports, e.g. machinery and equipment, base metals, construction materials and vehicles, increased markedly during the 2005-2007 economic boom, equipping Georgia's new production lines and providing inputs for the expansion in the construction sector.

Turkey is Georgia's leading trade partner on the imports side as well after it replaced Russia in 2007 and continued to expand its share in total imports to 15.5 percent in 2008 and 19.6 percent in 2009. Ukraine and Azerbaijan are second and third with a share of about 10 percent each in 2008-2009.

Table 4.6 Structure of exports and imports by country (in percent of the total)

	1995-2000	2001	2002	2003	2004	2005	2006	2007	2008	2009*
Exports of goods										
Turkey	16.7	22.0	15.5	17.9	18.3	14.1	13.2	13.9	17.6	19.6
Azerbaijan	9.0	3.1	8.5	3.6	3.9	9.6	9.5	11.2	13.7	15.6
Canada	0.0	0.0	0.0	0.0	0.6	4.1	5.2	5.7	8.8	9.3
Armenia	8.3	3.9	5.8	6.7	8.4	4.6	7.9	9.0	8.2	7.4
Bulgaria	2.6	0.2	0.0	0.0	2.4	5.0	6.7	4.8	7.2	7.3
Ukraine	3.6	3.6	3.7	6.5	2.4	4.3	6.1	7.6	9.0	6.2
United States	2.5	2.8	3.9	3.3	3.3	3.1	6.2	12.1	6.8	2.9
Russia	26.3	23.3	17.7	18.2	16.2	17.8	8.1	3.7	2.0	2.5
Other	30.9	41.1	44.9	43.8	44.5	37.5	37.2	31.9	26.7	29.0
Imports of goods										
Turkey	13.4	14.2	11.3	9.8	11.0	11.4	14.2	14.0	14.9	18.3
Ukraine	4.2	6.7	7.4	7.0	7.7	8.8	8.7	11.0	10.4	9.5
Azerbaijan	9.8	9.7	10.1	8.2	8.5	9.4	8.7	7.3	9.6	8.7
Germany	6.4	10.1	7.5	7.3	8.2	8.3	9.5	7.4	7.9	6.9
Russia	13.7	12.4	15.4	14.1	13.8	15.4	15.2	11.1	6.8	6.4
United States	9.6	8.5	8.6	8.0	6.0	5.9	3.5	3.9	5.7	5.5
Other	43.0	38.3	39.7	45.6	44.8	40.9	40.2	45.3	44.7	44.7

Source: National Bank of Georgia

* Jan-Oct 2009

4.3.5 Poverty Reduction

The Government of Georgia declared fighting poverty as one of its top priorities in the Poverty Reduction Strategy Paper (PRSP) published in 2003. However, weak economic performance, low fiscal revenues, and widespread corruption in the late Shevardnadze period made it very difficult to effectively pursue policies aimed at increasing social spending and reducing poverty. Such a chance came with the fiscal consolidation that occurred in the wake of the Rose Revolution 2004-2007. However, the PRSP and the two PRSP Progress Reports published in 2005 and 2006, respectively, provide only very fragmentary insights into poverty indicators. Furthermore measuring the dynamics of poverty across time is burdened with uncertainty surrounding the coherence of methodologies. These documents point to a sharp decline in poverty rates between 2002-2003 (51-52 percent) and 2004 (35.7 percent) followed by an increase in 2005 (39.4 percent) and a subsequent decline in 2006 (33.6 percent, see Table 4.7).

The World Bank databases offer a more complete picture of poverty-related performance indicators in the area of education and health. To provide a comparative context Table 4.7 also presents the values of the same indicators averaged over two WB/IMF classification country groups that Georgia belongs to: the low middle income country group (LMI) and Europe and Central Asia (ECA).

Table 4.7 Selected development and social indicators for Georgia and two country groups that include Georgia: lower middle income group (LMI) and Europe and Central Asia group (ECA)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	Latest available*	
	Georgia									LMI**	ECA***
GNI per capita, Atlas method (current US$ bn)	0.70	0.68	0.73	0.86	1.05	1.33	1.67	2.12	2.47	2.08	7.42
Aid per capita (current US$)	36					69			87	9	13
Poverty rate (in percent of the population)			52.0	51.0	35.7	39.4	33.6				
Education											
Public spending on education, total (% of GDP)	2	2	2	2	3	2	3	3		3	4
School enrollment, primary (% gross)	100	97	94	94	95	94	96	99		111	97
School enrollment, primary (% net)						90			95	90	94
School enrollment, secondary (% gross)	79	81	82	84	80	83	85	90		65	88
School enrollment, tertiary (% gross)	38	39	41	42	41	46	38	37		19	53
Health											
Health expenditure, total (% of GDP)			9	8	8	9	8			5	5
Health expenditure per capita (current US$)			64	74	97	123	147			75	304
Health expenditure, private (% of GDP)			7	7	7	7	7			3	2
Health expenditure, private (% of total health expenditure)			84	85	85	80	78			56	34
Health expenditure, private (current US$)			248	287	369	444	511			..	..
Health expenditure, public (% of GDP)			1	1	1	2	2			2	4
Health expenditure, public (% of total health expenditure)			16	15	15	20	22			44	66
Hospital beds (per 1,000 people)				4		4	4	3		2	7
Physicians (per 1,000 people)		4	4	4			5			1	3
Immunization, measles (% of children ages 12-23 months)	73	73	73	80	86	92	95	97	97	80	97
Mortality rate, infant (per 1,000 live births)	31					28	27	27	27	46	21
Mortality rate, under-5 (per 1,000)	35					32	31	30	30	65	23
Life expectancy at birth, total (years)	70		70			71	71	71	71	68	70

Source: World Bank, World Development Indicator, HNP Stats – the World Bank's Database of Health, Nutrition and Population statistics, PRSP Progress Reports 2005 and 2006

* - Latest available data (2006, 2007 or 2008 for most indicators)

** - LMI – low middle income country group (includes Georgia)

*** - ECA – Europe and Central Asia country group (includes Georgia)

Georgia scores very well in the area of school enrolment and succeeded in improving its enrolment ratios over 2000-2007 in primary and secondary education. The tertiary enrolment rose initially until 2005 but declined in 2006-2007 to the level prevailing in 2000. Public spending on education grew from 2 percent of GDP in 2000-2003 to 3 percent in 2006-2007, in line with the spending in the LMI group and slightly lower than that in ECA.

Total health expenditure seems to be very high in Georgia compared to both country groups but this is only due to high private spending. The actual public spending is low (1 percent in 2002-2004 and 2 percent in 2005-6) – at the level of the LMI average or half the ECA level. The number of hospital beds per 1000 people remained at 4 during 2003-

2005 but declined to 3 percent in 2006. On the other hand the number of physicians rose from 4 in 2001-2003 to 5 in 2006. In the latter indicator Georgia scores much better than the LMI (1) and even ECA (3).

Immunization for measles became markedly more universal over 2000-2008 and reached 97 percent in 2008, the same as in ECA. Georgia also showed good progress in reducing infant and under-5 mortality rates by 4 and 5, respectively between 2000 and 2008. However, the country still lags considerably behind ECA in terms of the level of mortality indicators. Finally life expectancy at birth increased from 70 in 2000-2002 to 71 in 2005-2008, respectively 3 and 1 year higher than in the LMI and ECA group.

4.4 Conclusion

As a result of implemented reforms Georgia's economic development during the last decade allows for a positive appraisal of the country's achievement of short-to-medium term macroeconomic objectives related to the MFA operation. In addition to improving debt sustainability (analyzed in chapter 5) these objectives included economic reforms aimed at macroeconomic stabilisation and fostering growth as well as the sustained reduction of poverty.

Prudent economic policies and the reformist approach of the authorities resulted in the acceleration of real GDP growth from 3.6 percent on average during 1998-2002 to 9.6 percent during 2003-2007. While the global crisis and the armed conflict that struck Georgia in the second half of 2008 slowed growth considerably in 2008 and 2009 (to 2.1 percent and -4 percent, respectively) the medium-term outlook is positive, with growth projected to rebound to 2 percent in 2010. Buoyant economic performance was underpinned by large capital inflows in the form of massive FDI related to large-scale privatisation and infrastructure projects, as well as of other capital inflows (e.g. portfolio, loans and grants), which were drawn to the country by responsible macroeconomic policies and structural reforms. These reforms included public finance management, simplification of the tax system, liberalisation of the customs regime, and reduction of corruption and red tape.

Inflation has been kept under control, largely at a single-digit level, benefiting from prudent monetary policy and the appreciating lari. Responsible fiscal policies and extensive tax and budgetary system reforms have led to substantial fiscal consolidation, with impressive gains in revenues, from 23.1 percent of GDP in 2004 to 30.7 percent in 2008. The overall fiscal balance deteriorated over the years, but high privatisation revenues and ample foreign financing helped close the gap. Following the 2008 crisis and the regional war, the fiscal deficit widened to 9.4 percent of GDP, but the Government is determined to reduce it over the medium term by implementing an ambitious fiscal adjustment programme supported by the IMF.

External openness of Georgia has increased markedly, with imports rising from 46.4 percent of GDP in 2003 to 57.7 percent in 2008 and exports remaining around 30 percent of GDP in the same period. The resulting trade gap raised the current account deficit from below 10 percent of GDP in 2004-2005 to 22.6 percent in 2008. However, large financial flows (both FDI, loans and grants) have helped to finance the deficit, thus ensuring the country's external sustainability.

Overall, while the transition to a well-functioning market economy is still incomplete and the global crisis has exposed many vulnerabilities (e.g. shrinking private capital flows and deteriorating fiscal balance) the country's efforts in macroeconomic stabilisation in the period 2004-2009 can be considered a great success. Moreover, good relations with the IFIs resulting in substantial foreign loans and aid (much on concessional terms) pledged in the coming years are very likely to help steer the country through the economic crisis and ensure its commitment to completing the reform process.

5 External sustainability

5.1 Introduction

Table 5.1 presents the second group of evaluation questions which analyses the external sustainability. This Chapter addresses these evaluation questions.

Table .5.1 Evaluation questions related to analysing external sustainability

	To what extent has the MFA contributed to returning the external financial situation of the recipient country to a sustainable path over the medium to longer term?
1	How did the external financial situation of the recipient country evolve prior to and during the MFA operation? (Q4.1)
2	How is the country's external financial situation likely to evolve in the five years following the final disbursement, given the likelihood of changes to current conditions? (Q4.3)
3	What are the main internal and external factors on which the current trend in the country's external financial situation and its prolongation into the future are conditional? (Q4.2)

5.2 Gross impact – actual evolution of external sustainability indicators

1: How did the external financial situation of the recipient country evolve prior to and during the MFA operation?

Balance of Payments

The current account balance started to deteriorate rapidly after 2005 (as illustrated by Figure 4.6 in Chapter 4 and Table 5.2), when the improved economic outlook that came with the new government boosted economic growth and import demand. The buoyant economy's need for consumer and investment goods led to a sharply widening merchandise trade gap (see Figure 4.7). The trade deficit increased from about 15 percent of GDP in 2003-2004 to 30 percent in 2008. With other current account balances broadly unchanged this caused the overall current account deficit to triple between 2004 and 2008, from 6.7 percent to 22.6 percent in 2008.

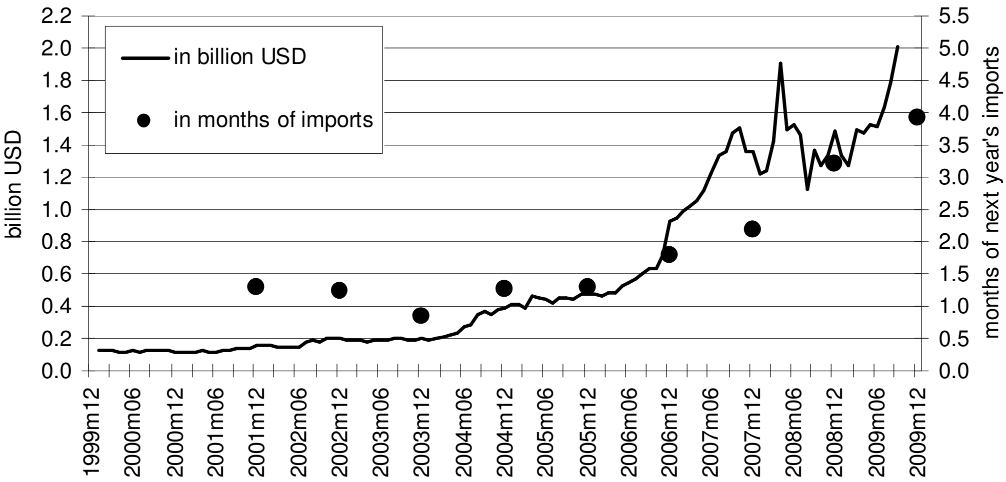
Table 5.2 External debt and other external sustainability indicators, 2002-2008

	2002	2003	2004	2005	2006	2007	2008
Public external debt							
Total debt stock							
In US$ billion	1.78	1.86	1.86	1.73	1.70	1.79	2.69
in percent of GDP	52.0	51.4	52.3	46.5	36.2	27.1	21.9
In percent of exports	482	144	113	79	67	56	73
Debt service							
In US$ billion	0.20	0.15	0.17	0.16	0.20	0.11	0.13
In percent of exports	19.7	11.6	10.2	7.5	8.0	3.5	3.4
Private external debt							
Total debt stock							
In US$ billion	0.08	0.19	0.28	0.36	0.99	1.82	2.65
in percent of GDP	2.4	4.7	5.5	5.6	12.8	17.8	20.6
In percent of exports	22.2	14.5	17.0	16.5	38.9	57.3	71.9
Debt service							
In US$ billion	0.06	0.09	0.10	0.26	0.23	0.74	1.11
In percent of exports	5.9	7.0	6.0	11.8	9.0	23.1	30.2
Total external debt							
Total debt stock							
In US$ billion	1.86	2.04	2.14	2.10	2.69	3.61	5.34
in percent of GDP	54.7	51.2	41.7	32.7	34.6	35.3	41.5
In percent of exports	504	158	130	96	105	114	145
Debt service							
In US$ billion	0.26	0.24	0.27	0.42	0.43	0.85	1.24
In percent of exports	25.7	18.6	16.3	19.3	17.0	26.6	33.6
International reserves							
in US$ billion	0.19	0.17	0.35	0.47	0.88	1.36	1.48
in percent of total external debt	10.4	8.5	16.5	22.6	32.8	37.7	27.7
in percent of next year's imports	1.2	0.8	1.3	1.3	1.8	2.2	3.2
Memorandum items (percent of GDP):							
CA balance	-6.4	-9.6	-6.9	-11.1	-15.1	-19.7	-22.7
Capital and financial account	3.9	10.2	11.5	12.5	22.7	24.0	22.6

Source: IMF

Concerns about the size of the deficit were substantially mitigated by the composition of its financing, which was dominated by the FDI both before and during the 2006 MFA operation. However, while FDI inflows had been growing continuously since 2000, it wasn't until 2006 that they reached levels above 15 percent of GDP. Robust inflows of FDI from 2006 until the first half of 2008 were accompanied by increasing private sector loans (reflected under "other investments" in Figure 4.8) and portfolio investments (especially in 2006 and 2008) which jointly secured a comfortable financing for the widening current account gap.

Figure 5.1 Total gross reserve assets in millions of US$ and in months of imports*



Source: National Bank of Georgia (in US$, monthly) and IMF (months of imports, end-year)

* Next year's imports of GNFS (goods and non-factor services), IMF definition

Reserves

Total international reserves in US$ terms have been rising gradually over the last decade, including the period prior to and during the MFA operation (Figure 5.1 and Table 5.2). However, when measured in terms of months of imports remained stagnant fluctuating in the range of only 0.8-1.3 months during 2001-2005. The reserve-to-imports ratios began to rise on the back of improvements in the macroeconomic and external outlook after 2005. In particular, the period of the MFA operation saw a dynamic accumulation of reserves, by 50 percent and 90 percent in US$ terms in 2006 and 2007, respectively. Expressed in terms of months of imports, the stock of reserves rose to 1.8 and 2.2 in 2006 and 2007, respectively. Reserves in US$ terms continued to rise until April 2008, but subsequently fell sharply due to the unfavourable geo-political and global economic events in the second half of 2008. Reserves started to rebound again in early 2009. Expressed in months of imports they rose to 3.2 in 2008 and 3.9 (projected) in 2009, largely reflecting the shrinking import base.

The reserves-to-external-debt ratio rose from 6.9 percent in 2000 to 37.7 percent in 2007 amid periodical fluctuations and then fell to 27.7 percent in 2008 (see Table 5.2).

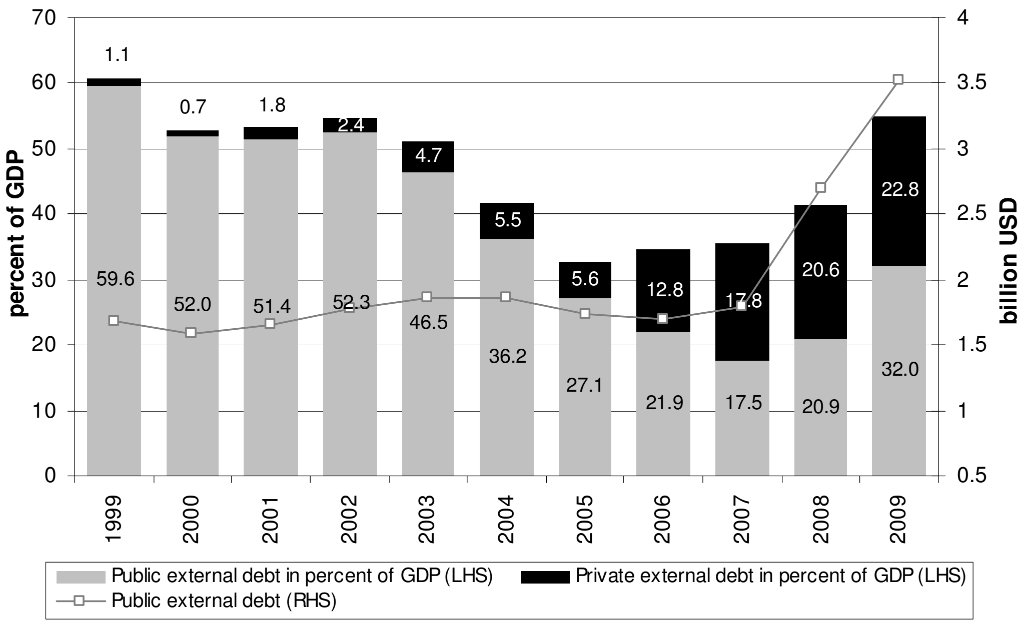
External debt – general trends

Improving Georgia's debt sustainability by reducing its external indebtedness was a major objective explicitly stated in the Council Decision and the MoU. External public and publicly guaranteed debt went up from US$1.56 billion in 2000 to US$1.86 billion in 2004, subsequently declining to around US$1.7 billion in 2005-2006 and rising again sharply to US$ 2.69 billion in 2008 (see Table 5.2 and Figure 5.2). However, expressed in percent of GDP, public debt more than halved between 2002 and 2008 falling gradually from 52 percent in 2002 down to 20.9 percent in 2008.

Declining public debt to GDP ratios were accompanied by growing importance of private debt in GDP which surged from negligible level before 2000 to 20.6 percent of GDP in

2008. This trend has been balancing the shrinking public debt and was responsible for growing total-debt to GDP ratios from after 2005 (see Figure 5.2).

Figure 5.2 External debt (total and public) in US$ and as percentage of GDP 1999-2008 with a projection for 2009

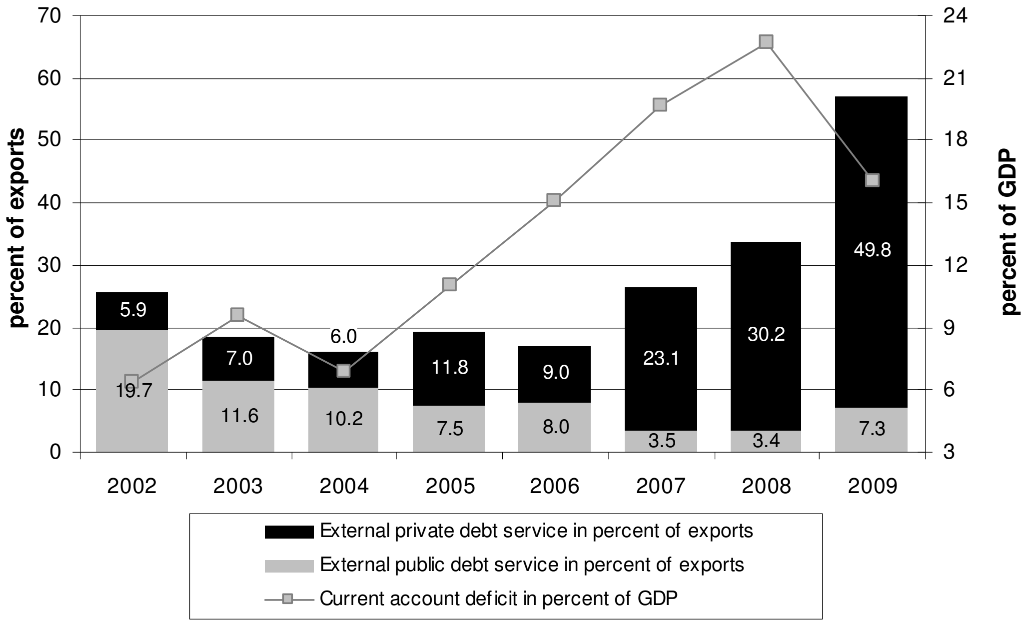


Source: IMF data (1999-2008) and projections from Country Report 09/267 (2009)

* projections made in July 2009

The ratios of public external debt service to exports had been going down continuously several years prior to and during the MFA operation. The public debt service-to-exports ratio declined from 19.7 percent in 2002 to a comfortable 3.4-3.5 percent in 2007-2008. In line with the growing importance of private debt, as evidenced in Figure 5.2, related service payments began to rise quickly from negligible in the late 1990s to one-third of total service payments in 2002 and more than one-half in 2005 (see Figure 5.3). Private debt service rose continuously during the period of MFA operation to reach roughly 90 percent of the total external debt service in 2007-2009 reflecting both the growing indebtedness of the private sector and higher interest rates.

Figure 5.3 The current account deficit as percent of GDP and the external debt service in percent of exports, 2002-2008 and projections for 2009*



Source: IMF data (2002-2008) and projections from Country Report 09/267 (2009-2029)

* projections made in July 2009

Structure of the debt

The share of multilateral donors in total public debt has increased consistently from 19 percent in 1994 to 38.3 percent in 1996, 50 percent in 1999-2000 and 70 percent in 2007 (see Table 5.3). This trend has been largely due to the growing involvement of the World Bank, which became Georgia's largest creditor by 1999 and continued to expand its share in total external debt up to 50 percent in 2007. Bilateral debt has become less important over the years, accounting for less than one third of the total debt since 2006. Russia, Turkmenistan, and Germany are the biggest bilateral creditors, with the highest shares in 2008-2009.

The issue of Eurobonds in 2008 (US$ 500 million) significantly increased the total external debt, shifting the debt structure trends away from multilateral and bilateral donors. However, in absolute terms both key multilateral donors (IMF and WB) continue to increase their credit to Georgian economy.

Georgia's debt to the EU came down from 15.1 percent in 1994 (when EU was the biggest multilateral donor) to 7 percent in 1999 and 5.5-6.3 during 2000-2005. The early principal repayments related to the 2006 MFA operation lowered the EU debt by an additional € 28 million in 2006 to 4.4 percent of the total debt. The first scheduled principal repayment (€ 22 million in July 2009) brought the EU debt to 1.6 percent of the total external debt in the second half of 2009.

Table 5.3 Structure of external public debt (end year), 2004-2009 in percent of the total unless otherwise stated

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009*
External public debt (US$ million)	**1629**	**1676**	**1590**	**1655**	**1777**	**1856**	**1858**	**1735**	**1697**	**1790**	**2691**	**3302**
In percent	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Multilateral	**46.9**	**49.5**	**49.6**	**51.9**	**53.1**	**55.8**	**59.3**	**60.7**	**65.2**	**70.0**	**61.3**	**67.9**
IMF	18.5	19.0	17.7	17.6	17.3	15.6	14.3	13.4	13.9	13.9	17.3	24.2
World Bank	18.4	21.4	23.7	26.7	27.6	31.6	36.5	39.1	46.2	49.4	36.7	35.7
EU	**8.0**	**7.0**	**5.8**	**5.5**	**5.4**	**6.2**	**6.3**	**5.8**	**4.4**	**4.5**	**3.0**	**1.6**
EBRD	1.9	1.9	2.2	1.9	2.4	2.1	1.8	1.7	1.9	1.9	1.1	0.9
Bilateral	**53.1**	**50.5**	**50.4**	**48.1**	**46.9**	**44.2**	**40.8**	**39.4**	**29.3**	**29.2**	**19.7**	**16.8**
Russia	11.0	10.7	9.9	9.5	8.8	8.5	8.2	8.7	8.5	6.7	4.4	3.6
Turkmenistan	22.9	20.8	21.2	19.6	18.2	13.7	8.5	5.8	2.4	0.3	7.8	6.4
Turkey	3.3	3.2	3.4	3.3	3.1	2.9	2.9	3.2	3.2	2.7	1.6	1.1
Austria	5.5	5.0	4.6	4.2	4.6	5.3	5.4	5.0	0.1	0.1	0.1	0.0
Germany	2.8	3.1	3.2	3.3	3.7	4.6	6.1	6.4	4.9	9.4	6.3	5.9
Eurobonds	…	…	…	…	…	…	…	…	…	…	18.6	15.1
Memorandum Items												
Private external debt (US$ million)	5	30	22	58	82	186	281	360	992	1823	2653	2764**
EU debt (€ million)	**110.0**	**100.0**	**100.0**	**92.0**	**92.0**	**92.0**	**85.5**	**85.5**	**57.5**	**57.5**	**57.5**	**35.5**

Source: IMF CR 06/171 (1996-2005), Ministry of Finance monthly information on External Debt of Georgia (2006-2009) and IMF CR 09/267 (Private external debt in 2009)

* September 2009, ** June 2009

Evolution of external debt outlook

The developments in external debt sustainability are analysed on the basis of regular debt projections of the IMF supplemented by long-term detailed debt sustainability analyses (DSA) available in three reports dated 2006 and 2008. To understand the development of debt sustainability in the context of the MFA operation it is of particular interest to see how the debt outlook looked like prior to and during the MFA operation.

Interviewees pointed to the fact that debt sustainability was one of the most severe problems Georgia continued to face in the wake of the Rose Revolution. Back in 2004 and early 2005, there was still not enough evidence that the Saakashvili team would deliver on its reform commitments. Hence investigating the debt outlook at that time and its evolution over the years can shed more light on the appropriateness of the choice of the debt focus for the MFA and the resulting changes to external sustainability.

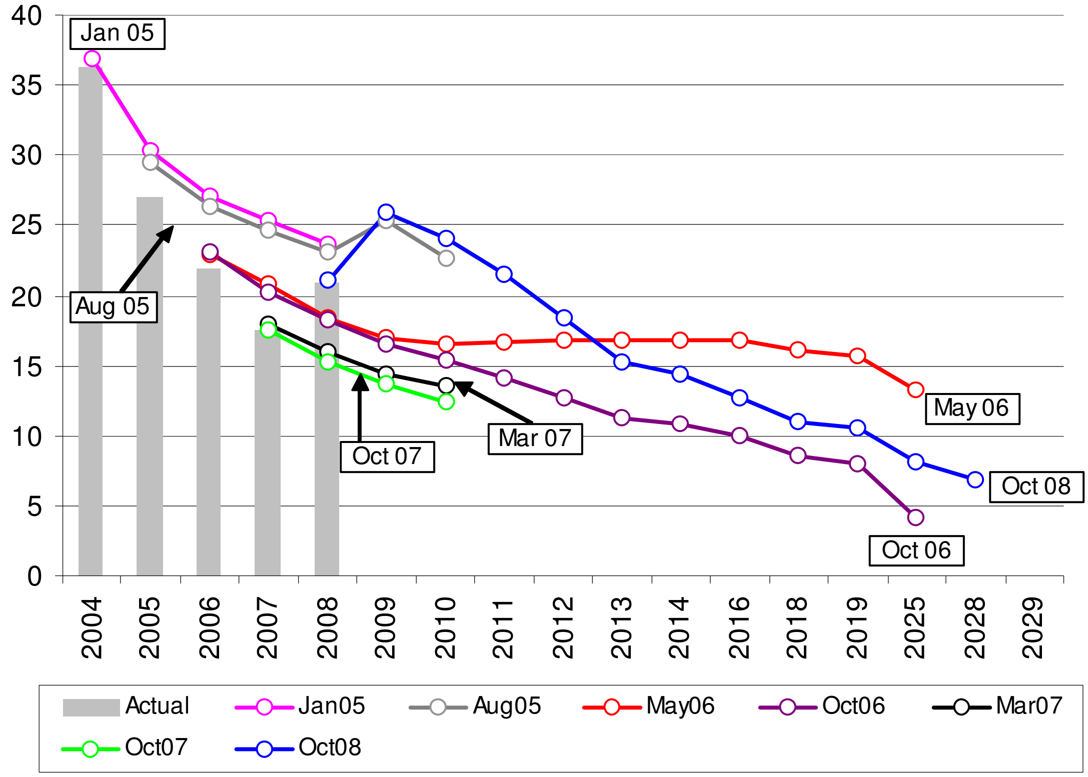
Figure 5.4 presents the actual values of external public debt as a percent of GDP along with official projections of the IMF taken from the ten subsequent IMF country reports for Georgia covering the period 2005-2008[13]. The figure indicates clearly that projections from *all IMF reports* dated 2005-2007 point to a gradual decline of public debt ratios over the short-to-medium term. In particular during the discussion and negotiations phase

[13] Dates of the reports are as follows CR05/01 (Jan 2005), CR05/314 (Aug 2005), CR06/175 (May 2006), CR06/395 (Oct 2006), CR07/107 (Mar 2007), CR07/299 (Aug 2007), CR08/328 (Oct 2008).

in late 2004 and throughout 2005 (the period covered by the first three country reports Jan 2005 – May 2006) the short-to-medium-term debt projection was positive and implied consistent lowering of the debt/GDP ratio to 20 percent by 2008 (in 2005 reports and early 2006 report, respectively). The three subsequent reports (late 2006 and both 2007 reports), roughly overlapping with the period covering the actual operation, also contain rather positive projections.

The events of 2008 introduced an upward adjustment to the debt ratios and the short-term trend reversal in the latest report during the MFA operation in October 2008. This was the result of the war with Russia which affected the outlook in the second half of 2008 and continued in 2009. The current debt outlook (dating back to mid 2009) is discussed in the next section.

Figure 5.4 Public and publicly guaranteed external debt as percentage of GDP – actual and projected by the IMF



Source: IMF country reports indicated by the publishing date in the legend and CR09/267 (July 2009) for actual values in 2004-2008

Summing up, the external debt outlook was quite positive even during the negotiation period prior to the MFA in 2005 and improved markedly during the operation declining to lowest levels ever registered in Georgia by the end of 2007.

The rationale for the debt focus of the MFA

Since the debt stock in 2005 was relatively low and the outlook positive and consistently improving, what was the rationale behind focusing on the debt sustainability in the design of the MFA operation? The first reason is operational and relates to the fact that the MFA effectively replaced the unfinished EFA planned for 1997-2005 but cancelled prematurely without disbursing the remaining € 33.5 million (see section 3.2.1 for details). Many interviewees confirmed that the MFA was conceived as a completion of the previous programme with the same operational scheme of grant disbursements against higher early debt repayment resulting in positive net payments to the EC. Therefore the decision to condition the operation on early debt repayments may not have been motivated so much by the severe debt outlook in 2005, but rather by the willingness to complete the unfinished EFA operation.

Another reason could be related to the markedly improving macroeconomic and policy outlook for Georgia since the Rose Revolution and the ensuing expectations of robust inflow of fiscal and privatisation revenues. The EC could have followed the conservative line of reasoning implying that the upcoming tax and privatisation receipts should better be channelled to lowering the country's indebtedness rather than spent via the current budget especially in the absence of the PFM instruments in place.

5.3 Projections for external sustainability

2: How is the country's external financial situation likely to evolve in the five years following the final disbursement, given the likelihood of changes to current conditions?

Projections for external sustainability are based on the most recent Debt Sustainability Analysis (DSA) published in July 2009 in the IMF Country Report 09/267. Related sustainability indicators along with key assumptions are presented in Table 5.4.

The external debt sustainability outlook
According to the most recent IMF debt sustainability analysis (IMF CR 09/267) Georgia's total external debt is expected to reach 55 percent in 2009, increasing up to 65 percent in 2011. Beginning with 2012 the total debt will decline gradually to 52.5 percent in 2014 and then further down to 41.9 percent in 2019 and 28.9 percent in 2029. Private debt - following the fast expansion during 2000-2008- is projected to rise much slower over 2009-2014.

The IMF assesses the external sustainability as not raising immediate concerns and the risk of debt distress as moderate. Compared to the previous DSAs debt projection rose sharply as a result of the combination of lower GDP growth outlook and increased spending-to-GDP ratios. Nevertheless both factors are expected to be temporary with positive economic growth set to resume in 2010 and the ambitious fiscal adjustment planned for 2010-2012[14]. Furthermore the financing gap seems to be comfortably secured in the medium term particularly through increased flows to the public sector in the form or loans and grants (for details see the section below and Table 5.5). These factors are expected to reverse the current rising trend in public debt in 2011 and ensure its smooth decline over the longer horizon.

14 For details see IMF CR 09/267 (fiscal adjustment plan) and Table 5.4 (GDP growth assumptions).

Table 5.4 External sustainability indicators and key macroeconomic assumptions 2009-2029

	2009	2010	2011	2012	2013	2014	2019	2029
Public external debt								
Total debt stock (nominal/face value)								
In US$ billion	3.52	4.33	4.66	4.74	4.62	4.53	5.24	7.35
in percent of GDP	32.0	40.2	41.2	38.6	34.8	31.5	24.6	15.8
Total debt stock (present value)								
in percent of GDP	24.2	31.1	32.3	31	28.7	25.4	19.8	13.5
Debt service (nominal/face value)								
In percent of exports (nominal/face value)	7.3	5.6	6.7	11.1	26.6	13.0	6.4	5.7
In percent of exports (present value)	7.5	5.9	6.6	10.8	25.6	12.4	6.1	5.5
Private external debt *								
Total debt stock (face=present value)								
In US$ billion	2.51	2.56	2.72	2.80	2.88	3.01	3.67	6.12
in percent of GDP	22.8	23.8	24.1	22.8	21.7	21.0	17.3	13.1
Debt service								
In percent of exports (face=present value)	49.8	37.6	35.8	36.7	39.3	35.4	27.1	19.0
Total external debt								
Total debt stock (nominal/face value)								
In US$ billion	6.03	6.89	7.38	7.54	7.51	7.54	8.91	13.5
in percent of GDP	54.9	64.0	65.3	61.3	56.5	52.5	41.9	28.9
Total debt stock (present value)								
in percent of GDP	47.0	54.9	56.3	53.7	50.3	46.4	37.0	26.6
Debt service								
In percent of exports (nominal/face value)	57.1	43.1	42.5	47.8	65.8	48.4	33.4	24.6
In percent of exports (present value)	32.9	24.5	25.8	29.1	46.6	29.5	21.1	17.0
Debt dynamics (percent of GDP)								
Change in total external debt	13.2	9	1.2	-3.9	-4.8	-3.9	-1.2	-1.2
Identified net debt-creating flows:	10.3	6	3.1	1	0.1	-0.9	-1.1	-1.9
1) Non-interest current account deficit	13.6	13.7	13.1	12.1	11	10	8.6	5.8
• Deficit in balance of goods and services	23	24	22.9	21.1	19.4	17.9	15.1	10.3
• Net current transfers (negative = inflow)	-7.8	-7.9	-7.6	-6.9	-6.4	-6.2	-5.2	-3.7
o/w official	-2.4	-1.4	-1	-0.6	-0.4	-0.4	-0.2	-0.1
• Other CA flows (negative = net inflow)	-1.6	-2.4	-2.2	-2.1	-1.9	-1.8	-1.3	-0.8
2) Net FDI (negative = inflow)	-8.3	-9.7	-10.8	-11.2	-11.2	-11	-10	-8.1
3) Endogenous debt dynamice**	4.9	2.1	0.8	0.1	0.3	0.2	0.3	0.4
• Contribution from nominal interest rate	3	3.2	3.2	3.1	3.1	2.8	2.3	1.8
• Contribution from real GDP growth	1.9	-1.1	-2.4	-3	-2.8	-2.6	-2	-1.4
International reserves								
In US$ billion	1.93	2.17	2.34	2.35	2.17	2.14	3.42	8.73
In percent of total external debt	32.1	31.5	31.7	31.2	29.0	28.3	38.4	64.9
In percent of next year's imports	3.9	4.1	4.2	4.0	3.4	3.2	3.6	4.5
Key macroeconomic assumptions								
Real GDP growth (in percent)	-4	2	4	5	5	5	5	5
Growth of exports of G&S (US$ terms, in percent)	-20.1	12	11.8	10.8	10.1	9.1	8.5	8.5
Growth of imports of G&S (US$ terms, in percent)	-27.1	7.5	6.8	6.4	5.9	5.8	7.2	7.3
Current account balance (percent of GDP)	-16.0	-16.4	-16.0	-15.3	-14.5	-13.8	-12.3	-9.5
Capital and financial account (percent of GDP)	17.3	15.1	16.9	17.1	16.1	15.8	13.4	10.8

Source: IMF CR09/267 (July 2009), based on table 13a and other IMF data. *) Assumes that present value of private sector debt is equivalent to its face value. **) Derived as [r - g - r(1+g)]/(1+g+r+gr) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and r = growth rate of GDP deflator in US$ terms.

Chronic current account deficits will remain the key net debt-creating element over the medium term 2009-2014 in spite of their moderation to 13-14 percent of GDP in 2009-

2011 and the subsequent gradual decline to 10 percent in 2014[15]. Smaller deficits will be a consequence of the shrinking gap in the balance of goods and services, which is projected to decline markedly over 2009-2014 (see Table 5.4) but also of the robust inflow of net current transfers (e.g. grants and remittances) and mildly increasing other CA flows. After remaining below 10 percent of GDP over 2009-2010 FDI inflows are projected to stabilise just above 10 percent, indicating their diminished significance as a debt-countering factor compared to the peak period 2005-2007. While the contribution of the interest rate is projected at roughly 3 percent until 2014, that of economic growth directly reflects the IMF's GDP forecast, e.g. indicates a positive debt-creating effect of the negative growth in 2009 (+1.9 percent) followed by a continuous negative effect from 2010 onwards.

The present value of Georgia's external debt is considerably lower than the nominal projections due to the high share of the public debt on concessional terms. While the present value of private debt is assumed equal to its face value the difference follows entirely from the value of public debt which is projected to rise from 15.3 percent of GDP in 2008 to 32.3 percent in 2011.

Present value of public debt service obligations is expected to increase to 7.5 months of exports in 2009 (up from 3.5 in 2007/8) largely as a result of the sharp contraction in exports. It is projected to fall temporarily to 5.9-6.6 percent of exports in 2010-2011 and then surge to 25.6 percent/26.6 percent (for present and face value, respectively) in 2013 which marks both the peak repurchases to the IMF (about US$425 million or 9.5 percent of exports) and the maturity of the 2008 Eurobond issue (US$500 million or 11 percent of exports). Together with the private debt, the total debt service to exports ratio will peak at 65.8 percent/46.6 percent in 2013 (for nominal and present values, respectively) – the highest ever for the Georgian economy. While the Government expressed the will to rollover the Eurobond its capacity to do so will depend critically on regaining the confidence of international financial markets. Dealing with the bunching of debt repayments in 2013 is viewed by the IMF as one of the biggest risks and challenges for Georgian authorities over the medium term.

Gross international reserves are projected to expand steadily over the medium term from US$ 1.9 billion at end-2009 to US$ 3.4 billion in 2019 –amid minor trend fluctuations- benefiting from positive overall balance of payments and the gradual improvements in Georgia's external position (Table 5.2). In terms of months of exports reserves are expected to rise from the (barely adequate) level of 3.2 months in 2008 to roughly 4 months in 2009-2012, before declining slightly to 3.2-3.4 months in 2013-2014.

External Financing

Public financing is projected to take up a clearly dominant role in the short-to-medium term as reflected in the doubling of public debt from 21 percent of GDP in 2008 to 41 percent in 2011 and the widening of its share in total debt from 50 percent in 2007/8 to 63 percent over 2010-2012. These assumptions are underpinned by the results of the Brussels donor conference in October 2008 which generated pledges amounting to US$ 4.5 billion of external assistance to Georgia over 2008-2010.

15 Non-interest current account deficit.

Table 5.5 presents on overview of expected financing requirements. The private sector flows are projected to contract from 24.6 percent of GDP in 2007 to 14.5-15 percent in 2009-2010 and rebound subsequently to above 18 percent in 2011-2013. This pattern broadly mirrors the assumptions regarding the long-term private loans. Slowing private flows are projected to be balanced by increased capital flows to the public sector which are set to increase to above 6 percent in 2008/9 and then persist at above 4 percent on average during 2010-2014. IMF financing will intensify in 2009 and 2010 when Georgia will gain access to substantial additional Fund resources in helping it close the external gap.

Table 5.5 External financing requirements and sources 2007-2014 (in percent of GDP)

	2007	2008	2009	2010	2011	2012	2013	2014
Total requirements	**-22.3**	**-25.5**	**-22.5**	**-21.2**	**-21.5**	**-21.8**	**-26.8**	**-20.0**
Current account deficit	-19.7	-22.7	-16.1	-16.6	-16.0	-14.9	-13.8	-12.5
Capital outflows: Repayments of MLT loans	-2.6	-2.8	-6.4	-4.7	-5.5	-6.9	-12.9	-7.5
Total sources	**22.3**	**25.5**	**22.5**	**21.2**	**21.5**	**21.8**	**26.8**	**20.0**
Capital flows	25.9	24.8	20.8	19.9	22.1	21.9	25.4	19.8
Public sector	1.3	6.2	6.3	4.8	3.6	3.3	6.7	2.6
Project grants	0.7	0.7	1.8	1.2	0.7	0.5	0.4	0.3
Long-term loans to public sector	1.5	1.8	4.2	3.6	2.9	2.8	2.6	2.3
Other	-0.9	3.7	0.2	0.0	0.0	0.0	3.8	0.0
Private sector	24.6	18.6	14.5	15.1	18.5	18.6	18.7	17.2
Foreign direct investment in Georgia	17.1	12.2	8.3	9.7	10.8	11.2	11.2	11.2
Long-term loans	8.3	5.9	5.3	3.9	4.4	4.7	5.1	4.7
Other net inflows	-0.8	0.6	1.0	1.4	3.3	2.7	2.5	1.3
Financing	0.1	1.7	3.7	3.5	0.9	0.0	0.0	0.0
IMF	0.4	2.0	3.7	3.5	0.9	0.0	0.0	0.0
Change in arrears, net (- decrease)	-0.3	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Advance Repayments	-0.1	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Change in reserves (- increase)	-3.7	-1.0	-2.1	-2.2	-1.5	-0.1	1.3	0.3

Source: IMF CR 09/267 (Table 10).

Sensitivity analysis of external sustainability

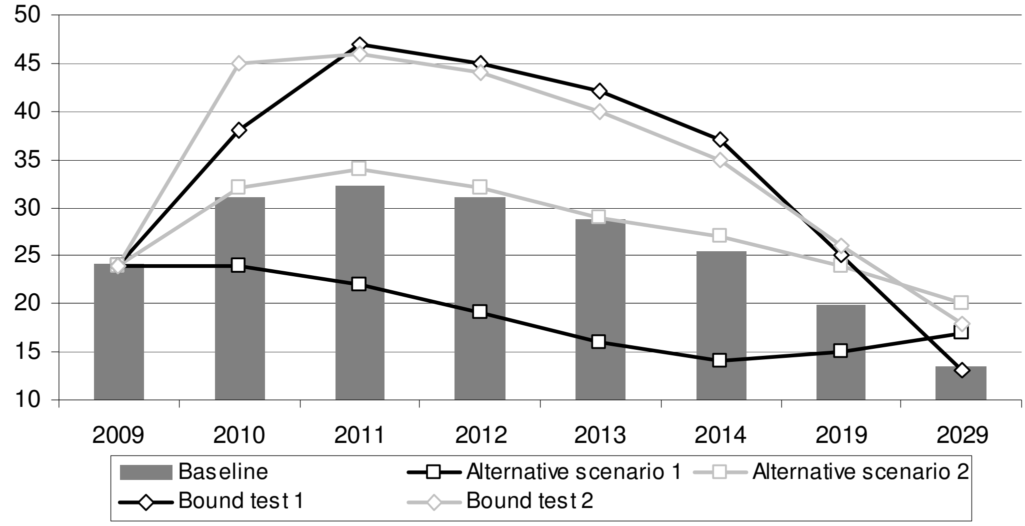
An important part of the DSA performed in July 2009 is subjecting the external debt sustainability framework to a series of alternative scenarios and stress tests. The baseline scenario involving the official IMF assumptions for key macroeconomic indicators (presented in Table 5.4 and elaborated on in the above section) is then modified in a set of experiments reflecting the potential deviation of some indicators from their official projection.

The IMF included two alternative scenarios for the evolution of a set of variables that are key to the external debt outlook. This set is composed of: real GDP growth, growth of GDP deflator (in US$ terms), non-interest current account deficit in percent of GDP as well as non-debt creating flows (FDI, grants). Scenario 1 sets the path of these indicators over 2009-2029 at the level of their historical averages. Scenario 2 changes the terms of new public sector loans over 2009-2029 to less favourable (+2 percentage points with grace and maturity periods unchanged) compared to those officially expected (Table 5.4). The resultant path of debt-to-GDP ratios are presented in Figure 5.5 along with the baseline scenario marked by the official IMF estimates. Worsening the terms for public sector loans (scenario 2) increases present value of debt by several (1-4) percent of GDP over 2010-2019 and by 7 percent in 2029. Setting the key variables to their historical averages (scenario 1) actually implies a much more favourable debt ratio path (up to 13 percent lower) than in the baseline over 2009-2019 and a slightly higher debt in 2029.

Out of the six bound tests performed by the IMF we present the results of those two that produced the highest increase in the debt ratios. Bound test 1 assumes that all net non-debt increasing flows are set to their historical average minus one standard deviation and results in the debt-to-GDP ratios of up to 15 percent higher than the baseline with the gap narrowing to zero in 2029. The second bound test involves a one-time 30 percent depreciation shock in 2010 which produces an immediate surge in the debt to 45 percent in 2010 (+14 percent vs. the baseline) with the gap narrowing very slowly to 6 percent in 2019 and 5 percent in 2029.

While some of the tests raise the debt ratios markedly above the baseline none of the tests or alternative scenarios produces a truly worrisome scenario. In particular none of the resulting public debt ratios breach relevant thresholds prescribed by the low-income country DSA frameworks

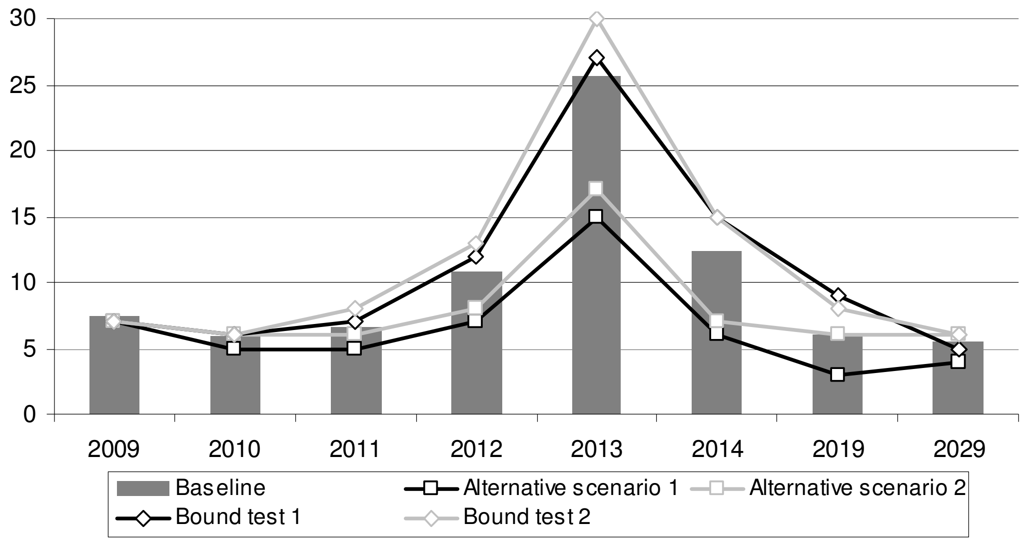
Figure 5.5 Sensitivity analysis for present value of debt-to-GDP ratio, 2009-2029



Source: IMF CR 09/267 (Table 13b).
Notes:
Alternative scenario 1 – Key variables at their historical averages in 2009-2029
Alternative scenario 2 – New public sector loans on less favourable terms in 2009-2029 (2 p.p. higher)
Bound test 1 – Net non-debt creating flows at historical average minus one std. dev. in 2010-2011
Bound test 2 – One-time 30 percent nominal depreciation (GEL:1US$) relative to the baseline in 2010

The same set of alternative scenarios and bound tests were applied to debt service-to-exports ratio. Here, both scenarios imply debt service obligations that are slightly lower over 2010-2012, and markedly lower in 2013-2014. The first of the two bound tests producing the highest increase in the debt service ratios happened to be common for both experiments. Test 1 (assuming the lower inflow of FDI and official transfers) results in slightly higher (by 1-3 percent) debt-service-to-exports ratios until 2019. Test 2 sets the export value growth to historical average minus one standard deviation. This test produces a path of debt service ratios several percentage points higher than the first test and up to 4 percentage points higher than the baseline (in 2013). In fact this test causes the debt service payments to reach 30 percent of exports – which is the DSA framework threshold for low income countries.

Figure 5.6 Sensitivity analysis of debt service-to-exports ratio, 2009-2029



Source: IMF CR 09/267 (Table 13b)
Notes:
Alternative scenarios 1 and 2 / Bound test 1 as in Figure 5.5
Bound test 2 – Export value growth at historical average minus one std. dev. in 2010-2011

The sensitivity analysis revealed that external debt and debt service ratios are sensitive to worsening the underlying macroeconomic assumptions. In particular the scenarios with the most adverse impact on external debt sustainability are those that involve:

- New loans at less favourable terms;
- Lower non-debt creating financial flows (FDI & official transfers);
- Lower export growth;
- Sharp nominal depreciation of the lari.

These adverse developments would deteriorate public debt and related service ratios in the short and medium term horizons. While the IMF sensitivity analysis did not reveal any breach of prescribed thresholds resulting from introducing alternative scenarios or bound tests (except for debt service hitting the threshold in 2013 in one test) the risks following from these scenarios are apparent. They may materialize in case of an unfortunate combination of several adverse shocks or in case of a sharper deterioration of a macroeconomic indicator than assumed in the tests.

Of particular concern is the bunching of debt service payments from 2012 and their peak in 2013 when public debt payments is expected to reach 25.5 percent of exports. The smooth debt servicing in 2013 (with the possibility to rollover the Eurobonds) will require sustained improvements in the fiscal outlook over the medium term and sound economic policies, which would make it possible to regain the confidence of international financial markets.

As confirmed in early October 2009 by our interviewees from the IMF the macroeconomic assumptions as well as resultant DSA indicators from July remain largely unchanged.

5.4 Identification of major risks

3: What are the main internal and external factors on which the current trend in the country's external financial situation and its prolongation into the future are conditional?

Political domestic and regional instability
Domestic political uncertainty constitutes the most important source of risk to external sustainability, although the spring and early summer protests of the opposition demanding the stepping-down of the President and early parliamentary elections have come to an end. It is expected that the opposition will use some of the findings of the EU Report on the August 2008 war (e.g. blaming Georgia of the first shot) against the President. This may lead to a shift in the internal political balance away from the President.

Regional instability remains a serious risk since the end of the armed conflict with Russia. The risks relate to the uncertain status of the regions Abkhazia and South Ossetia which Georgia continues to consider part of its own territory, but no longer controls. There is a high likelihood of provocations on both sides and tensions on political and economic sovereignty of the regions (e.g. the recent seizure by the Georgian army of two Turkish cargo ships heading to Abkhazia).

Any manifestation of internal and regional instability will undoubtedly have a detrimental effect on Georgia's economic and financial situation, with the latter probably having more serious and far-reaching consequences. The most immediate impact of domestic and regional instability would be a sharp depreciation of the lari, a massive outflow of the already weakened private financial flows, and a surge in the country's risk premium, raising international financing costs. All of these consequences are among the bound-test scenarios that resulted in the largest deterioration of external debt and debt-service ratios in the most recent IMF DSA analysis (see sensitivity analysis in section 5.3). Hence, any serious disturbance to the fragile stability of the internal political situation or increased regional tensions will have an immediate detrimental impact on Georgia's external sustainability.

Failure to deliver on the IMF-supported adjustment program (local elections in 2010 and possibility of early parliamentary/presidential elections in 2010-2012)
In 2010 there will be local elections in Georgia and some of our interviewees pointed to the likelihood of fiscal loosening - typical of election years. The same risk is applicable to possible early parliamentary and/or presidential elections before the due year (2012 and 2013, respectively). Such a scenario would imply that fiscal policies would be relaxed and spending increased. In its latest report, the IMF strongly underlined the need for embarking on the fiscal adjustment programme in order to regain confidence of the international financial markets and investors. Such confidence is necessary for Georgia to

re-access international credit markets and in particular realize the plan of rolling over the Eurobond.

Failure to deliver on the fiscal adjustment programme is likely to worsen relations with the IMF with all the detrimental consequences for the country's credibility in international financial markets. The distrust of financial markets will quickly spill over to FDI investors, undermining the foundations for recovery of the Georgian economy in 2010-2013.

Global crisis
The uncertainty around the direction of the world economy in the next 2-3 years continues to be one of the major risks for Georgia. As indicated in Table 5.4 the recovery of Georgian economy depends very much on the sharp rebound in exports in 2010 and a gradual return of foreign investment. Georgia's export sectors -not fully recovered after the Russian embargo- were hit hard in the second half of 2008 by the war and the subsequent crisis. For 2009 the IMF projects the contraction of exports of goods and jointly of goods and services (in US$) by 29.3 and 20.1 percent, respectively. These assumptions seems plausible, considering that after eight months of 2009 exports of goods shrank by 31.7 percent year on year while those of goods and services together are down by 26.6 percent year on year in the first half of the year. The Fund expects exports of goods and services to rebound in 2010 and grow by 12 percent in both 2010 and 2011.

Likewise, gross FDI inflows are projected to rebound from 6.9 percent of GDP in 2009 to 8.4 and 9.4 percent in 2010 and 2011, respectively and remain at around 10 percent in 2012-2014. Total private capital flows (including FDI, loans and portfolio investments) are also expected to pick up from the low of 14.5 percent of GDP to 15.1 percent in 2010 and then sharply up to 18.5-18.7 percent over 2011-2013 (see Table 5.5). This scenario clearly reflects the expectation of a rebound in global economy and in particular the relaxation of the global credit crunch prevailing in 2008 and 2009 combined with the return of investors to emerging economies including Georgia.

Those moderately optimistic scenarios implying the recovery of the demand for Georgian exports and the return of international financial and direct investors underpin the IMF's expectation of positive economic growth in 2010 (2 percent) and a stable growth path of around 4-5 percent afterwards. The risks to this scenario relate to the likelihood of the prolongation of the current crisis past 2009 or a much slower global recovery accompanied by a sluggish relaxation of the credit crunch. The materialization of this pessimistic scenario – partial or full- would imply a less upbeat path of macroeconomic indicators for 2010-2014 which would have a direct detrimental effect on the country's external sustainability.

5.5 Conclusion

Georgia has been successful in cutting its public external debt burden from 60 percent of GDP in 1999 to 17.5 percent in 2007 despite a significant widening of trade and current account deficits. This has been possible thanks to prudent macroeconomic policies and a series of structural reforms that improved tax collection, accomplished a successful large-scale privatisation programme and encouraged impressive FDI inflows. The reformist approach of the authorities and commitment to sound policies since 2004 have earned the country international recognition and helped maintaining good relationships with the IFIs, the EC and the international financial markets. This secured the country comfortable foreign financing of the budget and balance of payments deficits and underpinned the success of the first international Eurobond issue in 2008.

While the regional tensions and global financial turmoil considerably worsened the short-term outlook for private inflows (FDI and loans) Georgia secured an impressive US$4.5 billion of financing pledges for 2009-2011. These financing pledges have significantly improved external sustainability. However, the crisis-related contraction in GDP and deterioration in fiscal indicators led to a marked worsening of debt-to-GDP ratios. The most recent IMF projection (July 2009) sees the total and public debt rise to 65.1 percent and 41 percent in 2011, respectively and decline slowly afterwards. While the IMF evaluates the debt solvency ratios as not raising immediate concerns and the debt distress as moderate, there are considerable concerns related to the bunching of debt service obligations in 2013. The year (marked by the maturing of the Eurobond and peak repurchases of the Fund credit) will see the public and total external debt service payments rise to 25.6 and 46.6 percent of exports, respectively. The smooth debt servicing in this year (with the possibility to rollover the Eurobond) will require sustained improvements in the fiscal outlook over the medium term and sound economic policies that would make it possible to regain the confidence of international financial markets.

The DSA performed in July 2009 revealed that Georgia's debt sustainability is sensitive to the worsening of the terms of new loans, nominal depreciation shocks, lower export growth and lower non-debt creating flows (FDI, grants). These adverse scenarios are likely to be triggered by a series of risks such as domestic political instability, the tensions relating to the breakaway regions, the failure to meet the fiscal adjustment commitments (due to elections year) and a more pessimistic outlook of the duration and severity of the global crisis.

6 Structural reforms

6.1 Introduction

This chapter addresses the evaluation questions on structural reforms (see Table 6.1). First the rationale for the selection of the MFA conditionality is described, and their relevance to domestic needs evaluated. Then, the actual reform progress achieved in the areas related to MFA conditionality is assessed. The complementarities between MFA and other EU and IFIs instruments are also reviewed. The counterfactual and the net impact of MFA on structural reforms are analysed in Chapter 8.

Table 6.1 Relevant evaluation questions for analysing the development of structural reforms

	Impact of structural reforms
1	What are the short and medium-term expected structural effects of the assistance (in the context of the recipient country's reform programme)? (Q2.1)
2	How relevant are the short and medium-term expected structural effects of the assistance to the needs of the recipient country? (Q2.2.)
3	To what extent have the short and medium-term expected structural effects of the assistance (in the context of the recipient country's reform programme) occurred as envisaged? (Q2.3)
4	To what extent have structural effects been enhanced, if at all, by complementarities between the MFA and other EU instruments? (Q2.5)

6.2 Structural objectives of the intervention

1 What are the short and medium-term expected structural effects of the assistance (in the context of the recipient country's reform programme)?

The disbursement of the second and third grant instalments of the MFA in Georgia was made conditional upon the fulfilment of eleven different conditions, all falling in the Public Finance Management domain. The decision to focus on one single reform area was strategically and pragmatically taken to increase the impact of the operation, by concentrating political capital in a sphere deemed crucial to restore the country financial situation, and to facilitate monitoring, by circumscribing all conditionality to an area of expertise of DGECFIN.

The rationale behind the selection of specific conditionality was mainly driven by the willingness to maximize the degree of coordination with other IFIs. By setting conditions linked to the same reform actions addressed by the existing WB Poverty Reduction Support Operations (especially, PRSO II and PRSO III), and to a few structural performance criteria included in the IMF PRGF arrangement covering the 2004-2007 period, the MFA operation was designed to avoid dispersing Government's efforts over a wide set of objectives. An exception to this course of action characterized by significant cross-conditionality is represented by the inclusion of conditions addressing the internal audit and control function and mechanisms. The source for these conditions was the MFA follow up Operational Assessment, whereas the motivation behind their inclusion was mainly found in the context of the MFA support to other EC instruments (see section 6.5).

The MFA conditions are grouped into three main sub-areas:
1. Budget Preparation;
2. Budget Execution;
3. Transparency and Accountability.

The comparative review of MFA conditionality, WB PRSO triggers/reform actions and IMF structural performance criteria highlights that the MFA conditionality: (i) was much less detailed in the budget preparation sub-area, already addressed by WB PRSOs, (ii) matched other IFIs conditions in the budget execution sub-area, where the need for a reinforcing effect was considered comparatively more important; and (iii) was more specific or unmatched by other IFIs conditions as far as the transparency and accountability sub-area is concerned[16].

6.3 Relevance of MFA structural objectives

2 How relevant are the short and medium-term expected structural effects of the assistance to the needs of the recipient country?

Ownership of most of the proposed reforms and, therefore, their relevance to the Georgian needs were ensured by their explicit reference to the National Public Finance Management Reform Strategic Vision of 2005. This document was regarded as robust and comprehensive by the international donor community. As a result, the design of a large share of donor support (and conditionality) was consistent with this strategy, which makes all MFA conditionality relevant from a national policy point of view. All MFA conditionality was more or less mirrored by the National PFM reform strategy[17]. Nevertheless, a smaller degree of convergence was noted for the LEPL's accountability reform and the internal and external audit functions and mechanisms. Reference to the latter was also made in the National Anti-Corruption Strategy of 2005[18], prescribing the following preventive measures: (i) the reform of the offices of the Inspector General (paragraph 2.5); and (ii) the refinement of internal and external audit and accounting procedures applied in the state bodies (paragraph 2.7).

[16] For more information, see Annex VI listing all MFA conditionality for structural reforms and comparing them with WB PRSO triggers/reform actions and IMF structural performance criteria, to highlight the scope of cross-conditionality, but also to pinpoint the existing differences and illustrate their rationale.

[17] For more information, see Annex VII comparing MFA conditionality for structural reforms with actions included in the national PFM reform strategy.

[18] The National Anti-Corruption Strategy of Georgia was approved by Presidential Decree #550, dated 24 June 2005.

In addition, the Anti-corruption strategy calls for an institutional reform of law enforcement bodies. Paragraph 4.1 of this strategy states that: "*drafting and adoption of the law on Determination of Authorization of Regulating Agencies and Control Implementation Procedures is deemed as one of the most important anti-corruption reforms. The above law shall define the unified rules of inspection for businesses and establish regulation procedures for inspection (audit).*" Even in this case, little correspondence between MFA conditionality and envisaged national measures is found, and, as can be inferred from the above quotation mixing up internal audit and inspection, a true understanding of the issue at stake was rather limited at that time.

Most interviewees agreed that the selected conditionality was relevant to the Georgia policy agenda at that time. Some disagreement among stakeholders focused on conditions taken from the follow up Operational Assessment, i.e. those concerning internal audit and controls, which was not perceived as a national priority at the time of the launch of the MFA operation. Similar views were also expressed by IFIs, which, while praising the efforts made by the EC, thought that other more pressing and preliminary reforms (i.e. MTEF, treasury) deserved much more attention and, indeed, decided not to include any related conditionality. Nevertheless, the importance the IFIs[19] and the Government of Georgia[20] are now giving to the enhancement of the auditing functions seems to suggest that the audit reforms supported by the MFA operations could have played a useful role.

With the benefit of hindsight, most interviewees also stated that LEPLs reform was not seen as a priority. The setup of a regulatory framework for the LEPLs was seen as a positive development in combination with the introduction of GFS 2001. However, the potential fiscal risk associated to the existing poor monitoring and reporting system proved to be low.

6.4 Gross impact – actual structural reform outcomes

3 To what extent have the short and medium-term expected structural effects of the assistance (in the context of the recipient country's reform programme) occurred as envisaged?

6.4.1 Findings

I. Budget Preparation

MTEF-based budgetary process

The development and implementation of a MTEF-based budgetary process started in 2005 and has been progressing more than satisfactorily since then. Already in 2006, all line ministries were involved in the preparation of the 2007-2010 MTEF. Based on a PEFA self-assessment, the Budget Department identified a number of recommendations

[19] Submission to the Parliament of the Law on Internal Audit is one of the structural conditionality set under the IMF SBA.

[20] Internal Control is one of the key reform areas identified in the Public Finance Management Reform Policy Vision 2009-2013.

to increase clarity and comprehensiveness of the budget document. As a result of the implementation of these recommendations, the 2007 budget already displayed substantial improvements, including, among others, more detailed information on the Government's internal and external debt and an improved presentation of macroeconomic assumptions. Based on the self-assessment of the Ministry of Finance, the related PEFA indicator #6, "Comprehensiveness of information included in the budget documents", was lifted from 'C' to 'B'.

Further improvements were achieved in the preparation of the budget for 2008, which included: (i) fiscal deficit according to international adopted standards, (ii) the list of state financial assets, and (iii) summarized budget data according functional classification. As a result, the joint WB-EC assessment raised the score given to PEFA indicator #6 to 'A'.

Improved policy content of annual budget preparation and execution
Since 2006, the quality of guidance documents provided by the Budget Department to the spending agencies recorded significant progresses. Following a six-month effort conducted by a working group established within the Budget Department, the budget circular for the 2007 budget was redesigned to include more comprehensive and clear instructions for the spending agencies to develop their budget requests. The explanatory notes section was expanded to include information about the fiscal environment, Government priorities, the basis for expenditures ceilings and other issues. The data collection forms were revised and other forms were added to gather additional relevant information. Based on the self-assessment of the Ministry of Finance, the related PEFA indicator #11, which measures the orderliness and participation in the annual budget process, was lifted from 'C' to 'B'.

The quality of both budget circular and budget formats and instructions was further enhanced in the following year. Policy coverage of budget submissions expanded, with the number of spending agencies preparing explanatory notes with descriptions of expenditure priorities rose from 12 to 23, out of a total 44, leading to an increase of the score on the PEFA indicator #11, set at 'A' by the WB-EC joint assessment.

Capacity building of the MoF and line ministries
Capacity building was included in the MoU based on the assumption that, to effectively implement a MTEF budgetary process, both the MoF and the line ministries would need to undergo a series of capacity-building initiatives. A number of these capacity building activities were and are currently supported by several technical assistance projects, in particular by the multi-donor funded Public Sector Financial Management Reform Support Project (PSFMR-SP) and by different TACIS-funded projects (see section 6.5, on the complementarity with EC instruments).

The medium term effects of the reforms in the budget preparation sub-area would consist of a strengthened connection between national policy objectives and budget allocations, which should result in: (i) a narrowing of the discrepancy between actual expenditure and budgeted amounts, and (ii) a modification of the allocation of State budget expenditures among functional categories. Unfortunately, relevant quantitative indicators provide poor evidence in this respect, mainly due to two factors. First, the significant over-performance of revenue determined by the unexpected strong tax revenue increase and privatisation receipts inflated the discrepancy between actual and approved expenditure. In 2006, this discrepancy was as high as 17.7 percent, and in 2007, as result of four supplemental budgets, this percentage further increased. Secondly, the South Ossetia conflict in 2008 led to higher spending than budgeted and budget reallocation in favour of defence expenditure. However, as reported in the WB CPS completion report[21], some recent positive achievements have been obtained, namely: (i) expenditures for social services increased from 28 percent of the total budget in 2008 to over 35 percent in 2009, and (ii) defence and security expenditures dropped from 24 percent to 15 percent, over the same period.

The Government still faces a number of challenges in the budget preparation area, including, among others, (i) the further improvement of the quality of the BDD and its more wide dissemination, (ii) the strengthening of the analytical basis and justification for the resource ceilings, and (iii) the extension of medium-term action plans with clear statements of strategic directions and performance indicators to all spending agencies. The Government has displayed full commitment towards further improvement of the PFM system and has developed a new comprehensive strategy, the “Public Finance Management Reform Policy Vision, 2009-2013”. However, the ongoing difficult fiscal situation has negatively affected the reforming pace. Discussions between the Ministry of Finance and spending agencies focusing on resources ceilings hampered progress on performance based budgeting.

II. Budget Execution

Accounting reform - Annual financial statements

The Georgian Accounting Reform Strategy (2007-2015) was endorsed on the 10th of February 2006 and its implementation progressed during the MFA operation period. The budget classification has been moving fast towards compliance with GFS 2001. GFS 2001-compliant functional classification was implemented in 2007 budget, and GFS 2001-compliant economic classification in 2008. This required trainings on the use of the new classification for all line ministries and budget organisations as well as for local governments. Following this preparatory work, the 2008 budget submissions were prepared according to the new classification.

Treasury reform

A single treasury account became fully functional in January 2006 and the treasury general ledger became GFS 2001 compliant in January 2008. In addition, treasury database switched to the Real Time Settlement Regime with the National Bank of Georgia and the reporting standards and producing consolidated cash and commitment reports for the central government, Tbilisi and other large cities were developed in a very short period of time, largely exceeding initial expectations. Further progress towards the implementation a modern e-Treasury system are envisaged under the 2009-2013 PFM strategy.

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21 See the WB Country Partnership Strategy Completion Report (CPSCR) for FY06-FY09 annexed to the WB Country partnership Strategy for Georgia for the period FY10-FY13.

Legal Entities of Public Law (LEPLs)
A database of all LEPLs was set up in 2006 and has been constantly updated since then. LEPLs were then divided in two separate categories, namely: (i) government LEPLs, which were made subject to treasury reporting requirements, and (ii) not-for-profit LEPLs, which were made subject to an ad-hoc developed monitoring and reporting system. For more information, see relevant case study in the next Chapter.

III. Transparency and Accountability

New Law on the CoC
The approval of the law on CoC, aimed at elevating its mandate and responsibilities to a supreme audit institution in line with INTOSAI standards was accomplished in the last week of December 2008. The approval of the law took a long time due to the combination of exogenous, negative events (i.e. management changes at the Chamber, parliamentary and presidential elections, and armed conflict) and the political hesitancy to give independence to a body considered as highly corrupt and poorly performing. Based on the delayed fulfilment of this conditionality, the EC decided not to disburse the third grant instalment. For more information, see relevant case study in the next Chapter.

Implementation of the CoC reorganization plan and development of audit methodology
In 2006 a 5-year "*Strategy for Corporate Development and Reorganization Implementation Plan*" was prepared with support from various donors, including a training programme for certified auditors and an action plan to adopt audit instructions and audit methodology compliant with international standards. In 2007, the CoC made initial progresses in implementing this strategy; a five-year training plan was published and a preliminary re-evaluation of internal staff was conducted. However, due to a variety reasons (see relevant case study Chapter 7) the reorganisation of the Chamber as well as the development of an audit methodology suffered a sharp slowdown since mid-2008, when the appointment of the new Chairman injected fresh blood in the institution.

A new strategic development plan has been recently updated to cover the period 2009-2011. The revised strategy focuses on four main directions:
1. the development and implementation of an effective internal system of organizational management;
2. the adoption of modern audit methodology in line with international standards;
3. the increase of transparency and the build up of an indisputable reputation;
4. the modernization of the information technology systems and infrastructure.

Some of the above directions still reiterate the MFA conditionality.

Internal audit and control
The development of an adequate internal audit and control framework attracted comparatively much less attention from the GoG, despite its inclusion in the Government's reform agenda. Initial efforts produced very limited results. The ad-hoc working group chaired by the First Deputy Minister of Finance set up in mid 2007[22] never met and was dissolved soon after its formation. Faced with the complexity of the theme

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[22] Ministry of Finance, Ministerial Decree N. 991 of August 13th, 2007.

and the limited expertise locally available[23], the Government requested ad hoc technical assistance from the EC[24].

A variety of factors negatively affected the pace of developments. The misinterpretation of the concept that tended to attribute a disciplinary rather than advisory role to internal audit and the lack of trustworthiness on audit procedures (not based on 100 percent verification) translated into a low degree of prioritisation at Government level. The actual difficulty to recruit experienced local professionals and the limited international support received (only the EC provided assistance in this area) constituted additional obstacles. Finally, the management changes that occurred at the Chamber of Control (see related case study, Chapter 7) made it more complex.

Limited progress initially achieved was reflected in the low scores given to relevant PEFA indicators included in the joint WB-EC assessment. In particular, the framework for internal control was assessed as rather weak (score given to PEFA indicator #20 was 'C+') and the internal audit system as ineffective and not compliant with internally adopted standards (score given to PEFA indicator #21 was as low as 'D+'). A request to waive the internal audit-related conditionality was sent in April 2007. This waiver request also took into consideration that the issue would have been addressed as part of the following ENP Action Plan. The difficulty of achieving substantial improvements extended after the end of the MFA operation. The second disbursement of € 5 million EC SPSP support programme under the ENPI AP 2007 was reduced due to, among others, the non-fulfilment of the specific condition concerning the improvement in public financial internal control system and internal audit.

Recently, there seems to be an acceleration of reforms as a result of a change in the position of the government, realising the importance of developing the internal audit function to improve the effectiveness and efficiency of public expenditure management. The government seems more willing to implement 'checks and balances' in the system and strengthen the internal audit function: (i) a pilot internal audit unit under the General Inspectorate of the MoF has been established in early 2008 with support from the EC to conduct ex-ante financial control as well as performance and financial audit; (ii) the "Strategy for Reforms of Internal Financial Control within the State Agencies", prescribing, among other activities, the rolling out of internal audit units at MoF and line ministries by 2009 and internal audit units at local governments in 2010 as well as the development of an adequate normative basis for internal financial control, has been adopted by the government in March 2009; and (iii) the Law on internal audit is expected to be submitted to the Parliament by end of 2009 .

23 The limited understanding of the issue at stake is vividly depicted by the reportedly speechless reaction of GoG representatives who attended a seminar on the EC's PIFC (Public Internal Financial Control) organized by DG BUDGET in Tbilisi in 2006, within the context of the Georgia subscription of the European Neighbourhood Action Plan.

24 It is worth to be noticed that, in addition to this project, the EC has been assisting other line Ministries and putting pressure through a variety of instruments (see section 6.5 on the complementarity of EC instruments).

6.4.2 Conclusions

The degree of fulfilment[25] of the conditions and the short-term and medium term progress in the sub-areas of the various conditions are summarised in table 6.2 below. Short term is defined as the immediate positive effect of actual fulfilment of the conditionality, whereas medium term is defined as broader contribution the reform sub-area. As can be seen, not in all cases conditionality was fully and/or timely fulfilled, but it contributed to the subsequent achievement of some structural reform progress. In some cases it is simply too early to tell or not enough elements are available for a final judgement.

[25] A distinction has been made between conditionality fully fulfilled, and conditionality fulfilled. Conditionality fulfilled is e defined as a group of conditions with a different timing than envisaged or in slightly different terms than originally anticipated.

Table 6.2 Actual reform progress in the areas of MFA-conditionality

Conditionality	Degree of Fulfilment	Short –Term	Medium – Term
Budget preparation			
MTEF-based budgetary process	Fully fulfilled	Substantial progress. Relevant PEFA indicator raised from C to A	Despite the limited quantitative evidence available, the medium-term effect is likely to be 'Substantial'. New PFM strategy put in place
Policy-based annual budget	Fully fulfilled	Substantial progress. Relevant PEFA indicator raised from C to A	
CB activities undertaken by the MoF and line ministries	Fully fulfilled	Substantial progress. Several relevant TA projects implemented/ ongoing	
Budget execution			
Annual financial statements in accordance with international accounting standards	Fully fulfilled	Substantial progress. Budget classification moved fast towards compliance with GFS2001	Substantial. Further progress envisaged under the 2009-2013 PFM strategy
Treasury general ledger compliant with GFS 2001 budget classification	Fully fulfilled	Substantial progress. Treasury general ledger compliant with GFS 2001 since January 2008	Substantial. Further progress envisaged under the 2009-2013 PFM strategy
Database of and performance reporting system for all LEPLs	Fully fulfilled	Substantial progress. Both database and reporting system timely developed	Substantial. Further progress envisaged under the 2009-2013 PFM strategy
Transparency and Accountability			
New legislation on CoC	Not fulfilled	Limited progress. Law enacted immediately after the expiration of the MFA operation	Too early too tell, but significant progress recently materialized
Reorganization of CoC	Fulfilled	Limited progress. After initial progress in 2007, the reorganization of the CoC did not advance until late 2008	
Development of INTOSAI compliant audit instructions and methodology	Fulfilled	Limited progress. CoC expected to apply international audit standards of INTOSAI starting from fall 2009	
Internal audit in the Central Government	Fulfilled	Very limited progress. The Government needed support to progress in this new sub-area	Too early to tell, but significant progresses recently materialized
Internal control frameworks within budget organizations			

6.5 Impact of Complementarity with other EU instruments

4. To what extent have structural effects been enhanced, if at all, by complementarities between the MFA and other EU instruments?

During the period 2005-2008, the EC assistance included a variety of instruments providing budget support, technical assistance and a combination of the two, which paved the way to, reinforced, and ensured continuity of reforms addressed by MFA conditionality. The degree of coordination between the MFA operation and other relevant instruments, i.e. the TACIS programme, the Food Security Programme (FSP), and the European Neighbourhood Partnership Instrument, was high. First, budget support provided through different programmes was characterized by chronological coherency and consistent conditionality. Secondly, technical assistance was largely complementary to the EU budget support, providing support to local stakeholders to fulfil conditions set under budget support programmes (see also Annex VIII).

6.5.1 Budget Support

From a chronological perspective the MFA operation supplemented the phasing out of budget support provided by the FSP and prior to the effective launching of the ENPI. Support to the PFM reform under the MFA was largely instrumental to the subsequent SPSP to be provided under the ENPI AP 2007. Unfortunately, the MFA operation, initially expected to close down at the end of 2007, took longer than foreseen due to problems with implementation of certain reforms. This resulted in a situation in which the ENPI Sector Policy budget Support Programme (SPSP) and MFA both were operational in 2008. Conditionality attached to sequentially, partially overlapping programmes was largely consistent and mutually reinforcing.

Table 6.3 Historical overview of EC Budget Support operations, 2004-2008

Date	Event
July 2004	Disbursement of 1st tranche of FSP 2001 Second Cycle (€ 2 million grant)
October 2004	Initial Proposal to EFC to provide for EFA to Armenia, Georgia and Tajikistan
November 2004	Disbursement of 2nd tranche of FSP 2001 Second Cycle (€ 5 million grant)
December 2004	Disbursement of 3rd and 4th tranches of FSP 2001 Second Cycle (€ 5.9 million grant, in total)
August 2005	Financing Agreement on FSP 2005-2006 signed on 30th August 2005
November 2005	Disbursement of 1st tranche of FSP 2005-2006 (€ 1.5 million grant)
December 2005	Disbursement of 2nd and 3rd tranches of FSP 2005-2006 (€ 7.8 million grant, in total)
2006	Bilateral agreement on "The European Neighbourhood Policy: Action Plan with Georgia" signed
January 2006	Council approved MFA to Georgia in the amount of € 33.5 million
July 2006	MoU signed on 5 July 2006 and Grant Agreement signed on July 2006
August 2006	Disbursement of 1st MFA tranche of € 11 million grant
September 2006	Disbursement of 4th tranche of FSP 2005-2006 (€ 1.5 million grant)
November 2006	ENPI Action Plan for 2007 endorsed
December 2006	Disbursement of 5th and 6th tranches of FSP 2005-2006 (€ 7.4 million grant, in total, but maximum was € 8.2 million)
December 2006	Disbursement of 2nd MFA tranche of € 11 million grant
February 2008	Financing Agreement of Sector Policy Support Programme (SPSP) signed and the 1st tranche (€ 5 million) disbursed
December 2008	Financing Agreement on FSP 2007-2008 signed on 5th December 2005 and the sole grant instalment disbursed soon after (€ 3 million)
December 2008	Disbursement of 2nd instalment of SPSP of € 4 million (maximum was € 5 million)
December 2008	Sunset clause of Grant Agreement ends validity of the MFA operation

Food Security Programme

Since 1996, the FSP has been promoting a wide range of reforms through the conditions for budget support release and technical assistance. Initially, the conditions supported structural adjustment and the changing role of Government in the transition process. In more recent years, the reforms supported by the FSP concentrated on the promotion of development in agriculture, social assistance, child protection, and food security statistics. The reform of the PFM system was also addressed, especially in the 2005-2006 and the 2007-2008 programmes. A short description of the key features of these two programmes and their cross-conditionality with the MFA is provided below.

The EC financial contribution under the FSP 2005-2006 was € 20 million, of which € 19 million of budget support and € 1 million for technical assistance. The disbursement of the funds included both fixed and variable instalments and was made conditional upon the fulfilment of general conditions (GC) as well as specific conditions (SC). Specific conditions in the area of PFM were mainly designed to support the development of the MTEF-budgetary process and the consolidation of Treasury operations, thereby paving the way for MFA conditionality, and informally establishing a direct link between the two instruments. In addition, some specific conditions addressing the agriculture policy and sector management reform were meant to support the Ministry of Agriculture (one of the pilot ministries) with the introduction of MTEF policy based budgeting. The Ministry failed to present a well developed strategy linked to the budget through relevant and detailed programmes and MTEF allocations and execution, despite the technical assistance received under both EC-FSP and TACIS programme (see below). Due to lack of full compliance, the disbursement of EC-FSP for 2006 was reduced by € 0.8 million.

The financing agreement for the FSP 2007 – 2008 programme, consistent with the gradual phasing out of this instrument, provided a total amount of € 3.086 million, i.e. € 3 million as budget support in a single fixed instalment, and € 86,000 for technical assistance. The decision to disburse the amount in one single fixed instalment reflected the limited leverage of the programme given the small amount granted. The general conditions covered: (i) the implementation of a sound macroeconomic framework; (ii) the implementation of a sound public finance and fiscal management (based also on the review of the progress in areas addressed by the ENP AAP2007 SPSP PFM Reform Programme); and (iii) the development of a consistent medium-term Agriculture Strategy reflected in relevant budget submission. Specific conditions focused on the social and agriculture sectors. Despite a lack of fulfilment of some ENP SPSP conditions, the Government was considered to be largely compliant with general and specific conditions and the amount was disbursed in a single payment.

The European Neighbourhood Partnership Instrument

The European Neighbourhood Policy Action Plan (ENP AP), designating the basic fields for close cooperation between Georgia and EU for a 5-year period, was jointly endorsed by the Government of Georgia and the European Commission on November 14, 2006. The ENPI financial envelope for Georgia under the National Indicative Programme (NIP) 2007-2010 amounts to € 120.4 million. The indicative breakdown of resources allocated to ENPI priority areas is illustrated in Table 6.4.

Table 6.4 Indicative allocation ENPI financial envelope, 2007 - 2010 (in millions of Euros)

Priority area	Million €	%
Support for democratic development, rule of law and governance	31.5	*26*
Support for economic development and ENP AP implementation	31.5	*26*
Support for poverty reduction and social reforms	38.4	*32*
Support for peaceful settlement of Georgia's internal conflicts	19	*16*
Total	**120.4**	***100***

Source: ENPI EC-Georgia, National Indicative Programme 2007-2010

The 2007 ENPI Annual Action Programme for Georgia had an allocation of € 24 million. The majority of the ENPI assistance, i.e. € 16 million, was allocated to a SPSP aimed at supporting the PFM reforms. The remainder of the financial contribution was equally divided among two projects, namely: (i) twinning facility in support of the ENP-AP implementation, and (ii) economic rehabilitation and confidence building in the conflict zones of Abkhazia and South Ossetia.

The design of the SPSP – Support to Public Finance Management Reform took into consideration both the FSP and the MFA. The SPSP objectives and related conditionality display a strong degree of complementarity with both previous EC instruments. In particular, the Policy Matrix included in the financing agreement was extensively reviewed to ensure the continuation of the reform process supported by the MFA operation. The financing agreement signed in 2007 comprised of direct budget support (€ 15 million) and technical assistance (€ 1 million). The budget support would be released over three years from 2007 to 2009 in three equal, annual payments of up to € 5 million each.

The first instalment was paid at the signature of the financing agreement, upon compliance with the general policy conditions, namely: (i) continued implementation of a sound macro-economic policy, and (ii) positive progress of the PFM reform programme. The second and third disbursements consisted of both a fixed and a variable instalment, made conditional upon the fulfilment of both general and specific policy conditions. Most of the latter conditions include several objectives previously addressed by the MFA, namely: (i) improvement of MTEF-based budget process; (ii) progress in accounting and treasury reforms; (iii) development of external audit functions in line with INTOSAI; and (iv) improvement in public financial control systems and internal audit.

The second instalment included a fixed component (of € 3 million) and a variable component (of up to € 2 million), depending on the degree to which the specific conditions were fulfilled. By December 2008, this tranche was partially disbursed (€ 4 million), as a result of non-fulfilment of the conditions concerning:
1) the adoption of the law on the CoC;
2) the Government approval of a policy paper and action plan for the gradual introduction of a PIFC system; and
3) the adoption of an action plan for the restructuring of the public procurement legal and regulatory framework.

6.5.2 Technical Assistance

TACIS Programme
Since 2004, the TACIS programme was mainly focused on two areas, namely: (1) institutional, legal and administrative support, and (2) social consequences of transition. Important synergies with the MFA operation were in the area of support to the budget division of selected line ministries, especially aimed at increasing their financial management capabilities, introducing the MTEF, and setting-up internal audit and control functions. The selected line ministries were the Ministry of Labour Health and Social Affairs, the Ministry of Justice and the Ministry of Agriculture.

The project 'Increase of Financial Management Capabilities of the Ministry of Agriculture of Georgia' (IFMC) was implemented during the period 2004-2006 to help the MoA to set up a proper accounting system prior to the introduction of the MTEF-budget process. Assistance provided spanned from the strengthening of policy and economic analysis capabilities for budget preparation, execution and reporting, to the provision of training to financial units in the Department of General Administration on financial management and control, to the development and installation of an improved financial information system. Significant synergies were exploited with the USAID-funded AgVantage Project, which assisted the Ministry in developing detailed strategies.

Between 2006 and 2008, a TACIS-funded project supported the internal public administration and management reform of the Ministry of Justice. Among different specific objectives, the project aimed at strengthening the institutional capacities of the Ministry of Justice in relation to human resources and budget management. This was to be achieved by: (1) developing and implementing methodological guidelines for result-oriented budget preparation, in line with the MTEF; (2) drafting revised regulations on the procedures of financial management; (3) developing guidelines for internal audit function; (4) staffing and training internal audit unit of the Inspector General's Office; and (5) developing, adopting and implementing methodological guidelines for conducting efficient, economic and effective internal audit (Internal Audit Manuals).

More recently, a TACIS project started in 2008 to provide support services to the Ministry of Labour, Health and Social Affairs on PFM, in particular, to help the budget division to improve the budget preparation under the MTEF, and to improve the accounting and information system ant the internal control and audit system.

Other TACIS projects addressing areas subsidiary to those covered by the MFA supported reforms, included (1) strengthening the capacities at the MoF on macroeconomic and fiscal forecasts, and (2) support to the Revenue services. In particular:

- between 2004 and 2005 a project aimed at strengthening macroeconomic and fiscal forecasting capacity in the Ministry of Finance was implemented to support to implementation of MTEF;
- between late 2005 and late 2007, support was provided to implement the New Tax Code through reform of the tax department, the inclusion of a tax service and public awareness campaign;
- between April 2007 and October 2008, a project aimed at supporting the establishment of a predictable customs regime and the enforcement of an effective SPS import control system was implemented.

Furthermore, a TACIS project was implemented between April 2008 and April 2009 to assist the Ministry of Finance to develop a policy paper for the introduction of a internal audit system.

Other Relevant Projects

In addition to TACIS- projects, many other technical assistance projects funded by IFIs and bilateral donors supported the PFM reform in Georgia during the period of analysis; :

- since March 2006, the multi-donor funded Public Sector Financial Management Reform Support Project (PSFMR-SP) (US$ 15 million) provides technical assistance and financial support to the Georgian Ministry of Finance to enhance governance in the public financial management domain;
- DFID funded two projects: (1) a short-term TA project aimed at supporting the Ministry of Finance to start MTEF Framework, strategic planning and improve donor coordination (implementation period: 2004-2006); and (2) support to budget planning and management capacity building in the Ministry of Health, Labour, and Social Protection;

- the Embassy of Netherlands and the Embassy of Belgium co-funded the second phase of a US$ 1.12 million project implemented by the UNDP between June 2005 and December 2007 aimed at supporting the modernisation of MoF financial system;
- GTZ supports the Chamber of Control since 2003. This € 2.5 million TA project, initially expected to close down at the end of 2008, was extended to December 2010;
- since 2004 the UNDP provides assistance to the CoC to increase its operational effectiveness through the Strengthening the Effectiveness of State Control project;
- US Treasury has been supporting the Budget Department of the Ministry of Finance in improving the budget process.

6.6 Conclusion

The concentration of MFA conditionality on the PFM reform, unanimously considered as the top priority for Georgia, ensured the relevance of supported structural reforms. The strong coordination with other IFIs and donors, which translated into significant cross-conditionality and the provision of the required international technical assistance, increased the likeliness of achieving a substantial impact on PFM reform. A high degree of complementarity also characterized the implementation of different EC instruments, with the subsequent budget support interventions - FPS, MFA and ENPI - including consistent and mutually reinforcing disbursement conditions. The combination of these positive features contributed to the achievement of substantial progress in reforming the PFM system.

Nevertheless, this positive assessment hides substantial differences in reform progress in sub-areas. Progress achieved in the area of budget preparation and execution are impressive. All MFA conditions as well as all WB-PRSO related triggers were fully satisfied and initial expectations generally exceeded. However, less positive developments were achieved in the area of transparency and accountability. Despite the significant amount of technical assistance to support the development of the CoC, the enactment of a new law required three years, which lead to non disbursement of the last MFA tranche. Similarly, progress in the area of internal control and audit started to materialize in 2009 only. The scope and coherence of cross-conditionality and, more importantly, the degree of government ownership of the reforms in the area of external and internal audit were lower compared to other MFA supported areas.

7 Structural reforms: case studies

7.1 Introduction

We have conducted two case studies on structural reforms that allow a better understanding of beneficiary's perception of costs and benefits of proposed reforms and synergies with IFIs' operations. The selected case studies differ under several aspects:

1. one case study representing a successful conditionality and the other case study representing non compliance that lead to non disbursement of the third tranche;
2. the potential scope for MFA political and reinforcing effect, covering reforms falling or not under the direct responsibility of the MoF;
3. the importance of cross-conditionality, allowing for a better understanding of MFA causality vis-à-vis other IFIs instruments, i.e. WB-PRSOs and IMF-PRGF;
4. the size of relevant technical assistance given by other IFIs and donors, providing insights on synergies between the MFA and other EC instruments and donor-funded projects.

7.2 Case study: the Chamber of Control

7.2.1 Introduction

Amendment of the legislation on the Chamber of Control (CoC) was one of the structural reforms for which conditionality was included in the MoU (see Table 7.1). In this case study, the development of the external audit function is described with a focus on the events that finally led to the approval of the new law on the CoC, which entered into force on the 29th of January 2009, after the conclusion of the MFA operation.

Table 7.1 Conditionality in the MoU, Chamber of Control

External Audit conditionality in the MoU
Amend the legislation on the Chamber of Control taking into account the findings of the strategic review of its role and functions, abolishing any stipulations which are inappropriate for an independent supreme audit institution compliant with INTOSAI (2nd tranche)
Satisfactorily implement the new legislation and the re-organization implementation plan of the CoC (3rd tranche)
Take steps to develop a modernized set of audit instructions and audit methodology fully compliant with INTOSAI standards (3rd tranche)

7.2.2 Gross impact: actual reform outcomes

Historical overview

The CoC was re-established in June 1992, after Georgia's independence. In the following year, a law governing the CoC was approved, and subsequently amended in 1996. However, the effective discharging of the external audit function was hampered by numerous factors, such as: (i) conflict of interest caused by an excessively broad legal mandate, encompassing enforcement, internal audit, collection of fines and penalties, (ii) the absence of mechanisms ensuring systematic follow-up by parliament and the executive on its recommendations, and (iii) poor operational procedures and audit methodology.

In early 2000s, the EU and GTZ provided TA to address the above mentioned problems, and, in particular, to amend the law on the CoC. However, very limited progress was achieved and the negative reputation of the CoC remained intact. The Chamber was considered one of the most corrupted services within the government, which also explained the hesitancy of the GoG to transform the CoC into an independent body before it had proven to be able to properly and transparently discharge its function.

A first turning point in the transformation of the CoC took place in 2004, following the appointment of a new Chairman and the related change of management. The new management infused new vigour into reforming the institution and several positive steps were undertaken, such as: staff reduction (to 600 people), reorganisation, drafting of a new CoC law and preparation of a 5-year strategic document, "*Strategy for Corporate Development and Reorganization Implementation Plan*". All the above initiatives benefited from the support provided by the UNDP and GTZ (see below).

Both the EC-MFA and the WB-PRSO included conditionality explicitly supporting the amendment of the law on the CoC. A revised law was submitted to Parliament in 2006, but since then a series of negative factors hindered its approval, starting with the protracted illness of the president of the Chamber, who passed away in early 2007. The new chairman was reportedly not particularly active and committed towards reforming the Chamber.

A new draft law was submitted to the Parliament in late 2007. However, Parliament did not have enough time to consider and adopt it, due to early Presidential and Parliamentary elections. The CoC did not make further progress towards improving its performance and the very limited level of operation was clearly sanctioned by the 'D+' score given to the PEFA indicator #26 on "Scope, nature, and follow-up of external audit" in the joint WB-EC assessment.

In early 2008 the WB revised the new draft law and made some technical remarks. Key corrections to be introduced related to: (i) the provision of authority to audit the National Bank of Georgia, which despite not being explicitly prevented by the INTOSAI principles, was deemed to severely undermine the independence of the Central Bank; (ii) the provision of the authority to audit credit and financial institutions as well as any physical and legal entity in the private sector, which excessively enlarged the scope of the

CoC, enabling it to investigate the transactions of the commercial banks; and (iii) the lack of a provision indicating a superior institution/court in case of dispute settlement.

In mid 2008 a new chairman was elected for a five-year period by Parliament based on the proposal of the President (the second turning point). Enjoying full political support and strongly committed towards reforming the Chamber, the new management undertook significant reforms, starting with a structural and functional reorganization which led to a significant staff reduction (reducing total staff by one third) and change in the composition of staff (largely deemed too old staff members or staff members lacking the required flexibility to work on the new tasks of the CoC). Currently, about 350 people work at the CoC, of which 50 are interns on a six-month contract.

External factors, such as the armed conflict in August 2008, further slowed down the adoption of the law on the Chamber of Control. The new law was finally enacted on January 2009, i.e. after the MFA operation period, despite the political pressure put by the EC on the GoG (the Head of Delegation visited personally some key stakeholders, such as the Chair of Chamber and the Chair of Parliament) to get the law approved before the closing date of the MFA operation. Therefore, the decision was taken of not granting a waiver for non-compliance on external audit. A variety of factors reportedly played a role in the genesis of this tough decision, including, on the one hand, the EC willingness to provide a strong signal to the Georgian Government after years of laborious working relationships, and, on the other hand, the complex institutional structure of the MFA arrangement, hardly accommodating for a time extension, coupled with the possibility of launching a new MFA in the near future.

Interviewees had divergent views on the key factors hindering the timely enactment of the law. The GoG representatives stressed the role played by exogenous factors (such as changes of management, parliamentary and presidential elections, armed conflict, etc) and technical aspects, including the lengthy enactment process requiring three hearings in all committees, before going into the plenary session, and the limited possibility for the MoF to exert an effective pressure on the adoption of such a political decision. By contrast, EC representatives, without denying these political and technical aspects, tended to stress the weak political willingness to accept the new law ("*in the end, they had 3 years to enact a law and some constitutional changes were made in 2 days*").

Performance of the Chamber of Control

Only during the last year the Chamber started to increase its effectiveness and to gain the necessary political trust. The new legislation enacted on January 2009 is regarded as a good base for the further improvement of the CoC to move from a "control" to a "real audit" function. This should lead to a change of the negative reputation of the Chamber, which is still considered a control unit for 'punishment'.

Recent reforms have been praised by donors and experts. In the CPS Completion Report 2006-2009, the World Bank reported that, after a rather slow start, the recent adoption of a new law broadly in line with international standards shows a promise for acceleration of reforms in this area. Similarly, the Group of States against Corruption (GRECO) stated in its second compliance report that the new law on the CoC, together with the recently adopted Strategy for Internal Financial Control, is a positive step in the direction towards compliance with recommendation iv[26].

7.2.3 Other Determining Factors

Substantial efforts were deployed by the donor community to reform of the CoC, both through conditionality and through the provision of financial support and technical assistance.

World Bank

The World Bank supported CoC reform under four different PRSOs, setting a number of triggers linked to the review of its legal mandate and the adoption of its reorganization plan. Initially, the World Bank aligned with the EC position and set the enactment of the law as a precondition for the submission of the PRSO IV disbursement to the World Bank Board. In the event, however, the World Bank moved the conditionality forward and disbursed the funds. This decision, going into the opposite direction of the EC, was based on the consideration that, given the lack of a good track record of the CoC, the law to be approved should be carefully drafted to avoid abuse. Therefore, delays in the enactment of law were considered a minor issue compared to the risk of approving an unsatisfactory law.

European Union

The SPSP under the ENP AP 2007 included a set of specific conditions linked to the development of external audit functions. The disbursement of part of the second tranche was made conditional upon the submission to Parliament of the revised law transforming the CoC into a supreme external audit institution in line with INTOSAI principles and standards. Compliance with the following conditions was required for the disbursement of part of the third tranche: (i) adoption of draft law on the CoC, and (ii) the preparation by the Chamber of Control of Audit Management Policy & Procedure Guidelines.

GTZ

Since early 2003, GTZ has been implementing a technical assistance program to improve the organizational structure of and the audit methodology adopted by the CoC. Assistance mainly focused on the (i) human resources development, through the delivery of lectures on various topics[27], the organisation of study tours and staff secondment, the organisation of joint audits[28]; and (ii) the development of adequate audit methodology and appropriate guidelines, through assistance with the elaboration of an auditing handbook. In addition, the project provided continuous assistance and recommendations with reference to the drafting of the new Law on the CoC.

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[26] Under recommendation iv, GRECO recommended "*to (i) develop and implement a common methodology and standards for carrying out audits in respect of the public sector, bearing in mind the particularities of its various components; (ii) strengthen the auditing of local authorities, and (iii) ensure effective auditing of state enterprises*". See, Council of Europe, GRECO, Second Evaluation Round, Compliance Report on Georgia, Strasbourg, May 2009.

[27] Examples of topics addressed during organised workshops and seminars include the assessment of the basis of economic efficiency (certified), and the preparation of audit act and audit report.

[28] In 2007, two joint Audits were conducted: (i) complex audit of the Ministry of Justice; and (ii) complex audit of the Ministry of Agriculture.

UNDP

Since 2004, the UNDP project “Strengthening the Effectiveness of State Control” has been assisting the CoC to increase its operational effectiveness. The assistance provided has spanned over a wide range of areas, from support to the rehabilitation of the physical structure (e.g. reconstruction and expansion of premises of the Training Center) to the improvement of human resource management (e.g. installation of a personnel access control system), from the reinforcement of staff capabilities (training courses organized and delivered on various topics) to assistance in the preparation of Chamber legislative acts.

PSFMRSP

Since 2006, this multi-donor fund has provided support to the Chamber of Control to strengthen its structure and to develop and implement a training program on external audit. Main activities carried out included: (i) assistance to the preparation of the new draft law on the CoC; (ii) international advisory services to provide the management of the Chamber with strategic expertise to implement the 5-year development plan; and (iii) development of appropriate training policies, procedures and materials for CoC auditors.

7.2.4 Net impact of MFA conditionality

Based on the assessment it can be concluded that the approval of the new law on the Chamber was considered a sensitive issue for the Georgian authorities. Cross-conditionality between EC-MFA and WB-PRSO might have speeded up the approval process of the new law, but the subsequent inconsistent positions taken by the EC and the WB are likely to have reduced the political leverage. Furthermore, the conditionality fell outside of the direct control of the MoF, reducing the possibility of exerting a truly operational reinforcing effect.

Two other factors seem to have reduced the MFA leverage. First, the disbursement of US$ 250 million in budget support (without conditionality) from the USAID in December 2008 reduced the GoG interest in the € 11.5 million 3rd tranche disbursement. Second, a similar ‘disincentive effect’ on the GoG was produced by the international donors’ conference for Georgia on October 22, 2008, when a new MFA operation initiated.

Despite these limitations, which prevented a timely adoption of the new law on the Chamber of Control, it can be concluded that MFA had an operational effect (i.e. speeded up the implementation of the law). The effect of the law on improving the external audit functions still has to be demonstrated, but the latest developments seem to indicate that it could be substantial.

In addition, a positive side effect has emerged from the decision of not to grant a waiver for non-compliance on external audit. By refusing to grant a waiver the EC has sent a strong signal to the GoG, which seems to take policy discussions with the EC more seriously since then, and has requested assistance with the implementation of the new CoC law.

7.3 Case study: Database and reporting system for LEPLs

7.3.1 Introduction

The MoU included as conditionality to "*establish a database of all legal-entities of public law (LEPLs) and define requirements for their financial management and performance reporting on all revenues and expenditures*". With the aim to derive the net impact of the inclusion of this conditionality in the MFA-agreement, this section describes the developments related to this conditionality.

7.3.2 Gross impact: actual reform outcomes

Historical overview

The Georgian Law on LEPLs was approved in May 1999, premised on the idea that converting fiscal entities into LEPL status would give them greater financial and managerial autonomy, thereby allowing them to implement reforms faster and to increase their operational efficiency. However, the number of budgetary organisations converted into LEPLs initially remained rather low, at about 700 at the end of 2003.

Following the Rose Revolution, the pace of conversion accelerated. Within the context of a broader education reform and with the aim of further consolidating the fiscal position, the GoG converted a large number of schools from local budget government organisations into central government LEPLs under supervision of their line ministries. As result, the number of LEPLs increased to over 3,000 by the end of 2005.

The LEPLs were an extremely heterogeneous group of institutions, different in many respects, namely:

- (i) financing modality: primary and secondary schools receive an amount per student (a voucher) whose value varies according to the location of the school, while other entities, such as the civil registry, get direct subsidises from the central budget;
- (ii) size and revenue generation capacity: LEPLs include small rural schools with a minimal budget as well as regulatory authorities generating revenues of up to tens of million of lari; and
- (iii) financial reporting: LEPLs were exempted from the duty of reporting on the use of budget contribution as well as on the sources of revenues and financing. However, the financial situation of the most sizable entities was monitored, although in a rather unsystematic way.

The WB and the IMF decided to put pressure on the Government to develop an appropriate regulatory framework for the LEPLs, because they were concerned by the potential fiscal risks and the reduction of budget transparency that could result from this decentralization of fiscal responsibilities without a proper monitoring and reporting system. As a result, in 2006 the GoG set up a database of central government LEPLs in order to properly assess the size and composition of all LEPLs. Then, a monitoring and reporting framework was developed for the non-profit LEPLs, whereas Government LEPLs became subject to standard Treasury reporting requirements.

According to a new law enacted in 2008, the list of accountable LEPLs has to be approved by the GoG. These accountable LEPLs have to prepare quarterly reports and to submit them to the MoF. This list includes only the few institutions generating substantial revenues (schools, which account for the vast majority of LEPL, are excluded). Indeed, the number of LEPLs included in list for 2008 and 2009 was very small - 38 and 28, respectively. Further progress is currently being envisaged under the Reform Policy Vision for PFM for 2009-2011 to ensure the consolidation and comprehensiveness of accounts from LEPLs, local governments, and other public entities.

Gross macro-economic impact

The gross macro-economic impact induced by the improved accountability of the LEPLs can not be accurately quantified. In theory, the main potential negative effect in the absence of an improved monitoring and reporting system is the fiscal risk associated with LEPLs incurring debt and arrears. Nevertheless, interviewees from both IFIs and governmental authorities unambiguously ruled out the possibility that a significant risk of this nature could have actually occurred. All interviewees stated, with the benefit of hindsight, that the largest entities were not incurring debt and arrears. Furthermore, the Government was well aware of their financial status, even if not based on a consistent monitoring and reporting system.

7.3.3 Other determining factors

The MFA was not the only donor operation that may have contributed to the developments with regard to the increased accountability of LEPLs, as additional pressure was exerted by the World Bank and IMF. The World Bank included two different triggers on this area for the release of funds under the PRSO II and III. The triggers made reference to the set-up of a database on LEPLs and to the definition of financial and performance reporting requirements for all LEPLs in order to preserve the integrity of the budget. The IMF included references to the LEPLs in the Memorandum of Economic and Financial Policies (MEFP) of 2004 linked to the PRGF-program. In particular, two structural performance criteria for the disbursement of PRGF loan amounts referred to: (i) the establishment and population of a database of all central government LEPLs by end-March 2006, and (ii) the adoption of financial reporting guidelines for all not-for-profit LEPLs by the end-December 2006. In addition, the IMF provided direct assistance to the Government towards the achievement of these criteria.

7.3.4 Net impact of MFA conditionality

The net impact describes to which extent the gross effect can be attributed to the MFA-conditionality. Based on the assessment above the following conclusions can be derived. First, given the lack of a macro-economic gross effect, no net effect is detected. Second, as the IMF and, to a lesser extent, the World Bank played a driving role in bringing about LEPLs accountability reform, no operational effect can be attributed to the MFA.

8 Net impact of MFA

8.1 Introduction

This chapter provides an assessment of the net impact of the MFA operation on macroeconomic stabilisation, structural reforms, and external sustainability. Table 8.1 presents the evaluation questions for this net impact analysis.

Table 8.1 Evaluation questions for the counterfactual and net impact of the MFA operation

	Net impact of MFA
	Counterfactual
1	What arrangements would have been implemented if the MFA had not been granted? (Q0.1)
	Effects counterfactual
2	What are the structural and macroeconomic effects of the most likely implementation scenario(s)? (Q0.2)
	Net impact
3	What has been the contribution of actions resulting from the respect of structural conditionality criteria to the occurrence of expected structural effects? (Q.2.5)
4	What has been the contribution of the grants and/or loans provided by the MFA operation to the achievement of MFA objectives? (Q1.3)
5	What, if any, has been the contribution of actions arising as a result of the structural conditionality criteria to the achievement of the short and medium-term macroeconomic objectives of the assistance (i.e. the indirect effects of structural conditionality criteria)? (Q3.1)
6	What is the MFA contribution to medium and long-term external sustainability prospects? (Q.4.4)
	Unexpected Effects
7	Has the assistance given rise to any unexpected short and medium-term structural effects? What were they and how did they occur? (Q.3.2)
8	Has the assistance given rise to any unexpected short and medium-term macroeconomic effects? What were they and how did they occur? (Q 3.2)

8.2 Counterfactual

1. What arrangements would have been implemented if the MFA had not been granted?

This section presents the counterfactual for the impact analysis. In order to provide a complete assessment of the net impact of the MFA, this section also constructs counterfactuals for macroeconomic support and the structural conditions.

8.2.1 Counterfactual macroeconomic support

Alternative arrangements

As a background for the counterfactual scenarios we analysed two possible outcomes relating to the debt repayment that took place in 2006;

1. In the absence of MFA, the GoG would have started a voluntary early debt repayment scheme;
2. In the absence of MFA, no early debt repayments towards the EC would have been implemented.

On the basis of our interviews and discussions we found that:

- The GoG would not have engaged in early debt repayment vis-à-vis the EC without a supporting MFA operation. The GoG holds the view that voluntary repayment could raise questions by other creditors as to why this specific creditor (the EC) was chosen for early repayments. Therefore, a voluntary repayment arrangement towards any creditor was not an option for the Georgian authorities.
- Voluntary repayment would not have been beneficial for the GoG due to the preferential terms of the EC loans. The government would have preferred to use its resources to meet its expenditure needs instead of using them for early repayment to the EC.

These findings suggest that the GoG would not have considered early debt repayment to the EC without the MFA operation. Not only Georgia would have found it difficult to justify to all its creditors why it had chosen to engage in voluntary early repayment to one creditor only, but also because early debt repayment would not have been be justified on economic grounds. This leads to the conclusion that the second outcome is the only realistic assumption regarding the early debt repayment in the absence of the MFA operation.

In principle, this assumption implies that without the MFA operation the government would not have incurred the burden of net repayments totalling € 6 million in 2006 (grants received of € 22 million minus early debt repayments paid totalling € 28 million). This would leave the Government with additional funds to spend in 2006. On the other hand, in 2009-2013 it would have had to repay € 28 million more than in the situation with MFA.

This interpretation and the implied sequencing of debt-related events became more complex with the new MFA operation adopted by the Council on 30th of November 2009. The operation includes a grant in the amount of € 46 million conditional on to the IMF agreement being on track and specific conditions relating to the PFM reforms (internal control and internal audit, external audit, public procurement and the budget process). The grant will be divided into two equal tranches of € 23 million originally planned to be disbursed in 2009 and 2010, respectively. However, for EC related budgetary complications it was decided to disburse the first tranche in two instalments: €15.3 million by the end of 2009 and the remaining € 7.7 million in early 2010. As a consequence the division of funds between 2009 and 2010 will be: €15.3 million in 2009 and €30.7 million in 2010.

The amount of the grant (€ 46 million) was determined in the autumn of 2008 when the early debt repayment linked to the third tranche of the 2006 MFA operation (€ 17.5 million later reduced to € 11.5 million) was expected to take place in the fourth quarter of 2008. The € 46 million is equivalent to the outstanding debt to EC in 2008 (€ 57.5 million) minus the early debt repayment third tranche of € 11.5 million. Therefore, although the new MFA operation was conceived to absorb the full amount of the outstanding debt, the amount of grant (€ 46 million) falls short of the actual outstanding debt by exactly € 11.5 million as a result of the optimistic assumption of the projected debt stock in 2009.

The rationale behind the new MFA operation has implications for the counterfactual scenarios. According to the interviewees the EC would, in the absence of the 2006 MFA operation, have offered Georgia a new MFA operation in 2009 that would absorb all its outstanding debt towards the EU. With the debt stock remaining at € 85.5 million from 2004 until 2008 in the counterfactual scenario, we assume that the new MFA would be exactly equal to this amount (**first counterfactual scenario**).

However, we also investigate the likelihood of no MFA operation in 2009/2010 which would imply that the entire € 85.5 million outstanding after 2005 would have to be repaid without any grant support in 2009-2012. This is our **second counterfactual scenario** with a considerably smaller likelihood of materialization.

We also considered the possibility of designing an MFA operation in 2009/2010 with a grant scheme equal to less than the actual outstanding debt (€ 85.5 million) and supplementing the smaller grant with the extension of the grace period that would postpone the debt repayments past 2013. However, this scenario seemed less likely than the two counterfactual scenarios described above. Therefore we did not present a third counterfactual scenario.

The details of our actual and two counterfactual scenarios are summarized in Table 8.2. The actual situation takes account of the first principal repayment of € 22 million Georgia made in July 2009, and forecasts further regular repayments of € 22 million and € 13.5 million in July 2010 and July 2011, respectively[29]. In order to compare the complete fiscal outcome of the counterfactual, we also calculate debt service obligations accruing on the stock of EC debt according to the guidelines following from the agreement (for details see the note under the table). The € 46 million grant will be divided into several instalments totalling € 15.3 million in 2009 (part of the first tranche) and the remaining € 30.7 million in 2010 (the remainder of the first tranche + the second tranche). Resulting principal repayments net of the grant disbursements amount to € 6.7 million, € 8.7 million and € 13.5 million (in 2009, 2010 and 2011) with the total accumulated since 2006 (e.g. including the 2006 MFA repayment of €6 million) adding up to € 17.5 million. The total interest accrued since 2006 is estimated at € 8.4 million.

[29] According to the 1998 EFA agreement the loan (€110 million) had a maturity of 15 years and a 10-year grace period implying the first regular repayment of the principal (20 percent) in July 2009 with subsequent tranches to be paid once a year in July until 2013 or earlier until the amount is fully returned.

The counterfactual scenario 1 implies no repayments in 2006 and thus leaves the debt stock at € 85.5 million until July 2009 when the first scheduled payment lowers it by € 22 million. In this case – in contrast to the actual scenario - the regular scheduled repayments continue until 2012 reflecting the higher debt stock to be repaid. In Scenario 1 the new MFA operation is assumed to be € 85.5 million to be disbursed in 2009 and 2010. In line with the actual situation we assume that only € 15.3 million will be disbursed in 2009 (for EC related budgetary reasons) and the remaining € 70.2 million in 2010. Clearly, the total net repayment accumulated over 2006-2012 in this scenario is zero – as a direct consequence of the assumption underlying the operation that the total grant is set equal to the outstanding debt. However the higher debt stock outstanding during the entire period produces higher interest payments (€ 13.3 million or € 5 million more compared to the actual scenario).

The counterfactual scenario 2 is identical to counterfactual scenario 1 except it assumes no MFA operation in 2009/2010. This implies that principal repayments net of MFA are equal to actual gross principal repayments in 2009-2012 and additional net principal repayments are € 68 million higher than in the actual scenario.

Table 8.2 Implications of the actual and counterfactual scenario for the debt stock, interest payments and the new MFA operation , 2005-2012

	2005	2006	2007	2008	2009	2010	2011	2012	2006-2012(/1)	2006-2012(/2)
Actual scenario: MFA in 2009/2010 with total grants equal to € 46million										
Debt stock in € million at end-year	85.5	57.5	57.5	57.5	35.5	13.5	0.0	0.0		
Principal repayments during the year	24.5	28.0			22.0	22.0	13.5		85.5	
Interest due **3/**		1.6	2.0	2.5	1.9	0.3	0.1	0.0	8.4	
New MFA grant disbursements with the total grant amount €46m of which €15.3 m (33.3 percent) disbursed in 2009					15.3	30.7			46.0	
Principal repayments net of MFA grants		6.0			6.7	8.7	13.5		17.5	
Counterfactual scenario 1: MFA in 2009/2010 with total grants equal to € 85.5million										
Debt stock in € million at end-year	85.5	85.5	85.5	85.5	63.5	41.5	19.5	0.0		
Principal repayments during the year	24.5				22.0	22.0	22.0	19.5	85.5	
Interest due 3/		2.0	3.0	3.7	2.9	0.7	0.7	0.3	13.3	
new MFA grant disbursements with the total amount €85.5m of which €15.3 m disbursed in 2009					15.3	70.2			85.5	
Principal repayments net of MFA grants					6.7	-48.2	22.0	19.5	0.0	
Additional net principal payments implied by the counterfactual scenario		-6.0			0.0	-39.5	8.5	19.5	-17.5	-19.2
Additional interest obligations implied by the counterfactual scenario		0.4	1.0	1.2	1.0	0.4	0.6	0.3	4.8	5.0
The overall fiscal effect (principal+ interest) implied by the counterfactual – in € million		**-5.6**	**1.0**	**1.0**	**1.0**	**-39.1**	**9.1**	**19.8**	**-12.7**	**-14.2**
– in percent of total fiscal revenues 4/		**-0.34**	**0.05**	**0.04**	**0.04**	**-1.88**	**0.46**	**1.05**	**-0.08 5/**	
– in percent of GDP		**-0.07**	**0.01**	**0.01**	**0.01**	**-0.36**	**0.08**	**0.16**	**-0.02**	
Counterfactual scenario 2: no new MFA in 2009/2010										
Debt stock in € million at end-year	85.5	85.5	85.5	85.5	63.5	41.5	19.5	0.0		
Principal repayments during the year	24.5	0.0	0.0	0.0	22.0	22.0	22.0	19.5	85.5	
Interest due **3/**		2.0	3.0	3.7	2.9	0.7	0.7	0.3	13.3	
No new MFA									0.0	
Principal repayments net of MFA grants					22.0	22.0	22.0	19.5	85.5	
Additional net principal payments implied by the counterfactual scenario		-6.0	0.0	0.0	15.3	30.7	8.5	19.5	68.0	65.3
Additional interest obligations implied by the counterfactual scenario		0.4	1.0	1.2	1.0	0.4	0.6	0.3	4.8	5.0
The overall fiscal effect (principal+ interest) implied by the counterfactual – in € million		**-5.6**	**1.0**	**1.2**	**16.3**	**31.1**	**9.1**	**19.8**	**72.8**	**70.3**
– in percent of total fiscal revenues 4/		**-0.34**	**0.05**	**0.05**	**0.68**	**1.49**	**0.46**	**1.05**	**0.49 5/**	
– in percent of GDP		**-0.07**	**0.01**	**0.01**	**0.15**	**0.29**	**0.08**	**0.16**	**0.09**	

Source: own calculations based on materials and information from the EC

Notes: 1/ Ordinary sum of nominal (face) values over 2006-2012, 2/ The sum of present values (for 2009) of flows with the discount factor set equal to the interest rate of the EFA loan (see 3/) in respective years.

3/ According to the 1998 EFA loan agreement interest payments are due twice a year (late January and late July) and the applied interest rate is the floating 6-month LIBOR minus 5 basis points (0.05%). The amounts of interest due in the table are based on own approximations made with historical values of the 6-month LIBOR EUR rates and the outstanding debt stock in January and July each year. The future values of LIBOR are based on the forecasts of the Economist Intelligence Unit forecasts

4/ Based on IMF fiscal revenues projections in 2009-2012, 5/ Simple average over 2006-2012

In summary over the period 2006-2012, the counterfactual scenario 1 implies lower principal repayments in the amount of € 17.5 million. This is a result of the € 6 million repayment made under the 2006 MFA and the assumption (made during the negotiations on the next MFA) that an additional € 11.5 million would still be repaid within the same operation, which effectively lowered the grant payment of the new operation[30]. On the other hand, the counterfactual scenario 1 implies that additional € 4.8 million would be spent on servicing the debt. The resulting total nominal net gain to Georgia is € 12.7 million (or € 14.2 million calculated as present values of gains and losses over 2006-2012). The counterfactual 2 represents a considerable deterioration of the debt repayment scenario for Georgia as the absence of grants in 2009-2010 produces additional overall nominal fiscal cost of € 72.8 million (or € 70.3 million measured at present values).

8.2.2 Counterfactual structural reforms

All interviewees stated that, without MFA, most reforms related to the MFA conditionality would have been implemented. They noted that in the counterfactual situation genuine Government interest would have secured progress for the majority of areas, whereas external pressure from other donors is perceived as more likely for a few other areas. The Government was the driving force behind the reforms of budget preparation and execution. However, IFIs played a crucial role in the enhancement of LEPLs accountability. MFA conditions are considered the leading source for introducing internal audit and control reforms, which only recently have started to materialize.

We conclude that without MFA (counterfactual) most reforms would have been implemented, because the Government had strong reform ownership. However:
- initial steps in reforming internal audit and controls would probably not have been taken. Other donors did not raise this issue and the government did not see this as a top priority;
- the enactment of the new law on CoC would have probably taken somewhat longer, given the political sensitiveness around this reform and the more flexible position adopted by the World Bank.

Table 8.3 overleaf reports conclusions on counterfactuals per conditionality.

[30] Therefore the new MFA operation actually fell short of absorbing the outstanding debt in full (by €11.5 million)

Table 8.3 Counterfactual assumptions per conditionality

Conditionality	Counterfactual	Comments
	Budget preparation	
MTEF-based budgetary process	Would have been implemented	Action already present in the Government agenda and under implementation. WB parallel conditionality much more specific.
Policy-based annual budget	Would have been implemented	Conditionality already included in the Government agenda. MFA reinforced an already existing WB conditionality.
CB activities undertaken by the MoF and line ministries with reference to MTEF-budgetary process	Would have been implemented	Institutional strengthening initiatives already arranged as part of a wide range of donor-funded technical assistance projects.
	Budget execution	
Annual financial statements in accordance with international accounting standards	Would have been implemented	Conditionality already included in the Government agenda. MFA reinforced an already existing WB conditionality.
Treasury general ledger compliant with GFS 2001 budget classification	Would have been implemented	Conditionality already included in the Government agenda. MFA reinforced an already existing WB conditionality.
Database of and performance reporting system for all LEPLs	Would have been implemented	The item was not clearly perceived by Georgian counterparts as deserving action, but WB and IMF included specific conditionality.
	Transparency and Accountability	
New legislation on CoC	Would have taken longer to implement	Debate on the law would have possibly continued for a longer period.
Reorganisation of CoC	Would have been implemented	Already included in the Government agenda, but limited political willingness to advance with reform. MFA reinforced an already existing WB conditionality.
Development of INTOSAI compliant audit instructions and methodology	Would have been implemented	Specific MFA conditionality helped compliance with generic WB conditionality. World Bank would have formalised more pressure and taken over conditionality.
Internal audit in the Central Government	Both actions would not have been implemented	The progress achieved so far in this area can be entirely attributed to the MFA conditionality. The item was only confusingly perceived by Georgian counterparts as deserving action.
Internal control frameworks within budget organizations		

8.3 Effects of the counterfactual scenario

2. What are the structural and macroeconomic effects of the most likely implementation scenario(s)?

Georgia made improvements in tax collection and accelerated the ambitious privatisation programme in late 2005. By early 2006 both tax and privatisation receipts were exceeding expectations and all quarterly IMF targets for both tax and privatisation inflows were over executed by large amounts. This led to the introduction of two budget supplements, increasing expenditures jointly by as much as 4.6 percent of GDP. The total revenue (incl. grants) in 2006 reached GEL 3.85 billion (27.9 percent of GDP) up by 23 percent from GEL 2.99 billion as projected by the IMF in early 2006.[31] Revenues were still growing robustly in 2007 and 2008 and are projected to fall gradually from 2009 (see Table 4.3).

Table 8.2 presents the ratio of overall fiscal effects of both counterfactual scenarios to total fiscal revenues and to GDP over 2006-2012 (using IMF projections in 2009-2012). In both scenarios additional fiscal costs (positive numbers) or gains (negative numbers) in individual years are negligible, under 1.2 percent of fiscal revenues and under 1/4 of a percentage point of GDP. The gain under the counterfactual scenario 1 would amount to 0.06 percent of fiscal revenues and 0.02 percent of the GDP on average in 2006-2012. The counterfactual scenario 2 would imply the cost of 0.48 percent of total fiscal revenues and 0.09 percent of the GDP on average in 2006-2012.

Altogether these magnitudes are very small in individual years making the likely macroeconomic impact negligible. This finding has been confirmed by many of our interviewees.

In the counterfactual the large majority of the reforms would have been implemented at any rate. Furthermore, we assumed a delayed enactment of new law of the Chamber of Control and the lack of materialization of progress recently achieved in the area of internal audit and control.

8.4 Net impact on structural reforms

3. What has been the contribution of actions resulting from compliance with structural conditionality criteria to the occurrence of expected structural effects?

Table 8.4 summarises preliminary conclusions on the net effect of MFA. The net effect distinguishes between:

a) *political reinforcing effect*: all relevant actors were familiar with the MFA conditions and perceived them as an incentive to overcome political resistances (an overall increase of chances of happening);
b) *operational reinforcing effect*: impact on the speed of reform implementation (the lack of pre-emptive effects of other instruments).

[31] IMF CR 06/171

We have identified both a political and an operational reinforcing effect in the cases of internal audit and control and the enactment of the law on CoC. However, in the latter case, the intrinsic nature of the reform, requiring parliamentary approval, limited the scope for the MFA operational reinforcing effect.

The EC could have also played a role in accelerating the pace of reforms in the area of budget preparation through the provision of relevant technical assistance to the MoF and the budget division of selected line ministries. Taking into consideration the strong commitment of the GoG towards the implementation of the reforms together with the lack of local expertise to implement reforms, interviewees stressed that the provision of ad-hoc technical assistance is likely to have brought a higher value added for 'supporting' the reforms compared to the MFA conditionality themselves.

Table 8.4 MFA net impact and most likely alternative scenario

Conditionality	Political reinforcing effect	Operational reinforcing effect	Rationale behind assessment
		Budget preparation	
MTEF-based budgetary process	No	No	Action under implementation before MoU was signed and already addressed by the WB
Policy-based annual budget	No	No	Action under implementation before MoU was signed and already addressed by the WB
CB activities undertaken by the MoF and line ministries with reference to MTEF	No	No	Relevant donors funded technical assistance projects already undergoing
		Budget execution	
Annual financial statements in accordance with international accounting standards	No	No	Action under implementation before MoU was signed and already addressed by the WB
Treasury general ledger compliant with GFS 2001 budget classification	No	No	Action under implementation before MoU was signed and already addressed by the WB
Database of and performance reporting system for all LEPLs	No	No	Process largely driven by the IMF and the World Bank
		Transparency and Accountability	
New legislation on CoC	+	+	MFA pushed to conclude the process before the end of the MFA operation
Reorganization of CoC	?	No	Unclear whether any political signalling effect was made due to the leading role played by the WB, but no detectable operational consequences
Development of INTOSAI compliant audit instructions and methodology	(+)	No	Possible political reinforcement effect, but no operational effect
Internal audit in the Central Government	++	++	By setting light conditions, simply indicating the initial steps to undertaken (coupled with the provision of the required technical assistance), and through the adoption of a flexible approach, giving enough time to 'digest' this complex theme, the MFA played a significant reinforcing effect
Internal control frameworks within budget organizations	++	++	

++ :verifiable and substantial effect
+ :verifiable but small effect
(+) :not verifiable but possibly a small effect
? :no verifiable effect
No :no effect

8.5 Net impact on macroeconomic stabilisation

4. What has been the contribution of the grants and loans provided by the MFA operation to the achievement of MFA objectives?

5. What, if any, has been the contribution of actions resulting from the respect of structural conditionality criteria to the achievement of short and medium-term macroeconomic objectives of the assistance (i.e. the indirect effects of structural conditionality criteria)?

No quantifiable macroeconomic impact
The fiscal effect of both counterfactual scenarios was negligible viewed in individual years (2006-2012) and amounted to less than 1.2 percent of total fiscal revenues and less than one-quarter of a percent of GDP. With such a negligible quantifiable effect we decided not to engage in macroeconomic modelling to identify macroeconomic effects.

However, there seems to be an indication of a positive indirect macroeconomic impact of the MFA operation. This indirect effect is not quantifiable, but worth mentioning. Several interviewees indicated that by engaging in early debt repayment to the EC (under the MFA operation), Georgia sent a positive signal to other IFIs and the financial markets. Back in 2005 Georgian authorities were in need of establishing themselves as responsible and predictable and show that the country was finally on track with economic reforms after being considered a "failed state" for a number of years. Therefore, when the negotiations on initiating the new MFA operation were ongoing throughout 2005 it was very much in Georgia's interest to show cooperation and commitment. It is not possible to measure in macroeconomic terms the extra credibility gained through such an agreement. However, the existence of such an effect has been mentioned in the context of building and strengthening the Saakashvili's team's commitment to responsible and sound macroeconomic policies.

One of the more concrete examples of the likely effects of the country's credibility gain was the successful Eurobond issue in 2008. The operation, worth US$ 500 million (in five-year bonds) was the country's first international sovereign bond issue and, as some of our interviewees mentioned, would have been impossible without the credibility gained from programmes such as the MFA, which demonstrated the country's ability to repay its debts early.

Macroeconomic effects from structural reforms?
MFA conditionality was largely related to PFM reform. While it is hard to disentangle the macroeconomic effects of these reforms from other ongoing processes and reforms, it is very likely that over longer time horizons –if combined with good policies in other areas- they can have some positive effect on the overall macroeconomic situation. However, considering the limited marginal effect of the MFA on the developments in the area of structural reforms, we conclude that the causality from the MFA to developments on the macroeconomic scale cannot be plausibly established.

8.6 Net impact on long-term external sustainability

6: What is the MFA contribution to medium and long term external sustainability prospects?

In line with the counterfactual scenarios summarized in Table 8.2 the contribution of the 2006/7 MFA to medium/long term external sustainability comes from lowering the debt stock following the repayment of € 28 million in 2006. Both counterfactual scenarios imply the same path of the debt stock over 2006-2012 so no distinction is made between the two in this section. Table 8.5 presents the hypothetical path of external debt (in US$ and as percent of GDP) as well as the resultant net effects. The MFA operation lowered the debt stock by US$ 41.2 million over 2006-2010. In terms of the actual and projected debt stock the net MFA impact is the highest in 2006 when it reaches 1.3 percent to fall subsequently to 0.4 percent in 2011 and eventually to zero from 2012 onwards. The impact in terms of GDP reaches 0.45 percent in 2006 and declines gradually to 0.24 percent in 2011.

Table 8.5 MFA contribution to total external debt, 2004-2012

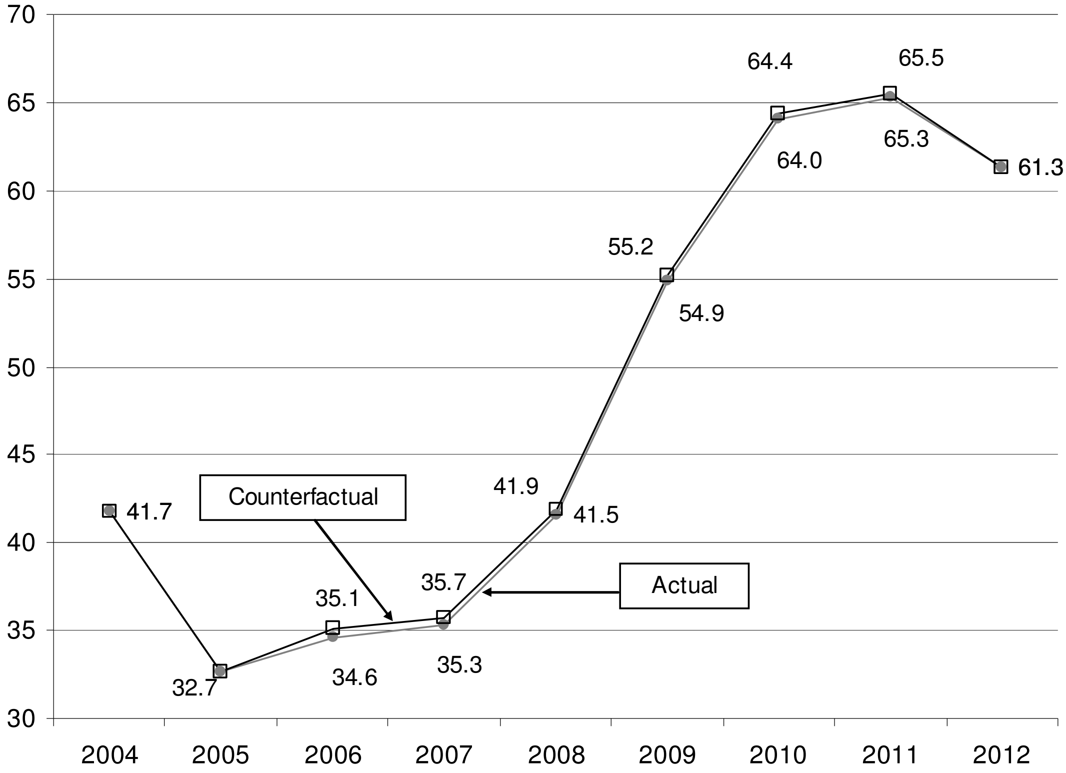
	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total external debt stock, actual (in million US$)	2 138	2 095	2 689	3 613	5 345	6 025	6 889	7 381	7 536
Impact of MFA (in million €)			-28.00	-28.00	-28.00	-28.00	-28.00	-19.50	
Impact of MFA (in million US$)*			-35.28	-38.36	-41.16	-38.08	-38.92	-27.69	
Total external debt stock, counterfactual (in million US$)	2 138	2 095	2 725	3 651	5 386	6 063	6 928	7 409	7 536
Total external debt stock, actual (In percent of GDP)	41.7	32.7	34.6	35.3	41.5	54.9	64.0	65.3	61.3
Total external debt stock, counterfactual (In percent of GDP)	41.7	32.7	35.1	35.7	41.9	55.2	64.4	65.5	61.3
Net effect of MFA on external debt stock (in percent of the actual debt stock)	**0.00**	**0.00**	**1.31**	**1.06**	**0.77**	**0.63**	**0.56**	**0.38**	**0.00**
Net effect of MFA on external debt stock (in percent of GDP)	**0.00**	**0.00**	**0.45**	**0.38**	**0.32**	**0.35**	**0.36**	**0.24**	**0.00**
Memorandum item: Nominal GDP in billion US$	5.13	6.41	7.76	10.22	12.86	10.98	10.76	11.31	12.29

Source: Own calculations based on the IMF data for actual external debt stock

* Official IMF projections for US$/€ exchange rate in 2009-2011

Table 8.5 and figure 8.1 make it clear that the effect of the MFA operation on the debt stock was rather small and temporary. The operation contributed to lowering the external debt by a mere 0.45-0.24 percent of GDP over the period 2006-2011.

Figure 8.1 Actual and counterfactual total external-debt-stock-to-GDP ratios over 2004-2012



Source: Own calculations based on the IMF data for actual external debt stock

8.7 Unexpected Effects of the MFA operation

8. Has the assistance given rise to any unexpected short and medium-term structural effects? What were they and how did they occur?

As indicated in Section 8.3, the early debt repayments linked to the 2006-2008 MFA operation came at a time when reforms resulted in increased tax and privatisation revenues. As a consequence of the secure fiscal situation the sum of gross and net repayment made in 2006 (€ 28 million and € 6 million, respectively) was commonly viewed as not presenting a challenge for the GoG. On the other hand, if the repayment had to be done as part of the regular repayment cycle in 2009-2013 it would constitute a greater problem, because of the much less comfortable fiscal situation projected over 2010-2012. While back in 2006 the authorities were not aware of the fiscal deterioration coming in a few years' time, the crisis of 2008-2009 makes the early debt repayment in 2006 a very good decision in retrospect. In light of the current economic crisis, the MFA operation in 2006-2008 is viewed as positive, both on design with net early debt repayments as on timing. This can be seen as an unexpected effect of the operation.

8.8 Conclusion

Negligible macroeconomic impact
The early debt repayment in the framework of the 2006 MFA operation implied a sequence of losses and gains in individual years over 2006-2012 that add to a total loss of €12.7 million (or € 14.2 million at present value) in the counterfactual scenario 1 and a total gain of € 72.8 million (or € 70.3 million at present value). However, viewed over individual years these fiscal shifts are rather negligible and remain under 1.2 percent and 0.25 percent of total fiscal revenues and the GDP, respectively, in each individual year. Altogether these very small shifts in individual years make the likely macroeconomic impact negligible.

Reinforcing effects on reforms in the area of internal and external audit
We have identified a clear political reinforcing effect of MFA conditionality in the cases of internal audit and control and the enactment of the law on CoC. In addition, in the case of internal audit political pressure was accompanied by technical assistance, which facilitated the implementation of the reform as well.

Small effect on external sustainability
The effect of the MFA operation on the debt stock was rather small and temporary. The operation contributed to lowering the external debt by a mere 0.45-0.24 percent of GDP over the period 2006-2011.

Unexpected effect
The MFA operation required net early debt repayments in the period in which Georgia could easily afford these net repayments. If the EC and Georgia would have kept the regular repayment scheme (2009-2013), the country would have had much more difficulties paying back its debt in the current economic situation. In retrospect it can be concluded that the MFA rescheduling of debt repayment was (unexpectedly) aligned with Georgia's capacity to pay back.

9 Design and implementation of MFA

9.1 Introduction

This chapter describes the impact of the design and implementation of MFA in Georgia. The assessment contains a number of observations that might also be relevant for the design and implementation of other future MFA operations. Table 9.1 below shows the fifth generic evaluation question.

Table 9.1 Evaluation question on design and implementation effectiveness and efficiency

	How has the way in which the MFA operation was designed and implemented conditioned its effectiveness and efficiency?
1	In what way has the design and implementation of the MFA conditioned the performance of the MFA operation in respect to its cost and its objectives? (Q5.1)

Section 9.2 presents specific findings on the operation's design and implementation that conditioned the performance of MFA in Georgia. Section 9.3 presents the conclusions and our recommendations.

9.2 Findings

Objectives and design of the MFA operation

Compared to most other MFA operations, this MFA operation was exceptional as it did not originate from a residual balance-of-payments financing need. The objectives of this MFA operation explicitly mentioned the goal of reducing external indebtedness. The Council Decision stated "*to support economic reforms and help Georgia improve debt sustainability*", whereas the MoU used slightly different wording "*to help reduce external indebtedness*".

While the goal of the operation focussed on improving debt sustainability in the medium term, which was considered at risk before and just after the Rose Revolution, the MFA operation mainly shifted repayments on EC debts and did not actually provide debt relief. Since the EC did not provide debt relief, it was not a member of the Paris Club. However, by providing MFA by means of grants at almost the same time as the early debt repayments, the debt stock was effectively lowered.

The initial timing of the MFA operation was also fortunate as a new government came into power with an ambitious reform agenda. The government needed the necessary support from the international donor community, including the EC, to implement its reform programmes. The MFA assistance intended to complement and reinforce assistance provided by other IFIs and bilateral donors in support of the Georgian authorities' economic stabilisation and reform programs. The MFA was seen as a potential timely instrument to support the government. Therefore, the exceptional character is reinforced by the political character of the operation. The political context has played a role in deciding on MFA provision.

In addition, the amount in this MFA operation was equal to the last undisbursed tranche of the previous EFA operation (€ 33.5 million) and not based on a needs assessment. Since no 'new' money was proposed, this would give less 'resistance' or 'critical comments' of the member states (through the EFC and subsequently the ECOFIN Council) to this operation.

Lengthy start up period and changing financial context
The Council Decision of January 2006 was prepared in mid 2005. When the MFA operation was first discussed after the donor conference at the end of 2004, the country's future debt position was uncertain. However, at the end of the following year, when the draft Council Decision was prepared, the debt position had improved substantially and further improvements were expected due to a successful privatisation scheme and in particular buoyant tax revenues. Cancelling the MFA operation was not considered. Instead, the design of the operation was adjusted. Whereas the original idea was to design an operation in which early debt repayments were balanced by grant tranches, the EC opted for an operation in which early debt repayments were linked to lower grant tranches resulting in net payments to the EU, and consequently a reduction of Georgia's debt stock and therefore improved debt sustainability.

Focus on one key area of reform and EC capacity to support
Compared to many other MFA operations, the conditions in this MFA operation focussed only on the PFM reform area. As mentioned, the main reason was the existence of 'a failed state' situation at the wake of the Rose Revolution. This focus reinforced the PFM focus of other donors and gave clear support to the new government. It allowed also to concentrating the political capital of the donor community by speaking with '*one voice*'.

An additional advantage of having one focal reform area was the ability of the EC to provide technical support. Many interviewees have indicated the knowledgeable and supportive role of the DG ECFIN staff visiting the country and staff of the EC delegation. The Head of Delegation had been very active in supporting and 'pushing' for certain PFM reforms.

Consistency of MFA instrument and other EC instruments
While in a number of other MFA operations the MFA was considered as a single instrument focussing on macro-financial support, this MFA operation appeared to be closely aligned to other EC instruments. The MFA operation in Georgia filled the gap between the phasing out of the FSP which contained a high degree of budget support and the launching of ENPI enabling sector budget support. The MFA enabled the EC to continue its policy dialogue with the government on structural conditions in the area of PFM, just after the FSP, and it paved the way for a policy dialogue for SPSP under the

ENPI. In addition, the degree of internal EC coordination was extremely high, considering explicitly the complementarities between the various EC instruments.

Refusing a waiver for non-compliance

The discussion on disbursing the third tranche concentrated on the Chamber of Control condition ("satisfactory implementation of the new legislation"). The DG EFCIN missions and the EC Delegation put pressure on the Government to do it utmost in speeding up the process in Parliament with regard to discussing and accepting the law. Finally, the law was accepted in January 2009, a few days after the MFA agreement expired. Although the EC had the option to waiver this condition as was done, for instance, in the case of the MFA operation in Serbia, it decided against the waiver and let the operation expire.

The relative strict position of the EC is almost contrary to the design of the early debt repayment scheme under the MFA operation, since the 3rd tranche was the least important for Georgia, including a net repayment of € 6 million (€ 11.5 million grant linked to € 17.5 million early debt repayment). However, the CoC condition was also a condition in the SPSP, which had to be taken into account while deciding on granting or not a waiver.

By pressing for the reform and not willing to provide a waiver, the EC gave a strong signal to Georgia. At the same time, it affected the 'one voice' donor community approach, which was followed from the start of the MFA operation. The different view of the World Bank resulted in mixed messages to the government: Was conditionality focused on the need for a new law or also about the quality of the law?

Development of internal audit and control as a condition

Progress in the area of internal control and audit was low during the MFA operation. However, since the beginning of 2009 the GoG started to implement these reforms. Key stakeholders underlined the difficulty to reach progress in this area. As in all CIS countries, Georgia has a tradition and culture of a system of 'checks and punishments'. This culture is hard to change even under a modern internal audit and control system characterised by 'assessment, dialogue, and improvements'. Other donors held the view that in the period 2004-2008 it was too early to stimulate internal audit and control developments. The EC included this area of reform in its conditions related to the FSP, MFA, and SPSP. Eventually the 2nd SPSP disbursement had to be reduced due to the non-compliance with the condition concerning the improvement in PIFC system and internal audit.

9.3 Conclusions and recommendations

We draw the following conclusions from our analysis and interpretation of the MFA operation in Georgia. Where relevant we provide our recommendations for future MFA operations.

MFA objectives and design

As explained in section 9.2 the MFA operation in Georgia was different from other MFA operation as it was not initiated merely because of the existence of a measurable residual financing gap, but for other economic and political reasons. The economic rationale related to medium term debt sustainability. The political rationale was to provide timely support to a new government with an ambitious reform agenda, in a way which was well-coordinated with other donors. In a strict sense a MFA operation is typically initiated when there is a residual financing gap. In our view there were other valid reasons for the MFA operation in Georgia, which allowed for a more flexible use of the MFA instrument compared to a more 'automatic' financial support instrument.

> **Recommendation 1:** We suggest that DG ECFIN promote formally the concept that the MFA instrument could be initiated for other reasons than the existence of a residual financing gap. DG ECFIN could adjust its Vademecum on EC macroeconomic assistance to third countries and propose changes to the Genval criteria to allow for this

Preparation of the operation

The preparation of the MFA operation in Georgia had a lengthy start up period during which the economic and financial context was changing. The long preparation process would point to building in more decision moments in the preparation and approval process to allow reconsidering explicitly the rationale for continuing with the MFA operation, especially under rapid changing circumstances. On the other hand, reconsideration of disbursement of tranches has been done in the past (for instance in the MFA operation in Albania where DG ECFIN reacted to a changing context, i.e. disappearance of the residual financing gap due to privatisation proceeds.)

> **Recommendation 2:** We suggest that in case of a long preparation process DG ECFIN should build in more decision moments to allow reconsidering the rationale of a proposed MFA operation as it is doing when deciding on disbursement of tranches.

Focus on one area of reform

Compared to previous MFA operation, the conditions linked to the MFA operation in Georgia targeted only one focal area: Public Finance Management. This was a reform area in which swift progress was required in order to reverse the "failed state' situation at the end of 2003. In addition, the concentration of international community capital on this focal reform area coupled with internal EC capacity strengthened the implementation of the MFA operation.

> **Recommendation 3:** The experience of the MFA operation in Georgia has showed the success of selecting very limited focal reform areas. Therefore, we suggest that DG ECFIN continue with this focussed approach when deciding on conditionality.

Consistency among EC instruments

The MFA operation in Georgia demonstrated the complementarities between the MFA instrument and other EC instruments. These complementarities were taken into account. The degree of internal EC coordination was extremely high. We understand that this practice is being applied more generally.

Non-compliance waivers

The CoC condition in the MFA operation in Georgia shows the difficulty in deciding on whether to grant or not a waiver, as too many different aspects come at the forefront, from rational considerations concerning the content of the law to political pressure elements. While the rationale for a decision to provide a waiver may vary on a case-by-case basis, a more structured approach towards non-compliance waivers should be adopted.

Recommendation 4: We suggest that DG ECFIN adopts a more structured approach to granting waivers. Such approach may include:

- measures allowing the EC more manoeuvring space and therefore flexibility in implementation of a MFA operation without having to consider the possible opinions of the EFC and subsequently the ECOFIN Council. The idea of having a framework regulation for MFA operations could be considered, as this will, among other, address a more structured and flexible approach to granting waivers.
- another approach would be to make more explicit in the MoU the circumstances a waiver may be provided and when not.

Formulation of conditions in new areas

As mentioned in section 9.2, progress in the area of internal control and audit was low during the MFA operation. Many stakeholders underlined the difficulty to reach progress in this area. In their view it is debatable whether the timing of supporting internal audit and control through conditions and technical assistance was optimal.

In our view the pioneer activities promoted by the EC allowed to GoG to start addressing a relevant and truly complex issue. This was one of the few areas where the MFA together with other EC instruments had an impact. This was achieved through the setting of very basic conditions indicating the path for reform, coupled with the provision of the required technical assistance, and the adoption of a flexible approach. At present all donors are pushing towards the development of internal audit. The EC condition enabled to develop a firmer commitment in this area. This beneficial effect offset the lack of fulfilment of the specific conditionality.

Recommendation 5: DG ECFIN should continue to require the development of good internal control and audit systems in future MFA operations, even if the level of development in this field is very low.

Annex I Key persons interviewed

Table I.1 presents a list of people interviewed in Tbilisi, Washington, and Brussels and the key stakeholders which participated in the key stakeholders session on the 3rd of December 2009. In total 35 persons were interviewed.

Table I.1 Persons interviewed

Organisation	Name	Role/Involvement in the MFA operation
European Institutions		
DGAIDCO	Ms. Sirpa Tulla	Former country desk officer Georgia at DGECFIN
DGECFIN	Mr. Andreas Papadopoulos	Deputy Head of Unit, DGECFIN
EC Delegation	Mr. Michel Jambou	Current Attaché
EC Delegation	Ms. Julia Jacoby	Current Project manager, Good Governance and Rule of Law
EC Delegation	Mr. Per Eklund	Current Head of EC Delegation to Georgia
EC Delegation	Mr. Robin Liddell	Current First Counsellor
EC Delegation	Mr. Philippe Bernhard	Current Project Manager
EC Delegation	Ms. Maria Iarrera	Attaché. Trade and Economic Issues ,and Institutional Capacity. PFM expert. In charge of SPSP.
EC Delegation	Mr. Irakli Khmaladze	PFM Expert
Georgian Institutions		
Independent Economist	Mr. Merab Kakulia	Economist at the Georgian European Policy and Legal Advice Centre (a EU financed think tank). Worked at the Central Bank (Vice-President) and was contact person for the OA.
MoF	Ms. Nino Tchelishvili	Deputy head, Treasury Services
MoF	Mr. Aleksi Aleksishivili	He used to be the Minister of Finance and signed the MoF. He now works for his own consulting firm (PMCG).
MoF	Mr. Goga Gugava	He used to work at MoF (deputy head of the budget department) and is now Head of Parliamentary Budget Office
MoF	Ms. Tinatin Kachkachivili	MoF, donor coordination
MoED	Mr. Kakha Damania	Former deputy Minister of Economic Development, expert on privatisation
CoC	Mr. Levan Bezhashvili	Chairman
CoC	Mr. George Alasania	Lawyer and Advisor to the Chairman
CoC	Mr. Devi Vepkhvadze	Deputy Chairman
MoED	Mr. Georgi Tskhakaia	Former deputy of the Ministry of Economic

Organisation	Name	Role/Involvement in the MFA operation
		Development
MoF	Mr. Dimitri Gvindadze	Deputy Minister of finance in 2006
MoF	Mr. Josef Sichiztladze	Director of International Relations Department
MoF	Mr. Zurab Bregvadze	Deputy Director of External Relations Department
MoF	Konstantine Kintsurashvili	Lead Specialist, External Relations Department, International Investment Projects Division
MoF	Mr. Hennie Maters	Economic Advisor to the Minister. Long term consultant PFM at MoF
MoF	Mr. Archil Sharashidze	Head of Internal Audit
MoF	Mr. George Kurtanidze	Internal Audit
MoF	Ms. Tatia Eliadze	Internal Audit
MoF	Ms. Nino Jikia	Internal Audit
MoF	Mr. George Sekhniashvili	Internal Audit
International development community		
WB	Ms. Elena Imnadze	WB Economist
WB	Ms. Rosalinda Quintanilla	Lead Economist, Macroeconomics II, Europe and Central Asia
WB	Ms. Donna Dowsett-Coirolo	Country Director Armenia, Azerbaijan, Georgia
WB	Mr. Tony Cholst	Lead Country Officer, South Caucasus Country Department, Europe and Central Asia Region
WB	Ms. Saumya Mitra	Lead Economist, Europe and Central Asia Region
IMF	Mr. John Wakeman-Linn	Former Head of Mission mid-2005 to mid-2007, now Division Chief African Department
IMF	Mr. Edward Gardner	IMF Resident Representative and Head of Mission in Georgia
USAID	Mr. Joakim Parker	Deputy Mission Director
USAID	Ms. Anne Patterson	Director, Office of Health and Social Development
USAID	Mr. Rezo Ormotsadze	Senior Financial & Commercial Sector Advisor, Office of Economic growth

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Annex III Overview IMF reviews 2004-2009

Table III.1 presents an overview of all review missions that took place under the IMF PRGF June 2002 programme and the IMF PRGF/EFF February 2006 Programme. All in all, Georgia managed to keep progress in reforms and maintain macroeconomic stability throughout the 2002-2007 period. The first two reviews of the 2008 stand-by-agreement indicate the problems associated with the global economic crisis, but the programme remained on track.

Table III.1 Overview IMF programmes and review conclusions in Georgia in the period 2004-2009

Date	Activity	Amount	Selection of IMF review conclusions
June 2004	**PRGF-ESF programme agreed**		
June 2004	Board approval	SDR 14 million	
December 2004	1st review	SDR 14 million	Economic growth has remained robust and inflation subdued, against the backdrop of steady remonetisation. Performance under the PRGF-supported program has been encouraging, underpinned by strong fiscal results. All quantitative performance criteria (PCs) and most indicative targets through September 2004 were met. Rapid growth in fiscal revenue—thanks to an anti-corruption drive and improved administration—has permitted a faster-than-expected clearance of domestic arrears. A waiver for nonobservance of a June structural PC on energy sector legacy debt is requested, since the issuance of a strategy paper to deal with that problem was delayed for technical reasons. The authorities have made a very good start in strengthening Georgia's economic fundamentals and launching structural reforms. On this basis, together with sound indications regarding the main elements of the official macroeconomic and reform plans for 2005, IMF staff supports the authorities' request for completion of the first review under the PRGF arrangement.
July 2005	2nd review	SDR 14 million	Economic growth has remained robust and the exchange rate has stabilized around its end-2004 level. All quantitative performance criteria (PCs) for end-December 2004 were met, but the indicative target on reserve money growth was exceeded, mainly because of large unsterilized intervention in the foreign exchange market. The authorities are requesting a waiver for nonobservance of a December

Date	Activity	Amount	Selection of IMF review conclusions
			structural PC on upgrading the Budget Systems Law to the status of an organic law, since parliamentary approval was delayed owing to a crowded legislative agenda. IMF staff supports the authorities' request for completion of the second review under the arrangement and a waiver for nonobservance of a structural performance criterion.
March 2006	3rd review	SDR 14 million	Policies and structural reforms have resulted in robust growth rates, inflation in single digits, and a significantly improved revenue performance that has allowed for many fiscal initiatives to be undertaken while maintaining fiscal stability. Performance under the program has been good. All but one quantitative performance criteria were met. The target on arrears clearance was missed due to concerns about inflation, but the authorities are committed to clear the entire stock by end-2006. The structural performance criterion on the submission of a new customs code was delayed, mainly to give more time for discussions with the business community. The authorities have requested completion of the third review under the arrangement, and waivers for the missed performance criteria. IMF staff supports the authorities' request for waivers for the nonobservance of performance criteria and recommends the completion of the third review of the PRGF arrangement.
September 2006	4th review	SDR 14 million	Economic growth continues to be strong, but inflation has increased substantially. All end-March quantitative performance criteria under the program were met, as were all but one of the end-June indicative targets. The fiscal deficit at end-June was 0.6 percent of GDP higher than programmed. One structural performance criterion for the fourth review was missed, as the database of central government Legal Entities of Public Law (LEPLs) that was established by end-March was later found to have missed a number of LEPLs. The authorities have completed the database and requested a waiver. IMF staff supports the authorities' request for completion of the fourth review, and a waiver for nonobservance of a structural performance criterion.
February 2007	5th review	SDR 14 million	Despite economic sanctions imposed by Russia in 2006, Georgia's economic growth continues to be strong and inflation has declined. The authorities' strong record bodes well for continued successful program implementation. Therefore, staff supports the completion of the review and the authorities' requests for a waiver. for nonobservance of a structural performance criterion for end-June 2006. The performance criterion required the introduction of a poverty alleviation program targeted on households living in extreme poverty. The program was, however, fully implemented in

Date	Activity	Amount	Selection of IMF review conclusions
			September 2006. The Review also agreed with an extension of the present arrangement.
August 2007	6th review	SDR 14 million	Economic performance in recent years has been impressive, with the establishment of macroeconomic stability, a dramatic fiscal turnaround, and remarkable improvements in governance and the business environment. While all quantitative performance criteria for the final review were met, the structural performance criterion to pass fit and proper legislation (related to the banking sector) was missed. Draft legislation has been submitted to Parliament in time, but discussions have been delayed as a result of Parliament's busy work schedule. Three of four structural benchmarks were met or met with delays. Given the authorities' strong performance, IMF staff supports the completion of the sixth review and the request for a waiver.
September 2008	**Stand-by Agreement agreed**		
September 2008	Board approval	SDR 161.7 million	
December 2008	1st review	Not drawn	The stabilization actions following the conflict proved effective, but financial conditions began deteriorating in late September, leading to market uneasiness. Georgia began to feel the effects of the global financial crisis. The end-September quantitative targets were met with ample margins and the end-October structural benchmark on signing and implementing a Memorandum of Understanding (MoU) between the NBG and the Financial Supervisory Agency (FSA) was also observed. The quantitative targets for end-2008 and for 2009 were adjusted to reflect the earlier than-anticipated transfer from the sovereign wealth funds to reserves and the impact of donor financing. The authorities have indicated that, given expected donor financing and the availability of resources transferred from the sovereign wealth funds (SWFs), they do not draw the SBA tranche (SDR 63.1 million) that would be available following completion of the first review.
April 2009	2nd review	SDR 126.2 million *(includes 63.1 not-drawn funds from the 1st Review and 63.1 million for the 2nd Review)*	The economy—seriously affected by the August armed conflict with Russia— is feeling the impact of the global downturn. GDP contracted in the second half of 2008, resulting in real growth of 2 percent for the year as a whole, down from 12½ percent in 2007. External imbalances remained large, and official inflows -which partly replaced the declining private capital inflows -financed a large fiscal deficit. All SBA performance criteria for end-December were observed. The quantitative targets, the structural benchmark on budget submission to parliament, and the structural performance criterion on preparing a revised LOLR facility

Date	Activity	Amount	Selection of IMF review conclusions
			regulation—to ensure that loans are provided only to solvent institutions and that the Financial Supervisory Agency (FSA) plays an active role in monitoring the use of resources—were met. The impact on the NIR target of greater-than-anticipated NBG intervention was offset by an accelerated repatriation of government savings (from the sovereign wealth funds) and higher donor support. The fiscal target was slightly adjusted upward to reflect the availability of additional financing. On the basis of Georgia's performance under the SBA arrangement, IMF staff supports the authorities' request for completing the second review.
August 2009	3rd review	SDR 94.6	The authorities' policies have been in line with program expectations. All quantitative and structural performance criteria have been met, and all but one of the structural benchmarks through end-July have been observed. The end-June structural benchmark on the appointment of the remaining members of the Financial Supervisory Agency (FSA) board was not observed owing to the decision of the authorities to merge the FSA and the NBG.

Source: International Monetary Fund, various documents on www.imf.org

Annex IV WB programmes 2005-2008

Table below presents a comprehensive overview of the World Bank programmes and project in the period 2005-2008.

Table IV.1 Overview of the World Bank programmes ongoing in the period 2005-2008 (amounts in US$)

Description	Principal	Disbursed	Approval	Closing
Agriculture Development	6,511,004	5,967,166		
	15,000,000	13,848,013	March 1997	June 2005
	500,000	0	March 1997	June 2005
Enterprise Rehabilitation Project	15,000,000	15,059,655	December 1998	December 2006
	1,985,000	0	December 1998	December 2006
Social Investment Fund Project	20,000,000	19,124,650	December 1997	September 2007
	5,000,000	5,463,867	December 1997	September 2007
	500,000	0	December 1997	September 2007
	420,000	419,684	December 1997	September 2007
Primary Health Care Development Project	20,300,000	13,817,940	August 2002	December 2009
	430,000	0	August 2002	December 2009
	500,000	372,508	August 2002	December 2009
	477,400	459,913	August 2002	December 2009
Roads Project	40,000,000	41,091,840	May 2000	December 2005
	600,000	0	May 2000	December 2005
Forests Development Project	15,700,000	8,629,862	August 2002	June 2009
	990,000	0	August 2002	June 2009
	315,500	315,482	August 2002	June 2009
Protected Areas Development Project (GEF)	350,000	350,000	May 2001	December 2008
	8,700,000	8,217,737	May 2001	December 2008
Integrated Coastal Management	4,400,000	4,595,317	December 1998	February 2007
	1,379,875	1,352,440	December 1998	February 2007
Structural Reform Support Project	16,500,000	16,963,862	June 1999	June 2007
	1,237,510	865,537	June 1999	June 2007
Electricity Market Support Project	27,370,000	23,818,854	May 2001	December 2008
	3,600,000	3,016,733	May 2001	December 2008
	1,000,000	0	May 2001	December 2008
	600,000	445,909	May 2001	December 2008
Irrigation And Drainage Community Development Project (APL 1)	27,000,000	27,088,738	June 2001	April 2009
	7,800,000	6,383,796	June 2001	April 2009
	5,200,000	4,943,874	June 2001	April 2009
	1,200,000	0	June 2001	April 2009

Description	Principal	Disbursed	Approval	Closing
	915,150	883,503	June 2001	April 2009
	142,482	50,000	June 2001	April 2009
Education System Realignment and Strengthening Program-Phase I (APL 1)	25,900,000	28,765,190	March 2001	June 2008
	1,150,000	0	March 2001	June 2008
	377,650	377,650	March 2001	June 2008
Judicial Reform Project	13,400,000	13,352,360	June 1999	June 2006
Reform Support Credit	24,000,000	24,446,986	June 2004	December 2004
	3,662,700	3,909,450	June 2004	December 2004
Integrated Coastal Management (GEF)	1,300,000	1,299,121	December 1998	October 2006
Public Sector Financial Management Reform	3,000,000	160,000	February 2006	March 2010
	377,550	0	February 2006	March 2010
	490,000	348,176	February 2006	March 2010
Agricultural Research, Extension, And Training Project (GEF)	2,480,000	2,480,000	May 2000	June 2008
Agricultural Research, Extension, And Training Project	7,600,000	7,913,801	May 2000	June 2008
Energy Transit Institution Building Project	9,630,000	10,152,363	March 2001	August 2008
Second Social Investment Fund Project	15,000,000	16,212,199	May 2003	December 2007
	427,000	261,665	May 2003	December 2007
Social Protect Ref (Dropped)	410,000	392,351	February 2005	NA
STATS CAP BLDG IDF	300,000	57,200	June 2002	February 2006
Second Municipal Development and Decentralization Project	19,410,000	22,249,458	August 2002	December 2007
Rural Development Project	8,882,186	2,881,643	May 2005	June 2010
	807,472	99,135	May 2005	June 2010
	10,000,000	4,498,097	May 2005	June 2010
	667,600	667,600	May 2005	June 2010
	4,500,000	709,700	May 2005	June 2010
First East - West Highway Improvement Project	19,000,000	18,134,326	December 2006	February 2011
Secondary and Local Roads Project	20,000,000	20,034,144	June 2004	31-Oct-09
Prog Mntrg/Eval Min Agric/Food IDF	250,000	0	December 2003	June 2007
First Poverty Reduction Support Operation	13,500,000	13,277,094	September 2005	July 2006
	6,500,000	6,390,045	September 2005	July 2006
	4,707,600	4,767,000	September 2005	July 2006
Second Poverty Reduction Support Operation	20,000,000	20,396,476	October 2006	July 2007
	6,639,750	6,580,250	October 2006	July 2007
Strengthening E-Government Procurement	295,000	98,278	December 2005	May 2009
Second East-West Highway Improvement Project (SEWHIP)	35,000,000	12,349,881	December 2007	February 2012
	440,000	434,598	December 2007	February 2012
Grad Econ In Caucasus	252,511	252,181	June 2006	NA
Imprv Usage Of Socio-Econ Stats IDF	244,700	194,216	July 2005	March 2009
EDUC II (APL 2)	15,000,000	3,055,373	November 2006	December 2009
	4,950,000	912,541	November 2006	December 2009
Infrastructure Pre-Investment Facility	5,000,000	3,585,225	February 2006	September 2009

Description	Principal	Disbursed	Approval	Closing
ENV IDF	388,000	30,000	November 2005	May 2009
AVIAN FLU - GE	3,500,000	654,616	May 2006	August 2009
	3,500,000	1,512,407	May 2006	August 2009
	1,400,000	184,583	May 2006	August 2009
	1,600,000	434,931	May 2006	August 2009
Third Poverty Reduction Support Operation	20,000,000	20,219,324	June 2007	January 2008
	3,415,861	3,531,625	June 2007	January 2008
Fourth Poverty Reduction Support Operation	22,700,000	0	May 2008	March 2009
	925,000	553,990	May 2008	March 2009

Source: World Bank, Country Lending Summaries – Georgia, extracted from database on www.worldbank.org

Annex V History of events 2003 - 2009

Table V.1 provides a chronological overview of events which are related to the MFA operation.

Table V.1 Historical overview events relevant for the MFA operation

Date	Event
November 2003	Rose Revolution
February 2004	New President inaugurated
June 2004	IMF Board approved a three-year Poverty Reduction and Growth Facility (PRGF) arrangement for SDR 98 million to support the government's economic programme. The first instalment of SDR 14 million was disbursed upon approval.
June 2004	Paris Club creditors agreed to restructuring of Georgia's bilateral official debts contracted before November 1999
June 2004	Donors' conference co-chaired by the Commission and the World Bank where € 850 million in total was pledged. The EU pledged € 125 million which included the planned disbursement of a grant instalment of the previous EFA and an indicative amount of € 33.5 million under a new EFA.
October 2004	Initial Proposal to EFC to provide for Exceptional Financial Assistance to Armenia, Georgia and Tajikistan
October 2004	Critical Comments of EFC on initial EFA proposal
December 2004	1st IMF review completed; disbursement of SDR 14 million
July 2005	2nd IMF review completed; disbursement of SDR 14 million
March 2005	Proposal to EFC to provide for Macro Financial Assistance to Georgia
August 2005	World Bank adopted new Country Partnership Strategy for 2006-2009
September 2005	First World Bank PRSO of US$ 20 million approved
October 2005	EFC Meeting to decide on MFA operation
December 2005	EC mission to Georgia related to follow-up mission to the Operational Assessment of October 2004 and included preliminary discussions with Georgian authorities on implementation modalities.
2006	Georgia and The European Union signed a bilateral agreement on "The European Neighbourhood Policy: Action Plan with Georgia"
2006	Russia suspended all transport links and postal communication with Georgia
January 2006	Council approved MFA to Georgia in the amount of € 33.5 million
February 2006	World Bank approved Public Sector Financial Management Reform Project that is supported by bilateral donors as well.
March 2006	3rd IMF review completed; disbursement of SDR 14 million
May 2006	EFC has been consulted on the signing of the Memorandum of Understanding and first grant instalment
July 2006	Memorandum of Understanding signed on 5 July 2006 and Grant Agreement signed on

Date	Event
	July 2006
July 2006	Review mission by Commission staff
July 2006	Georgia paid € 13 million to fulfil early debt repayment requirement linked to first grant instalment
August 2006	Disbursement of 1st MFA tranche of € 11 million grant
September 2006	4th IMF review completed; disbursement of SDR 14 million
September 2006	NATO declared the start of "intensive dialogue" with Georgia
October 2006	Second World Bank PRSO of US$ 20 million approved
November 2006	ENPI Action Plan for 2007 endorsed
December 2006	Disbursement of 2nd MFA tranche of € 11 million grant
Beginning of 2007	Gazprom more than doubled the price for gas deliveries to Georgia, to the level charged to Western European countries.
February 2007	5th IMF review completed; disbursement of SDR 14 million
May 2007	Letter Director General ECFIN to Minister of Finance of Georgia, declining amendments proposed by Georgia to the MoU
June 2007	Third World Bank PRSO of US$ 20 million approved
August 2007	6th IMF review completed; disbursement of SDR 14 million
October 2007	Review mission by Commission staff concluding a/o that the review could not be concluded until the draft Chamber of Control law had been re-submitted to the parliament with clear indications on the timetable for the deliberations and adoption.
November 2007	Email of Ministry of Finance of Georgia to DG ECFIN requested disbursement of final tranche in 2007, indicating that the amount had been already included in the 2007 state budget of Georgia
January 2008	New presidential elections
February 2008	Signing Financing Agreement Sector Policy Support Programme (SPSP) and disbursement of first tranche (€ 5 million
May 2008	Fourth World Bank PRSO of US$ 20 million approved
August 2008	Georgia engaged in an armed conflict with Russia and separatist groups from South Ossetia and Abkhazia
September 2008	IMF Board approved an 18-month Stand-By Arrangement (SBA) for SDR 477.1 million to help restore investor confidence in the wake of the armed conflict with Russia in August 2008. A first instalment of SDR 161.7 million was disbursed upon approval.
October 2008	International Donors' Conference
October 2008	Supplemental Financing to Georgia's PRSO IV in the amount of US$40 million approved
December 2008	1st IMF review completed; instalment of SDR 63.1 million not drawn
December 2008	Disbursement of second instalment of SPSP of € 4 million (maximum was € 5 million)
December 2008	Sunset clause of Grant Agreement ends validity of the MFA operation
April 2009	2nd IMF review completed; disbursement of SDR 126.2 million

Annex VI MFA and WB/IMF conditionality

Table VI.1 Comparison between MFA Conditionality and WB PRSO triggers and IMF structural performance criteria

Conditionality listed in the MoU	WB PRSO Reform Actions (triggers in bold) & IMF structural performance criteria	Comments
Budget preparation		
1. Develop and implement a MTEF-based budgetary process with a progressively increasing number of line ministries (2nd & 3rd tranche)	✓ Satisfactory progress in implementing MTEF-based budgetary process **(WB PRSO II & III).** In particular, **under WB PRSO II**: • 2006 budget to be passed by Parliament, consistent with MTEF, reflecting 2006 allocations and outer-year forward estimates, and annexes showing textual descriptions of expenditure priorities and anticipated results of all budget users and overlap between budget allocations and national policy objectives; • Improved revenue forecasting component of the fiscal modelling framework in place; • Progress is achieved in integrating BDD and MTEF inception memorandum for preparation of 2007 budget; • All major spending ministries submit 2006 budget requests to MOF which are consistent with 1) their budget resource ceiling and 2) the timetable in the BSL; • MTEF business processes are rolled out to a substantial group of non-pilot ministries; • MOF initiates development of performance reporting/monitoring system for line agencies; • Ceilings for 2007 budget and MTEF are consistent with conservative resource envelope (as reflected in IMF and Government fiscal framework and revenue estimates). In particular, **under WB PRSO III**: • Improvements in revenue forecasting methodology achieved; • Ceilings for 2008 budget and MTEF are	WB PRSO reform actions are much more detailed and consequent *Consistently with follow up OA recommendations, MFA put emphasis on the expansion of involved ministries*

Conditionality listed in the MoU	WB PRSO Reform Actions (triggers in bold) & IMF structural performance criteria	Comments
	consistent with conservative resource envelope (as reflected in IMF and Government fiscal framework and revenue estimates). ✓ MTEF business processes are rolled out to a substantial group of non-pilot ministries **(WB PRSO II**) ✓ **Substantial share of budget spending is covered by sector strategy expenditure matrices (WB PRSO III)**	
2. Improve policy content of annual budget preparation and execution through a wider use of sector policy and expenditure strategies (2nd & 3rd tranche)	✓ **Satisfactory progress is achieved in improving policy content on annual budget preparation and execution, including better linking of MTEF to the budget cycle (WB PRSO II & III)**	Matching with WB PRSO trigger *Not clearly specified as a follow up OA recommendation*
3. Take steps to strengthen capacities in the Ministry of Finance and in line ministries so as to support interaction process in MTEF/budget preparation and management (2nd & 3rd tranche)	✓ Strategy for strengthening line ministry capacity for budget planning and management under implementation, along with development of performance monitoring and reporting system for line agencies **(WB PRSO II)** ✓ Performance monitoring and reporting system for line agencies completed as per plan **(WB PRSO III)**	Partial matching with WB PRSO reform actions, which are more specific, consequent and verifiable *Follow up OA recommendations were more detailed, making reference to the need of training dedicated staff within MoF and line ministries and budget requests development/assessment*
	Budget execution	
4. Adoption and initiate implementation of a strategy to produce annual financial statements in accordance with international accepted accounting and reporting standards (2nd tranche)	✓ **Adoption and initiation of implementation of strategy to produce annual financial statements in accordance with internationally accepted accounting and reporting standards (WB PRSO II)**	Matching with WB PRSO trigger *Not specifically addressed by the follow up OA recommendations*
5. Complete centralisation of the Treasury Service of the MoF database and implementation of Treasury General Ledger, incorporating GFS 2001 compliant budget classification (3rd tranche)	✓ Centralisation of the central government Treasury database and implementation of Treasury General Ledger completed, incorporating GFS 2001 compliant budget classification **(WB PRSO III)**	Matching with WB PRSO reform action *Not specifically addressed by the follow up OA recommendations*

Conditionality listed in the MoU	WB PRSO Reform Actions (triggers in bold) & IMF structural performance criteria	Comments
6. Establish of a database of all LEPLs and define requirements for their financial management and performance reporting on all revenues and expenditures (3rd tranche)	✓ Registry of all LEPLs, including details of the enabling legislation of each LEPLs completed and a database on LEPLs operational and fully populated **(WB PRSO II)** ✓ Government defines financial and performance reporting requirements for all LEPLs **(WB PRSO III)** ✓ Establish and populate a database of all central government LEPLs by end-March 2006 (**IMF PRGF)** ✓ Adopt financial reporting guidelines for all not-for--profit LEPLs by end-December 2006 (**IMF PRGF)**	Matching with both WB PRSO reform action and IMF structural performance criteria, but timing issue: the establishment of a database would had been already accomplished by the MFA conditionality become relevant *Not specifically addressed by the fup OA recommendations*
	Transparency and Accountability	
7. Amend legislation on the Chamber of Control (CoC) taking into account the findings of the strategic review of its role and functions, abolishing any stipulations which are inappropriate for an independent supreme audit institution compliant with INTOSAI standards (2nd tranche)	✓ Legislation governing the scope, nature and legislative scrutiny of the CoC amended to address the issues raised in the CoC' strategy for Corporate Development and Reorganization Implementation Plan **(WB PRSO II)**	Matching with WB PRSO reform action, different phrasing but same essence *Combination of two follow up OA recommendations*
8. Satisfactory implementation of new legislation on the CoC and the reorganization implementation plan of the CoC (3rd tranche)	✓ Satisfactory implementation of CoC reorganization plan (as measured against the plan's indicators) **(WB PRSO III)**	Partial matching with WB PRSO III, not including a trigger specifically referring to law enactment. A similar condition was included as prior action under WB PRSO IV
9. Take steps to develop of a modernized set of audit instructions and audit methodology fully compliant with INTOSAI standards (3rd tranche)	None	MFA more specific compared to the WB PRSO, which generally referred to the implementation of CoC reorganization plan
10. Develop a strategic note with a timeline for its implementation on the appropriate organization and functions of internal audit in	None	Not covered by WB PRSO triggers / reform actions *Both are follow up OA*

Conditionality listed in the MoU	WB PRSO Reform Actions (triggers in bold) & IMF structural performance criteria	Comments
the central government (3rd tranche)		*recommendations, with high priority and 2 years time frame*
11. Develop a strategic note with a timeline for its implementation on appropriate internal control frameworks within budget organizations, starting with the elaborations of generic minimum requirements (such as clear segregation of duties, minimal organisational requirements of the financial function and essential processes for which written procedures are required) (3rd tranche)	None	

Annex VII MFA conditionality and PFM strategy

Table VII.1 Comparison between MFA Structural Conditionality and Future Reform Actions under the National PFM Strategy

PFM sub-area	Conditionality listed in the MoU	Actions foreseen in the Georgia PFM Reform Strategic Vision (2005)
Public Finance Reform		
1. MTEF-based budgetary process (2nd & 3rd tranche)	Development and implementation of a MTEF-based budgetary process involving an increasing number of line ministries	Several actions foreseen, including: • *Fully integrating and institutionalising the MTEF within an integrated budget process;* • *Improving the connectivity between the national strategy, Basic Data and Directions (BDD) and sector and ministry level expenditure policy priorities with a clear statement of goals and the identification of indicators through which progress will be measured;* • *Developing the analysis underlying and further elaborating the macro-fiscal framework so that it can facilitate improvements in the planning and management of budget operations*
2. Annual budget preparation and execution (2nd & 3rd tranche)	Improving policy content of annual budget preparation and execution	Several actions foreseen, including • *Developing and introducing budget planning process reforms supported by a revised budget classification, improved circulars and better guidance to ministries and agencies* • *Introducing a more strategic approach in the MoF to the review and processing of budget submissions. Building capacities within the MoF to undertake such review* • *Improving the presentation of budget documentation to facilitate better understanding of the goals and priorities for public spending*
3. Capacity building of the MoF and line ministries (2nd & 3rd tranche)	Strengthening of capacities in the Ministry of Finance and in line ministries to support interaction process in the MTEF/budget preparation and management	• *Strengthening capacities for budget preparation and the introduction of improved budget planning procedures within ministries in order to support a strategic policy-led approach to resource allocations*

PFM sub-area	Conditionality listed in the MoU	Actions foreseen in the Georgia PFM Reform Strategic Vision (2005)
	Budget execution	
4. Accounting reform - Annual financial statements (2nd tranche)	Adoption and initiation of a strategy to produce annual consolidated financial statements in accordance with international accepted accounting and reporting standards	• *Gradually introducing International Public Sector Accounting Standards (IPSAS): first cash based, then modified cash based, and finally accrual based*
5. Treasury reform (3rd tranche)	Complete centralisation of the Treasury Service of the MoF database and implementation of Treasury general ledger, incorporating GFS 2001 compliant budget classification	• *Continuing the implementation of Treasury reforms involving: (i) completing introduction of the Treasury Single Account; (ii) introducing an interim Treasury General Ledger, and (iii) progressing towards implementation a modern Treasury system* • *Adopting a GFS compliant budget classification system*
5. LEPLs (3rd tranche)	Establishment of a database of all LEPLs and definition of their financial and performance reporting requirements	• *Building accounting and reporting capacities across government and in quasi-government entities involving: (i) implementation of improved reporting procedures; (ii) development of electronic links between Treasury and ministries; and (iii) provision of relevant accounting training (Treasury, ministries, local governments, LEPLs etc.)*
	Transparency and Accountability	
7. External Audit Function #1 (2nd tranche)	Amendment of draft law on CoC to elevate its mandate and responsibilities to a supreme audit institution in line with INTOSAI standards	No future reform action foreseen, but the situation analysis quotes*: "New audit legislation is being developed and will set out the role of CoC and the scope and coverage of the audit function"*
8. External Audit Function #2 (3rd tranche)	Satisfactory implementation of new legislation on the CoC and its reorganization plan	• *Implementing organisational reforms in Chamber of Control of Georgia*
9. External Audit Function #3 (3rd tranche)	Development of a modernized set of audit instructions and audit methodology fully compliant with INTOSAI standards for CoC auditors	• *Adopting and implementing international external audit standards covering compliance, financial and performance audit*
10. Internal Audit (3rd tranche)	Development of a strategic note on the appropriate organization and functions of internal audit in the Central Government	• *Introducing internal audit legislation and the progressive development of internal audit processes and capacities within ministries*
11. Internal Controls (3rd tranche)	Development of a strategic note with a clear time plan for the introduction of appropriate internal control frameworks within budget organizations, starting with the elaborations of generic minimum requirements	• *Developing a comprehensive set of financial management regulations, including internal controls that are consistent with international standards*

Annex VIII MFA conditionality and related synergies

Table VIII.1 MFA Conditionality and related synergies

Conditionality	FSP 2005-2006	FSP 2007-2008	ENP AAP 2007 (year 2007)	ENP AAP 2007 (year 2008)	ENP AAP 2007 (year 2009)
Budget preparation					
MTEF-based budgetary process **Policy-based annual budget**	SC (2005): the Basic Data and Directions (BDD) Document, produced through the MTEF process and in consultation with pilot line ministries, is approved by Government SC (2006): significant progress in MTEF elaboration and use (*criteria: (i) 2007-2010 budget based on BDD 2007-2010 and new round of MTEF process presented to Parliament in last quarter of 2006; (ii) expansion of MTEF process to ministries not covered by the pilot stage for 2006 budget*) SC (2006): a detailed programme based MTEF for FY2007-9 for the MoA, […],	GC: sound public finance and fiscal management (*criterion: ongoing implementation of the PSFMRSP, and progress in compliance with the conditions of the ENP AAP2007 SPSP PFM Reform Programme*)		Budget planning and MTEF process is further strengthened by improving medium-term sector planning along with improved sector costing and integrating this into the annual budget formulation process. Content of the MTEF 2009-2012 contributions is improved in 3 selected line ministries and coverage is extended to include regional government strategies and priorities	Detailed costing and performance indicators at programme level are further introduced in line ministries and a formal review process is established to evaluate programme performance versus planned

Conditionality	FSP 2005-2006	FSP 2007-2008	ENP AAP 2007 (year 2007)	ENP AAP 2007 (year 2008)	ENP AAP 2007 (year 2009)
	submitted to Parliament with the budget for FY2007 (*criteria: (i) baseline policy and expenditure report; (ii) estimates of projected expenditure 2006-2008; and (iii) final Sectoral MTEF Expenditure Strategy Report of the MOA that is clearly linked to MOA strategy and priorities*)				
CB activities undertaken by the MoF and line ministries with reference to MTEF-budgetary process					
Budget execution					
Annual financial statements in accordance with international accounting standards		GC: sound public finance and fiscal management (*criterion: ongoing implementation of the PSFMRSP, and progress in compliance with the conditions of the ENP AAP2007 SPSP PFM Reform Programme*)		The first phase of introducing GSFM 2001 has been completed	The State Budget 2008 execution report will be prepared pursuant to GFSM 2001 standards
Treasury general ledger compliant with GFS 2001 budget classification	SC (2005): Implementation of the Treasury Single Account as part of the completion of the Treasury Reform process				
Database of and performance reporting system for all LEPLs					

Conditionality	FSP 2005-2006	FSP 2007-2008	ENP AAP 2007 (year 2007)	ENP AAP 2007 (year 2008)	ENP AAP 2007 (year 2009)
Transparency and Accountability					
New legislation on CoC		GC: sound public finance and fiscal management (*criterion: ongoing implementation of the PSFMRSP, and progress in compliance with the conditions of the ENP AAP2007 SPSP PFM Reform Programme*)	The revised law that will transform the CoC into a external audit institution in line with INTOSAI principles is submitted to the Parliament	Draft Law on the CoC adopted	
Reorganization of CoC					
Development of INTOSAI compliant audit instructions and methodology				The Chamber of Control has prepared Audit Management Policy & Procedure Guidelines	The CoC Audit Management Policy & Procedure Guidelines, fully aligned with INTOSAI standards are approved
Internal audit in the Central Government **Internal control frameworks within budget organizations**				A policy paper and an action plan for the gradual introduction of a harmonized public internal financial control system (managerial accountability and internal audit) is approved by the Government.	A draft law on public internal financial control and internal audit that is compliant with international standards and EU best practices has been drafted and submitted to the Parliament